Economic Policy Council Report
2020

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Economic Policy Council

VATT Institute for Economic Research

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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 should evaluate:

1. the appropriateness of economic policy goals;
2. whether the goals have been achieved and whether the means to achieve the policy goals have been appropriate;
3. the quality of the forecasting and assessment methods used in policy planning;
4. coordination of different 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 Council is appointed by the government based on a proposal by economics departments of Finnish universities and the Academy of Finland. Current Council started its work in April 2019, when the Council also adopted a rotating scheme, with two of its members changing every two years. At the same time the term of each member was reduced to four years. The Council members participate in the work of the Council in addition to their regular duties.

In the seventh report of the Economic Policy Council we evaluate the government's fiscal policy and its employment-promoting policies. As in the previous reports, in addition to fiscal policy, the Council concentrates on fiscal sustainability and on the connections between social security and employment.

The Council does not make its own macroeconomic or fiscal projections but relies mainly on forecasts made by the Ministry of Finance. The most recent information used in this report is the Ministry of Finance Winter 2020 Economic Survey and the December release of the Statistics Finland Labour Force Survey.

The Economic Policy Council has resources to commission research projects to support its work. These reports are published as attachments to the Council report, but the authors of the reports are responsible for their content. Any opinions expressed in them may or may not be in agreement with the Council's views.

Four background reports have been published in connection with this Council report. Essi Eerola, Teemu Lyytikäinen and Sander Ramboer of the VATT Institute for Economic Research examine household leverage, tenure choice and macroprudential measures. Joonas Ollonqvist and Jussi Tervola of Finnish Institute for Health and Welfare together with Jukka Pirttilä of University of Helsinki and Thor O. Thoresen of Statistics Norway examine distributional impacts of tax-benefit policies. Johanna Niemi, University of Turku discusses Debt adjustment proceedings in Finland. Sara Kinnunen from the secretariat discusses personal insolvency in Finland.

Several experts have attended Council meetings or contributed to parts of the report. We thank Joonas Ollonqvist and Jussi Tervola of Finnish Institute for Health and Welfare, Essi Eerola, Sander Ramboer and Teemu Lyytikäinen of the VATT Institute for Economic Research, Paavo Miettinen of Bank of Finland, Leena Mörttinen, Sami Yläoutinen, Markku Stenborg and Olli Kärkkäinen of the Ministry of Finance for sharing their views and expertise. We would also like to thank Veliarvo Tamminen and Ilari Ahola of the Ministry of Finance for patiently responding to several detailed questions by the Council. We also thank Hanna Putkuri of Bank of Finland. Elena Ahonen, Sara Kinnunen and Tuukka Huhtala have been competent research assistants for the Council. We are also thankful to Anna-Maija Juuso, Marjo Nyberg, Riikka Könönen and Markku Kivioja of VATT for their help in administration and communication.

Helsinki, 26 January 2021

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1. Summary

The Covid-19 pandemic has affected the Finnish economy in the form of weaker export demand and cautious consumer behaviour and investment. It has also led to the closure of certain parts of the service sector. While the Finnish economy suffered less than other European countries in 2020, the uncertainty associated with the virus may influence economic behaviour and structures over a longer time horizon.

The government responded by introducing an extensive recovery package. The package consisted of business subsidies, capital injections and funds to finance infrastructure investments and spending in various fields, e.g. education. The government also increased its support to municipalities. Furloughed workers were helped by extending the coverage and levels of unemployment benefits. Firms were supported with changes to bankruptcy legislation. Businesses were also supported with subsidies, mainly using existing channels, e.g. through various business subsidies but also with the possibility to postpone tax payments.

The stimulus effect of the government's measures on domestic demand may be delayed as the appropriations will be partly rolled over to 2021 and some will be offset by increased net saving by the municipalities.

In 2020 the European economy was supported by both monetary and fiscal policy. During the economic crisis coordinated fiscal measures at the EU level are having positive spillovers that are strengthening aggregate demand over what could have been achieved through deficit-financed expansive policy in a single country.

In the Council's estimation, the government's crisis response was, in the main, adequate and timely. Automatic stabilisation provided by the welfare state helped workers, and the support of firms, while initially not well targeted, has

now been organised via a new, better-designed system. When the crisis is over, these temporary measures need to be discontinued.

Employment policy

According to the latest estimates, the unemployment rate was below its equilibrium level in 2018 and 2019. The unemployment rate increased in 2020, and there is a risk that the number of long-term unemployed will start rising again. It also seems that the labour market matching process did not improve during the previous business cycle, indicating that labour market reforms are needed in order to keep the structural unemployment rate on its declining trend. While part of the decrease in employment, especially in the service sector, is likely to be short-lived, it will be difficult to reach the employment rate target of 75% without policies that increase the participation rate and reduce equilibrium unemployment. The possibility of a prolonged increase in long-term unemployment due to Covid-19 renders achieving this target ever more challenging.

In the autumn of 2020, the government published measures, or draft measures, designed to increase employment by 30,000 persons. WThe government sees these measures as a step towards achieving its target of increasing employment by 60,000 persons.[1]

The government aims to increase employment with a policy focused on reforming the structures of the labour market, social benefits and unemployment services. The measures, planned or implemented, are designed to increase employment and decrease structural unemployment, but the government has also implemented reforms that work in the opposite direction, via e.g. decreased incentives for work.

Evaluation of employment policies should be as comprehensive as possible, also including those policies that lead to negative employment effects. The activation model was implemented such that its effects were difficult to measure. The same difficulty also applies to the planned and implemented employment policy measures – with a number of measures being implemented simultaneously without reference groups, it is almost impossible to

[1] The employment target was set in the government programme with two interpretations: an employment rate of 75% by the end of 2023 and an estimated required increase in employment, i.e. 60,000 persons. As the crisis worsened the medium- and long-term outlook, the government extended the employment policy target. The new aim is to increase employment by 80,000 persons by the end of the decade.

identify their effects later on. When aggregating the effects of different measures, they should be treated as equally as possible, taking into account the uncertainty of their ex-ante effects.

In its programme the government has also set other societal targets, e.g. decreasing inequality and wage differences and aiming for carbon neutrality by 2035. The policies to reach these objectives, although not solely related to the economy or employment, may increase or decrease employment. The government should also take into account all the effects when discussing and evaluating the attainment of its employment targets. Furthermore, the effects of some of these measures will be fully realised with a delay. For example, the education reform increases expenditure from 2021 onwards, but the full employment effect, which renders the reform budget-neutral, will only be realised in the long term.

The main motivation behind the employment target is the need to strengthen public finances (currently with a structural deficit), and to increase the long-term sustainability of public finances. The fiscal effects of different measures vary extensively. Some measures are expensive to implement for society. Some other measures, such as the removal of early unemployment channels, may be against the government's objective of decreasing inequality. The fiscal benefits of employment growth are reduced if employment growth is disproportionately part-time. In the Council's view the government's employment policy, and the public discussion of it, should pay more attention to its main implications for public finances, rather than to exact employment numbers.

Assessment of the fiscal policy stance

The government's fiscal policy was formed in the spring of 2019 when the economy was cooling down from the peak of the economic cycle with general government finances in a structural deficit of over -1% of GDP. The idea of the fiscal policy was to increase permanent spending and to stabilise public finances, mainly through employment-boosting policies, with net tax increases taking a minor role. Decreases in revenue and increases in expenditure imply that general government finances deviated from the planned path in 2020.

Fiscal policy will support aggregate demand in 2021. Compared to the general government fiscal policy plan for 2020-2023 published in October 2019, public spending in 2021 will increase due to the flexibility in central government spending limits, the rolling-over of appropriations from 2020, the full use of

reserves for future-oriented investments, and by bringing forward investment expenditure spending from 2022. Additional expenditure directly related to the Covid-19 pandemic also implies increased expenditure. The fiscal policy stance for 2021 is appropriate and it will help the economy to recover from the crisis. It is worth noting that while the currently low interest rates on the accumulating debt make deficit financing attractive, debt has to be refinanced accordingly.

The Finnish general government has been in deficit since 2009, but the headline number conceals different trends: central government net borrowing has been slowly decreasing due to consolidation, but net lending by social security funds has been decreasing due to an increasing number of pensioners. When the cyclical effects on the general government balance are removed, the resulting structural balance indicates that general government finances have been in a structural deficit for over a decade and the structural balance is forecast to stay below -2% of GDP over the medium term.

The general government debt-to-GDP ratio reached almost 70% in 2020 and it is forecast to continue to grow in future. The Council expresses its concerns about the projected rapid increase in the debt ratio. Developments in 2020 highlighted the importance of the availability of fiscal capacity. Long-term projections without policy changes indicate that the debt-to-GDP ratio will increase by more than 20 percentage points in the next 15 years.

Finland has a significant long-term fiscal sustainability problem caused by the prevailing structural deficit, a declining share of the working-age population and an increasing share of the old-age population.

The government fiscal policy target to balance general government finances by 2023 seems unattainable without the introduction of new consolidation measures. If the crisis is prolonged, the unavoidable consolidation could be postponed, but a longer crisis could also lead to an accumulation of structural problems in the Finnish economy and in public finances.

The government has published a broad plan, i.e. a roadmap, to strengthen public finances. In its current state the plan lacks actual measures, but the government intends to provide a more precise list in spring 2021. The current objective of the plan is to stabilise the debt-to-GDP ratio in the 2020s. The plan lists potential areas for structural measures, but even together their potential effect will not reach the estimated need for fiscal consolidation. Many

of these recognised potential elements require fiscal stringency, which is difficult to maintain over a decade, especially as this period includes two election terms.

As the need for consolidation of public finances seems evident from the medium- to long-term perspective, the Economic Policy Council restates its recommendation of an arrangement whereby such a consolidation and strengthening plan would be discussed and decided in parliamentary negotiations. Such decisions would serve as an anchor, not only for the current but also future governments. Such an anchor would help to avoid political cycles in fiscal policy, which could emerge when consolidation measures start to bite.

During the pandemic specific numerical fiscal targets were relaxed at the EU level. However, the original problem of negative spillover effects from excessive deficit and debt accumulation are likely to return after the crisis. Domestic targets are needed to set a path for policy decisions, but the current communication of objectives and strategy remain unclear. There is considerable lack of clarity, especially given the existence of multiple employment targets. With the accumulation of structural problems, the government should reiterate its objectives and publish an assessment of the measures required to attain these targets.

Household indebtedness and public policy

Household indebtedness has been rising in past years and very high debt-to-income ratios are concentrated among a minority of households. Household debt is most often used to finance investments in housing and small businesses and is often intended to be paid back from expected future income. This may place households at the risk of falling into insolvency when severe economic crisis occur. Increased insolvency problems and sluggish bankruptcy processes may postpone economic recovery from a downturn or depression.

During an overheating period, the financial system may accumulate systemic risks that tend to emphasise business cycle fluctuations and even cause economic crises. In October 2019, the Ministry of Finance recommended a considerable tightening of lending regulations. The Council supports this proposal but would like to introduce some elements into the discussion.

In the Council's evaluation, the proposed regulation of housing company loans is too lenient. While such loans are useful instruments for smoothing the costs of renovation in housing companies, the benefit of using them to finance new-build housing is not clear. Also, the current practice of allowing tax reductions on capital charges increases the risks of inflated housing prices and is also an unnecessary tax expenditure.

According to commissioned research, the proposed restriction on the maximum debt-to-income levels would tend to affect younger-than-average first-time home buyers in productive densely populated areas - the proposed restriction would have an effect on capital accumulation and the distribution of wealth.

The introduction of a positive credit register, the costs of which should be borne by the financial sector, could help lenders to acquire a comprehensive picture of the overall indebtedness of borrowers. It could also help borrowers to signal their creditworthiness.

The change in the Finnish unsecured consumer credit market in the beginning of the 2000s has increased households' indebtedness, and the number of debtors in enforcement has increased. After the current temporary regulation of instant loans expires, new restrictions on the marketing and availability of these will be needed.

The great depression of the 1990s led to several bankruptcies, which postponed economic recovery and inflicted social problems. Over-indebted people in Finland have had the possibility to apply for debt adjustment since 1993, but the procedure has been used relatively little. The Council welcomes the review and reform project of insolvency laws to account for the requirements of the Preventive Restructuring Directive (1023/2019) pending at the Ministry of Justice. The Council notes that, while access to a fresh start either in the bankruptcy process or in a debt adjustment process that feasibly follows a bankruptcy process could encourage entrepreneurship, there are associated moral hazard problems. In addition, the Council recommends a thorough assessment of debt adjustment for private persons. From an economic point of view, the system is cumbersome, with procedural and bureaucratic complexities that hamper the efficiency of the procedure.

2. Recent economic developments

The cooling of the economic cycle in 2019 rapidly turned into a global downturn in 2020 following the spread of the Covid-19 pandemic. According to the latest forecasts and statistics, world trade decreased by 9% in 2020 and economic growth in the eurozone is forecast to recover slowly in 2021. Finland's gross domestic product is estimated to have decreased by 3 to 4% in 2020. The fiscal responses of developed countries to the crisis have been robust, but the duration of the downturn is still unknown.

As in many other countries, Finland has imposed partial lockdowns and restrictions on travel and public gatherings to reduce the spread of the virus. The economy has been mostly affected by changes in consumer behaviour that have reduced demand for face-to-face services.

Forecasts indicate that the economic outlook continues to be exceptionally uncertain, with downward but also upward risks. The recovery of the Finnish economy depends both on reactions to the epidemic within Finland and on the recovery of European and international economies. The forecasts presented in this report were prepared in autumn 2020, and they may be subject to significant revision by next spring. Prolonged uncertainty in the economy can inflict a heavy toll, which in turn raises the risk of financial turmoil in fragile countries and companies.

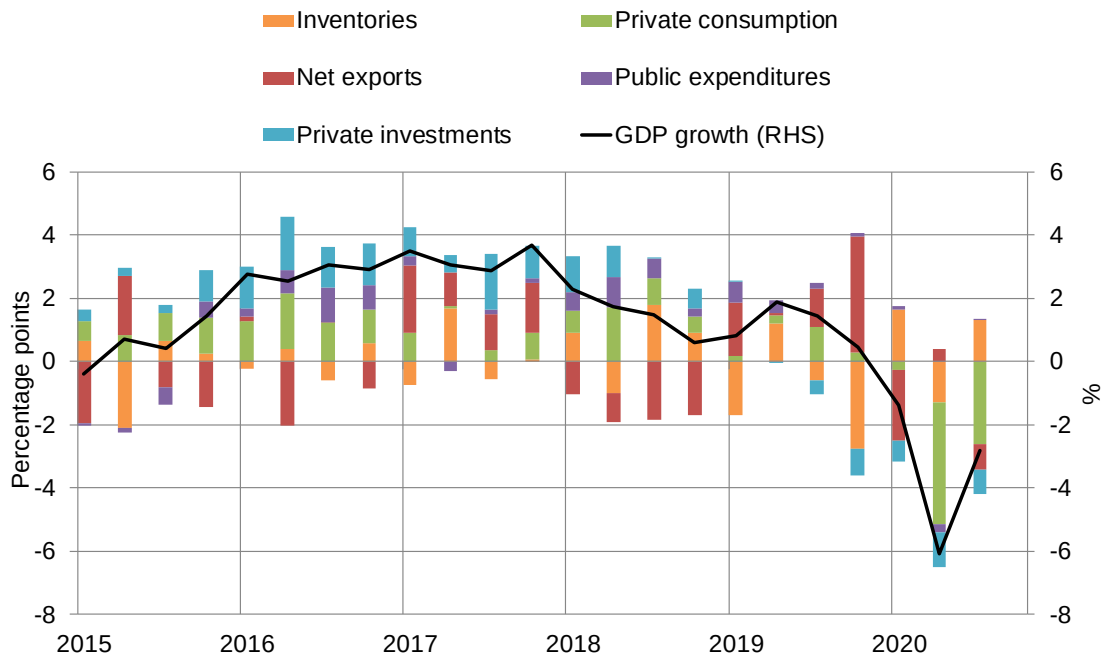
This chapter discusses recent economic developments and their implications for an appropriate fiscal policy stance.

2.1. Domestic GDP growth and its components

In the first half of 2020 the Covid-19 crisis hit both consumer and business confidence. According to the quarterly national account statistics, the decline in GDP in 2020 was mostly caused by a decrease in private consumption, see

Figure 2.1.1. While voluntary and mandatory social distancing affected demand for services in particular, the decrease in demand for durable goods might have been caused by uncertainty. Private investment has been on a downward trend since the beginning of 2019. The increase in government expenditure during 2020 does not appear in the preliminary quarterly national account statistics as an increase in public demand or production. The data on public consumption is mostly based on annual data and data on the public sector payrolls which have been growing steadily. Measures taken in 2020, such as eased tax payment arrangement and strong increases in transfers and subsidies on production, hinder the preparation of preliminary statistics.

Figure 2.1.1. The decrease in private consumption has been pronounced.



Sources: Statistics Finland and EPC.

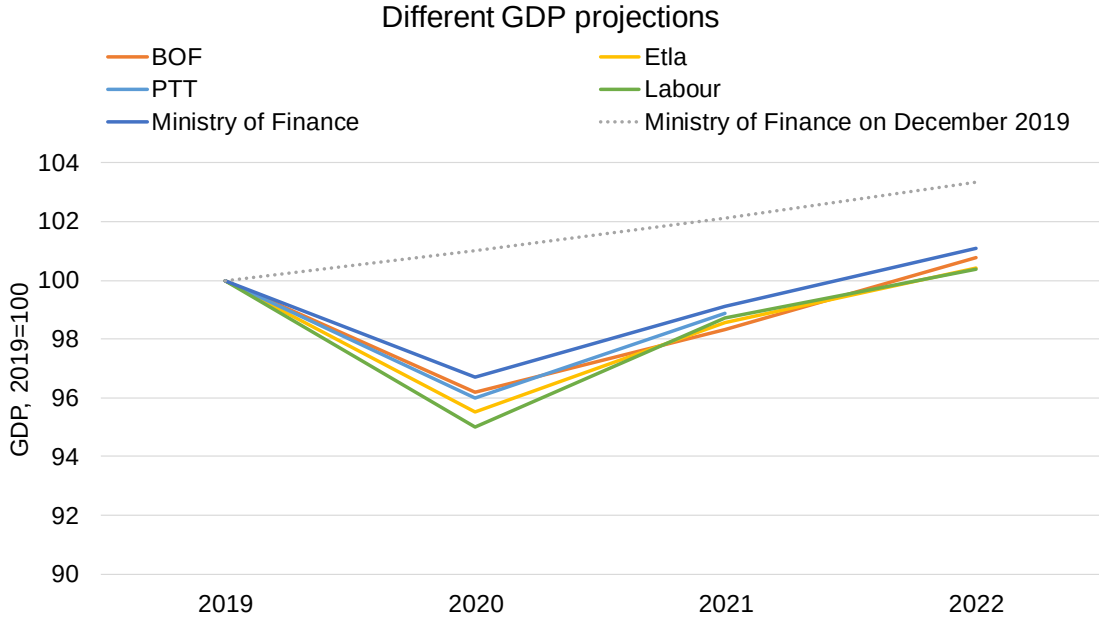
Table 2.1.1 presents a summary of growth forecasts by various national and international organizations. As 2020 was a crisis year, the National Accounts Statistics contain an unusually high degree of uncertainty and the size of the decline in economic activity in 2020 is likely to be revised as more information becomes available. While there is broad consensus among forecasters that the decline in GDP will not continue into 2021, there seems to be an unusually high level of variation regarding the projected strength of the recovery.

Table 2.1.1. Forecasts of real GDP growth rates (per cent).

	2020	2021	2022	2023	2024	2025
Ministry of Finance (Dec 2020)	-3.3	2.5	2.0	1.4	1.4	1.3
Bank of Finland (Dec 2020)	-3.8	2.2	2.5	1.5		
OECD (Dec 2020)	-4.0	1.5	1.8			
European Commission (5 Nov 2020)	-4.3	2.9	2.2			
IMF (13 Oct 2020)	-4.0	3.6	2.0	1.8	1.3	1.3
LABOUR (16 Sept 2020)	-5.0	3.9	1.7			
PTT (15 Sept 2020)	-4.0	3.0				
ETLA (14 Sept 2020)	-4.5	3.2	1.9			

The growth forecasts in the above table are translated into levels in figure 2.1.2. Even the forecast with the most optimistic recovery path predicts that in 2022 Finland's GDP will still be 2.8% below the path projected by the Ministry of Finance at the end of 2019.

Fig. 2.1.2. GDP is forecast to reach its pre-crisis level in 2022.



Sources: Latest forecasts by the Bank of Finland, Etla, Pellervo Economic Research (PTT), the Labour Institute for Economic Research and the Ministry of Finance.

Potential production can be defined as the level of production that can be sustained over the long run. Domestic production can be above potential when, for example, excess domestic demand is at an unsustainable level or increases

in employment accelerate wage inflation. Also, a production level below potential can be associated, for example, with sudden decreases in demand or production difficulties.

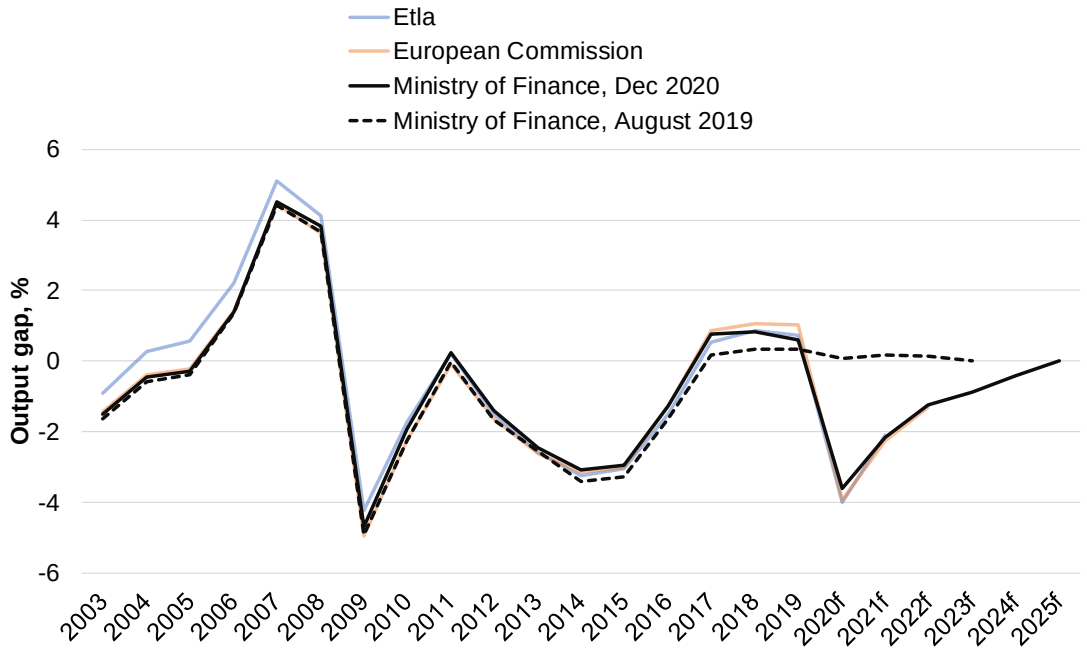
In normal times, assessment of potential output and the output gap involves a great deal of uncertainty arising from methodological issues, possible revisions to current data, and from the forecasts that the estimates are based on. The current crisis makes estimation even more difficult. In the beginning of the crisis the decline in economic activity was expected to be short-lived. As the crisis has now lasted for several quarters, the possibility of long-lasting, i.e. structural, losses in economic output is becoming more certain. Basically, the question is whether the sudden decrease is a deviation from the output potential or whether the output potential has decreased. The result of this assessment also has implications for economic policy. If the decline is permanent in nature, the permanent increase in the structural deficit in public finances will require consolidation measures after the crisis, but if the decline is only a deviation from trend, the crisis will only increase public sector debt.

Figure 2.1.3 presents various institutions' output gap estimates. Although these institutions do not publish their estimates of potential output, they can be traced back using their forecasts. The consensus view seems to be that potential output has not declined during the crisis, but annual growth in it has slowed to close to 1%.

From the production function perspective, growth in potential output is driven by changes in the growth of the labour force, production capital and productivity. The high employment rates experienced in 2017-20219 seem to be associated with a positive output gap, which raises concerns that the employment rate is not likely to return to these levels after the crisis. As the working-age population is slowly decreasing, the number of employed persons is also forecast to be on a declining trend. In the medium term, growth in the capital stock and productivity will keep Finnish GDP increasing at a 1% growth rate on average.[2]

[2] In June 2019, various domestic research institutions published their estimates of the growth rate of the Finnish economy in the next 20 years. The mean estimate for annual GDP per capita growth in the next 10 years is 1.1% and 1.4% in the following decade. See, Heimonen and Lehkonen (2019).

Figure 2.1.3. Output gap estimated by various institutions.



Sources: Etla, European Commission, Ministry of Finance.

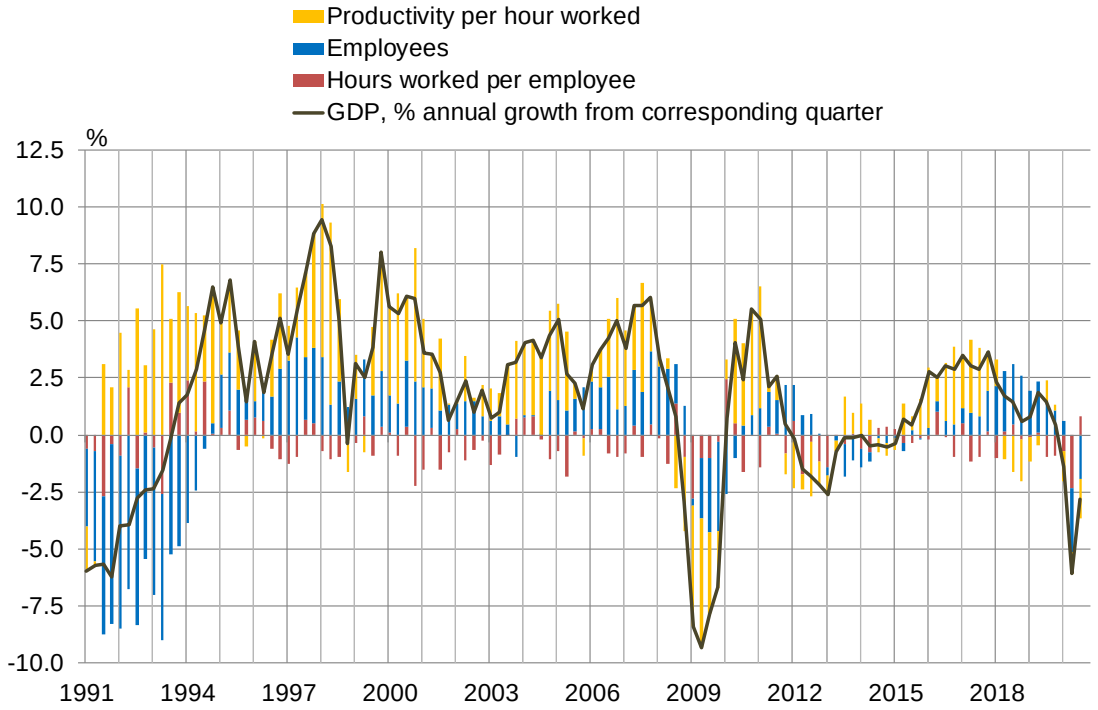
2.2. Labour market

The number of employed people declined rapidly in the second quarter of 2020. According to the Quarterly National Accounts, most of this decrease occurred in services, i.e. retail trade, accommodation and food services, arts and entertainment and other services.

The decline in GDP in 2020 can be divided into a decline in the number of employed people and a decline in hours worked by employed person, see Figure 2.2.1. In the second quarter of 2020, hours worked per employed person declined rapidly. One reason for this decline was short temporary layoffs. According to current data, productivity per hour worked has not declined during the crisis to the extent that it did in the financial crisis. The decrease in employment also continued in the third quarter.

In 2018, employment increased while productivity per hour worked decreased. The decrease in productivity is a rare phenomenon and could indicate that there was an increase in employment in industries with lower productivity. According to the Labour Force Survey, the increase in employment in 2018 was strongest in hotel and restaurant activities – the same industry has suffered most during the Covid-19 crisis.

Figure 2.2.1. Productivity per hour worked has been declining since 2018.



Sources: Statistics Finland and EPC.

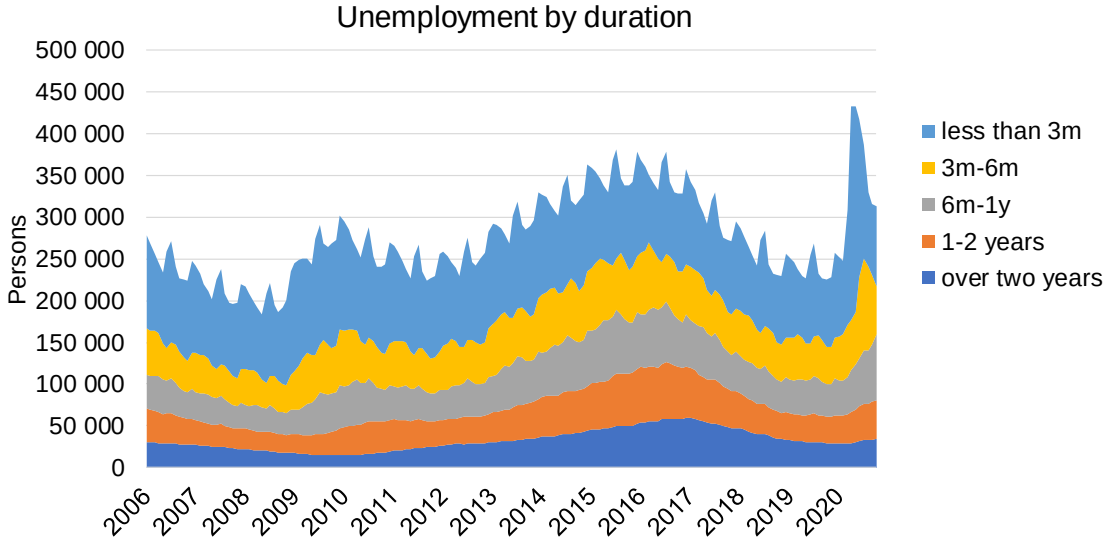
According to the Labour Force Survey, the number of employed persons, 20-64-year olds, has decreased by 50,000 between 2019Q3 and 2020Q3. In the same period, the number of unemployed persons, i.e. the number of people actively searching for employment, increased by 46,000, and the number of people outside the labour force increased by 13,000. Hidden unemployment, i.e. the number of people registered as unemployed but not actively searching for employment, increased as the number of laid-off workers averaged 154,000 in 2020Q2 and a fall in employment opportunities discouraged the job-searching efforts of unemployed people.

According to the Labour Force Survey, the fall in employment affected women more than men. Compared to the previous year, the number of employed men aged 20-64 years was 30,000 lower in the second quarter of 2020, while the number of employed women was 41,000 lower. Also, the number of unemployed women increased by 20,000 compared to the previous year, and the number of women outside the labour force increased by 15,000, the number of unemployed men increased by 11,000 and the number of men outside the labour force increased by 19,000. These differences between the sexes evened out in the third quarter. Among different industries, the hospitality industry has suffered most from the COovid-19 pandemic. Most of the decline

in consumer demand for services requiring social interaction in this sector was caused both by the partial lockdown and voluntary changes in consumer behaviour. The results by Caselli et al. (2020) suggest that the Finnish economy will continue to operate below potential as long as the health risks persist, see Box 2.1., and the difficulties in the hospitality industry will be prolonged.

In April 2020 the number of registered unemployed peaked at over 433,000 persons, including over 160,000 laid-off workers. The poor situation in the labour market extended the duration of unemployment and the number of people unemployed for more than 6 months started to increase, see Figure 2.2.2. The number of registered unemployed persons had decreased to 315,000 by November 2020. In its labour market forecast, the Ministry of Employment and Economic Affairs predicts that long-term unemployment will increase drastically in 2021, see Alatalo et al (2020).

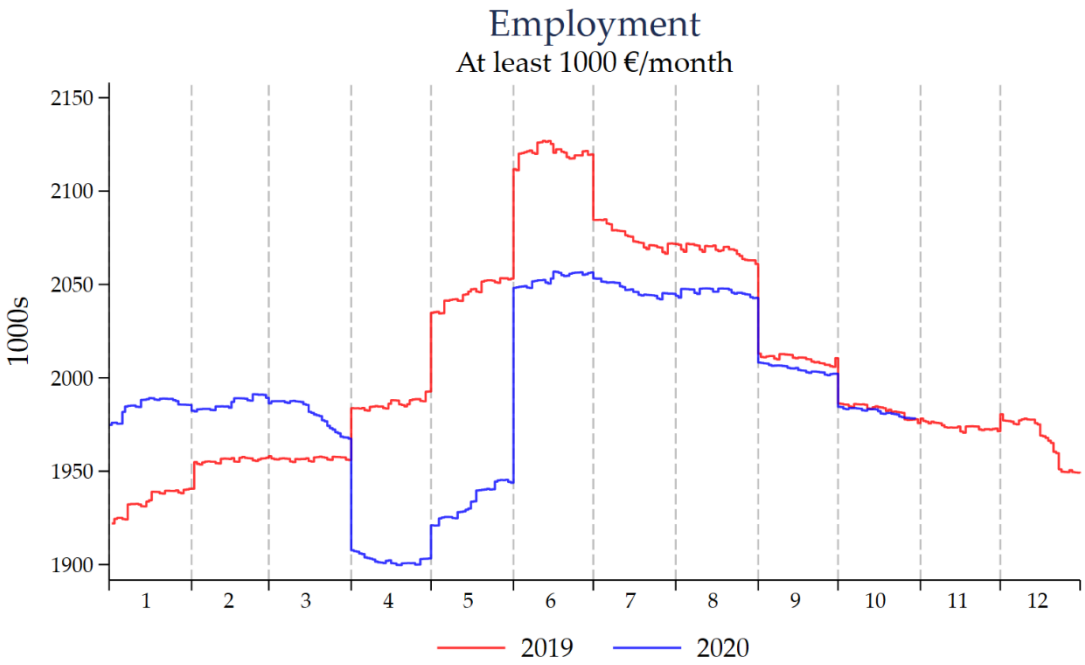
Figure 2.2.2. Unemployment has increased and spells have become longer.



Source: Ministry of Employment and Economic Affairs.

The trend employment rate of 15-64-year-olds reached its highest value of 73.6% in December 2019 and the trend unemployment rate was at its lowest in winter 2019 at 6.6%. By October 2020 the trend unemployment rate had risen to 8.3% and the trend employment rate had decreased to 71.7%. According to recent forecasts, the employment rate is expected to start increasing in 2022. According to data provided by the HGSE situation room, the number of people with monthly earnings over EUR 1000 had recovered to the previous year's level already in October.

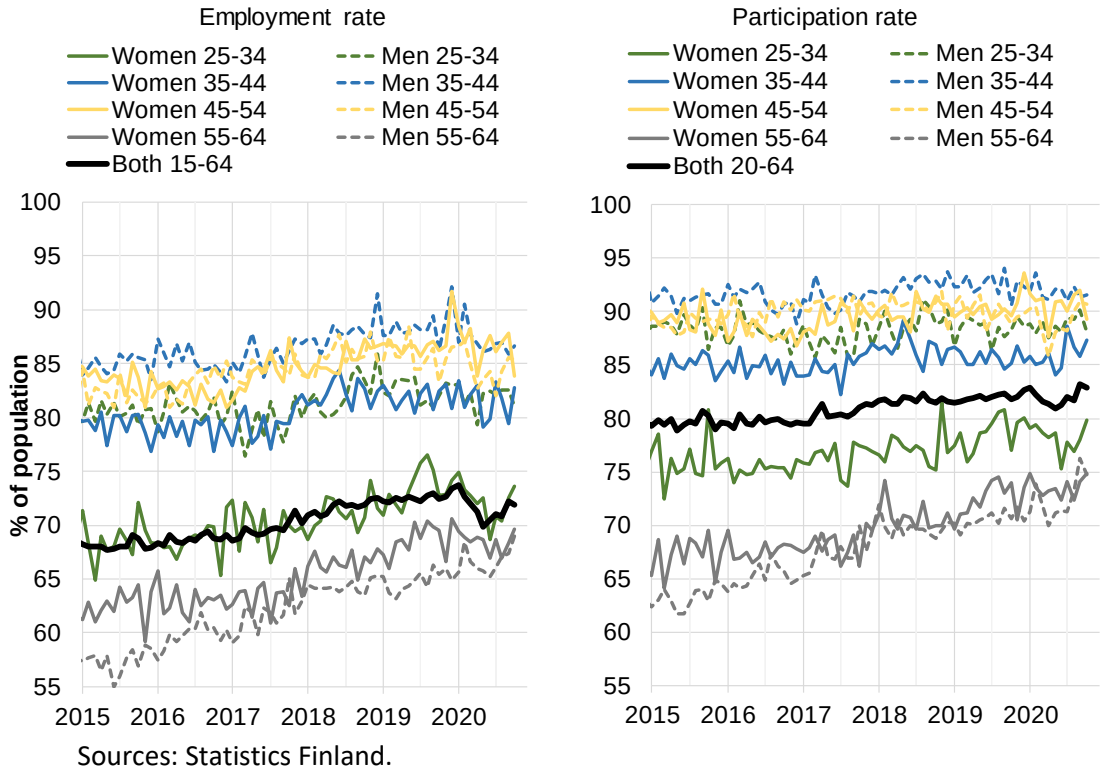
Figure 2.2.3. Number of employed persons with monthly earnings of EUR 1000 or above.



Source: Helsinki GSE Situation Room, www.helsinkigse.fi.

The increasing trend in the employment rate turned into a sudden decline in 2020. The reduction in employment was strongest among women in the 25-34-year-old age group. While the employment rate recovered only partially in 2020, the participation rate of 20-64-year-olds has reached its previous high level. While the overall participation rate has been trending upwards, the participation rate of 35-44-year-old men has turned into a slight decline, possibly due both to the Covid-19 pandemic and the unfavourable business cycle. Both the employment and participation rates of women aged 23-44 years are notably lower than those of men in the same age group.

Figure 2.2.4. Employment has not yet recovered, but unemployed have not left the labour force.

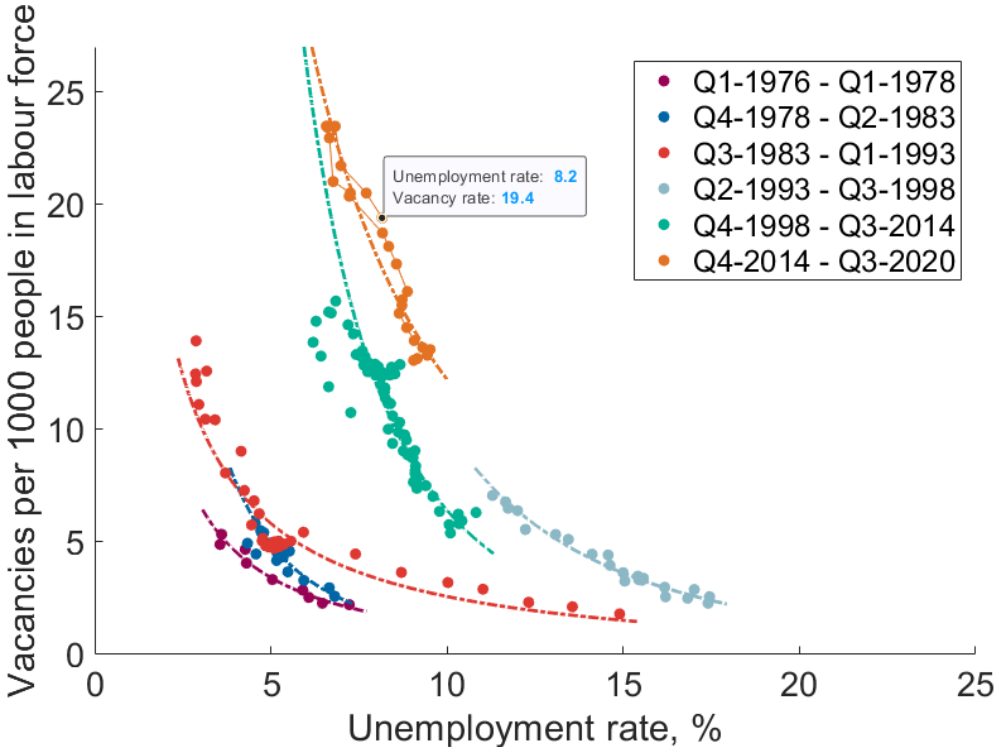


Sources: Statistics Finland.

The drop in economic activity is also reflected in the number of job vacancies. Figure 2.2.5 depicts the evolution of the vacancy rate and the unemployment rate around an estimated Beveridge curve. The Beveridge curve plots the relationship between the vacancy rate and the unemployment rate over time, where both rates are defined relative to the size of the labour force. From a theoretical perspective, movements along the curve result from fluctuations over the business cycle, while shifts in the curve itself can be interpreted as changes in matching efficiency.[3] This decrease in matching efficiency increases the unemployment rate at any given stage of the business cycle. It seems that the labour market matching process has not changed in recent years.

[3] If the number of vacancies and job-seekers increases simultaneously, one interpretation is that the economy has become worse at matching the two. The Beveridge curve may shift for reasons related to economic conditions or for reasons related to changes in policies. A reduction in unemployment benefits, for example, would most likely incentivize the unemployed to intensify job-searching and reduce unemployment for a given number of vacancies. In this framework such a policy reform would improve matching.

Figure 2.2.5. Labour market matching has not improved since 2014.

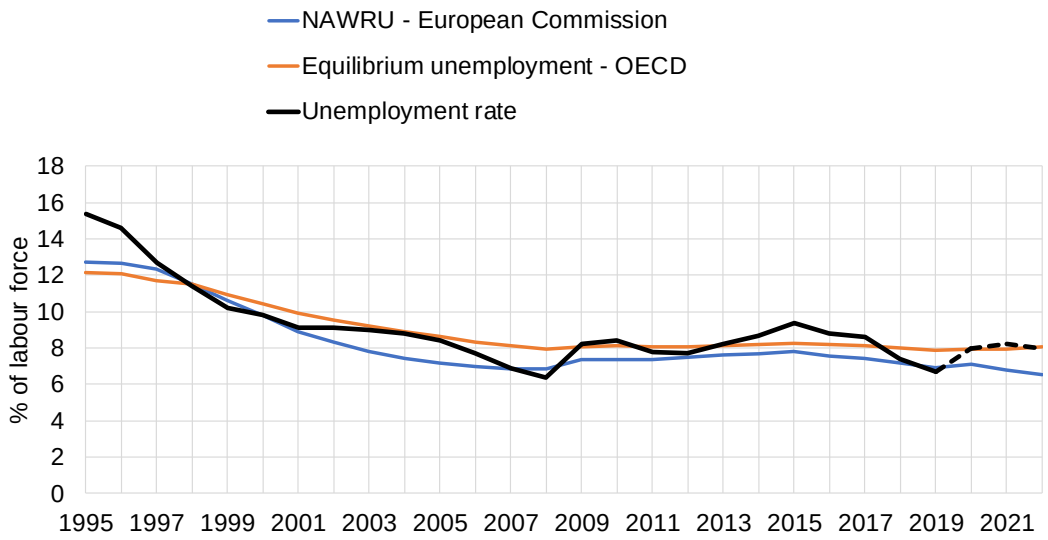


Sources: Ministry of Employment and Economic Affairs, OECD, Statistics Finland and EPC.

The decrease in the unemployment rate experienced in 2017-2018 happened without inflation pressures, indicating that the equilibrium unemployment rate, or NAIRU/NAWRU[4], could also have decreased. Figure 2.2.6 shows the equilibrium unemployment rates estimated by the European Commission and the OECD and unemployment rate as forecast by the Ministry of Finance. The OECD estimates indicate that the unemployment rate is at its equilibrium level, while the NAWRU rate as calculated by the European Commission is declining. This difference can be explained by differences in forecast unemployment– the EC predicts that the unemployment rate will decline to 6.5 % in 2022, while the OECD's forecast is close to that of the Ministry of Finance. There are also methodological differences, as the EC estimates relate the unemployment rate to wage inflation and the OECD estimate is closer to the results that could be obtained with a univariate filter.

[4] NAIRU is the Non-Accelerating Inflation Rate of Unemployment, and NAWRU the Non-Accelerating Wage Rate of Unemployment.

Figure 2.2.6. Unemployment has increased, but structural changes are uncertain.



Sources: OECD, AMECO database, Statistics Finland, forecast for 2020-2022 by Ministry of Finance.

Box 2.1. Covid-19 lockdown measures and voluntary social distancing

To contain the spread of the coronavirus, most countries have resorted to some sort of restriction measures, varying from recommendations on social distancing to stringent lockdown measures. In the first few months of the pandemic and again during the second wave in the autumn, so called restriction measures have included closing schools and business activities and sometimes even preventing people from leaving their homes except for essential reasons. Governments have strengthened these restrictions as the pandemic situation has worsened but often hesitated in their implementation due to the associated economic costs. Government-imposed restrictions have sometimes also been faced opposition from the public and businesses, but also support. As well as restrictions, economic activities requiring social interaction have slowed, due to both consumers' awareness and insecurity, which in turn took a severe toll on economic activity.

It seems that without vaccines and more efficient treatments, various social distancing measures remain key to slowing the spread of the Covid-19 pandemic. The economic question is how to control the pressures faced by healthcare systems while causing the minimum economic damage in the short term. Therefore it is critical to gain insight into what type of lockdowns provide the best economic and epidemiological outcomes. For example, according to Juranek et al. (2020) a comparison between employment developments in Denmark and Sweden shows that Denmark would have suffered a 30% lower decrease in

employment if the restriction measures had been as light as in Sweden. Watanabe and Yabu (2020) also find that government requirements are responsible for about a quarter of the decrease in outings in Tokyo, while the remaining three quarters are the result of information updates on the part of citizens via government announcements and the daily release of the number of infections.

Recent economic literature provides conflicting evidence on the role of lockdowns and voluntary social distancing. While some papers, see e.g. Coibion et al. (2020), Carvalho et al. (2020) and Chronopoulos et al. (2020), find that lockdowns have a severe impact on the economy, other papers, e.g. Chetty et al. (2020) and Goolsbee and Syverson (2020), argue that voluntary social distancing was the key driver of the economic contraction. A paper by Caselli et al. (2020) finds that the contribution of voluntary distancing to mobility was stronger in advanced economies, where people can work from home more easily and sustain periods of temporary unemployment because of personal savings and government benefits. By contrast, lockdowns played a much stronger role in low-income countries.

From the viewpoint of the above results, it seems that the decline in Finnish economic activity was due to voluntary social distancing - in 2020 Finnish working life demonstrated a great ability to shift to teleworking, and good social security enabled furloughed people to stay at home rather than taking on new employment that they might have found risky.

Using a large data sample on mobility, high-frequency indicators, job postings and infections, Caselli et al. (2020) also find evidence that lockdowns have decreasing marginal costs in restricting mobility and increasing marginal benefits in reducing infections. Their conclusion is that infections can be reduced at the lowest short-term economic cost with stringent shorter-lived lockdowns rather than with mild prolonged measures.

The contraction in economic activity is not only due to restrictions, and even in the absence of government lockdowns consumers and firms would have been more cautious in their activities. Public provision of appropriate information helps households and businesses to make their own decisions, but if individuals and firms do not change their behaviour as required, short-term stringent measures are needed

2.3. Fiscal responses to the Covid-19 crisis

In 2020, the Parliament of Finland has approved seven supplementary budgets, which in total increase government expenditure by EUR 11 billion and

lower estimated revenue by EUR 6.4 billion. This results in an increase in net borrowing of EUR 17.5 billion compared to the budget approved in the December 2019. Most of these changes in revenue and spending are direct consequences of economic developments caused by the Covid-19 crisis. Focusing only on budgetary measures, however, understates the total scope of the fiscal measures taken. Several sizeable measures have been taken that do not directly affect the government's budget, such as increasing the limits for contingent liabilities, and purchases in the corporate commercial paper market by the State Pension Fund.

Most of the support measures implemented have been targeted at firms, as is evident from table 2.3.1. The main contents included in each row of the table are as follows:

- **Subsidies:** These measures include general subsidy programmes via Business Finland (EUR 980 million) and the ELY Centres (EUR 425 million), and the business cost support programme (EUR 680 million). In addition, support for sole entrepreneurs by municipalities (EUR 250 million) and support for businesses in the food and beverage service sector (EUR 171 million) are included. The remainder of the subsidies are smaller and more targeted at particular industries.
- **Loans and capital investments:** These measures include purchases in the corporate commercial paper market by the Bank of Finland (EUR 1,000 million) and the State Pension Fund of Finland (EUR 1,000M), capital investments in Finnair (EUR 700 million) and the Finnish Minerals Group (EUR 150 million), and a EUR 400 million capital investment in Finnish Industry Investment Ltd (Tesi) to start a stabilization programme for medium-sized companies.
- **Guarantees:** An increase in Finnvera's authorization to grant guarantees for loans (EUR 10,000 million), a state guarantee for Finnair (EUR 600 million) and a state guarantee for key shipping companies (EUR 600 million) are included.
- **Changes in taxation and pension contributions:** These measures include delays in tax revenue caused by the changes in tax payment arrangements (EUR 753 million) and support for municipalities for their share of delayed tax revenue (EUR 547 million). In addition, a temporary reduction in employers' pension contributions by 2.6 percentage points (EUR 1,050 million) is included.

- **Other:** The largest measure in this category is the lower capital requirements for financial institutions set by FIN-FSA, which are estimated to increase private lending capacity by EUR 30,000 million. In addition, an authorization for the Financial Stability Fund to borrow a maximum of EUR 2,000 million to overcome possible challenges facing the deposit guarantee scheme is included.

Support measures to households have also been extensive during the crisis, even though most of the effect has come through automatic changes in social security expenditure. In evaluating economic policy, it is useful to make a distinction between discretionary measures and automatic responses by the social security system, as is done in table 2.3.1. Discretionary measures include mostly temporary changes to unemployment benefits, such as making unemployment benefits available for entrepreneurs (EUR 160 million), the removal of the waiting period and the relaxation of the qualifying work requirement (EUR 102 million). Other measures include temporary financial assistance due to an epidemic outbreak (EUR 94 million), an increase in the amount an individual can earn without affecting their unemployment benefits (EUR 13 million) and a relaxation of the conditions of the commuting and relocation allowance (EUR 25 million). An additional EUR 124 million was caused by extending these changes to the end of the 2020.

Table 2.3.1: Support measures to firms and households

Firms		**Households**	
Form of Support	**EUR million**	**Form of Support**	**EUR million**
Subsidies	2 628	Discretionary measures	561
Loans and capital investments	4 077	Automatic changes in the social security expenditure	1 030
Guarantees	11 200		
Changes in taxation and pension contributions	2 350		
Other	32 000		

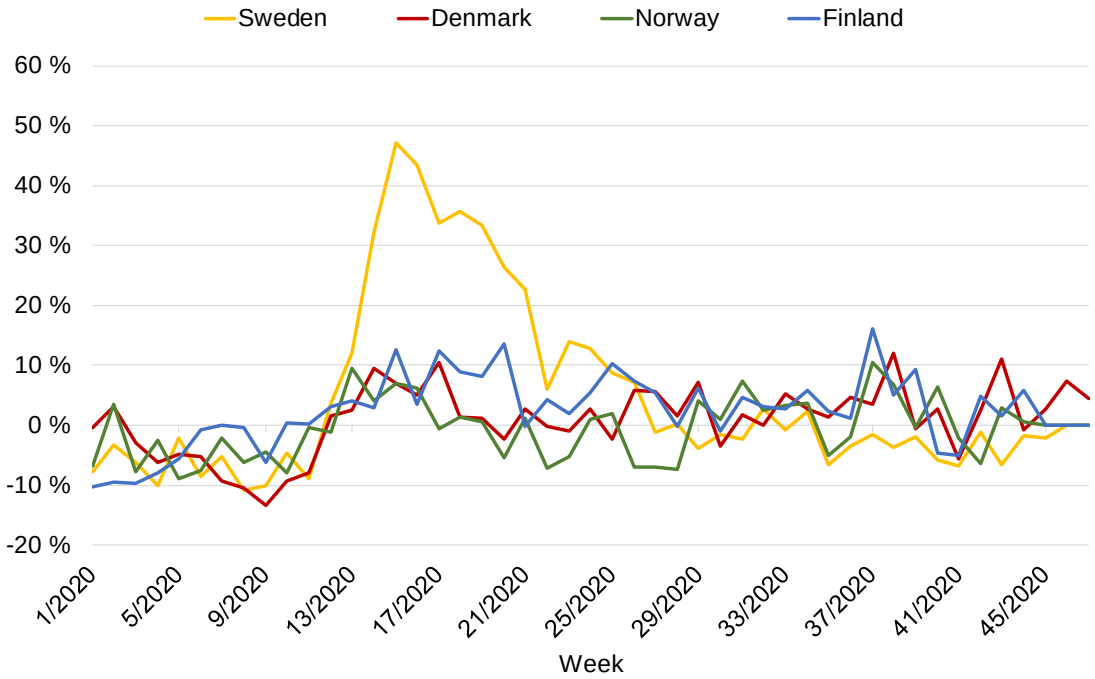
As a part of the fourth supplementary budget in June, an economic stimulus package was passed by the parliament. The package aims to stimulate aggregate demand, improve long-term growth and prevent climate change. This package's measures are hard to reconcile between different sectors, so it is presented separately in table 2.3.2.[5]

[5] Note that the stimulus package includes some measures that are also considered in table 2.3.1.

International comparison

The number of Covid-19 infections and resulting deaths vary a lot between countries. Figure 2.3.1 presents the excess mortality in 2020, as estimated by Hasell et al. (2020). According to their estimates, excess mortality in the Nordic countries Finland, Norway and Denmark in spring 2020 was of the same size, as were their policy reactions to the pandemic. Excess mortality was much higher in Sweden, a Nordic welfare state where containment was based on voluntary restrictions.

Figure 2.3.1. Excess mortality[6] during 2020: Deaths from all causes compared to previos years, all ages

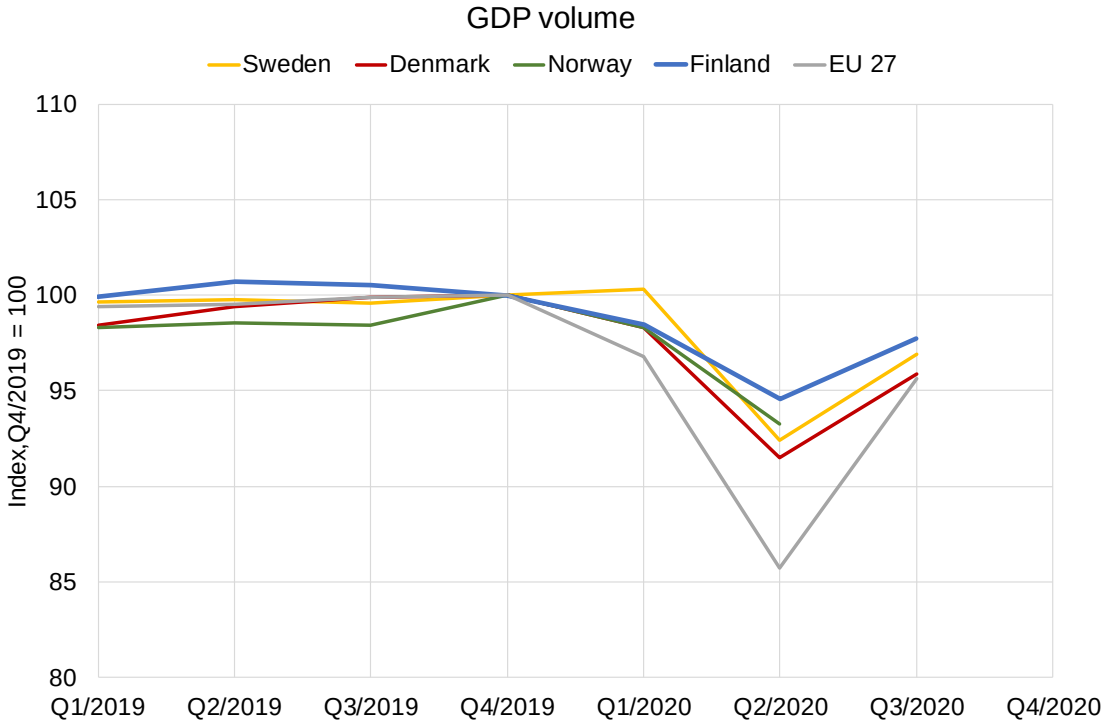


Sources: Human Mortality Database (2020), UK Office for National Statistics (2020), OurWorldInData.org

Figure 2.3.2 shows the evolution of gross domestic product in different countries. The response of GDP to the crisis has been of the same magnitude, at least according to the latest statistics, despite different policy responses and resulting health effects.

[6] The figure shows how the number of weekly deaths in 2020 differs as a percentage from the average number of deaths in the same week over the previous five years (2015-2019).

Figure 2.3.2. In 2020, Finland suffered from the pandemic less than its Nordic peers.



Source: Eurostat.

It is natural to compare the Finnish fiscal response to the Covid-19 crisis to that of the other Nordic countries (excluding Iceland). Overall, the Nordic countries' response to the crisis was very similar: most measures have been taken via existing systems and the bulk of the measures have been targeted at firms. There are, however, some notable differences, which we will briefly discuss here. In addition, a few interesting examples from other parts of the world are mentioned.[7]

It must be noted, however, that the comparison of fiscal measures between countries is very difficult. In many cases, different sources report somewhat different numbers and the information available is mostly incomplete. This means that especially quantitative comparisons are prone to errors, and therefore the focus is on qualitative comparisons.

[7] The information in this section is mostly based on OECD (2020b), OECD (2020c) and IMF (2020).

Firms

The forms of support to firms have been very similar across the Nordic countries. Supporting private borrowing by granting guarantees for loans and lowering capital requirements for financial institutions are measures that have been used extensively worldwide. In addition, all the Nordic countries have implemented general subsidy programmes to strengthen firms' liquidity across industries. A straightforward comparison shows that the relative size of these programmes has been smallest in Finland. On the other hand, Finland has the largest GDP share of general state guarantee programmes (see table 2.3.2). It is difficult to evaluate what is the right balance between subsidy and guarantee programmes. Subsidy programmes have larger budgetary effects, but they also support firms more directly and are therefore more efficient in providing liquidity.

More interesting differences arise when one focuses on the measures that aim to lower firms' costs. Rental costs in particular have been a target of support measures in many countries. In Australia, for example, rental payments have been lowered (with certain conditions) proportionally in response to the decline in the tenant's turnover. This kind of system ensures that landlords carry part of their tenants' losses and therefore leads to a more equal distribution of the adverse effects of the crisis. In the Nordic countries, measures directly targeting rental costs have not been common. The only Nordic example is from Sweden, where rental payments were temporarily lowered in some vulnerable industries.

The reason for the absence of these measures in the Nordics is that the general subsidies can be used to cover rental costs. However, in Finland, the business cost support scheme only became available in the beginning of July, whereas other Nordic countries announced similar programmes in March and April. In addition, the Finnish business cost support scheme has not been used to the extent expected: currently EUR 126 million of the budgeted EUR 300 million has been granted to firms, with approximately 72% of applications rejected.

Table 2.3.2 compares the total amounts of different support measures in the Nordic countries relative to this year's GDP as predicted by European Commission. The term "general" refers to programmes that have been available

for firms generally across industries.[8] This restriction limits the analysis, since significant support measures have been targeted at certain industries. It is, however, necessary in order to tackle the problems of quantitative comparisons mentioned earlier. In addition, state loans and capital injections exclude the commercial paper purchases by the Bank of Finland, as corresponding measures in the other Nordic countries are part of their autonomous monetary policy.

Table 2.3.2: Support to firms in Nordic countries, relative to GDP.

	Finland	**Sweden**	**Den-mark**	**Norway**
General state guarantee programs, % of GDP	4.37 %	3.15 %	2.82 %	1.81 %
General subsidy programs, % of GDP	0.75 %	0.82 %	2.97 %	1.63 %
State loans and capital injections, % of GDP	1.15 %	1.64 %	0.61 %	1.64 %
Sum, % of GDP	**6.27 %**	**5.61 %**	**6.40 %**	**5.08 %**

Taxation

A key observation is that tax relief by means of reducing actual tax rates has largely been absent during the crisis in Finland, Sweden and Denmark. Changes in taxation have focused mainly on more flexible payment arrangements and temporary refunds of value added taxes (VAT) already paid. In Denmark, the temporary refunds have been interest-free, and in Sweden the interest rate has been 1.25%. These lower rates make it more attractive for firms to make liquidity-strengthening tax payment arrangements, compared to the 2.5% rate used in Finland.

Norway's government, on the other hand, has reduced the rates of several taxes, including VAT, fuel tax and the employer's tax. Reductions in the VAT rate have been implemented in many other countries as well, such as the United Kingdom, Belgium and Germany. The VAT reduction in Germany has been particularly extensive: the standard VAT rate has been temporarily reduced from 19% to 16% and the reduced rate from 7% to 5%. Montag et al. (2020) study the effects of these reductions by analysing fuel prices. They find that the effects have been rapid but incomplete. Although VAT cuts have been the most common tax cuts during the Covid-19 crisis, they are certainly not

[8] For example, the Finnish general subsidy programmes include the support provided by Business Finland and the ELY Centres, and the business cost support programme. Similar programmes in other Nordic countries are considered in the comparison.

the only option. In addition to the measures in Norway, several countries have instituted relief on, for example, property and income taxes.

Households

Support measures aimed at households have been quite similar in the Nordic countries. Discretionary measures have been mostly taken through existing social security systems by easing conditions and extending coverage. A large share of support provided has come through the automatic functioning of the social security system.

In Sweden, Denmark and Norway, sickness benefits have been made available starting from the first day of sickness, which is a pre-existing condition in Finland.

All the Nordic countries have implemented a programme supporting short-term temporary layoffs in order to enable firms to reduce personnel costs and to prevent permanent layoffs. These programmes are thus meant to support both firms and households. In Sweden, the government has subsidized short-term layoffs so that firms can reduce their wage costs, while employees still receive approximately 90% of their normal wages. In Denmark, for firms that are forced to lay off more than 30% of their employees or more than 50 employees, the government will compensate 75% of the employees' wages. Firms must commit not to permanently lay off employees for financial reasons during the support period and to cover the remaining 25% of employees' wages. Thus, employees receive their full wages during a short-term layoff. In Norway, employees experiencing short-term layoffs have been guaranteed full wage compensation from the government for days 3–20 of the layoff period. The first two days are compensated by the employer. Starting from September, the employer-paid days were increased to 10 and the wage compensation was reduced. In Finland, unemployment benefits were made available starting from the first day, but they do not normally cover such a large share of income. For example, the compensation rate for a single person with an average wage and no children is 55% of the previous in-work income (OECD Statistics).

Another difference between the Nordic countries is that Sweden, Denmark and Norway have all supported students in various ways. These measures include a temporary removal of the income ceiling for student aid in Sweden, a one-time cash transfer of DKK 1,000 (approximately EUR 134) for students in

Denmark and an increase in the amounts of student loans and grants available to students who have lost employment income in Norway. No such measures have been taken in Finland.

Many countries have also supported households using direct transfer payments. In Japan, for example, all permanent residents have received a cash transfer of JPY 100,000 (approximately EUR 800). In the United States, the government has supported households through so-called Economic Impact Payments that are available to all U.S. citizens and permanent residents. In the Nordic countries, direct transfer payments have not been used extensively, which is consistent with the fact that the Nordic countries have comprehensive social security systems.

2.4. Conclusions

The corona pandemic has affected the Finnish economy through weaker export demand, cautious consumer and investment behaviour, and closing down of certain parts of service sector.

The government has responded to the crisis through increased social protection spending, support to firms, increases in health care spending and through expansive fiscal policy. An advantage of a generous welfare state is that the system provides a great extent of social insurance automatically via a wide availability of benefits.

Government's response to the crisis has been, by and large, appropriate. The expansion of social protection to the self-employed and the removal of the waiting time of furloughed workers represent rational policy responses to the crisis. In supporting enterprises in the beginning of the crisis, the government was forced to use those policy tools that were available, namely subsidies channelled via Business Finland. These were not well targeted at firms suffering the most from the crisis, but additional subsidies were introduced for such firms later during the year. The temporary freeze on bankruptcies has contributed to business survival.

Coordinated measures at the EU level are beneficial and such a package have positive spillovers on other economies. The economic development has also been supported by monetary policy.

3. Employment policy

The government set its main goal for employment policy in its government programme, which targets an employment rate of 75% by 2023. This objective has also been translated into policy decisions designed to increase employment by 60,000 persons. The reasoning for the employment target is long-run economic sustainability, and growth in employment is given as one of the main sources of revenue growth over the government term.

The employment rate reached 73% in 2019, but the Covid-19 crisis put an end to the positive trend. In response to the worsened employment situation the government updated its policy goal to reach an increase of 80,000 persons.

The reasoning for setting a high employment target is that work implies higher income, thus better enabling citizens to meet their needs. Employment is also said to increase social cohesion. Most of all, government policies to increase employment are justified on the grounds of improving the sustainability of Finland's public finances and the welfare state. In 2020 it was estimated that public finances need to be rebalanced by EUR 5 billion in the 2020s, EUR 1-2 billion of which could be achieved through increases in employment.

The Finnish general government has been running a deficit for the past 10 years, and the situation is not expected to change without fiscal adjustments and measures to increase both employment and productivity. Of these two, the employment rate is more directly related to government policies than productivity in the private sector. Thus, the employment rate is a sensible policy target, and the government's emphasis on this indicator is fully justified.

Labour market structures are formed by past agreements and policies. These agreements also affect the employment possibilities of people outside the labour force. Besides the economic effects, it is important to acknowledge that labour market participation has important social policy effects and contributes to social inclusion.

In this section we assess the government's employment policy and its targets, discuss recent research on Finland's labour market structures, and assess the effects of government policies on labour supply.

3.1. Employment policy targets

Employment and unemployment targets have a long history as policy objectives. The reduction of unemployment as a government objective was mentioned for the first time in 1932 in the programme of Prime Minister Kivimäki's government, and reducing structural unemployment was mentioned already in the programme of Prime Minister Törngren's government in 1954. The first numerical employment objective was set in the programme of Prime Minister Jäätteenmäki's government in 2003, where the objective was to increase employment by 100,000 persons over the government's term. The current target of an employment rate of 75% or increasing employment by 60,000 persons was revised to 80,000 persons due to downward revisions of medium-term developments. Government intends to achieve the latter target in the 2020s. With longer horizon, the target takes better account the long-run effects of policy reforms.

Alongside the employment target, the government aims to balance public finances, reduce inequality, narrow income gaps and put Finland on a path towards achieving carbon neutrality by 2035. The multitude of policy targets raises concerns that policy decisions to reach one target may affect negatively the attainment of the others.

While the government has restated its economic and employment targets, the overall setting of policy goals remains somewhat unclear. This is because the original targets were made under the assumption that economic conditions would remain normal. While the economic conditions might return to normal by 2023, it is difficult to find and implement policy measures that would increase the employment rate to 75%. The government has remained committed to finding policy measures that would increase employment by 60,000 people, another interpretation of increasing employment rate from 73% to 75%.

In autumn 2020, the government published a list of selected policy measures with an employment effect that it has already implemented or is about to implement. Although an ex-ante evaluation of the employment effects of any

government measure is difficult, the Ministry of Finance was able to produce indicative estimates of the effects. These measures are discussed in more detail below. As most of the measures are under preparation it may be premature to assess their fiscal effects. As the government programme acknowledges, the effect of increased employment on public finances and thereby on fiscal sustainability may vary depending on the quality of the jobs and the policies implemented to achieve them.

3.2. Employment policies

Overall, the government is committed to a number of principles but specifies few policy proposals in its programme. The following are some of the key principles the government has committed to in its employment policies:

- In addition to the employment rate of 15-64-year-olds, the government will monitor the employment rate of 20-69-year-olds, hours worked, the full-time-equivalent employment rate, and the quality of jobs.
- The government will evaluate employment growth vis-à-vis the target "continuously", with developments monitored annually when drafting the general government fiscal plan, when drafting the budget, and in the government's mid-term review.
- In its labour market policies, the government commits to taking no actions with negative employment effects without simultaneously compensating them with more efficient employment-improving policies.

The government programme includes some information as to how the employment target is to be monitored and how fiscal policy is to be made conditional on achieving it:

> *'The aim is that, under the normal economic circumstances described above, the combined effect of [certain measures listed in the programme] and other measures will be at least an additional 60,000 people employed. Of the measures referred to above, half will be in place by the government budget session in August 2020. If this is not the case, the government budget session will assess the expenditure increases previously decided, which were made relative to the technical General Government Fiscal Plan.'*

The government published a list of its employment measures as an appendix to the 2020 budget. The list includes both implemented measures and

measures under preparation. The list of implemented measures is short and includes only those measures with a positive effect on employment. The listed measures are:

Adult education support reform, which is designed to promote the possibility of simultaneous access to work and study for wage-earners. This reform took effect on 1 January 2020, and its estimated effect on employment is 200 persons.

Linear model of the part-disability pension, which provides a linear reconciliation of partial disability pensions and earned income. As well as a partial disability pension, recipients can earn income up to the protected amount without affecting their pension, and once the protected amount is exceeded, the pension is reduced linearly. The estimated entry into force of the reform is 1 January 2023. The Ministry of Finance calculates that the economic incentives of the reform could improve employment for the partially employed by about 200 persons. The reform would increase the working effort of pensioners already in employment, meaning the change would not necessarily increase the number of employed people. Increased working effort by one group of employed persons can possibly reduce demand for labour from other groups. However, as the main effect is already quite small, any secondary effect would be of negligible size.

Postponement of the minimum age of the additional day entitlement for unemployment protection. After the measure came into effect on 1 January 2020, unemployed persons born in 1961 or later qualify for additional days of unemployment protection at the age of 62, the previous age limit having been 61 years. The estimated employment effect is 6,500 to 7,000 additional employed persons.

Reduction of early childhood education payments by EUR 70 million will increase employment by about 2,500—3,600 jobs. The estimated effect is based on microsimulation modelling. According to the government proposal, the net effect of the measure on general government finances is negative by EUR 100 million. The measure will take effect in August 2021.

The effects of these three measures were estimated by the ministry of Finance using the best available data and relevant elasticities from literature. The list

does not mention the partial abolishment of the activation model[9] by the previous government. The government programme states that the government will adopt employment policy measures with negative employment effects only if there are immediate measures with a more positive effect. The absence of partial abolition of the activation model from the list may be because a research study by Kyyrä et al. (2019) could not give a definitive answer to the employment effects of the model due to deficiencies in its implementation from a research perspective. The government's proposal on the activation model did not evaluate the employment effects of the model. Instead, it emphasized that model would at least be budget-neutral as the increase in employment would increase tax revenue and reduce unemployment expenditure. The unemployment expenditure would also be reduced by the associated sanctions for inactive unemployed persons. This reduction would compensate for the shortening of the waiting period for unemployment benefits. The reduction of the waiting period was not abolished. The government's proposal on the abolition of the sanctions in the activation model notes that the employment objective of the model was 5,000 - 12,000 persons. This effect was estimated by a preparatory working group with a model slightly different from that implemented in legislation. The range of 5,000 – 12,000 additional workers is quite rough and could possibly include the similarly estimated effect of the final legislation. However, this assessment does not take into account the displacement effect, which can be substantial.[10] Using a similar estimate of the displacement effect as the Ministry of Finance uses in its analysis of the Nordic labour services model would reduce the employment effect of the activation model to 2,000 – 4,900 persons. The inclusion of this negative effect in the aggregation of the government's employment policies is problematic, as on the one hand there is no evidence of the employment effects and on the other there are usable results based on economic literature. Evaluation of the employment impacts of proposed new measures and of discontinued policies should be conducted using a similar approach.

[9] The activation model reduced unemployment benefits by 4.65% for inactive jobseekers. Activity was monitored in three-month periods, the requirement being to have done 18 hours of paid employment, participated in employment services for five days, or earned 241 euros as a self-employed person. Kyyrä et al. (2019) report that around one third of all benefit recipients faced sanctions due to inactivity, with older jobseekers being more likely than others to see their benefits cut.

[10] See e.g. Pehkonen (1997) for discussion.

Extension of compulsory education to the age of 18 years from the current 16. Measures associated with the expansion of compulsory education are explicitly targeted at the low-skilled and low-income segment of the population, where it can be assumed that they could reduce the number of years lost and thus increase the employment rate and help Finland to survive a long-term labour shortage caused by demographic change. The medium-term employment impact of the reform is estimated to be 1,600 persons and the long-term impact 15,000 persons. These estimates are based on Seuri et al (2018). The reform takes effect in August 2021.

The government also listed possible measures. These included:

Nordic labour services model - in order to support job search and guidance services, assessment of the services needed by unemployed people will be improved and job search support increased so that unemployed people are targeted every two weeks in the early stages of job-searching. Jobseekers are required to apply for 0-4 jobs a month, depending on the labour market situation in the region and their own capacity. If a jobseeker fails to meet the requirement, the penalty is a 5-day benefit loss, and a 10-day benefit loss in the event of repeated failure. The government plans to introduce a reform of the law in this area with the objective of increasing employment by at least 9,500 persons. The reform package is still on the planning state.

The reform of the Nordic model consists of three main elements. The Ministry of Finance has evaluated the expected employment effects of these as follows: (i) intensive interviews of unemployed persons by the employment service officials every second week for the first six months and every month thereafter (+8,600 employed), (ii) quantitative requirement for job applications, but simultaneously abolishing current system of obligatory job offers (-1,200 employed), and new system of monitoring job search activity with a reform of the sanctions to become progressively increasing but reducing the maximum sanction (+2,000 employed). The estimated total effect is then +9,400 employed. The evaluation of each component is based on research literature studying the effects of similar reforms mainly in other Nordic countries using best-practice research methods. The Ministry of Finance estimates also account for the displacement effects of reforms. When an unemployed person is incentivized to be more active in job–searching, it reduces the probability of other jobseekers finding employment. Again using estimates from literature, the displacement effects are estimated to be almost 60% of the main effect,

resulting in a net effect on employment of about 40%. It is furthermore considered that the reform will achieve less than full coverage of unemployed jobseekers. Therefore the forementioned employment effects appear to have been competently estimated.

Simplification of the wage subsidy system by setting a level of aid of 50%regardless of the length of unemployment and increasing wage subsidies for employees with partial working capacity to 70%. Together with other minor details, the estimated employment effect of the reform is 500-1,000 persons, which is in line with research by Asplund et al. (2018), who find that subsidies increase the earnings of persons hired in the private sector via wage subsidies, and also increase their months of employment while simultaneously decreasing their months of unemployment. However, these effects are not found to be large. A more precise assessment of the employment effects of this reform has not been published. The reform package is still on the planning state.

Increasing employment of over 55-year olds mainly by abolishing the additional days of unemployment protection. Employment of over 60-years-old would be enhanced also by an increase in the cap on working income reduction. Proposal includes also a new model of redundancy pay and training obligation for people aged 55 or over and new 70% wage support model for over 55-year olds. The Ministry of Finance estimates that the package could potentially increase employment by 9.000 persons. The abolishment of so-called unemployment-tunnel would increase employment by 7.900 persons. The assessment is based on the assumption that unemployment risk and re-employment probabilities of people in older age groups would converge with those age groups not affected by the unemployment tunnel. The reform package is still on the planning state.

The government also has multiple employment reforms in the planning stage. Government documents indicate that these measures include: increasing employment of persons with partial working capacity, transferring employment services to the local level, developing unemployment security, mental health services for younger persons in the workforce, learning continuing training programme, integration and work-related immigration, reform of employer contributions, and further work on local contracting.

Most of the measures still under preparation can be considered as active labour market policies. Active labour market policies reduce unemployment

and thus increase employment. Kauhanen (2020) discusses active labour market policies and their effects on employment.

According to Kauhanen's literature review, active labour market policy measures improve the employment of those involved in them over the reference group. However, active labour market policy measures have significant side effects - part of the positive effect comes from the measures negatively affecting employment in the reference group. Conventional evaluation studies ignore side effects, meaning that active labour policy is less effective in raising employment rates than most evaluation studies show.

The active labour market policies planned by the government should take effect during a downturn. According to Kauhanen, the effects of active labour market policy are particularly positive if started during a downturn, but end in an expansion, and the negative side effects also can be particularly high in a downturn. However, due to the reduced lock-in effect, training is more cost-effective in a downturn than in an expansion.

Spending on active labour market policies varies between countries. Studies including Havik et al. (2004) and Gäddnäs (2019) show that countries with higher expenditure on active labour market policies per unemployed person have lower structural unemployment. However, these studies do not discuss the causality.

Active labour market policies are costly to implement. The main motivation for policies to increase employment is fiscal, thus a cost-benefit analysis should also be performed of proposed policies, at least at a basic level.

In its previous report, the Council listed some principles that could be useful when assessing the employment effects of government measures. These principles pointed out that evaluation of the effect of government actions on employment should be comprehensive; increased employment due to government measures should be permanent or at least very long-lasting; the quality of employment growth in terms of its fiscal effect should be discussed; possible spill-overs of policies should be discussed and considered whenever possible and when aggregating effects of multiple government policy decisions on employment, the possible overlap of these effects across individuals should be taken into account.

With some amount of uncertainty in the parameters, the proposed measures come close to fulfilling the objective of introducing measures in the autumn of 2020 to increase employment by 30,000 persons. However, when the effect of partial abolition of the activation model is taken into account, the effect of employment policy decisions taken in 2020 is lower.

If the government aims to achieve its target of increasing employment by 60,000 persons by the end of its term, or by 80,000 persons by the end of the decade, it needs to consider the employment effects of its other policies that directly affect the employment decisions of households and individuals. Such measures include changes in income taxation, social security and other transfers.

A background study by Ollonqvist et al. (2021) finds that policy changes extended unemployment spells by roughly 5,500 person-years. At the intensive margin incentives to increase earnings were mostly decreased and yielded a decrease in earnings of around of EUR 140 million.

The employment effects of various policies discussed above are summarised in table 3.2.1. As can be seen, the estimates are not precise and it would be difficult to aggregate them into one estimate or even an interval. However, one may conclude that the overall effect of government policies on employment will be positive.

Table 3.2.1. Estimates for employment effects of government decisions and proposals.

	Positive effect on employment	Negative effect on employment
Adult education support reform	200	
Linear model of the partial-disability pension	200	
Postponement of the minimum age for the additional day entitlement to unemployment protection	6,500 - 7,000	
Partial abandonment of the activation model*		5,000 - 12,000 (2,050 - 4,920)
Reduction of early childhood education payments	2,500 - 3,600	
Changes in taxation and social security		2,800 - 8,500
Nordic labour services model **	9,500	
Simplification of wage subsidy system **	500 - 1,000	
Extension of compulsory education	10,000	
Increasing employment of over 55-year olds	9,100	
Adult education support reform	1,600	

Sources: Calculations by Ministry of Finance, Ollonqvist et al. (2020) and EPC.

* Numbers in parenthesis take into account an approximation of the displacement effect.

** Measures under preparation. Other measures have been implemented

3.3. Government policies and inequality

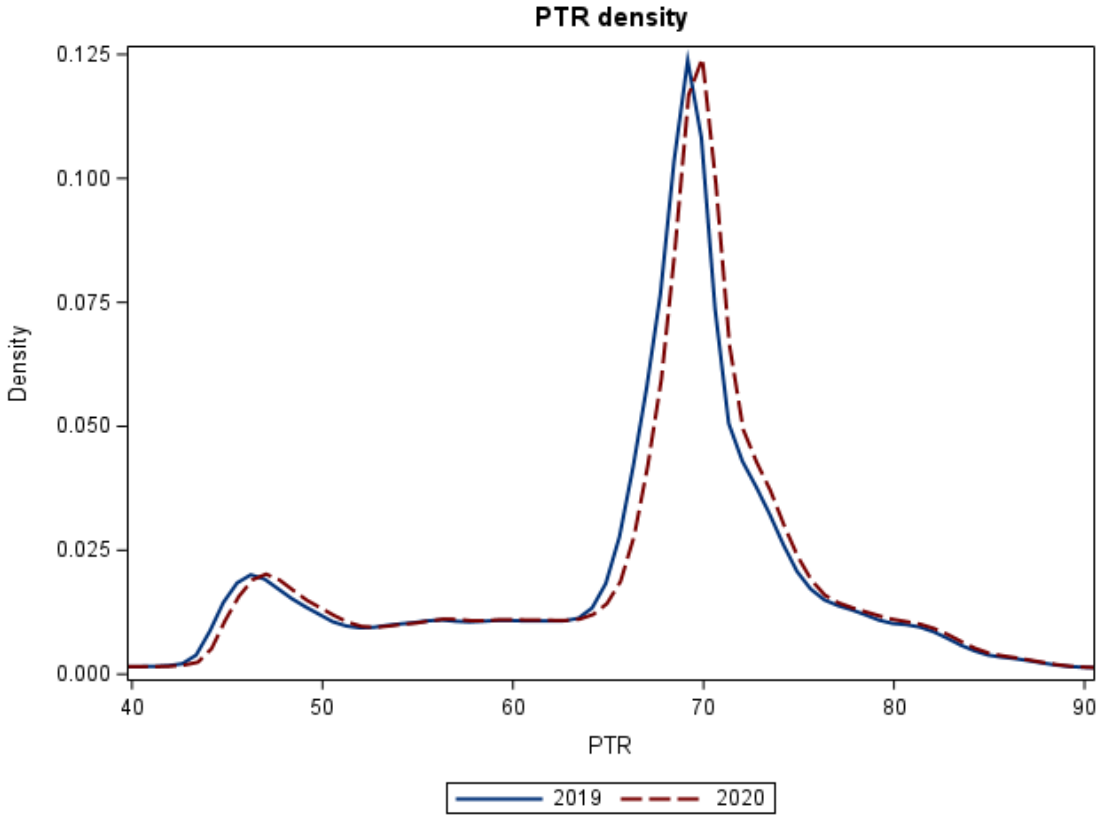
One of the objectives of the government programme is to reduce inequalities. A background study by Ollonqvist et al. (2021) evaluates the impact of tax and transfer policy reforms on the risk of poverty and inequality using a microsimulation approach. The exercise concerns the impacts of government policies in this area during its first year in office, i.e. policy changes in 2019 that took effect in early 2020, before the Covid crisis. Any analysis of the whole of 2020 must take into account the drastically changed economic and social conditions due to the pandemic, and we will return to such analyses at the end of this subsection.

The Sisu microsimulation model used by Ollonqvist et al. (2020) includes direct tax and transfer policies, whereas public service provision and changes in indirect taxes are not considered. The analysis is conducted both by assuming that the policy changes did not have any behavioural impacts and also in a more dynamic manner, including behavioural changes in employment and earned income when taxes and benefits are altered. Instead of estimating the reaction of employment to taxes, the study contains a literature survey of the

econometric evidence based on quasi-experimental approaches and related to the impact of tax and benefit policies on employment (the extensive margin) and earnings when employed (the intensive margin). The paper then uses elasticities (set to 0.2 for both margins in the benchmark case) from the literature to set parameter values for the behavioural part of the simulation.

The incentives for the extensive margin labour supply are measured using the notion of a participation tax rate, which measures the increase in taxes and the reduction in benefits as a share of gross earnings when a currently unemployed individual finds a job with an income level predicted by their background characteristics. The higher the tax rate is, the lower the incentives are to take up a job. Figure 3.3.1 depicts the participation tax rate (PTR) for 2019 and 2020. A mechanical impact of increased transfer amounts is reflected in a moderate increase in the participation tax rate, which is visible in the chart.

Figure 3.3.1. Distribution of participation tax rate.

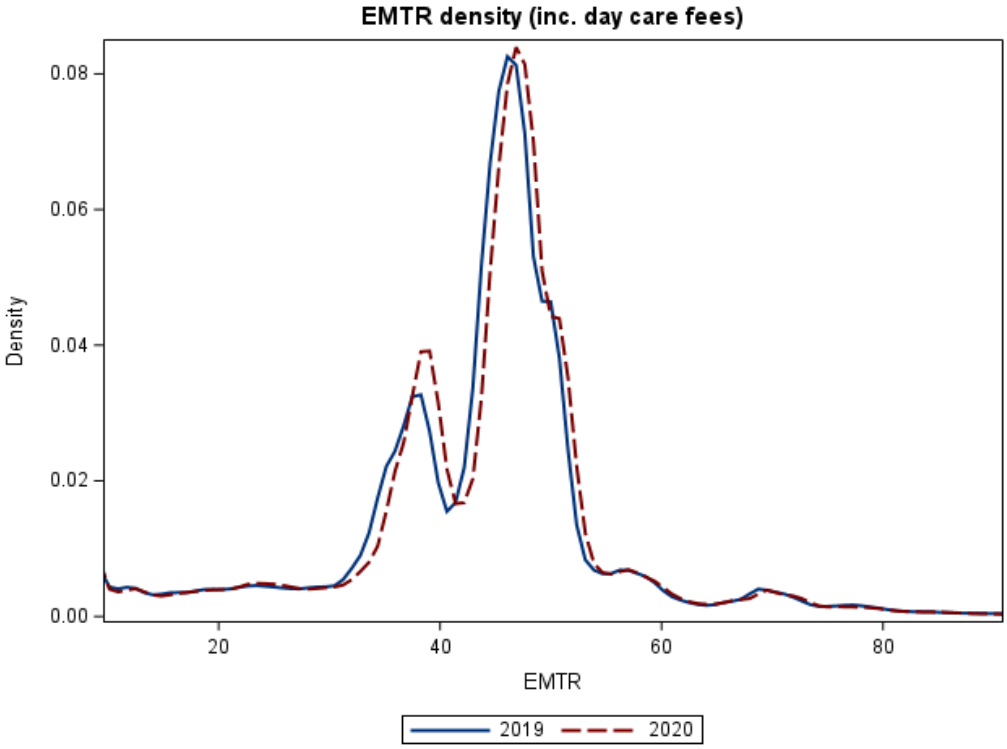


Source: Ollonqvist et al. (2021).

The intensive margin incentives, i.e. the incentives related to working more hours or earning extra income by other means, are measured using effective marginal tax rates, which also take into account the reductions in benefits when income increases in addition to the marginal income tax rate. Figure

3.3.2 illustrates the level of the effective marginal tax rate (EMTR) for both years, whereas Figure 3.3.3 shows the change between the two years. The effective marginal tax rates were lowered for those with low incomes, whereas the incentives worsened for people earning higher incomes. The changes in the participation tax are estimated to extend unemployment spells by roughly 5,500 person-years. At the intensive margin, the incentives to earn more mostly decreased and this is estimated to result in a EUR 140 million decrease in reported earnings.

Figure 3.3.2. Distribution of effective marginal tax rate.



Source: Ollonqvist et al. (2021).

Figure 3.3.3. Changes in effective marginal tax rate between 2019 and 2020.

Source: Ollonqvist et al. (2021).

The overall impacts of the policy changes on inequality, the risk of poverty (measured with a fixed poverty line set at 2019 incomes), and government revenues are summarised in Table 3.3.1. The column labelled 'Pure static' reports the results from a simulation without any behavioural changes, and the following columns contain the impact of extensive and intensive margin behavioural changes as well as their joint effect.

Table 3.1.1. The overall impacts of the policy changes on inequality, the risk of poverty and government revenues.

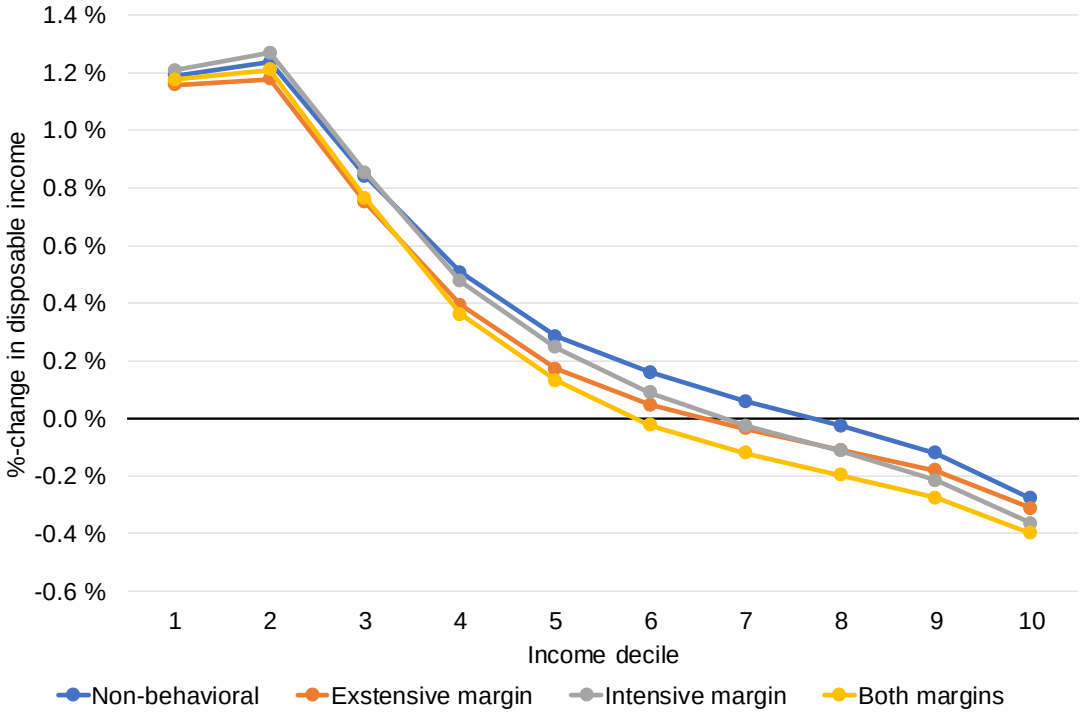
	Bench-mark	Pure static	Extensive margin	Intensive margin	Both margins	Static + be-havioural
Gini coefficient	28	-0.3	0.0	0.0	0.0	-0.3
Equalized income Median	24335	54	-29	-17	-47	7
At risk of poverty						
Whole population (%)	13.39	-0.59	0.03	-0.01	0.02	-0.57
Whole population (N)	73 8018	-32 500	2 000	-200	1600	-30 900
Children (%)	12.55	-0.43	0.05	0	0.06	-0.37
Children (N)	13 3576	-4 600	600	100	600	-3 900
Elderly (%)	12.73	-1.37	0	0	0	-1.37
Elderly (N)	15 0129	-16 200	0	0	0	-16 200
Fiscal changes						
Taxes (M€)	35 700	130	-40	-70	-110	20
Benefits (Me)	13 600	360	90	0	90	450
Taxes-benefits (M€)	22 100	-230	-140	-70	-210	-430

Source: Ollonqvist et al. (2021).

According to the results, inequality, as measured by the Gini index, decreased by 0.3 points, and the behavioural effects had a negligible impact on the reduction. Government policies lifted 32,500 individuals above the poverty line, but the increase was somewhat smaller (by 1,600 individuals) with behavioural changes. Behavioural changes had a more marked influence on the overall fiscal consequences of the policy changes: instead of a net worsening of approximately EUR 200 million, the worsening in the government budget balance was around double when behavioural changes are taken into account.

The results are further illustrated in Figure 3.3.4. The profile in the change in disposable income stays the same irrespective of whether behavioural impacts are taken into account. With both extensive and intensive margins, disposable income declined somewhat for households earning above the median income and increased in a more significant manner for the bottom two deciles.

Figure 3.3.4. Changes in disposable income by household income decile.



Source: Ollonqvist et al. (2021).

Note: Non-behavioral refers to pure non-behavioral effects, Extensive margin is the non-behavioral effect + extensive margin responses, Intensive margin shows non-behavioral effect + intensive margin responses and Both margins is the total effect (i.e. non-behavioral + behavioral responses).

The overall policy changes can be considered relatively modest, and therefore the corresponding impacts were also moderate, with an even smaller difference between results with or without behavioural changes. The main value of the exercise is to provide a setting for an evaluation of similar policy changes that takes into account both employment and taxable income changes. The scale of behavioural impacts is taken from – in the best possible case – literature that provides credible causal evidence about the impacts of taxes and transfers on employment and income. Another advantage of the approach is transparency: if users of the calculations think another set of elasticities should be used, they can easily do so by changing the parameter values.

The distributional consequences of the Covid pandemic

Kyyrä et al. (2021) examine the impact of the Covid crisis on disposable income, also within a microsimulation setting. They first calculate the unemployment incidence for various types of workers (by gender, age, occupation, and region) in July 2020 on the basis of Helsinki GSE Situation Room data.

They then combine this information with the dataset underpinning the Sisu microsimulation model and amend the data so that employment corresponds to the July 2020 situation. The model is run with this updated dataset, and new tax and transfer amounts are calculated for all households.

The results suggest that gross earnings declined by approximately 4.5 per cent during the crisis year, in comparison to a counterfactual of a small earnings increase predicted on the basis of pre-shock data. Even in the absence of the modelling of the new social insurance mechanisms (such as the expansion of unemployment insurance for the self-employed),[11] the welfare state provides strong automatic stabilisation. Because of the reduction in direct taxes paid and an increase in benefits received, the drop in disposable income turns out to be only around 1 per cent.

The proportional reduction in disposable income is greater among households from the 3rd to the 8th deciles, whereas households in the bottom and the top deciles experience a lower reduction in their disposable incomes. This finding squares well with the observation that the incidence of layoffs and temporary unemployment in 2020 has been atypical and more concentrated in middle-income groups. Households with the household head in the youngest age group suffered the most. Overall, the Gini coefficient increased, but very little (from 0.277 to 0.280). The risk of poverty rate (share of households below 60 per cent of median income), calculated with a pre-crisis poverty line, increased from 13.1 to 13.8 per cent. In the short run, therefore, the crisis was fairly well contained by the welfare state.

3.4. Council views

The government has introduced relevant measures that will increase employment in the long run. These include the removal of the early retirement scheme and further measures related to active labour market policies and the extensions of the school-leaving age. The Ministry of Finance has evaluated their employment impacts in a transparent and appropriate way.

However, the evaluation of the employment consequences of government policies should be comprehensive, and it should also include such policies that lead to negative employment effects. Certain earlier policy changes, such

[11] Hard to model on the basis of the existing data which underpin the model.

as increases in benefit amounts, are likely to have negative employment effects.

Therefore, significant further policy measures will be needed to reach the government's employment goals. In addition, some of the policy changes require additional public expenditure, which limits their potential to improve the fiscal situation.

While the expansion of unemployment benefit coverage and levels has been reasonable during the crisis, when moral hazard concerns are not a priority, it should be understood that such measures are meant to be temporary. In the longer run, the design of the unemployment insurance system requires a comprehensive approach, also including the appropriate treatment of the self-employed within the system.

One of the government goals has been to reduce economic inequality. Some of the benefit levels were raised to reach that goal. According to work commissioned by the Council, these measures were most likely successful in lowering inequality and the risk of poverty, even if one takes into account the potential negative employment consequences of greater benefit levels.

4. Fiscal policy

The Covid-19 crisis and the associated economic downturn increased the central government deficit in 2020 and will also do so in 2021. The crisis is also likely to have a considerable effect on public finances in the medium term.

In its programme, the government set the main targets of its economic policy to be reached by 2023: an employment rate of 75% and general government finances in balance. It was also stated that policy decisions would aim at decreasing inequality, narrowing income gaps, and putting Finland on a path towards achieving carbon neutrality by 2035. These targets were conditioned on a normal economic environment, in Finland and elsewhere.

During the coronavirus crisis the government revoked the central government expenditure ceiling framework for 2020 to be able to increase spending in order to support public health and the economy. The increased level of debt, increased structural deficit and lower employment have resulted in a situation in which all the government's fiscal targets, as set in October 2019 in the General Government Fiscal Plan for 2020-2023, have become more difficult to meet. However, the government has not withdrawn or revised these targets, but has published a new objective of stabilizing the growing debt-to-GDP ratio during the current decade.

The government programme set net borrowing targets for central and local government and pension and social security funds, with net borrowing at zero at the general government level in 2023. According to forecasts published at the end of 2020, this goal will not be reached without making new decisions with a substantial impact on public finances. The current forecast for the structural balance in 2023 is -2.1% of GDP, while the target set by the government in 2019 was -0.5% of GDP. The debt-to-GDP ratio is also forecast to be on an increasing trend at the end of the government term.

4.1. Discretionary fiscal measures and fiscal policy stance

In its programme, the government announced a plan to permanently increase central government expenditure by EUR 1.4 billion by 2023, compared to a no policy change scenario, and launched a future-oriented investment programme of temporary spending of up to EUR 3 billion in 2020-2022. Permanent spending increases were front-loaded and a large part of these started already in 2020. In 2020 the government also made a number of new spending decisions, both one-off and permanent. These new decisions will gradually increase permanent spending over the parliamentary term, reaching EUR 230 million by 2023. The temporary stimulus package and other one-off measures increased central government spending by EUR 3.8 billion in 2020. In 2021 new temporary discretionary measures will amount to EUR 1.3 billion, gradually decreasing thereafter.

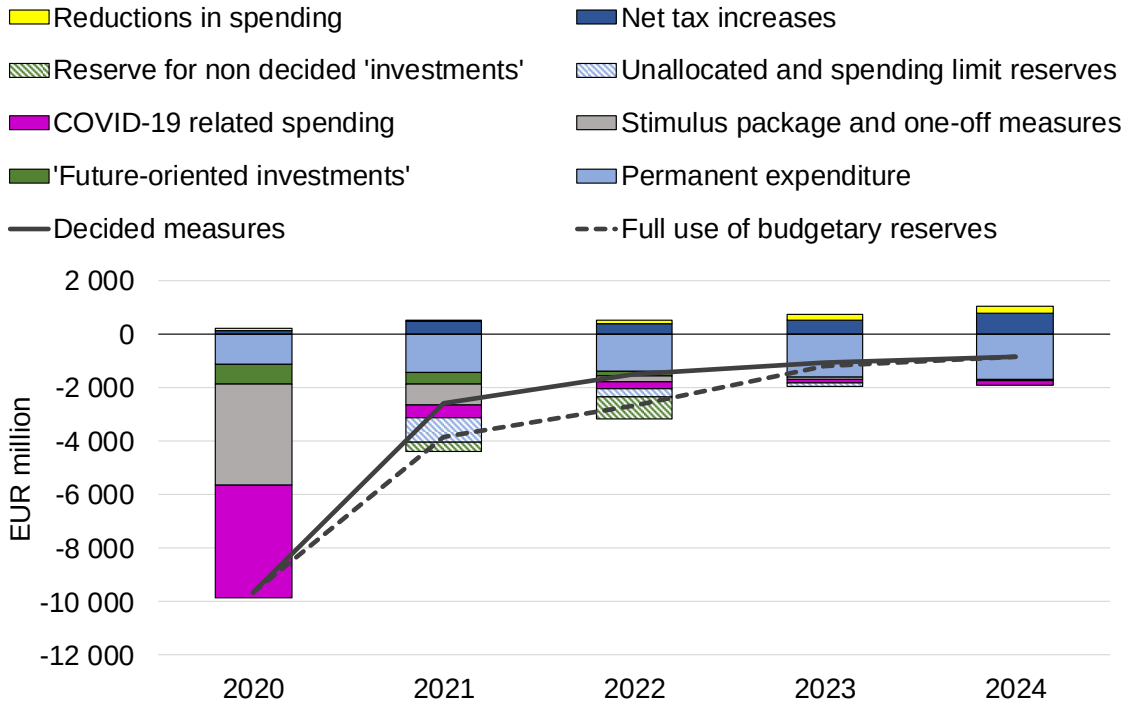
The government has announced that increases in expenditure will be financed for example by raising taxes, by higher tax revenues associated with an increase in employment, and by selling central government financial assets. The appropriations related to the future-oriented investment package were partly used to finance the economic stimulus package agreed in 2020. The government announced in October 2019 that tax revenue will increase gradually towards the end of the government term. The government has introduced tax changes with a permanent increase in tax revenue almost by EUR 800 million in 2023.[12] However, tax revenue will be reduced during the parliamentary term by a temporary increase in the depreciation allowances for new investments in 2020-2023. In the long run, the static effect of this temporary tax change is negligible. Due to the current market situation, sales of shares related to the financing of future investments, decided in 2019, have also been postponed and are now expected to take place in the period 2021—2022.

Figure 4.1.1 illustrates the impact of the discretionary measures on the central government budget. The expenditure increases in the figure are divided into permanent and temporary spending, following the convention used in the government programme. Spending increases directly related to the

[12] Half of the permanent increases in tax revenue come from tobacco and alcohol taxes. Increasing taxation of these goods is likely to reduce consumption of them, thus the increase in tax revenue cannot be regarded as permanent as in some other forms of taxation.

Covid-19 crisis are separated from other temporary spending increases. The reductions in spending are marked in yellow. The net tax increases exclude adjustments to the income tax schedule due to inflation and wage growth.[13][14]

Figure 4.1.1. The effect of discretionary measures on the central government budget balance (EUR million), as compared to a path with no policy changes.



Sources: General Government Fiscal Plans for 2020-2023 and 2021-2024, Government bills, budget review 2021; calculations by the Economic Policy Council.

The solid line in Figure 4.1.1 shows the net effect of the discretionary measures on the central government budget balance in comparison to a situation with no policy changes, i.e. the situation described in the technical General Government Fiscal Plan of April 2019. Discretionary measures have worsened the budget balance in 2020 by EUR 9.7 billion and by EUR 3.6 billion in 2021. The ending of the temporary stimulus package will improve the budget balance in 2021 and 2022. Compared to the no policy change path, this

[13] All numbers presented refer to static estimates. They represent the direct effects of tax changes on revenue in the absence of any behavioural effects. For example, they do not account for possible changes in labour supply induced by changes in income taxes.

[14] The temporary changes in employers' pension contribution rates are not taken into account in Figure 4.1.1. as they do not affect the central government budget balance.

bottom-up perspective shows that the new fiscal policy decisions will be expansionary throughout 2020-2024[15] . The figure also shows the reserves agreed inside the central government spending limits, marked with striped blue and green bars. Spending limit reserves are normally used fully through supplementary budgets. The unallocated funds inside the spending ceiling are exceptionally large for 2021, as they include EUR 500 million for possible fiscal measures related to the Covid-19 epidemic.

The government has also left a EUR 780 million reserve for 2022, to be spent on future-oriented investments and on other spending related to structural and cyclical policies. The reserves for undecided future-oriented investments, EUR 322 million, are included in the forecasts by the Ministry of Finance.

The darker blue bars in Figure 4.1.1 show the static effect on central government revenue of the discretionary tax policy measures decided by the new government since 2019. The comparison is again with a situation with no changes. In terms of the size of their effect, the three largest tax decisions are the increase in fuel tax, excise tax on tobacco and the continuation of the temporarily higher income tax rate levied on high-income individuals. In 2023, these tax decisions will increase revenue by almost EUR 700 million, while lower taxes on electricity and other minor items will reduce revenue by approximately EUR 250 million. The temporary increase in the depreciation allowances for new investments in 2020-2023 will cause an annual revenue loss of approximately EUR 200 million – the associated decrease in tax revenue turns into an increase from 2024 onwards.

According to the forecast of the Ministry of Finance, total central government expenditure will increase to EUR 70 billion in 2021, which is EUR 8 billion higher than in 2019. The respective revenues will decrease to EUR 58.2 billion, which is EUR 0.9 billion lower than in 2019. While the fall in revenue is due to decreased economic activity, expenditure is increased by e.g. increased public consumption and transfers, and Covid-19 related spending. In 2023 the central government deficit is forecast to be EUR 6.5 billion.

Local government expenditure started to increase in 2018, while revenues were expected to remain broadly constant. In 2020, central government transfers to local government increased by EUR 3.5 billion to EUR 17.9 billion.

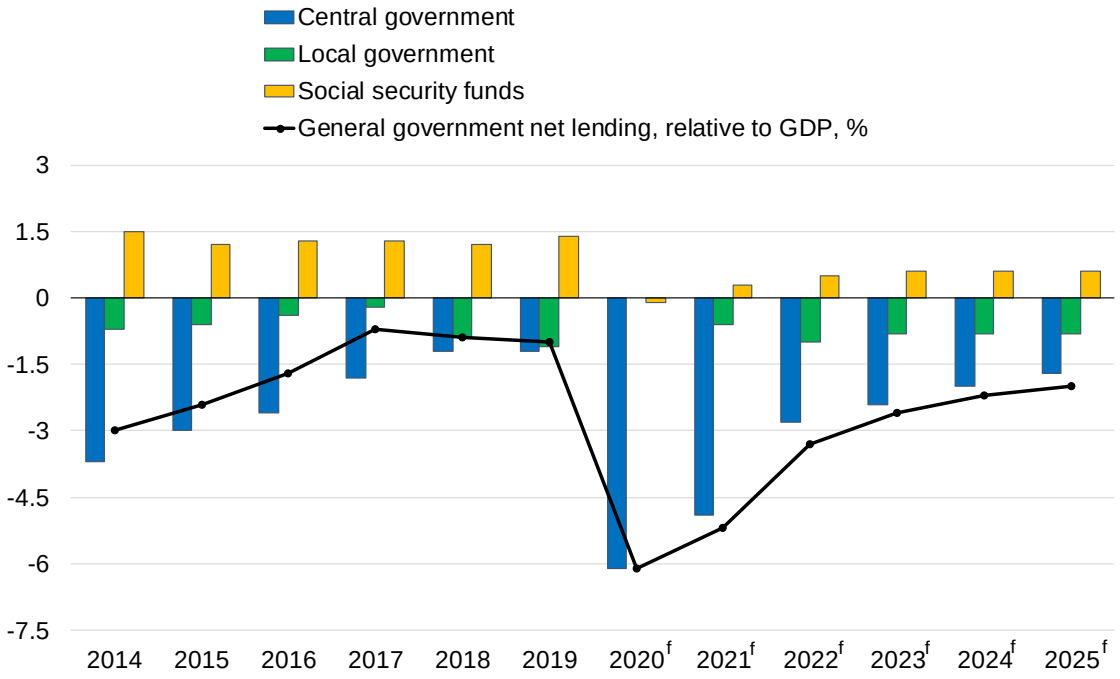
[15] This comparison describes the effect of policy changes on economic growth relative to a no policy change path. The change in the fiscal stance can also be measured with reference to the implied annual changes in net lending or the structural balance, see Figure 4.1.2.

Although transfers are expected to remain at around EUR 17 billion in future, the annual deficit of local government is expected to remain close to EUR 2 billion. The reasons for the high deficit are increasing age-related spending, while government decisions to strengthen education and social and healthcare services will also add to the tasks and obligations of municipalities. Increases in transfers will be made to compensate these additional costs.

Social security funds and pension funds are both defined as being a part of the Finnish general government. The funds have accumulated a remarkable amount of financial wealth, but growth in their interest income is forecast to slow in future years. The pension funds' surplus declined in 2020 due to decreased revenues from pension payments caused by a fall in the wage sum. Also, employers' contribution rates were cut by 2.6 percentage points for the second half of the 2020. To compensate for the cut, the contribution rate will be correspondingly increased in 2022. Increased unemployment and reduced unemployment fund contribution rates have increased the expenditure of other social security funds and reduced their income, turning social security funds into a deficit in 2020. The social security funds have shown a surplus of at least 1% of GDP since 1975. In future years, an improved employment situation is expected to improve the balances of both social security funds and pension funds.

The general government's deficit-to-GDP ratio started to deteriorate in 2018 due to the increasing deficit of local government and a decline in the pension funds' surplus. The improvement in the local government balance in 2020, due to transfers from central government, is offset by unfavourable developments in both central government and the pension funds. The general government deficit-to-GDP ratio is forecast to reach 6.1% in 2020 and 5.2% in 2021 (see Figure 4.1.2).

Figure 4.1.2. Net lending/borrowing by government sector

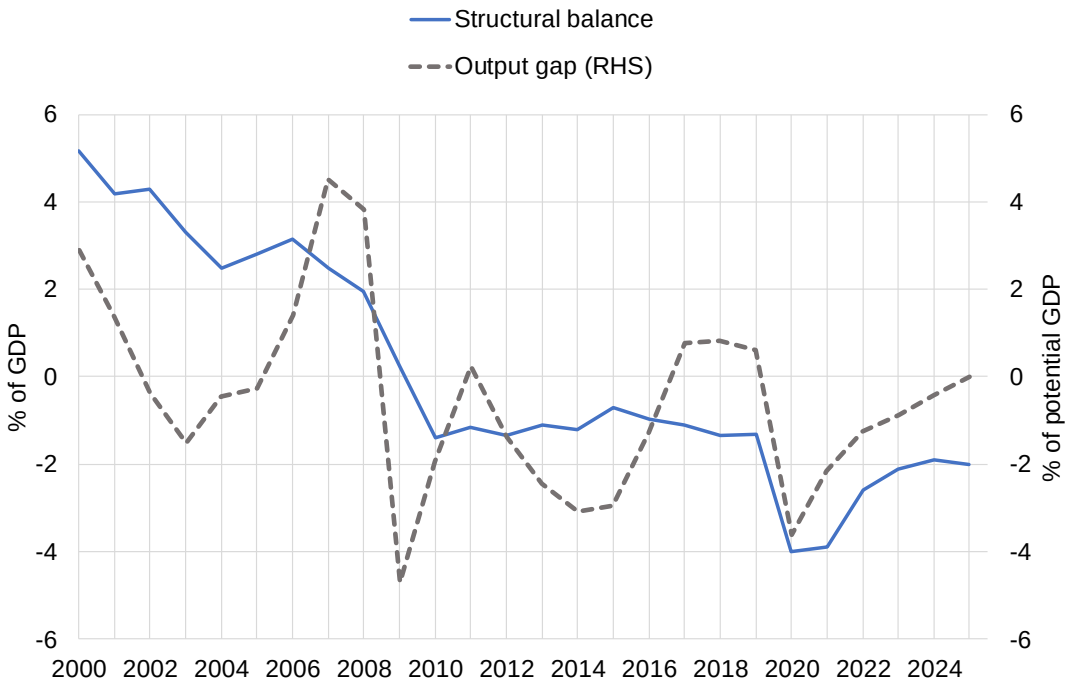


Sources: Statistics Finland and Ministry of Finance Winter Forecast 2020.

An indication of the effect of decisions on general government net borrowing can be derived by controlling for the business cycle and one-off revenues and expenditures when calculating net borrowing. Changes in the resulting structural balance are often used as an indicator of the fiscal stance: fiscal policy is expansive when the structural balance worsens and contractionary when it improves.

The blue line in Figure 4.1.3 shows the evolution of the general government structural balance. According to the winter forecast of the Ministry of Finance, the structural balance has worsened over past five years despite the positive output gap in 2017-2019. In 2020, the structural balance worsened by 2.7 percentage points. The forecasted changes in the structural balance indicate fiscal tightening in 2021-2024. Assessment of the structural balance is prone to changes both in statistics and in forecasts. In December 2019, the Ministry of Finance estimated that the output gap would be closed in 2017-2023. The change in the output gap estimate in a more positive direction in 2017-2019 has also lowered the level of the structural balance in these years but has not changed the overall picture of a long-term trend of fiscal easing, i.e. a worsening of the fiscal balance.

Figure 4.1.3. Structural balance has been trending downwards since 2002.



Sources: Ministry of Finance winter 2020 forecast and EPC calculations.

Measuring the fiscal stance by the change in the structural balance is not straightforward as there are several factors that need to be taken into account. The adjustment that controls for the business cycle is based on an estimate of the output gap[16], which is used to purge the annual net lending-to-GDP ratio of business cycle effects using the budget balance semi-elasticity estimated by the OECD (2014). The aim is to remove the cyclical components of revenue and expenditure items from the headline net lending figures. Unfortunately, due to revisions in both statistics and forecasts output gap estimates tend to be revised annually, which naturally also affects the estimates of the structural balance.

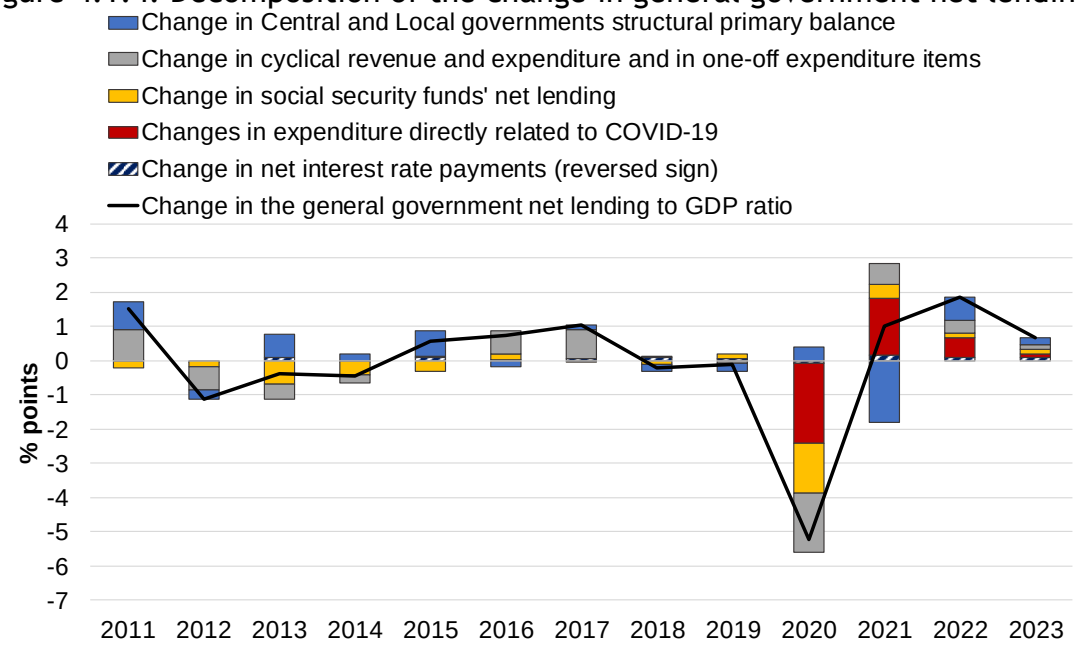
The business cycle adjustment tries to make a difference between automatic and discretionary expenditures. The methodology takes into account the increase in public expenditure due to spending that is caused by normal legislation, e.g. changes in social security expenditures. Part of the increase in public expenditure in 2020 was due the healthcare spending caused by the

[16] The output gap measures the deviation of actual GDP from its potential level. A negative output gap indicates that the economy is performing below its potential capacity. See Section 2.2.

Covid-19 pandemic, which should be disregarded from changes in discretionary spending.

Figure 4.1.4 decomposes changes in general government net borrowing into changes due to policy measures, cyclical effects, spending related to the Covid-19 epidemic and changes in social security and pension fund balances. The improvement in the general government financial position in 2013-2015 was due to discretionary fiscal measures (blue bar), which were offset by decreases in social security funds' surpluses and the worsening economic situation (grey bar). Economic growth improved the headline balance in 2016-2017. In 2018 and 2019, cyclical conditions were stable and the slight deterioration in net borrowing was due to government policy. The changes in expenditure directly related to Covid-19 played a large role in explaining the changes in the nominal balance in 2020 and 2021, as this is estimated to cause an increase of 2.3 percentage points in 2020 and a decrease by 1.7 percentage points in 2021. The improvements in the business cycle in 2021-2022 do not fully compensate the losses of 2020.

Figure 4.1.4. Decomposition of the change in general government net lending



Sources: Statistics Finland, Ministry of Finance and EPC calculations.

4.2. The government's objectives and fiscal rules

The economic policy of the current government aims at increasing wellbeing and prosperity. The key economic policy objectives for the government term are listed as:

- To raise the employment rate to 75% by the end of 2023 and the number of people in employment by a minimum of 60,000.
- To balance Finland's general government finances in 2023, given normal global economic circumstances.
- Government decisions to decrease inequality and narrow income gaps.[17]
- Government decisions to put Finland on a path towards achieving carbon neutrality by 2035.

The government programme seems to suggest that the economic objectives are structural in nature. This makes the aim of balancing the general government finances appear to be a target for the structural balance, albeit relative to the world economy instead of the more usual domestic business cycle conditions.

Despite the adverse economic developments in 2020, the government has not withdrawn its economic objectives. Obviously, the global economy was not in a normal state in 2020 and will not be so in 2021, but according to current forecasts both the global and Finnish economies will have reached normal growth rates in 2023. As discussed in Chapter 2, the current economic downturn will cause a level shift downwards from the growth path experienced before the crisis, making it difficult to reach the employment rate target of 75 % within the indented timeline. Thus the government has focused on structural reforms designed to increase employment by 60,000 persons. While the goal of an increase of 60,000 persons in employment was still mentioned in the budget proposal, the government has announced that it will aim to reach an increase in employment of 80,000 persons by the end of the decade.

While the objectives set in the government programme appear precise, the reference to the normal state of the global economy makes this target hard to

[17] The income gap is defined as the gap in income between different income groups, e.g. between the top 20% of income earners and the bottom 20%.

define, over and above the usual difficulties of data revisions and other technical issues. Despite these concerns, the message of the economic objectives is rather clear – the government is aiming for a balanced budget. The government has announced that it commits to change its policy if it risks missing its targets. Attainment of the fiscal and employment targets is also constrained by the statement that policy aims at decreasing inequality, narrowing income gaps, and putting Finland on a path towards achieving carbon neutrality by 2035.

Finland's fiscal policy rules are adopted from the rules of the Stability and Growth Pact. Roughly speaking, these EU-rules aim to ensure that net borrowing is no greater than 3 % of GDP and that the debt-to-GDP ratio remains below 60 %. The rules are technical in nature and only give guidance once problems begin to escalate – e.g. if the debt-to-GDP ratio exceeds the 60 % threshold, it should be put a downward path to reduce the excess debt by 1/20 annually. On 20 March 2020, the European Commission published a communication in which the general escape clause of the Stability and Growth Pact was activated based on the severe economic downturn caused by the coronavirus outbreak. As the Member States supported the activation of the general escape clause, Member States may be permitted to depart from the adjustment path towards the medium-term budgetary objective, provided that this does not endanger fiscal sustainability in the medium term. While the domestic fiscal rules are not valid for 2020 due to the escape clause, it is worth discussing the implications of fiscal rules after the crisis is over.

The debt-to-GDP ratio almost reached 70% in 2020 and is expected to grow further. In the near future public finances will be burdened by increasing age-related costs. While there is agreement that the Finnish public sector has a considerable long-run sustainability problem, there is no consensus on what fiscal policy actions are required to tackle it. Addressing this lack of consensus would help the government set short- and medium-term targets in a way that would support the need for increased age-related expenditures in the future. A wide consensus is needed to help avoiding the use of any fiscal space created by consolidation for politically motivated short-term spending.

The government decree on the General Government Fiscal Plan requires the government to set and update annual target paths for the main public finance indicators, e.g. the general government debt-to-GDP and deficit-to-GDP ratios. In 2020 these targets were not set, which is quite understandable. The target path should be in line with a medium-term budgetary objective (MTO) for the

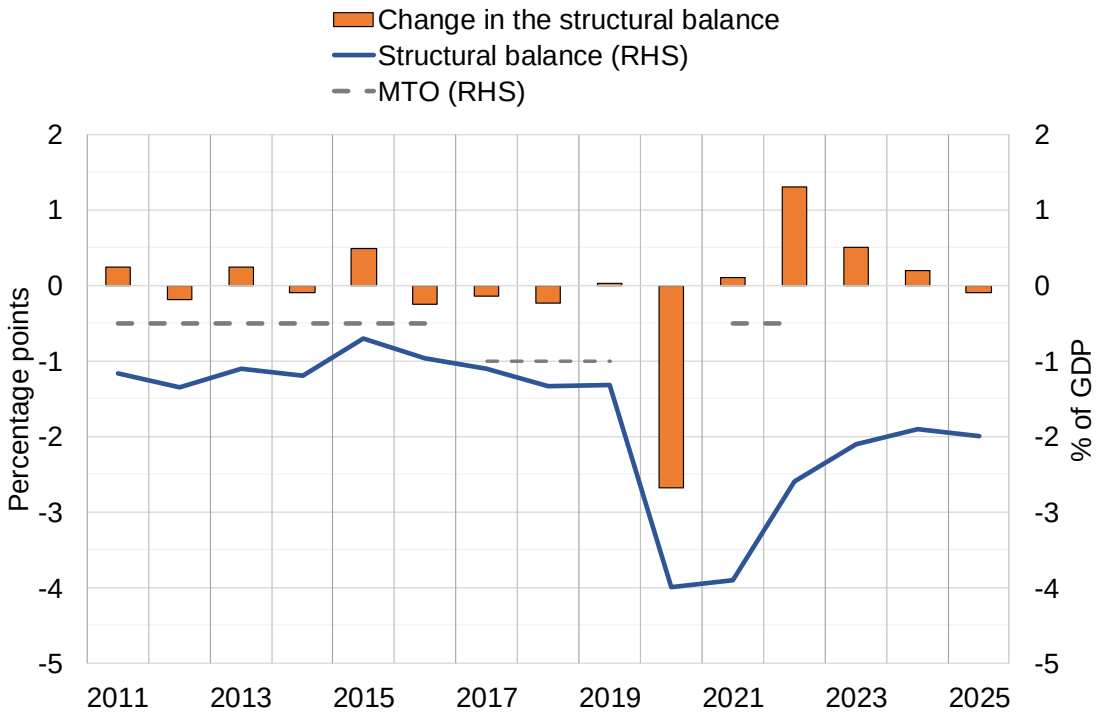
structural balance, which the government set at -0.5% of GDP in 2019. The required speed of fiscal adjustment towards the MTO depends inter alia on the business cycle and on the debt-to-GDP ratio. While 2020 is considered to be an exceptional year with when rules set previously do not apply, ideas should already be formulated regarding the required adjustment towards the MTO in 2022 and onwards. In its previous report, the EPC commented that the MTO target should be set at a level tighter than -0.5% of GDP to support fiscal sustainability.

The government decree on the General Government Fiscal Plan also requires the government to set balance targets, relative to GDP, for all subsectors of general government that are in line with the MTO target set. These targets were set in 2019 to yield a balance in the general government level. The government has neither revised nor restated these targets in 2020 as it is not sensible to set multiannual targets for general government finances until there is a better understanding of the economic fundamentals.

Recent estimates by the Ministry of Finance show that the MTO was almost reached in 2015, when the structural balance was -0.7% of GDP (see Figure 4.2.1). After 2015, the structural balance has deteriorated, mostly due to reductions in taxes that were implemented in 2016-2019. As Finland had introduced major structural reforms to pensions and the competitiveness pact, a temporary deviation from the MTO was granted by the Council of the European Union in the spring of 2017 based on Regulation (EC) 1466/97. Flexibility was granted for a period of three years. In total it reduced the MTO target by 0.5 percentage points, i.e. the structural balance was allowed to reach a maximum of -1.0% of GDP in 2017-2019. In 2020 deviations from the MTO for the structural balance are allowed, as discussed above.

According to the latest estimates, the structural was -1.1% of GDP in 2017 and -1.3% in 2019. In 2020 the structural balance worsened to -4% of GDP. Without new measures or favourable changes in either the budget balance or estimates of the output gap, Finland will deviate from the MTO by 2.1 percentage points in 2022.

Figure 4.2.1. General government structural balance deviates from its target level of -0.5% of GDP.



Source: Ministry of Finance Winter Forecast 2020.

Achievement of the MTO is assessed by the European Commission from an ex post perspective. The Commission considers the structural balance to be in line with the MTO if it is within ¼ pp of GDP of its value. That convention has been applied over time and aims to account for the inevitable uncertainty in estimating the structural balance. If the Member State is not at its MTO in one of the years under consideration, it must nonetheless be on an appropriate adjustment path towards it. According to EU rules and convention, Finland and other eurozone Member States should pursue an annual improvement in their structural balance of 0.5% of GDP as a benchmark. If the debt-to-GDP ratio exceeds 60%, a faster adjustment path, i.e. above 0.5% of GDP, is expected. All Member States should undertake a greater adjustment in good economic times, while the effort may be more limited in bad economic times. According to the documents of the European Commission[18] required fiscal adjustment towards the MTO would be 0.5 percentage points in 2021 and 2022 and larger than 0.5 percentage points thereafter. These requirements are however uncertain. The general escape clause of the Stability and Growth

[18] For a detailed discussion on the Stability and Growth Pact, see European Commission, (2019).

Pact may be extended also for 2021 and the future requirements could be updated after the general escape clause is deactivated.

The forecast path of the structural balance for 2021-2023 is roughly in line with that required by the EU rules. However, to meet the targets set by the government in 2019, i.e. the set of targets that lead to reaching the MTO by 2023, a vast amount of austerity measures should be undertaken.

It should be emphasised that the Stability and Growth Pact does not preclude increasing the level of permanent expenditure. The purpose of the rules is to ensure that increases are achieved in a fiscally sustainable way that does not lead to sudden jumps in the deficit. The presence of rules is often motivated by the need to avoid deficit bias, see box 4.1.

Box 4.1. Deficit bias, expenditure ceilings and fiscal rules

In the economic literature the term deficit bias is used to refer to the tendency of governments to allow deficit and public debt levels to increase. A main contributing factor to the deficit bias is the common pool problem familiar to economic theory, see e.g. Von Hagen and Harden (1995), Velasco (2000) and Krogstrup and Wyplosz (2009). The common pool problem arises when there are several policymakers involved in setting the budget. Public expenditure is financed with tax revenues, a budget deficit or by selling government-owned assets. Tax revenues and assets represent a common resource and as the budget deficit represents claims on future tax revenues, the budget deficit can be considered a common as well. The common pool means that the cost of any measure presented by elected politicians that benefits voters will be shared by all taxpayers through a higher general future tax burden. As a result, there is a tendency to promote policies that increase public expenditure, while measures that would reduce spending are hard to implement. A deficit bias is the natural result. In Finnish central government budget negotiations, representatives of different ministries negotiate how to use public resources. All mainly concerned about the resources of their own ministry, and are not directly concerned about financing the common budget.

Another factor contributing to the deficit bias could be party-political calculations on the part of the government, see e.g. Alesina & Tabellini (1990). If a change in government seems probable, it could be advantageous for the governing party to increase the deficit prior to elections. This would leave the incoming government to bear the costs of its predecessor's irresponsible policies. The same phenomenon can also take place at the local level before mergers of municipalities.

Because the political process has a tendency towards the deficit bias, possibly producing excessive growth in public expenditure, governments have set budgetary and fiscal rules to keep growth in expenditure within the limits set by the available resources. The Finnish practice of budgetary ceilings is by its nature a political agreement, decided in the first budget negotiations of the government together with General Government Fiscal plan for the following four years. The overall spending framework for central government expenditure is set in advance for the entire electoral period of four years. The decision includes also spending limits for each administrative branch, but these can be changed according to changes in policies. Although the ceilings framework is often described as rather non-transparent, partly due to forementioned changes, they have been well observed since being introduced in the early 1990s, and their removal in 2020 was exceptional. In

the 2000s the spending limits effectively restricted growth in central government expenditure. While the spending limits are set for the central government finances, general government finances are also subject to the EU's fiscal rules.

A deficit bias can also arise for purely economic reasons in the Economic and Monetary Union, when national fiscal policies spill over into other countries. While there is no common pool problem, there are potential negative externalities to government debt levels for the common interest and exchange rates of the EMU countries. To avoid this, the preventive arm of the Stability and Growth Pact contains an expenditure benchmark, setting a threshold for expenditure growth linked to the potential growth rate of economy.

One often-cited factor contributing to the deficit bias is the electoral cycle. Impending elections could incentivize political decision-makers to increase expenditure or to cut taxes. Such deficit-financed policy changes could give a short-term boost in elections if the electorate cannot understand the costs accruing later as a result of the increased government debt. A similar problem may arise if a government formed by parties seldom in power fears that it will lose the next election and implements deficit-financed permanent spending or tax measures that would not be implemented by ensuing governments. Evidence of the electoral cycle has been seen at the local governance level, where fiscal rules do not apply. For a discussion see e.g. Bonfatti & Forni (2017).

According to empirical studies, the common pool problem often seems to cause the deficit bias, while there is less empirical support for the view that uncertainty of re-election causes deficits, see e.g. Krogstrup and Wyplosz (2009). Numerical fiscal rules and spending limits have been argued to reduce the deficit bias, see e.g. Kopits (2001). According to Heinemann et al (2018) find a statistically significant and constraining impact of fiscal rules on fiscal aggregates at the national level, especially on deficits.

4.3. Central government spending limits and budget decisions

Central government on-budget spending, i.e. spending by ministries, government institutions and agencies, is partly constrained by spending limits.[19] The spending limits cover about 80% of budgetary items, and do not apply to expenditures that depend on cyclical conditions, interest on central government debt, financial investment expenditure, and expenditures related to transmitted payments and external funding contributions. Changes in the criteria for cyclical expenditures are included in the spending limits, e.g. unemployment benefits, housing allowances and basic social assistance. Excluded from the ceiling is the compensation paid to municipalities for tax policy changes that affect their revenue, e.g. changes in the bases for labour or income taxes.

The government updated the rules on the spending limit framework for the new government term in 2019. While the main set of rules remained unaltered, two additional items of flexibility were added to the spending limit: 1) the option to increase central government spending by EUR 500 million in two subsequent years if the economic situation is exceptional, and 2) the option to use any remainder on one-off expenditure items in the following year, assuming that the spending limits have not been completely exhausted by supplementary budgets.

The severe downturn in 2020 required the flexibility clause to be activated. As a result, the spending limits for 2021 were increased by EUR 500 million and same increase would have been available for 2020. Parliament approved emergency legislation on 18 March 2020 and on 20 March 2020 in the proposal for the first budget amendment the government announced that, given the circumstances, the budget ceiling framework would not limit central government expenditures in 2020. The motivation was the growing need for one-off spending related to Covid-19 and the economic downturn.

The actual central government budget proposal for 2020 was in deficit by EUR 2.2 billion, with decided expenditure of EUR 57.7 billion. During the year the government made seven budget amendments, and the following gives a rough overview of their contents, see also Table 4.3.1. In the first budget

[19] Central government spending that is not included in the budget consists of spending by universities and Yle (the Finnish public broadcasting company), spending by limited liability companies controlled by central government and operating outside of financial markets, and spending by funds owned by central government.

amendment the government announced that the spending limits would not apply for 2020 and proposed an increase in expenditure of EUR 400 million. This increase was increased in parliament to EUR 1.1 billion. The increase in expenditure consisted mainly of business subsidies. The second budget amendment increased central government expenditure by EUR 3.6 billion, EUR 2.2 billion of which was related to healthcare and social security, EUR 750 million to business subsidies and EUR 550 million to support to municipalities. The government postponed selling financial assets due to the fall in stock markets and revised its tax revenue forecast. The third budget amendment increased expenditure by EUR 880 million, including EUR 700 million for strengthening Finnair's financial position and subsidies to restaurants of EUR 171 million. While the first three budget amendments were motivated by subsidizing the business sector and people, the fourth budget amendment increased expenditure by EUR 4 billion and included a recovery package. The largest single items of the recovery package were EUR 1 billion in support for municipalities, EUR 800 million for unemployment benefits, EUR 300 million for business subsidies, and EUR 400 billion of capital injections in state-owned firms. The package consisted of a large number of expenditure items, many of them intended to be used in 2020 or in 2021. The fifth budget amendment included a positive change in revenue forecasts and the government proposed a decrease in subsidies to municipalities of EUR 429 million and some small increases in some spending items. Parliament increased the cut in the above subsidies by EUR 4 million. The sixth budget amendment increased appropriations for Covid-19 testing by EUR 200 million. The seventh budget amendment increased central government expenditure by EUR 1.5 billion, of which subsidies to municipalities and municipal co-operations totalled EUR 950 million. While unemployment subsidies were forecast to be EUR 650 million less than was expected in the previous budget amendments, business subsidies were increased by EUR 710 million through different channels.

Table 4.3.1. Central government expenditure and revenue estimates for 2020

Budgets approved by the parliament, EUR million			
	Revenue	**Expenditure**	**Balance**
Actual budget for 2020	55 493	57 691	-2 198
1st budget amendment	+1	+1 084	-1 083
2nd budget amendment	-5 759	+3 630	-9 390
3rd budget amendment	0	+880	-880
4th budget amendment	-1 315	+4 006	-5 321
5th budget amendment	+1 021	-238	+1 255
6th budget amendment	0	+200	-200
7th budget amendment	-341	+1 495	-1 836
	49 100	68 749	-19 650

Source: Ministry of Finance.

Although the spending limits were abolished, the government's proposal for the seventh budget amendment reports the amount of expenditure items that would be included inside the ceilings to be EUR 55.1 billion, EUR 7.3 billion more than in the actual budget proposal. The spending items outside the spending limits were increased by EUR 3.4 billion to EUR 13.6 billion. Also, it seems that decisions made in 2020 will increase spending in 2021 by EUR 1 billion.

The government set the spending limits for 2020-2023 on 7 October 2019. The spending limits decision for 2021 and 2022 included an exceptionally large reserve for future-oriented investments of EUR 840 million for 2021 and EUR 850 million for 2022. The spending limits are set at the price level of the first year of the spending limits. As usual, the limits for 2021-2023 were updated on 16 April 2020 in the general government fiscal plan for 2021-2024. Usually the update includes a correction to the price level and a possible structural correction due to e.g. changes in the timing of some projects. In the April 2020 update the correction to the price level was EUR 558 million and was due to e.g. increases in the cost level of municipalities. This correction in the price level affected all years of the spending limits. The structural changes amounted to EUR 17 million. In the budget proposal for 2021 the government updated the spending limits, with structural changes of EUR 962 million and price adjustments of EUR 110 million. The large structural adjustment for 2021 included a EUR 500 million for the exceptional situation mechanism and EUR 500 million reserve for one-off spending related to the Covid-19 crisis. The spending inside the spending limits for 2021 was proposed to be EUR 51.2 billion. The higher spending limits were arranged by using some of the

EUR 372 million reserve for future-oriented investments for other purposes and by bringing forward spending on future-oriented investments in 2022 by EUR 49.3 million. The ceiling includes an annual supplementary budget provision of EUR 300 million in 2021-2022 and EUR 100 million in 2023.

In the budget bill for 2021, the government proposes expenditure outside the spending limits of EUR 13.5 billion, which is EUR 2.2 billion more than what was included in the general government fiscal plan for 2021-2024. The increase includes an expected EUR 1.7 billion for health security spending arising from the coronavirus situation. Expenditure outside the spending limit is estimated to be around EUR 11.7 billion in 2022-2024.

The government decided its spending limits rule in 2019 and published it as an annex to the government programme. The spending limits rule lists the expenditure items that are not included inside the spending limits as:

- Cyclical expenditure i.e. unemployment security expenditure, social assistance expenditure, wage guarantee and housing allowance. Unemployment security expenditure will also be used to finance the pay subsidy. However, the expenditure effects generated by changes to the criteria for these items and by other discretionary decisions affecting their level will be included in the spending limits.
- Interest expenditure on central government debt.
- Compensation to other tax recipients for changes in taxation (including social security contributions) decided by central government.
- Expenditure corresponding to technically transmitted payments and external (including EU) funding contributions.
- Expenditure corresponding to the return on profits from gambling activities.
- Financial investments.
- Appropriations for VAT expenditure.
- Funding for the Finnish Broadcasting Company

This list does not include spending on healthcare, making the decision to define the EUR 1.6 billion of Covid-19-related expenditure as being outside the ceilings a bit problematic. The purpose of the spending limits in central gov-

ernment finances is to limit the total amount of expenditure to be met by taxpayers. The Finnish spending limit framework has been used in different contexts – e.g. in relation to the EU's fiscal policy coordination procedure –as an example of a well-functioning fiscal policy rule. The credibility of the rules is one of the key issues for fiscal policy. Keeping growth in public expenditure under control reduces concerns over sudden adjustments in fiscal policy. Such concerns could hamper the decision-making process of economic agents. While there are good reasons to use resources on healthcare in the current situation, placing this item outside the spending limits means that there was no need to displace any other spending items. Finland's spending limits are by their nature a political agreement and there is a good chance that exceptional political circumstances will also materialize in future and that the path that has now been opened for an increase in the tax burden will be utilised.

4.4. Council views

The structural deficit has been deteriorating for many years. The fiscal stimulus implemented in response to the Covid-19 crisis has naturally made the situation worse, and the need to make plans to reverse the trend in the future is now greater.

Since the economy will still suffer from the corona crisis in 2021, the government's fiscal policy may still be adequate for 2021.

A more problematic question is the optimal speed of fiscal adjustment after the crisis has passed. A steep fiscal tightening very rapidly, while beneficial for the long-run sustainability, would jeopardize growth in the shorter run.

At the time of writing, it appears possible that the economy will return to some degree of normality in 2022. If it does then fiscal policy should also be normalised. In particular, it is imperative to set a plan and timetable for the introduction of credible policy measures to achieve fiscal consolidation and sustainability.

The communication of the government's fiscal policy targets could have been clearer in 2020. When the immediate crisis has been passed, the medium run fiscal policy targets, especially the planned consolidation for the rest of the cabinet term, should be communicated in a transparent manner.

The Council also notes that local governments have run deficits for years, and the trend is likely to continue. This requires urgent policy attention.

5. Fiscal sustainability and fiscal risks

Fiscal sustainability is broadly defined as the ability of a government to maintain its current spending, taxation and other policies without threatening insolvency. In countries facing an acute debt crisis, insolvency, or an inability to borrow funds to cover a budget deficit, lack of fiscal sustainability is a very immediate problem. Although the debt-to GDP ratio has risen rapidly, this is currently not the case for Finland, as the government is able to borrow at very low interest rates. For Finland the problem is fiscal sustainability in the longer term.

A key factor in determining longer-term fiscal sustainability is the projected evolution of the debt-to-GDP ratio under current policies and assumed demographic developments, the use of publicly funded transfers and services, the employment rate, and so on. These projections are naturally subject to uncertainty, but they point to a significant long-term sustainability problem for Finland. Uncertainty as such is not a reason not to act; prudent policies mean that government finances are sustainable even when negative risks are realised.

According to the Ministry of Finance's assessment, a permanent adjustment of the public budget in the order of 3.5% of GDP is required to balance expected future expenditures with expected future revenues. The government plans to make up for the shortfall by permanent tax increases and by increasing employment. In the beginning of its term, the government increased permanent spending by EUR 1.3 billion. If the employment target of 60,000 more persons in employment by 2023 is met, the government decisions will not have improved fiscal sustainability, but merely prevented it from deteriorating further. Economic developments in 2020 have worsened the structural imbalances of general government. In order to turn the debt-to-GDP downwards, the government has released a roadmap for sustainable public finances.

In this chapter we discuss several topics related to fiscal sustainability: the general government balance sheet and short-term risks, medium- and long-term fiscal sustainability, and details of the sustainability roadmap published by the government in autumn 2020.

5.1. General government assets and liabilities

Fiscal sustainability is determined by the accumulation of assets and liabilities in the past, and assumptions about how the assets and liabilities will evolve in the future. Government decisions that have an immediate effect on its assets and liabilities also influence future expenditure and revenue flows.

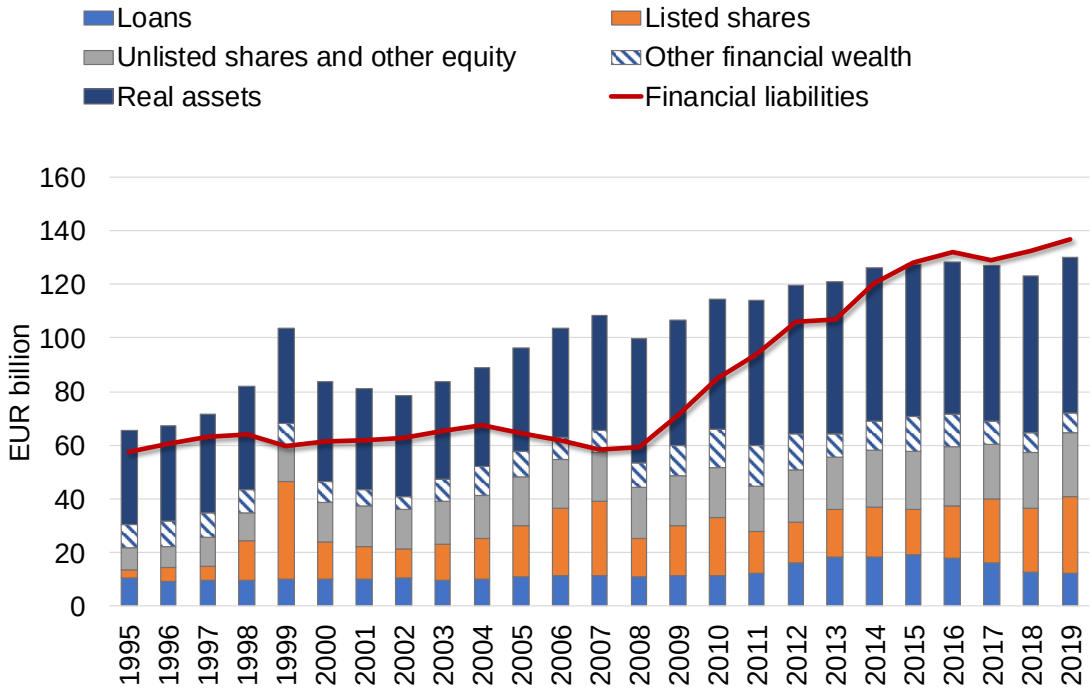
In Finland, the value of general government financial assets exceeds the market value of government financial liabilities, meaning that the general government net debt position is negative. The total value of financial assets is approximately EUR 320 billion, while the total value of gross debt and liabilities is EUR 175 billion. Most of the financial assets are held by pension funds and have been accumulated to cover the funded part of accrued pensions. When the current value of pension liabilities and general government real assets are taken into account, the net worth of general government is severely negative.

The largest liability item of general government is pension liabilities. As these refer to pensions to be paid in the future, their current value is sensitive to assumptions made about the discount rate and their total value is estimated by the Finnish Centre for Pensions. The most recent estimates cover accrued pension rights at the end of 2017, amounting to EUR 714 billion. In total, general government liabilities are almost EUR 900 billion, of which approximately 80% are pension liabilities. General government net worth can further be defined as net liabilities plus real assets, which mostly consist of land, buildings and structures. Almost two thirds of these real assets are owned by local government and one third by central government. General government net worth is below -200% of GDP.

Figure 5.1.2 charts the evolution of the stock of central government financial and real assets and financial liabilities. In the 2010s, financial wealth has been stable at EUR 60-70 billion. The largest financial asset item is listed shares, which totalled almost EUR 24 billion in 2019. Shares in unlisted companies and other equity have remained in a range of EUR 13-15 billion over the last

15 years. The stock of loans owned by central government has been decreasing. Repayment of such loans has helped central government finances, especially in 2018. The figure also shows the deteriorating net financial position of the government sector from positive net wealth of EUR 7.2 billion in 2007 to negative net wealth of EUR -65 billion in 2019. The net wealth of central government turned negative in 2015.

Figure 5.1.2. Central government financial and real assets and financial liabilities.



Sources: Financial Accounts by Statistics Finland and EPC.

The value of the stock of shares owned by central government tends to vary annually as the market value of listed and unlisted companies varies. The government earns dividend income from these companies and may sell some or all of the stocks it owns. If a company is considered to be of strategic interest then the government typically wants full or at least partial control over decision-making. Such control can be exercised by holding sufficient voting power at the company's shareholder meeting. Selling assets reduces this voting power. However, private equity holders may see risks in government ownership in that company decisions are steered in directions that are not compatible with their best interests, which could then adversely affect the company's market price. Decisions on whether to buy or sell shares in listed or unlisted firms should therefore be based on an appropriate ownership strategy.

The current government has indicated that it will sell financial assets to finance its programme of increased temporary expenditure in 2021-2022. In terms of net wealth, the sale of assets is only neutral if the revenue from sales is used to finance investments in real assets. The so-called 'future-oriented investments' do not accumulate real assets in full, meaning that net wealth in the future will be even more negative. Any deficit must at least initially be financed through new debt or by selling assets, i.e. by a reduction of net wealth.

5.2. Fiscal risks

The government needs resources to provide public goods and promote economic growth in the longer term. Sound public finances are necessary in normal times to stabilise the economy and to help the economy recover from particularly difficult times. Changes that affect the public sector balance sheet can hinder the government's ability to fulfil these functions. With appropriate fiscal risk management, public finances can be made more robust. Fiscal risk management should also be considered when formulating fiscal rules. From the viewpoint of fiscal risks, the target for the debt-to-GDP ratio should be set such that the risks associated with central government expenditure and revenue can be faced without immediate problems in deficit financing. This was obviously the case in 2020.

Balance sheet risks arise because of events or changes in trends that affect assets or debt liabilities. They may also occur if the government takes on additional liabilities to finance private-sector entities, or if there are changes in the existing value of assets or liabilities. The main short and medium-term risks associated with revenue and expenditure flows are macro risks, i.e. risks of unexpected economic events, domestic or international. In 2020 the Finnish economy experienced a realisation of macro risk in the form of a global pandemic. The downturn of 2020 was forecast to decrease general government revenue by EUR 4.3 billion or by 3.4% from the previous year. In the same period total expenditure increased by EUR 7.7 billion, or by 6%. As a result, the debt-to-GDP ratio increased by almost 10 percentage points. Also current forecasts for 2021 contain considerable downward risks. These exceptional risks surrounding economic forecasts were well communicated in the Winter Forecast by the Ministry of Finance. The short-term outlook for general government finances are tied to the evolution of pandemic and to the availability of vaccines.

Despite its importance, the overall fiscal risk in Finnish public finances has not been measured. Such a measure would need to quantify the government's exposure to risk and the probability of the government making losses. It is important to quantify accurately the probability of the risk materialising, especially in connection with the risks associated with contingent liabilities.

In 2020 state guarantees have risen as part of the business subsidies provided through guarantees by Finnvera.[20] In the second quarter of 2020, central government guarantees totalled EUR 59.9 billion, almost 26% of forecast GDP. State guarantees are often used as a business subsidy as they are budget-neutral if the associated contingent risks are not taken into account. In the central government budget for 2021 the increased risks were noted and an appropriation to cover possible losses was included. It was decided that this appropriation would be outside the central government spending limits, i.e. the budgeting practice is not yet neutral between different ways of subsidising businesses. According to Finnvera (2020a and 2020b), expected and realised credit losses in 2020 increased to approximately EUR 600 million from EUR 9 million in previous year.

[20] Finnvera is a government-owned specialised financing company and is Finland's official export credit agency (ECA). Finnvera provides guarantees against political or commercial risks associated with the financing of exports. Political risks are risks that arise from the economic or political situation in a country where a Finnish export company has customers. Commercial risks pertain either to the buyer or to the buyer's bank. The risk involved in the contingent liabilities of Finnvera and the Housing Fund of Finland is discussed in Junttila and Raatikainen (2020).

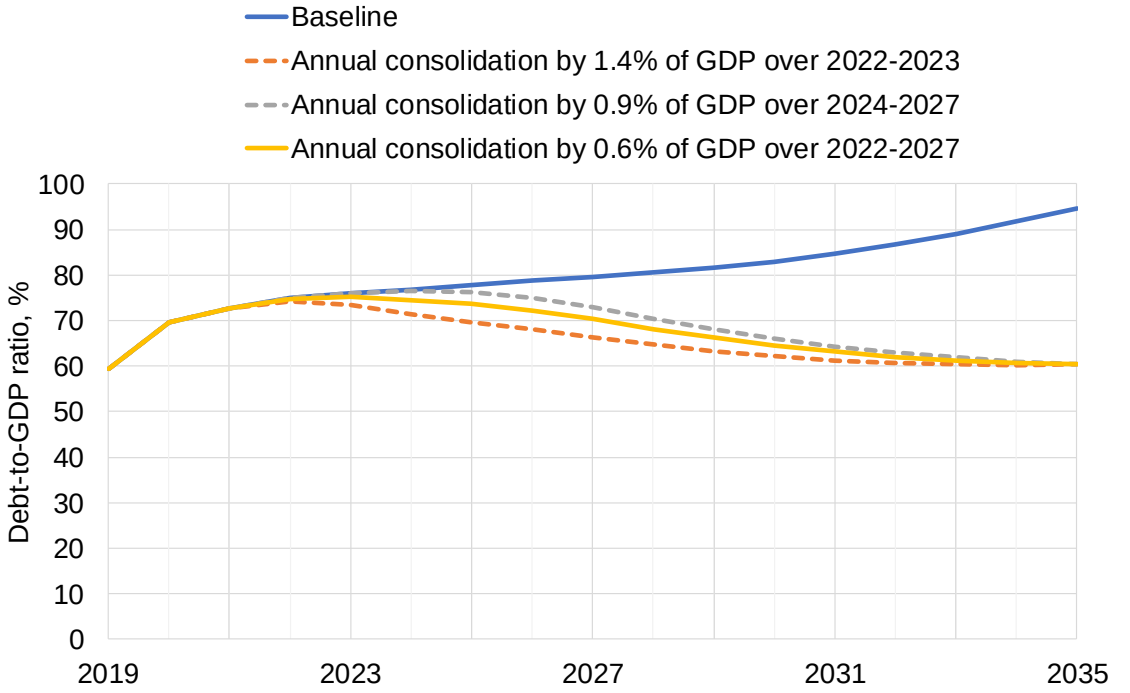
5.3. Medium- and long-term sustainability of public finances

In previous sections we discussed the sustainability of public finances in the short term. While the short-term fiscal risk indicators do not suggest any immediate need for consolidation, there is also a need to look at the sustainability of public finances over a longer period. Using the long-term projections of the sustainability calculations of the Ministry of Finance, we assess the sustainability of public finances over the period 2023-2035, i.e. over the following three parliamentary terms. Public finances can be considered as sustainable if there is no need for policy change over the defined period. In our analysis that translates into a required short-term consolidation that keeps the debt-to-GDP ratio on a path towards the 60% threshold level in 2035.

Figure 5.3.1 presents the results of our medium-term sustainability analysis. In the baseline projection, based on the long-term sustainability calculations by the Ministry of Finance, the debt-to-GDP ratio will reach over 90% by 2035.[21] In order to keep the debt-to-GDP ratio on a downward path and to reaching the 60% threshold over the next three parliament terms, public finances should be consolidated by 3% of GDP compared to the current forecasts during the present government term. This calculation also takes into account the effect of consolidation on GDP growth. Also, given the projected increase in age-related expenditures in the 2030s, the debt-to-GDP ratio will start to increase again after 2035. As a consolidation of this size would have adverse effects on growth, there are grounds to postpone the measures to future parliamentary terms. If the consolidation is done in 2024- 2027, the required amount of consolidation would increase to 3.5% of GDP. One possibility is to spread the consolidation over a longer horizon. A gradual annual consolidation of 0.55% of GDP over six years, resulting in total consolidation of 3.3 % of GDP, would keep the debt-to-GDP on a downward path. Also, 0.55% of GDP would translate into annual consolidation of EUR 1.4 billion or annual employment growth of over 50,000 persons.

[21]In the baseline calculations it is assumed that age-related expenditure increases in line with the population forecast, that interest expenditure on debt and revenue from financial wealth evolve according to the stock of debt and financial wealth, and that the GDP shares of other revenue and expenditure remain constant after 2024.

Figure 5.3.1. Putting the debt-to-GDP ratio on a downward path requires significant effort.



Sources: EPC calculations based on the sustainability assessment of the Ministry of Finance done in August 2020.

Although our medium-term analysis is based on the same prediction of increases in age-related expenditure as the long-term sustainability framework produced by the Ministry of Finance, the consolidation requirement is not fully comparable. The reason is that our medium-term analysis takes into account the dynamic effects of consolidation measures.[22] It should also be noted that the purpose of these calculations is to demonstrate the difficulty of bringing down the debt-to-GDP ratio without unforeseen favourable economic developments.

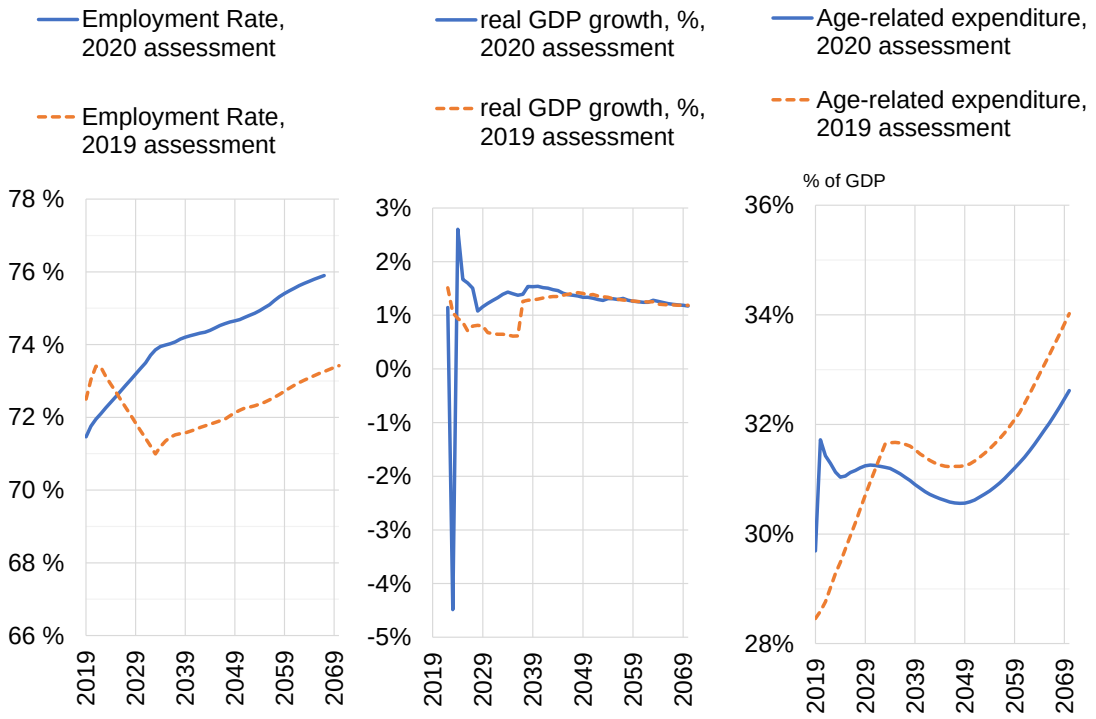
The long-term sustainability gap indicates the permanent adjustment in the primary budget balance (as a percentage of GDP) needed to ensure that the present value of future taxes is sufficient to cover the present value of future expenditures (plus the cost of servicing existing net debt). The sustainability gap estimate depends on projected population growth and various other factors, and so needs to be regularly updated.

[22] For a discussion on fiscal policy multipliers, see e.g. Seuri (2019) and Ahonen (2019).

In 2020, The Ministry of Finance revised the data and some of methods used in the calculation of the sustainability gap indicator S2. These revisions decrease the value of the S2 indicator by 1.5 percentage points, see Ministry of Finance (2020) for details. With new population forecasts and new assumptions on long-term labour market participation rates in different age-groups and the long-term unemployment rate, the long-term perspectives of the Finnish economy look a bit more promising than in the previous projections. As more employed people are assumed to share the burden of age-related costs, their GDP share is also revised downwards and, as a result, the value of the S2 indicator is also revised downwards. The latest main assumptions are compared to the previous assumptions, used in autumn 2019, in Figure 5.3.2. The assumed path of the employment rate is revised upwards from the 2030s onwards by 2.5 percentage points and is now close to that proposed by the Council in its 2018 report. The absence of the previously assumed decline in employment in the medium term increases economic growth and keeps the GDP share of age-related expenditure at a lower level than previously projected. According to the new assumptions, age-related expenditure will increase between the 2020s and 2060s by 0.6 percentage points.

As discussed above, the main reason for the revision in the S2 indicator was changes in the employment and growth predictions. This rather large change emphasises the uncertainty associated with the assumptions of the S2 indicator, but also the fact that the long-term sustainability of Finland's public finances rests largely on growth in employment and domestic value added.

Figure 5.3.2. Main revisions in the long-term assumptions.



Sources: Background material for the Ministry of Finance Autumn 2020 and 2019 forecasts.

The government estimated in autumn 2020 that the long term sustainability gap is approximately 3.5% of GDP. The long-term sustainability gap, or in European Commission phraseology the S2 indicator, has four elements: future growth in age-related spending, future costs of existing public debt, structural primary deficit in the base year of the calculation and future changes in property income. The breakdown of the sustainability gap estimate is in Table 5.3.1. The rightmost column of the table presents the breakdown presented in the autumn of 2019.

Table 5.3.1. Decomposition of the S2 sustainability indicator with previous estimates in parentheses.

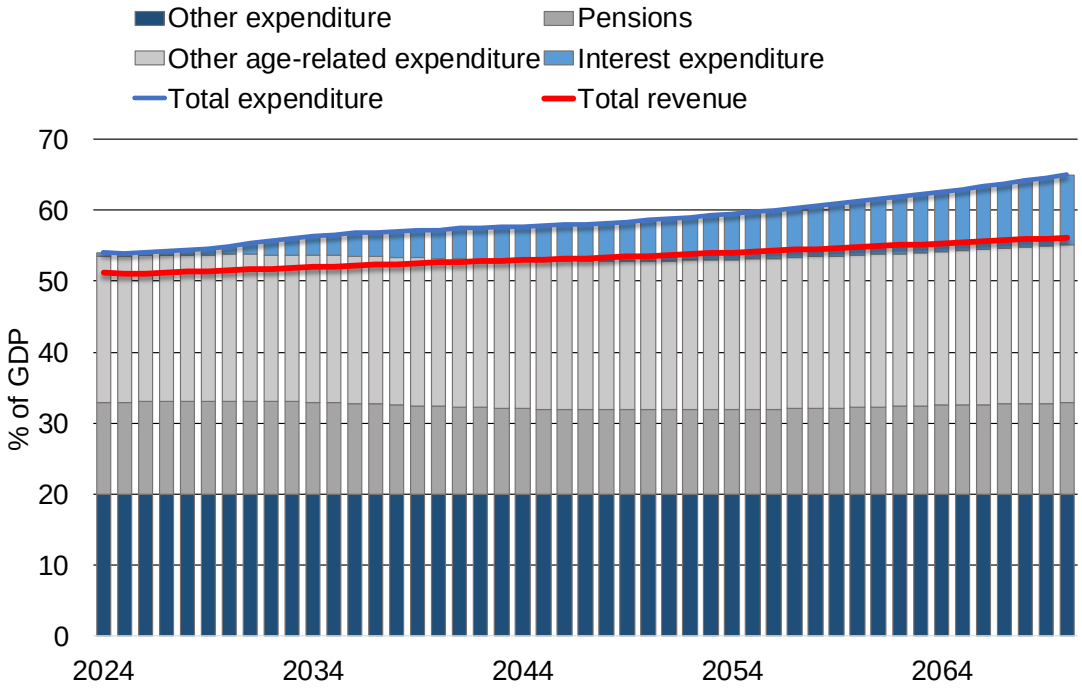
	2020	**2019**
Present value of interest expenditure on initial debt	0.5	(0.4)
Primary deficit in base year	2.2	(0.7)
Change in capital income	-0.2	(-0.1)
Changes in aged-related expenditure	1.1	(3.7)
S2 sustainability gap	**3.5**	(4.7)

Sources: Background material for the Ministry of Finance Autumn 2020 and 2019 forecasts.

In December 2020 the Bank of Finland estimated the S2 sustainability indicator to have a value of 5.5% of GDP with an increase from their previous estimate in 2019 of over one percentage point. The difference between the estimates of the Ministry of Finance and the Bank of Finland seem to result from differences in the long-term projections of economic growth and the employment rate. Although there is some uncertainty in the value of the S2 indicator, both estimates indicate a rather large long-term sustainability problem. Common to both these estimates is that the primary deficit in the base year of the calculation is the largest cause of the long-term sustainability gap underlining the sustainability problems in the medium term.

The main source of unsustainability, the deficit in the base year, comes directly from the latest forecast by the Ministry of Finance. We can divide expenditure in the base year into four parts: age-related expenditure, 31% of GDP in 2024; other expenditure, 23% of GDP; interest expenditure, 0.5% of GDP; and total revenue, 51.3% of GDP in 2024. Of these, age-related expenditure relative to GDP is expected to evolve during the calculation horizon, while the GDP shares of other expenditures stay fixed. Total revenue is projected to increase slightly through increases in capital income, while other income will remain fixed. When age-related expenditures start to increase in the 2030s and 2040s, the general government deficit will also increase and there will be a greater accumulation of debt and naturally an increase in interest expenditure. Given the current projections of general government finances being permanently in deficit, the debt-to-GDP ratio would increase to level that cannot be expected to materialize over time to a high level and interest rate expenditure would reach almost 10% of GDP by 2070. Naturally long-term assumptions about interest rates could turn out to be wrong. In the current long-term projection, the era of low interest rates is expected to continue till the 2030s. The current projection of these items is presented in Figure 5.3.3.

Figure 5.3.3. Long term projections of general government aggregate revenue and main expenditure items.



Source: Background material for the Ministry of Finance Autumn 2020 forecast.

Because of its long-term nature, the S2 sustainability indicator should not be taken as direct policy advice. In the sustainability framework, if general government finances were consolidated by the amount indicated by the S2 indicator over the current government term, public finances would be in surplus and the debt-to-GDP ratio would be on a downward path. Increasing expenditure would eventually decrease the surplus, but the debt-to-GDP ratio would stabilise at 10 %. Any smaller consolidation would eventually lead to an infinitely increasing debt-to-GDP ratio, and any larger consolidation would lead to an infinite accumulation of wealth. It is clear that the nature of these calculations is indicative.

These medium-term and long-term projections disregard all cyclical variation in the economy and can only be regarded as advice, but they help us to identify the main problems in the public finances. According to both the medium-term and long-term sustainability indicators, the main source of the unsustainability of Finnish public finances is the prevailing structural deficit and the accumulation of debt. To find solutions to this problem, the government launched an initiative to strengthen the sustainability of public finances. The initiative was launched in the beginning of April 2020 and its goal was to prepare a so-called roadmap to define the potential of different policy measures in reducing the long-term sustainability gap.

In the autumn, the government noted that it would seek to stabilize the debt-to-GDP ratio by the end of decade, to an as yet unspecified level. The required strengthening of public finances was estimated to be EUR 5 billion, but on an unknown horizon and via unspecified measures. The potential sources for strengthening the public finances were identified by the Ministry of Finance in June 2020, and they were re-evaluated in September 2020. The potentials identified were:

- Increasing employment and reducing unemployment, c. EUR 2 billion
- Strengthening the conditions for economic growth, c. EUR 1 billion
- Increasing the productivity of public administration, c. EUR 1 billion.
- Social and healthcare reform, c. EUR .5 billion

According to initial estimates in June , the total potential varied between EUR 1 and 5 billion, while the latest estimates sum up to more precise EUR 4.5 billion Completing the required strengthening of public finances with the above sources would require their potential to be used to the full, making it appear somewhat unrealistic. Specification of the measures was postponed till the central government spending limit negotiations of spring 2021. To support attainment of the EUR 5 billion strengthening of finances, a new employment target of increasing employment by 80,000 persons was introduced, as discussed in chapters 3 and 4.

Without more precise specification, it is quite hard to assess the feasibility of the potentials above. However, these could be discussed from the viewpoint of a few principles. The economy, both global, national and local, are always undergoing change. This change is caused by changes in people's preferences, changes in technology, new ideas and scientific discoveries, but also changes in population structures and many other things. The governance of a nation should also adapt to these changes. Thus improving the wellbeing of citizens, often by strengthening the conditions for economic growth, should always be on the agenda of a government. Based on this reasoning, it is quite hard to tell when a government has succeeded such that it could be considered to have strengthened public finances through higher economic growth. In other words, the government's revenue would increase due to economic growth while government expenditures would increase more slowly. In other words, that would mean stringent fiscal policy over the decade. The EPC already reprimanded the government in its previous report for a lack of fiscal stringency.

Strengthening public finances through increased productivity in public administration is beset with similar problems. While there obviously may be ways to increase productivity in this area, it could be considered to be a normal part of properly running any administration. It is quite hard to say when a change to more productive practices is complete or what should be considered as normal good governance. In previous years many of central government programmes to increase productivity have come down to slower growth in appropriations, i.e. fiscal stringency.

The potential of social and healthcare reform to strengthen public finances is identified as being EUR 0 - 1.5 billion. Possible sources of savings suggested in the proposed reform include introducing best practices and slowly increasing financing of the regions.[23] However, the regions may apply for additional funding if necessary. While a reduction in the number of organising bodies should lead to savings, the main motivation for social and healthcare reform has not been economic and mentioning it as a potential source of fiscal strengthening, possibly through fiscal stringency, may contradict other motivations of the reform. The employment targets and their potential fiscal effects are discussed in chapter 3.

Although the roadmap for strengthening the sustainability of public finances needs more specification, the Economic Policy Council welcomes such an initiative. As discussed above, many of the potentials recognised can be interpreted as fiscal stringency. It is hard to sustain such measures over a decade, especially as this period includes two elections. As in its previous report, the Council sees merit in an arrangement where such a medium-term plan would be discussed and decided in parliamentary negotiations, the decisions of which would serve as an anchor not only for the current but also for future governments.

[23] The financing of the regions is proposed to increase annually by 80% of the estimated increase in costs.

5.4. Council views

Finland has a significant long-run fiscal sustainability problem caused by the prevailing structural deficit, a declining share of the working-age population and an increasing share of old-age population. The assessment of long-run sustainability crucially hinges on projected employment level in the long-run, which highlights the significance of employment measures.

Fiscal space was reduced in 2020 and according to the long-run projections without policy changes, the debt-to-GDP ratio is projected to increase by more than 20 percentage points in the next 15 years.

The current debt-to-GDP ratio is at a moderate level when compared to other European countries. However, the Council expresses its concerns about the projected rapid increase in the debt ratio.

The crisis has demonstrated the value of fiscal space. This underscores the need to start preparing for the next possible crises immediately after the current crisis has ended.

The Council welcomes government's roadmap to strengthen the sustainability of public finances, but notes that it needs more specification. Many of the recognized potential elements require fiscal stringency, which is difficult to maintain over a decade, especially as this period includes two election terms.

In order to stabilise the debt level as set out in the roadmap, a budget adjustment must be in place at the end of the government term. The Council therefore sees merit in an arrangement where such a medium-term plan would be discussed and decided in parliamentary negotiations. The decision would serve as an anchor not only for the current but also future governments.

The stock of central government contingent liabilities is large in international comparison. These contingent liabilities increase the tail risk significantly. The associated costs should be taken into account when decisions are made.

6. Household indebtedness and public policy

Previous research has shown that household indebtedness has a crucial role in consumption dynamics over the business cycle.[24] By using debt, households are able to smooth consumption over their life cycle and finance their investments in e.g. housing or businesses. Household indebtedness has been increasing in Finland for many years. This may put them at risk of becoming insolvent in the event of a severe economic crisis. Even an increase in the risk of insolvency causes households to increase saving, which reduces economic activity. Insolvency causes huge economic stress for households and in some cases discourages participation in the labour market and business life.

The global financial crisis in 2007-2009 revealed shortcomings in market discipline and adverse real economic effects caused by the financial sector.[25] The liquidity, capital requirements and transparency of banks were inadequate. Regulating and supervising the soundness of individual financial institutions, alone was not enough to ensure financial stability. Also, the financial crisis showed that monetary policy, which targets price stability as its main objective, cannot adequately ensure financial (and economic) stability even when it is conducted effectively.[26] Therefore, the existing policy tools were not enough to ensure financial stability and new tools were urgently needed to

[24] For example, Le Blanc and Lydon (2020) analyse how household indebtedness affects the response to income and wealth shocks in Ireland when households hold a large amount of debt. They find that households entering a crisis with more debt were significantly more sensitive to changes in their income. Their findings suggest that the housing wealth effect and income shocks depressed household consumption during the financial crisis.

[25] These include, inter alia, large losses in GDP.

[26] An accommodative monetary policy stance increases lending. The ECB's monetary policy stance has been very loose in recent years e.g. targeted longer-term refinancing operations (TLTROs) provide banks longer-term funding in order to incentivise them to increase lending for non-financial corporations and households. Also, zero-interest rates have kept overall financial conditions favourable in the euro area.

address externalities associated with systemic risks.[27] This has gained importance in macroprudential policies, which pursue a reduction of systemic risks originating from excessive financial procyclicality and interconnectedness.

Factors that have been associated with financial crises are exceptionally rapid credit growth and indebtedness, asset price bubbles, and a rapid rise in financial institutions' short-term market-based funding.[28] Also, high leverage on the part of institutions and investors, their reliance on uninsured short-term funding and complex interconnectedness increase the risks to the financial system's stability. These increase the likelihood that a negative shock (e.g. a failure of a firm or bank) could lead to distress at other financial institutions through direct exposures, fire sales, contagion, or other negative externalities (Yilla and Liang 2020).[29]

Macroprudential policy refers to financial policy actions that aim to ensure the stability of the financial system as a whole, not just individual institutions or markets. The objective of macroprudential policy instruments is to reduce systemic risks (caused by procyclicality, interlinkages and common exposures of financial institutions), prevent financial crises, limit the impact of these on the financial system and macroeconomy, and strengthen the resilience of the financial system. In addition, macroprudential policies can reduce financial market volatility and influence economic activity by supporting the availability of credit and borrowing costs, helping to strengthen the transmission of funding, also during economic downturns.

In this chapter we discuss private debt, Finnish insolvency procedures, and the instruments and decision-making of macroprudential policies. As these policies restrict the behaviour of credit institutions, which in turn affects households' access to credit, it is important also to discuss their socioeconomic effects, e.g. effects on wealth distribution. We also discuss the Finnish insolvency procedure.

[27] Such externalities and market failures can come from financial frictions and market imperfections even when microprudential supervision and monetary policy are conducted effectively. On the other hand, weak conduct of microprudential and monetary policy can lead to procyclicality and systemic risks. More discussion can be found in Claessens (2015).

[28] E.g. Schularick and Taylor (2012) show that credit booms often lead to financial crises.

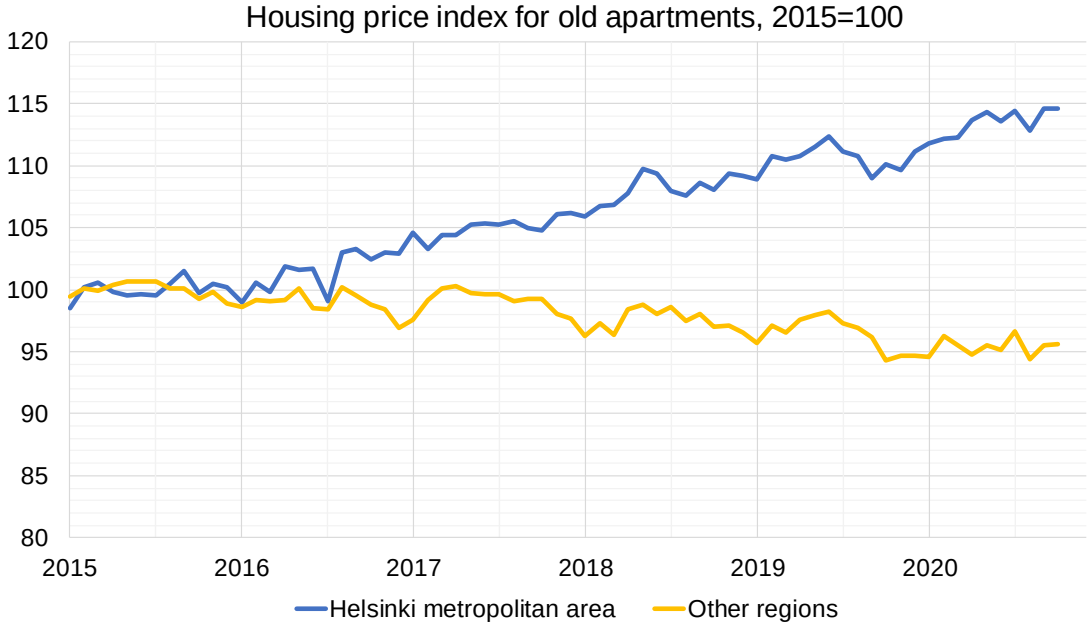
[29] The economic and social costs of banking crises in the past have been extensive.

6.1. Why are macroprudential policies important now?

Household indebtedness/private debt

Households in Finland are now considerably more indebted than before the global financial crisis in 2007-2009 or during the 1990s banking crisis. The depression of the 1990s also caused over-indebtedness, which took a long time to repair. Mortgages, especially in the Helsinki metropolitan area, are large. The polarisation of the housing market is continuing: housing prices are increasing in the Helsinki metropolitan area and other centres of growth (e.g. Oulu and Tampere), but are declining in smaller municipalities, see Figure 6.1.1. A relatively new phenomenon is large housing company loans, especially in the Helsinki metropolitan area.

Figure 6.1.1. Dwelling prices have diverged.

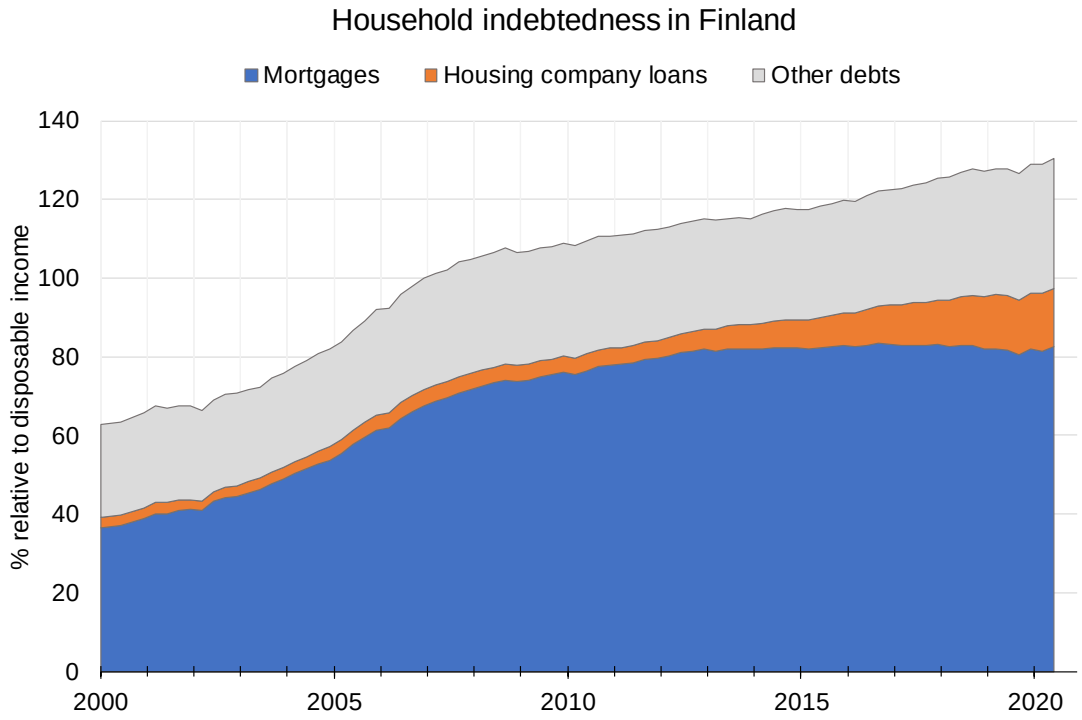


Source: Statistics Finland. Data for 2020 are preliminary.

Even though the Finnish housing market has been stable in the past two decades, several changes have occurred. Household indebtedness has increased due to larger new mortgages and housing company loans, longer amortisation periods, use of moratoriums (especially in the first years of housing company loans) and rented lots (Putkuri 2020). Also, a lower interest rate environment, easing of loan terms and favourable financial and economic conditions have contributed to the increase in housing-related debt.

As depicted in Figure 6.1.2, the majority of household debt (75% in June 2020) is housing-related debt, including mortgages, loans for housing investments and housing company loans. Currently 15% of housing-related debt consists of housing company loans. The share of housing company loans of housing-related debt has increased, whereas the share of mortgages has declined (Putkuri 2020).

Figure 6.1.2. Household indebtedness has increased steadily.



Source: Bank of Finland.

The change in the Finnish consumer credit market in the early 2000s has also increased household indebtedness. In 2005, operators outside the financial market started to supply credit through digital tools, which enabled credit to be provided to almost anyone with a mobile phone (Järvelä et al. 2019). These so-called "instant loans" soon began to cause debt problems for consumers because they are easy to access. Therefore, market regulation was urgently needed and legislation was gradually tightened.[30] Regulation of the consumer

[30] The instant loan market has been regulated several times in Finland. The amendment that was put to use in 2013 imposed a maximum actual annual interest rate cap of 50 % for instant loans under EUR2000 but loans larger than that were not regulated at all. In 2019 the regulation was tightened by setting interest rate cap of 20% for all consumer credit and instant loans. Also, the maximum amount of additional charges was set to EUR150 per year. In 2020 the interest rate cap for instant loans was set temporarily to 10% and their direct marketing was prohibited.

credit sector changed in 2013, with the introduction of new products in the market. Instant loans were replaced by "flexible and limit loans".

According to information from the Bank of Finland, the value of the consumer loan stock increased at approximately 5% a year before the Covid-19 crisis, implying that the stock of non-collateralised consumer credit has increased for several years. In September 2020, a total of 391,800 persons had a payment failure record, see Figure 6.1.3.[31] In the beginning of 2020, the Ministry of Justice launched a reform project, based on government programme, to examine inter alia changes to the law on debt adjustment for private persons.[32]

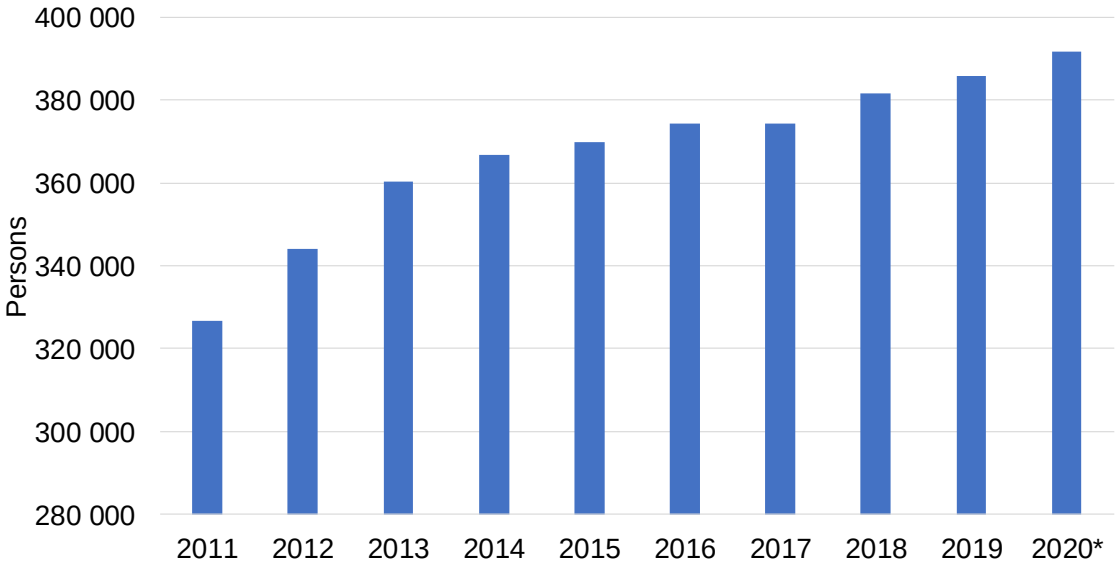
Takalo (2019) offers a thoughtful analysis of the economics behind regulating short-term consumer credit. He notes that since interest rate caps actually increase demand for loans,[33] other regulatory measures may be more desirable. Peltonen and Saastamoinen (2019) review international practices in regulating instant loans as well as the research examining the impacts of regulatory policies. They also offer a helpful consideration of potential policy changes to the regulation of these loans. The instruments which appear promising include banning certain types of marketing, requiring warnings in marketing information, and improvements in the choice architecture related to borrowing. One example of the latter category is a mandatory cooling-off period (e.g. 48 hours), after which consumers must still signal their willingness to take up a high-interest loan. More research is needed in order to compare the relative efficiency of various regulatory options.

[31] Source: Asiakastieto. https://www.asiakastieto.fi/web/fi/asiakastieto-media/blogit/389-500-suomalaisella-on-maksuhairiomerkintoja.html.

[32] See https://oikeusministerio.fi/ru/-/yrityssaneerausta-ja-velkajarjestelya-ryhdytaan-uudistamaan.

[33] Interest rate caps may help if they reduce the supply of these loans sufficiently.

Figure 6.1.3. Persons with payment default entries.



Source: Asiakastieto.

Housing company loans also increase household indebtedness and the quantity of these has risen considerably in recent years. Large housing company loans have become standard in new housing construction in Finland, but they are also used to fund repair construction in older buildings. Housing company loans are counted as household debt since the housing company charges apartment owners the capital costs and amortizations of the housing company loan. Typically, 30% of the price of a newly built apartment consists of the buyer's share of the housing company loan.

There three essential risks in particular related to housing company loans. First, buyers of new apartments may not understand their share of/responsibility for the housing company loan (especially if moratoriums are allowed for the first years of repayment). Therefore, the overall debt of the household may be much higher than just the mortgage debt. The second risk is rising interest rates, especially if a mortgage is too big relative to disposable income. Higher interest rates raise mortgage interest expenses and the capital costs charged by the housing company.[34] Third, large housing company loans increase the risk that some of the shareholders default and the responsibility is transferred to the housing company. If some shareholders default, the housing company will try to collect the payments, and ultimately the company may take over the apartment (based on the decision of the shareholders' meeting) and cover the capital costs by renting the apartment. This can lead to further

[34] As a result of the very loose monetary policy stance of the European Central Bank, interest rates are not expected to rise in the next few years.

actions, and the other shareholders may need to cover the missing capital costs. In the worst-case scenario, unpaid charges for capital costs could lead to the insolvency or bankruptcy of the housing company.

Covid-19 crisis

Due to the Covid-19 pandemic many Finnish firms have run into serious financial difficulties. A lack of economic activity caused by Covid-19 restrictions (social distancing and lockdowns) has caused liquidity problems for many firms. To minimise the economic impacts and costs of the Covid-19 crisis, the Finnish government, public authorities and financial institutions decided to support firms to ensure the survival of healthy firms and households through the crisis. The Finnish government has eased firms' cashflow crisis through direct support, increasing the guarantee responsibility of Finnvera and through some other actions. The ECB also has taken actions to safeguard financial market liquidity and the availability of funding for firms. All these actions have been highly important in minimising the impact of the weak economic situation on (long-term) unemployment and permanent job losses, which undermine the repayment of credit by households.

The economic contraction caused by the Covid-19 crisis has weakened the solvency of firms and households, which increases the probability of credit losses for banks. Total credit losses will rise further if the restrictions last longer and the economy ends up in long-lasting recession or depression. During the Covid-19 crisis, Finnish banks have increased their credit supply to firms and accepted moratoriums for households for 3-12 months. This has helped customers to overcome their difficulties.

In addition, the Finnish government has amended the Bankruptcy Act (120/2004) to prevent firms with temporary payment difficulties from going bankrupt. This amendment precludes creditors from invoking a payment notice with a seven-day payment period as grounds for bankruptcy. This amendment is in force until the end of January 2021. In January 2021 the payment period was extended to 30 days until the end of September 2021. As a consequence, the amount of bankruptcy filings went down in January - August 2020 by 150 compared to the previous year. The number of employees in these firms went up by 300 to 8,598.

The crisis resilience of the Finnish financial system is supported by the fact that housing prices have increased fairly moderately in recent years. In addition, after the financial crisis credit institutions were required to accumulate equity and liquidity buffers as protection against future banking crises, strengthening the resilience of the financial system. Some Finnish households are highly indebted relative to their income because of their large mortgages, consumer credit, student loans etc. This reduces the ability of households to adjust to shocks to their personal finances. In many countries the risk of a housing market crisis has been reduced by introducing macroprudential policy measures to moderate household borrowing.

To prevent instant loans from provoking household over-indebtedness during the Covid-19 crisis, the Finnish government decided to temporarily impose a maximum interest rate of 10% on instant loans and prohibit direct marketing of them from July 2020 to the end of September 2021.[35] The idea behind this decision was to ensure a moderate level of interest rates on instant loans and prevent aggressive marketing of them to individuals with financial difficulties.

Stability of the financial system

After the financial crisis, the risk absorption capacity of the banking sector has been systemically strengthened by macroprudential policies and microprudential regulation. Compared to the 1990s banking crisis, Finnish banks have stronger capital adequacy and interest rates are considerably lower. These have helped to maintain the resilience of the financial system.

The ongoing Covid-19 crisis may cause risks for the Finnish financial system and its stability, especially in the form of indebted households, firm losses or bankruptcies and increasing unemployment.

Also, the economic landscape in other countries may expose the Finnish financial system to risks. The Finnish banking sector is vulnerable to risks from the Nordic countries, since the Nordic banking sector is highly interconnected. The weaker economic outlook has caused fluctuations in financial and stock markets.

[35] Consumer Protection Act 7:17c (laws 512/2020 and 234/2020). Normally, the interest ceiling on consumer loans is 20%.

The Covid-19 crisis has hampered the business activity and revenue of many firms in Finland. Therefore, it is essential that banks can supply credit to healthy firms. However, for some firms meeting the collateral requirements for borrowing funds is challenging. Also, the economic uncertainty may make borrowing funds too risky for some firms. Therefore, government guarantees and direct support are essential to help healthy firms survive through the economic hardship caused by the Covid-19 crisis.

FIN-FSA has made a few macroprudential decisions to improve financial stability during the Covid-19 crisis. First, it provided temporarily relief on banks' additional capital requirements when the crisis started in March 2020. This decision was designed to increase the lending capacity of Finnish banks to households and the corporate sector and strengthen the banking sector's ability to survive possible credit losses. This was done by adjusting the specific requirements for credit institutions and removing the systemic risk buffer. All in all, these changes reduced the structural buffer requirements of all credit institutions by 1 percentage point.

In June 2020 the FIN-FSA Board decided to return the LTV ratio to 90% for borrowers other than first-time home buyers from the previous level of 85%. For first-time home buyers, the ratio has been at its normal level of 95%. This decision was made to support the Finnish housing market in a situation of heightened economic uncertainty, which reduced the amount of home purchases and new mortgage applications. In October 2020, FIN-FSA decided not to continue the validity of the risk weight floor.[36] The ECB's pandemic emergency purchase programme (PEPP) and its expansion in June 2020 also helped the financial conditions of households and firms in the eurozone.

So far, credit institutions in Finland have not suffered from major mortgage-related losses since households' ability to repay their debt has broadly remained good (Putkuri 2020). The moratoriums granted by banks have helped households during the Covid-19 crisis. However, the number of housing transactions declined temporarily during the crisis, also in the growth centres. Low interest rates and slim loan margins have however reduced the profits of credit institutions (Putkuri 2020).

[36] In June 2017, the board of FIN-FSA made a national macroprudential policy decision to set a 15% lower bound for average risk weights for mortgages for credit institutions that use an internal ratings-based approach. This decision was originally intended to be in use between January 2018 and December 2019, but was extended to end in December 2020.

6.2. Personal insolvencies

Kinnunen (2021) discusses the personal insolvency process and over-indebtedness in Finland. Household indebtedness increased rapidly in Finland in the beginning of the 1990s. The number of registered payment defaults has remained high and even increased since then (Kinnunen 2021).[37] Notwithstanding the rise in registered payment defaults, the number of individuals and households that have applied for debt relief through formal debt adjustment in courts has remained constant (c. 4,000 a year) since the late 1990s.

Finnish insolvency and debt enforcement legislation have been completely reformed since the 1990s debt crisis. In 1993, during the crisis, procedures were enacted for debt adjustment for private persons (Act 57/1993) and for restructuring enterprises (Act 47/1993). The number of debt adjustment proceedings for private individuals and households was high throughout the 1990s but has levelled out since the turn of the century. In the 1990s, some 70,000 individuals and households received debt adjustment relief. Debt adjustment can generally be seen as the main route to relief for over-indebted debtors.

The 1990s crisis also led to reforms of debt enforcement legislation. Standard debt recovery of includes the activities of private debt collection agencies, regulated in the Debt Collection Act (513/1999). Following the intervention of private debt collection agencies, debtors (or debt collection agencies acting as proxies) may seek a court judgement, which is then enforced by the state enforcement authorities. The enforcement authorities may, for example, impose garnishments on the debtor's income or carry out foreclosure procedures and sell the debtor's assets, including housing.

The Enforcement Code was reformed in 2007. In the aftermath of the 1990s crisis, the period for enforcement of judgements was limited. Previously, there was no upper time limit for enforcement. A creditor could continue debt collection and enforcement for eternity by reminding the debtor of the debt. Today, the debts of an individual expire in 20 years from the maturity of the contract and in 25 years if the creditor is also an individual. Until then, the creditor must as a rule remind the debtor three-year intervals. If the creditor

[37] According to Valkama (2011), the most common reasons for debt problems in Finland have been unemployment, termination of entrepreneurship, termination of an intimate relationship, personal guarantee liabilities and reckless activities, such as imprudent borrowing or excessive consumption relative to income.

has a judgement, the enforcement period expires 15 years from the judgement or after 20 years if the creditor is also an individual.

In the aftermath of the 1990s crisis, several other measures were implemented to alleviate serious debt problems. One of the first was the consolidation loan programme of the Guarantee Foundation, a private foundation established to help debtors. Today, several municipalities have consolidation programmes or social loans (Act 1133/2002).

As mentioned above, the main avenue for debt relief for private debtors is through debt adjustment. If a private person cannot repay their debt and becomes insolvent, they may apply for debt adjustment and receive a confirmed payment plan from the district court and eventually be relieved of their debt burden (Kinnunen 2021). However, individuals must attempt to solve their financial difficulties through a voluntary settlement with their creditors before applying for debt adjustment.

In addition, there are certain criteria that debtors must meet to qualify for debt adjustment and certain rules that debtors must comply with once an application has been submitted.[38] The procedure requires careful form-filling and the debtors are responsible for reporting all their debts, assets and living costs according to certain formulas. In addition, there are detailed rules on how the payment plan has to be prepared for the court.

Therefore, soon after the law came into force, a new profession of debt counsellor emerged. Initially, counsellors were often former bank employees who had become or were at risk of becoming redundant due to the banking crisis in the early 1990s. Also, many social workers noticed that their work had become debt counselling. Since the beginning of 2019, debt counselling has been transferred from municipalities to specialized units in state legal aid offices.

Another but related group of professionals has also specialized in preparing payment plans for the courts. These trustees are usually financial professionals who have found a business niche. However, many payment plans are prepared by counsellors. The fees of trustees are paid from the payment plan and, if the debtor is unable to pay, by the state.

The baseline message of the original law proposal and subsequent amendments has been that debt adjustment should not be too easy. The standard

[38] For more details of the debt adjustment procedure in Finland, see Kinnunen (2021).

length of a payment plan was first five years and is now three years. Exceptionally, debtors can keep their privately owned home, and then the payment plan may be longer.

Over-indebtedness and personal insolvency cause many adverse effects both for individuals and the economy. For example, a payment failure record hinders access to various types of credit (mortgages, student loans, hire purchase and credit cards), residential rentals, telephone and internet subscriptions, insurance and employment. Over-indebtedness may reduce consumption, distort the labour supply and eventually reduce economic growth.

Wage garnishments and payment plans raise individuals' effective marginal tax rate, and may therefore reduce the labour supply. In a debt adjustment procedure, an additional payment obligation of half of any additional net income is applied if the debtor's annual net earnings increase by more than EUR 2,000 (Kinnunen 2021). This may discourage unemployed persons from taking up employment during debt adjustment. In contrast, in the Finnish enforcement system a debtor can have garnishment-free months if they become employed.

One group with particular disincentives to work in the event of debt problems is private entrepreneurs. The amendment of 2015 allows private entrepreneurs to discharge both business and private debts in a debt adjustment process whilst continuing business activity. However, an entrepreneur debtor is required to meet certain conditions to be accepted for debt adjustment, e.g. the business activities must be reasonably small-scale and profitable enough to cover the costs of the business in the future. Nonetheless, debt adjustment is less costly and easier than a business restructuring.

In Finland, bankruptcy means the liquidation of a debtor's assets but does not grant debt to for the debtor.[39] Therefore, many debtors who file for bankruptcy apply for debt adjustment later (Kinnunen 2021). Heavy debt burdens have adverse effects for bankrupt entrepreneurs and can lead to social exclusion (Kinnunen 2021).

[39] In Finnish legislation, the bankruptcy of a natural person does not release the debtor from bankruptcy receivables that are not fully paid. This differs from personal bankruptcy in the United States, for example, where debtors can get a "fresh start", i.e. be released from their debt after liquidation of the debtor's assets.

As part of its efficient markets policy, the European Union has urged that unsuccessful entrepreneurs should be able to make a fresh start. In a new directive, the EU urges that entrepreneurs should be able to make a fresh start for after a maximum of three years.[40] According to Finnish insolvency legislation, a debtor must file separately for debt adjustment following bankruptcy. As a rule, this procedure means, that it is more than three years before a fresh start can be made.

The empirical evidence on the effects of debt relief is scarce, but existing research suggests that lack of debt relief or stringent conditions for it discourages private entrepreneurship. Most research has been conducted in the US, where the Bankruptcy Code mandates debt relief nationwide, although the conditions are somewhat different in each state.

Personal bankruptcy would allow entrepreneurs to make a fresh start and get quick debt relief. An amendment that would allow personal bankruptcy for entrepreneurs, i.e. give them a fresh start, could be beneficial in the current economic situation since the Covid-19 crisis may have increased the risk of bankruptcies. Current bankruptcy legislation and debt adjustment for private individuals may be inadequate in helping bankrupt entrepreneurs since, for example, being accepted for the debt adjustment procedure requires meeting strict requirements (Kinnunen 2021).

Unpaid debt often complicates setting up a new business, which might eventually slow down economic recovery from the ongoing downturn. While personal bankruptcy legislation should recognise that sometimes people and firms are genuinely unlucky and society could insure against that risk, overly lenient legislation may promote excessive risk-taking and high leverage. As it is difficult to design socially optimal insolvency legislation, thorough assessment should be made of current legislation and the incentive structures it creates.

6.3. Decision making in macroprudential policies

In Europe, the European Central Bank, the European Systemic Risk Board (ESRB) and the national designated authorities are responsible for macropru-

[40] Directive (EU) 2019/1023 of the European Parliament and of the Council.

dential decision-making. The ESRB was established to monitor macroprudential policy at the EU level by giving warnings and recommendations to be implemented to prevent and mitigate systemic risks (ESRB 2011; 2012). However, the national authorities are primarily responsible for adapting the necessary macroprudential tools to maintain financial stability. The recommendations in the macroprudential mandate of national authorities are given in ESRB (2012). Joint EU legislation contains regulations on macroprudential instruments in the banking sector. Most of the current macroprudential tools are designed to moderate risks and prevent vulnerabilities building up in the banking sector. The EU can adopt macroprudential policy instruments, but they have to be implemented at the national level. Most of the current macroprudential instruments are targeted at banks, mortgage lending and the systemic risks associated with these.

Systemic risks can be cyclical or structural. Cyclical systemic risks relate to credit booms and the ensuing economic downturns, leading to a reduction in the credit supply, which has adverse effects on the real economy. Cyclical systemic risks can be reduced, e.g. by the countercyclical capital buffer (CCB) requirements and the maximum loan-to-value (LTV) or debt service-to-income (DSTI) ratios for housing loans. The aim of the CCB is to reduce procyclicality in the financial system by requiring banks to build up capital buffers in economic expansions when systemic risks can rise, and release them in economic downturns to absorb losses. This helps to reduce risk-taking and protect against deleveraging and a restriction of the credit supply that could deepen the economic downturn.

Structural systemic risks are caused by an overly concentrated banking or financial sector structure or a credit supply that is overly concentrated in an individual industry/branch of business. Structural systemic risks can be prevented by building lender or borrower resilience to negative shocks, e.g. by setting additional capital requirements for systemically important financial institutions.

The idea of capital requirements is to reduce systemic risk by diminishing risk-taking and the probability of failure by financial institutions. Correctly designed, this tool internalises the exposure of a financial institution to systemic risk (Caruana 2010).

Besides protecting an individual borrower from excessive debt, macroprudential policy tools protect home values in neighbourhoods from falling rapidly if many borrowers have difficulties in paying their mortgages at the same time (Yilla and Liang 2020).

In Finland, decisions on the initialisation and use of macroprudential instruments are taken by the Board of the Finnish Financial Supervisory Authority (FIN-FSA) The macroprudential policy strategy of FIN-FSA was published in December 2018. The announced policy target is that the growth rate of household loans should not exceed the growth rate of households' annual disposable income in the medium term (FIN-FSA 2018).

6.4. Macroprudential instruments

Instruments currently in use in Finland

In Finland, there are currently seven macroprudential instruments in use. These are:

1. Countercyclical capital buffer (CCB).
2. Binding maximum loan-to-value (LTV) ratio for housing loans (loan cap).
3. Articles 124 and 164 of the Capital Requirements Regulation: risk weights for loans secured by mortgages on immovable property.
4. Article 458 of the Capital Requirements Regulation: stricter national measures to address macroprudential or systemic risk.
5. Buffer requirement for global systemically important institutions (G-SII buffer).
6. Buffer requirement for other systemically important institutions (O-SII buffer).
7. Systemic risk buffer requirement imposed on the basis of the structural characteristics of the financial system.

The idea of the CCB requirement is to require credit institutions to improve their risk resilience during economic upturns and release it during downturns in the credit cycle, dampening excessive contraction of credit in a downturn. FIN-FSA is allowed to set specific CCB requirements for Finnish credit institutions at 0% to -2.5% of total risk exposure.

The LTV ratio (loan cap) is aimed at the housing market by restricting the amount of a mortgage to a certain fraction of the total value of the available collaterals.[41] The purpose of this tool is to moderate overheating in the housing market, increased household indebtedness and credit institutions' risks related to household credit.[42] LTV is defined as 90% (95% for first-home purchases) of the fair value of collateral at the time the loan is granted. FIN-FSA can lower the LTV ratio by 10 percentage points and limit consideration of other than real security as collateral in calculating the LTV ratio in order to limit the risk of exceptional growth in financial stability risks. This makes the LTV tool more efficient.

Increasing the risk weights on loans secured by mortgages on immovable property requires credit institutions to increase their capital requirements for mortgage-backed lending. This indirectly reduces the risk of overheating in immovable property markets.

6.4.1. Instruments recommended by the Ministry of Finance working committee

To augment the existing array of macroprudential instruments in Finland, the Ministry of Finance working committee recommends introducing the following macroprudential instruments:

- **Debt-to-income (DTI) ratio:** total amount of previously assumed loans, possible shares of housing company loans and new loans to be maximum 450% relative to gross annual income.
- **Loan maturity of mortgages** at the time of loan approval should be maximum 25 years from raising the loan, or from the final instalment if the loan is raised in instalments.
- **Elaborating and improving management of insolvency risk regulation**

[41] Typically, the LTV ratio is calculated relative to appraised property value instead of available collateral. Taking into account the available collateral makes the tool more flexible since the borrower's wealth can be utilised more extensively in the loan approval process. Therefore, the LTV restriction in Finland is less restrictive than in countries where LTV is calculated relative to the property's value.

[42] Another macroprudential instrument to prevent risky lending in the housing market is to set a cap on the DSTI (debt-service-to-income) ratio of the borrower. There are also many other macroprudential instruments targeted at the housing market: changes in regulatory risk weights for mortgage loans, quantitative limits on mortgage lending, taxes on property gains, and stricter requirements for mortgage borrower credit worthiness, among others (Akinci and Olmstead-Rumsey 2018).

- **Loan-to-value (LTV) ratio:** 90% of current value of collateral when approving loan, for first-time home buyers 95%. The LTV ratio should be extended to cover other mortgage suppliers besides credit institutions.
- **Housing company loans**: housing company loans for new builds should be subject to legislation, with a maximum loan-to-value of 60% of the vendible share of stock in the unleveraged part of the housing company.
- **Expanding the supervisory liabilities of FIN-FSA.**

The committee also recommends setting up a positive credit register.

The DTI ratio restricts an individual's total amount of debt relative to their gross annual income, which is measured by the sum of the previous year's earned income, perquisites and permanent and regular unearned income.[43] In case of loans with joint responsibility, the DTI ratio is compounded by the sum of an individual's income and loans (Ministry of Finance 2019). This tool is effective in restricting the total amount of household debt if the restriction is not easily circumvented. Compared to LTV, the DTI limit is not affected by increases in housing prices.

Loan maturity restriction on mortgages would limit the growth of loan maturities, which have become longer in Finland in recent years. It could also limit mortgage sizes by ensuring reasonable debt servicing (Ministry of Finance 2019). This could reduce household indebtedness and growth in mortgage lending. The restriction would still allow necessary payment arrangements and moratoriums. On the other hand, these restrictions could be made less stringent by rescheduling the mortgage or making the last instalment larger.

Elaborating and improving the management of insolvency risk regulation would be important for consumer lending by improving customer protection and the principles of credit agreements and customs. The law would require credit institutions to evaluate the individual insolvency risks of each individual customer.

[43] A simpler tool is loan-to-income (LTI) ratio, which limits the amount of an individual loan (typically a mortgage) relative to income. Possible other classes of debt, e.g. consumer or student loans, that a household may have would be excluded from the calculation.

As a proactive action, it is recommended that the LTV regulation should be extended to cover other mortgage suppliers besides credit institutions. This would protect against the possibility of operators than other credit institutions starting to provide mortgages in the Finnish housing market in the future (Ministry of Finance 2019).

For housing company loans for new builds, the Ministry of Finance working committee recommends a maximum LTV ratio of 60% of the vendible share of the unleveraged part the housing company. Moratoriums would be prohibited in the first five years from the commissioning of the building. The loan maturity of housing company loans for new builds would also be restricted to a maximum of 25 years (starting from when the loan is raised). These restrictions would reduce excessive growth in housing company loans, which have been large, especially in the Helsinki metropolitan area. However, renovation construction and interest subsidy loans would be excluded from the recommended set of restrictions.

As pointed out earlier in this report, housing company loans represent a large part (around 15%) of households' housing-related debt. Therefore, the Ministry of Finance working committee recommends that macroprudential regulation should also cover housing company loans. Long moratoriums in the beginning of the loan period may complicate evaluation of the actual costs of loan repayment.

Empirical analysis on the potential role of the DTI limit

Eerola et al. (2021) examine the impacts of the introduction of a loan-to-collateral (LTC) limit in Finland in 2016 and a hypothetical DTI limit on mortgages. They use administrative data on the total Finnish population with information about mortgages and housing transactions from 2002 to 2018. Their analysis focuses mainly on first-time homebuyers and young households since the LTC and DTI limits are expected to affect these groups most. They find that renting has become more common in Finland in the 21st century, especially among young households. This development cannot be fully explained by postponing the transition from renting to owning. A similar trend has also been observed in other countries.

Their results suggest that first-time buyers are more leveraged, especially in urban areas, and have become more indebted following the financial crisis and after 2016, when the LTC reform was implemented. Eerola et al. find that

the 2016 reform led to lower loan-to-value ratios, but high-income households seem to have been less affected by the reform. However, the authors find no evidence that the reform decreased debt relative to gross income. In fact, the mortgage debt-to-income ratio seems to have increased also after the reform, especially among buyers of dwellings in housing companies. Given that the regulation was tied to house prices through the collateral limit, instead of income, it allowed more borrowing in areas where housing prices are increasing.

When analysing the hypothetical DTI restriction, they find that those first-time buyers above the DTI limit of 450% are usually younger than average first-time buyers in productive densely populated areas. This would indicate that the DTI limit would particularly affect young households borrowing against high future labour income. However, the fact that the reform would allow banks to lend a small share of loans to households whose DTI exceeds the threshold will mitigate this disadvantage.

Positive credit register

Introducing a positive credit register might forewarn the authorities of looming debt problems at the individual level and the build-up of systemic risks caused by private debt.

According to the current Finnish government programme, such a positive credit register will be introduced in 2023. The need for a positive credit register arises from the introduction of the DTI restriction. Debt information provided by the debtor can be insufficient since, in some situations, the debtor may not be willing to state (or does not know) the total amount of debt they have. Therefore, a positive credit register would ensure that an individual's total debt would not exceed their ability to repay.

Many Finnish organisations have issued statements on the new macroprudential instruments proposed by the Ministry of Finance working committee. All of the statements on the positive credit register support its introduction. The benefits of the register include the ability to make sure that a debtor's total amount of debt does not exceed their ability to repay. The register should also include loans via new digital channels. Many of the organisations recommend introducing the positive credit register before the DTI restriction. The reason for this is that the regulation cannot operate efficiently with inaccurate information on indebtedness. Many instant loan suppliers stated that

it is difficult to accurately evaluate the risks of default and over-indebtedness without a positive credit register.

6.4.2. Tax incentives

Taxes and tax deduction possibilities also affect households' and investors' ownership decisions. For example, investors benefit from housing company loans since they only need to put up a fraction of the total price of a dwelling in equity. The rest of the price is covered by the housing company loan, which may be cheaper than a loan taken out by the investor, since the interest rate is same for all shareholders.

If a dwelling is rented out, the landlord can deduct maintenance charges from taxable rental income. However, the tax treatment of capital charges depends on how the housing company treats them in its accounts. Capital charges are deductible from rental income if they are recorded as revenue in the housing company's accounts.[44]

In Finland, low-income households can receive housing allowances or supplementary benefits to pay their rent. Housing allowances may end up benefiting landlords due to the ability to deduct capital charges. Therefore, the ability of landlords to deduct the principal of debt-financed housing investment appears counterproductive.[45]

6.4.3. Instruments in use in advanced economies

Macroprudential instruments have been primarily targeted at the banking and housing sector. Table 1 depicts the borrower-based instruments in use in EU and ETA countries.

[44]See https://www.vero.fi/en/individuals/property/rental_income/deductions/maintenance-charges-and-capital-charges/

[45] The current government programme contains plans to study the prospects of limiting the right to deduct housing company loan premium repayments from rental income. It also includes phasing out the tax deductibility of interest payments on mortgages during the government's term of office. A memorandum of the Ministry of Finance ("Selvitys asuntosijoittamisen verotuksen uudistamisesta, June 2020) recommends the repeal of the tax allowance, since this would alleviate the risks of housing price inflation and level the playing field for different homebuyers.

Table 6.4.1. Borrower based macroprudential instruments in EU and ETA countries.

	INSTRUMENT				
COUNTRY	LTV	DTI/LTI	DSTI/LSTI	Amortization requirement	Loan maturity restriction
AUSTRIA	x		x		x
BELGIUM	x				
BULGARIA					
CROATIA					
CYPROS	x		x		
CZECH	x	x	x		
DENMARK	x				
ESTONIA	x		x		x
FINLAND	x				
FRANCE			x		x
GERMANY					
GREECE					
HUNGARY	x		x		
ICELAND	x				
IRELAND	x	x			
ITALY					
LATVIA	x				
LIECHTENSTEIN	x			x	
LITHUANIA	x		x		x
LUXEMBURG					
MALTA	x		x		x
NETHERLANDS	x		x	x	
NORWAY	x	x		x	
POLAND	x		x		x
PORTUGAL	x		x		x
ROMANIA	x		x		x
SLOVAKIA	x	x	x	x	x
SLOVENIA	x		x		
SPAIN					
SWEDEN	x			x	
UK		x			

x = recommendation, x = law.

Sources: Ministry of Finance (2019) and ESRB.

As shown by Table 6.4.1, many EU countries have adopted (borrower-based) macroprudential tools based on national legislation. The exceptions are Bulgaria, Croatia, Germany, Greece, Italy, Luxemburg, and Spain, which have not introduced any borrower-based tools. A cap on the LTV ratio has been the most commonly used borrower-based macroprudential tool in EU countries.[46] It is typically set at 80--95% of the appraised property value. A DSTI ratio is also common and is more prevalent than DTI. The idea of DSTI is very

[46] Claessens (2015) points out that in developed countries borrower-based tools (such as LTV and DTI) are used most, perhaps because of worries about excessive leverage. Emerging markets tend to favour foreign exchange and liquidity related policies more (such as foreign currency and reserve requirements), perhaps owning to their concerns about large and volatile capital flows and related systemic risks.

similar to DTI, but the DSTI limit changes when there is a change in interest rates whereas DTI does not.

6.5. Are macroprudential instruments effective?

Macroprudential policy tools, such as LTV ratios, limits on credit growth and CCB, have become common in many emerging and advanced economies. However, understanding how these tools work is still limited since they have only recently been adopted in many countries. The importance of macroprudential policies is justified by market failures and externalities, which are typically hard to identify (Claessens 2015). Also, there can be coordination issues with monetary policy and microprudential policy, since these policies interact with macroprudential policies.

Most of the literature on macroprudential policies focuses on empirical analysis, but a few theoretical analyses also exist.[47] Many previous papers (e.g. Lim et al. 2011) suggest that macroprudential tools, such as reserve requirements and caps on LTV and DTI ratios, have generally been advantageous in reducing financial pro-cyclicality and lowering credit risks. In particular, caps on LTV and DSTI ratios seem to affect housing markets by reducing booms and busts, which are fundamental sources of instability. Capital and liquidity requirements have reduced banks' risks by adding buffers to absorb losses and periods of illiquidity (Yilla and Liang 2020).

Many empirical studies on macroprudential policy tools have focused on establishing a link between different borrower-based instruments and their impact on credit growth and housing prices. For example, Cerutti et al. (2017) examine the impact of different macroprudential policies on credit and housing market developments in 119 countries in 2000–2013. They find that macroprudential policies are in general useful in reducing the growth of household credit, but the impact is weaker in more developed countries and more financially open economies. Based on their results, macroprudential policies also affect growth in housing prices. The impact of these policies tends to be larger in the boom phase of the financial cycle. The effect is, however, instrument- and country-specific.

[47] Galati and Moessner (2013; 2018) provide a literature review.

Grodecka (2019) investigates the interaction between LTV and DSTI constraints using a real business cycle model and Swedish microdata. She is able to show that when borrowers are bound by both LTV and DSTI constraints at the same time, tightening the maximum LTV ratio may leave the debt-to-GDP ratio unchanged and lead to higher housing prices in the equilibrium as the amount of debt will evolve according to growth in income and GDP.

Some previous studies focus on more specific aspects of macroprudential policies. For example, Frost and van Stralen (2018) find that macroprudential policies may also have direct redistributive effects. For example, LTV and DTI ratios can restrict households with a lower level of wealth or income from purchasing a dwelling or use a dwelling as collateral for business investments. They can also prevent lower-income households from increasing their income or utilising price increases. On the other hand, they may protect low-income households from price drops and smooth credit market and housing price developments, which diminish the redistribution of wealth by decreasing credit delinquencies and changes in asset valuation, over the financial cycle.

Even though the previous literature has studied various aspects of the effectiveness of macroprudential policies, there are still some gaps in our knowledge. It is still somewhat unclear how to apply these policies most effectively in specific situations, such as when and by how much to ease or tighten countercyclical capital requirements, taking into account specific country characteristics, such as financial market structures. In addition, the simultaneous use of multiple macroprudential tools complicates analysing the effectiveness of a specific tool. Also, the costs of macroprudential policies are to some extent unknown.[48]

[48] Poghosyan (2020) summarizes some limitations of previous studies. For example,

1. Most studies focus on the short-term effects of macroprudential policies, even though in many cases the full impact takes more time to actualize.

2. Many studies utilize indices of macroprudential tools for measuring macroprudential stance, while policymakers are typically interested in the effects of discretionary tightening and loosening actions.

3. Effectiveness of macroprudential tools presumably varies across types (e.g., legally-binding measures vs. recommendations, measures with and without sanctions).

4. Data and number of observations for empirical analysis is limited since some macroprudential tools have been put to use only recently and in a small number of countries.

5. Macroprudential measures are typically implemented in reaction to developments in target variables (such as housing prices or credit). This reverse causality biases the coefficient of the macroprudential variable upward.

6.6. Council views

Household indebtedness has risen, and very high debt-to-income ratios are concentrated among a minority of households. On balance, evidence suggests stricter macroprudential regulation helps limit the accumulation of risks in the financial sector. The Ministry of Finance proposal[49], which recommends considerable tightening of lending regulation, is therefore welcome.

The Council supports the Ministry Proposal, but notes that its views on regulating housing cooperative loans are too lenient. While such loans are useful instruments for smoothing the costs of renovation in housing cooperatives, the benefit of using them to finance building new housing is not clear. These loans may distort the overall costs of housing to new buyers and lead to greater risks for the owners and tenants. There would be good arguments to lower the maximum share of housing cooperative loans from the proposed 60 per cent.

The current practice of allowing tax reductions from the capital charges (principal of loans), used to finance rented flats by investors, increases the risks of inflated housing prices and it is also an unnecessary tax expenditure. This system should therefore be discontinued.

The introduction of a positive credit register, the costs of which should be borne by the financial sector, could help lenders to acquire a comprehensive picture of the overall indebtedness of borrowers. It may also help borrowers to signal their creditworthiness.

The number of over-indebted households has increased. After the current temporary regulation of instant loans expires, new regulation on their marketing and availability would be needed.

The Council welcomes the overview and reform project of the insolvency laws to account for the requirements of the Restructuring and Preventive Directive (1023/2019) pending at the Ministry of Justice[50]. While access to a fresh start either in the bankruptcy process or in a debt adjustment process that feasibly follows a bankruptcy process could encourage entrepreneurship, there may exist associated moral hazard problems.

[49] Selvitys keinoista ehkäistä kotitalouksien liiallista velkaantumista, Ministry of Finance, 2019.

[50] For details, see https://oikeusministerio.fi/hanke?tunnus=OM018:00/2020.

In addition, the Council recommends an assessment of debt adjustment for private persons. From an economic point of view, the system is cumbersome with procedural and bureaucratic complexities that decrease the efficiency of the procedure.

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