EDITORIAL

Now is the time to strengthen the public finances and the foundations for productivity growth

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Finland's economy will continue to grow, although its pace of expansion has for the time being moved past its peak. Growth is similarly expected to continue in the euro area; however, its inflationary outlook still calls for an accommodative monetary policy. Interest rate levels will therefore remain low, supporting growth conditions also in Finland. Risks to the global economy cast uncertainty over the economic outlook.

In spite of its recent recovery, the Finnish economy cannot be declared in rude health just yet: its public finances remain in deficit; its employment levels are too low; and its productivity growth remains relatively subdued. With an ageing population, it is unlikely that time alone will heal the economy's lingering ailments. Decisive measures are needed.

The state of the general government finances has improved in recent years. In 2014, the general government deficit relative to GDP reached its highest point since the turn of the millennium, as it climbed past 3%. The deficit remains substantially lower at present. Furthermore, the volume of general government debt relative to GDP has begun to decline.

The fiscal deficit has been eased not only by growth in the economy but also by fiscal policy measures. Fiscal policy has contributed to shrinking the deficit since 2015. In recent years, these policies have largely centred on measures restricting expenditure.

The deficit ratio has narrowed in spite of the baby-boomers' entering retirement over the last decade, which has contributed to the deficit. Pension expenditure has increased while the working-age population has declined at the same time, resulting in a weaker outlook for labour tax incomes.

In future, population ageing will continue to place even greater demands on public expenditure. The sustainability of the public finances is yet to be secured over the long term. According to a new estimate by the Bank of Finland, the sustainability gap still remains at about 3% of GDP. This means that either an equivalent amount need be saved through spending cuts or gained by increasing taxation, in order for general government income to meet expenditure.

Fiscal policy relaxed in 2018, and is expected to remain broadly neutral in 2019. With the sustainability gap in mind, and given the favourable cyclical conditions supporting the economy, taking a more decisive course towards strengthening the public finances would be well justified.

The employment rate in particular is key to securing the public finances for the future. As the Finnish economy has gradually recovered and returned to a path of growth, so has its employment situation improved — especially during the last year and a half. The growth of employment in recent years has been underpinned not only by the economic cycle, but also by measures taken by labour market organisations and the government.

The competitiveness of Finnish labour and manufacturing has been bolstered by the Competiveness Pact as well as fairly moderate wage policy. This has resulted in better conditions for production and employment in the open sector, and has subsequently lifted the income generation of the entire economy. Social security and tax policies have also undergone changes conducive towards employment growth.

How much further can the employment situation still improve? On the one hand, Finland is subject to the headwinds and tailwinds of the world economy, and this has an effect on its employment levels. On the other hand, employment in Finland is inarguably shaped by the functioning and structure of its labour markets.

It is important to take a holistic view for improving employment growth over the long term. In light of modern research, social security and taxation policies, housing availability, and wage dynamics all have an important bearing on employment. In addition, education policy needs to be well-thought out and successfully implemented, as do active labour market policies.

Robust employment does not alone guarantee economic growth and material well-being; instead, it must be supported by growth in labour productivity. Labour productivity describes how much output or value is created in a single hour of labour or by an individual worker.

The development of labour productivity in Finland remained considerably weak for several years, both historically and compared with other advanced economies. As the economy began to demonstrate signs of recovery, so did labour productivity start to improve.

In 2018, productivity growth has once again begun to slow. This may be somewhat related to a favourable development, namely that employment has grown exceptionally quickly.

However, it is also plausible that the slowdown in productivity growth is at least in part a response to the economic outlook. The recent decline in corporate fixed investment points towards the latter. This might be underpinned by uncertainties related to economic developments over the next few years and concerns surrounding the economy's long-term prospects.

In the long term, productivity growth is ultimately determined by innovation and the adoption of new technologies. Education, scientific research and R&D are the foundation for innovations that foster productivity growth. Thus, policy measures in these areas play a formative role in determining productivity growth.

The conditions that are needed for productivity growth can also be strengthened with policies that improve the allocation of the economy's resources. Such measures include promoting competition and maintaining healthy labour markets.

Laying the foundations for employment and productivity growth in the future remains very much the responsibility of domestic policymaking, even in an era where countries are closely interlinked with the world economy. At the same time, our future prospects are of course influenced by the decisions taken on international forums.

Climate change is a large social issue, and one where Finland should pursue an active and constructive role in shaping international policy. Climate change has great implications for financial stability and economic growth over the long term. From the perspective of the economy, climate change might be viewed as a huge market failure. Thus, it will prove central to mitigate its effects with economic policy tools.

Because climate change is a global concern, it should be combatted with measures that are available to as many countries as possible. It remains essential that a pricing mechanism be introduced for greenhouse gas emissions. This might be achieved through tax policy or emissions trading. As a result, each and every business and household would take the effects of climate change into account in their decision-making.

Favourable developments in the world economy have supported Finland's economic recovery and employment growth in recent years, but domestic economic policymaking has also played an important role here. Still, much more work needs to be done to secure the economy’s long-term outlook — for the public finances, employment and labour productivity alike.

In the decades to come, the people of Finland will undoubtedly wish to build fulfilling lives for themselves and satisfy their well-being. They must be allowed to do so, without a legacy of debt and environmental issues wrought by previous generations.

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Key words

climate change, economic growth, inflation, monetary policy, productivity, public finances