Economic Policy Council Report
2018

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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 members of the Council were appointed by the government for a five-year term based on a proposal by economics departments of Finnish universities and the Academy of Finland. The Council members participate in the work of the Council in addition to their regular duties. This is the fifth and final report of the current Economic Policy Council. A new Council will start its work in March 2019. At the same time the term will be reduced to four years and the Council will adopt a rotating scheme, with two of its members changing every two years.

In this report we first 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 selected key issues. This year the report concentrates on evaluation of social and health care and regional government reform.

The council does not make its own forecast but relies mainly on forecasts made by the Ministry of Finance. There are already 15 institutions that publish forecasts on Finnish economic developments. The value added of creating one more would be marginal. The most recent information used in this report is the Ministry of Finance Winter 2018 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.

Seven background reports have been published in connection with this Council report. Unto Häkkinen, Taru Haula, Satu Kapiainen, Merja Korajoki, Suvi Mäklin, Mikko Peltola, Tuuli Puroharju of the National Institute for Health and Welfare together with Mika Kortelainen and Kaisa Kotakorpi of the VATT Institute for Economic Research provide a survey of practices and research regarding provider compensation as well as an empirical analysis using Finnish data. Luigi Siciliani of the University of York surveys the literature on private vs. public provision in health care. Mika Kortelainen and Simon Lapointe of the VATT Institute for Economic Research conduct a literature review on fiscal federalism. Olli Karsio of the University of Tampere conducts a literature review on free choice in publicly funded social services. Olli Karsio and Liina-Kaisa Tynkkynen of the University of Tampere provide a report on an interview study of private health and social service providers. In addition, the Council secretariat has contributed two reports: one by Niklas Gäddnäs discussing the estimation of structural unemployment, and another by Siiri Naumanen discussing the funding of social and health care at the regional level.

Several experts have attended Council meetings or contributed to parts of the report. We thank Unto Häkkinen of the National Institute for Health and Welfare, Sinikka Salo and Vuokko Lehtimäki of the Ministry of Social Affairs

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The report is published in English, which is the working language of the Council. A Finnish summary is attached to the report. The report will be translated into Finnish and the Finnish language version will be published in the spring.

Helsinki, 23 January 2019

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1. Summary

The growth rate of the Finnish economy is gradually decreasing. The economy grew rapidly in 2017 and 2018 with annual growth rates of 2.8 and 2.5 per cent. After two years of rapid economic growth the GDP is expected to grow by 1.5 per cent in 2019. According to the current forecasts, the growth rate will slowly decline also after 2020 converging towards a medium-term growth rate of around 1 per cent.

Rapid growth in the past two years has made it easier to reach the policy targets set by the government in its 2015 program. The 72 per cent employment rate target was achieved already in November 2018. If growth continues as expected, the employment rate remains above 72 per cent at the end of the government's term in spring 2019.

Rapid economic growth and policy decisions of the government have also brought fiscal policy targets closer. In its first General Government Fiscal Plan, the target was to reduce the general government deficit to zero by the end of the government's term in office. In addition, as required by the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, government set a medium-term target for the cyclically adjusted structural deficit at 0.5 % of GDP.

According to current forecasts, these fiscal policy targets are close to being met by 2019. The general government deficit is estimated to be 0.4 per cent of GDP and structural deficit 0.8 per cent of GDP. According to the most recent forecasts by the Ministry of Finance, the local government deficit is at its target (0.5%), central government deficit (0.7%) slightly above its target (0,5%), and the surplus in social security funds (0.8%) slightly below the target (1%). Also, general government gross debt has fallen below the 60% of GDP threshold already in 2018 and is forecast to reach 58.4% in 2019.

Overall, both the employment situation and the public sector fiscal position are substantially better than what was predicted a year ago. Rapid growth in 2017 and in the first half of 2018 was a positive surprise to forecasters.

Despite these positive surprises, the long-term prospects remain problematic. According to the most recent estimates by the Ministry of Finance, the sustainability gap is still almost 4 per cent of the GDP. It should be noted that the current estimates are updated to include the effect of recent changes in population forecasts on age-related expenditure but do not include potential savings from the social and health care reform nor planned increases in defence spending.

The current estimate of the sustainability gap by the Ministry of Finance also implicitly assumes that the recent increase in employment is due to cyclical factors. In the current calculations the employment rate increases to 73 per cent by 2023 but then starts to decrease, reaching 70.8 per cent in 2033.

A more optimistic scenario based on assumptions that recent increases in employment are permanent and that employment rate keeps increases increasing in the future due to e.g. the pension reform would lead to a reduction of sustainability gap by 1.4 per cent compared to the current estimates. Even in this scenario an adjustment of expenditures or revenues will be necessary in the future.

In its program the government committed to making decisions that would eventually close the sustainability gap. A large fraction of the gap was to be closed by improving efficiency in health care. The social and health care reform package proposals are still debated at Parliament. Even if the reform passes it is unlikely to lead to the intended cost reductions.

1.1. Assessment of fiscal policy

In its previous report, the Economic Policy Council (2018a) criticized the government for expansionary fiscal policy at a peak of the business cycle in 2018. This critique has turned out to be even more appropriate in retrospect. Structural deficit increased from 0.4% of the GDP in 2017 to 1.1% of the GDP in 2018. At the same time, the GDP grew by 2.5% and the output gap turned positive. Hence, instead of smoothing the business cycle the government fiscal policy in 2018 contributed to intensifying cyclical variation.

The budget for 2019 is better in line with the prevailing business cycle situation and with medium-term prospects. Fiscal policy is slightly tightened, and the structural deficit is expected to decrease from 1.1 per cent in 2018 to 0.8 per cent in 2019. Central government deficit is reduced by EUR 1.5 billion. Also, the local government deficit is slightly reduced. The surplus in pension funds remains close to its current level, but the surplus in other social security funds turns into a deficit. This is mainly due to a decrease in unemployment insurance contribution rates.

While the Council views the government's current fiscal policy stance as roughly appropriate, it notes that the largest single fiscal policy decision of 2018 was made outside the budget process. The 0.8 percentage point reduction in the unemployment insurance contribution rates reduces public-sector revenue by EUR 600 million. This reduction is poorly timed in terms of the business cycle. The Employment Fund has a buffer fund for smoothing out the changes in the unemployment insurance contribution rates. However, the size of the buffer fund has repeatedly proven to be insufficient, and unemployment insurance contribution rates have been adjusted in a pro-cyclical way to avoid breaking the limits of the buffer fund. The most recent decrease in contribution rates was done as forecasts indicated that the buffer fund would approach its upper limit in 2019 and probably exceed it in 2020.

The government's fiscal policy has been almost sufficiently tight in terms of medium-term policy goals. If the current forecast turns out to be correct, the government's medium-term fiscal policy goals will be reached in 2020.

However, the current medium-term policy targets are insufficient to ensure long-term fiscal sustainability. If the entire sustainability gap should be closed by budget adjustments, it would require a permanent improvement in the budget of four per cent of GDP. Such full front-loading of adjustment to increasing future ageing costs is unlikely to be appropriate, but in a longer term budget adjustment is necessary. The longer such adjustment is postponed the larger the problem, and the more drastic the adjustment will have to be.

1.2. Assessment of employment policy

At the beginning of its term, the government set a highly ambitious goal of reaching a 72 per cent employment rate within its term in office. To the surprise of many observers, including the Economic Policy Council, the target was reached already in November 2018.

A favourable business cycle situation has naturally been a key reason for improvements in employment. Still, the growth rate of the Finnish economy has not been exceptionally high compared to other countries during the last two years. Rather, Finland stands out as a country where growth picked up later than elsewhere.

The government has made active policy choices that have most likely had a positive impact on the employment rate. Disentangling the contribution of government policies from improvements in the business cycle is a difficult task that has so far not been conducted in a convincing way.

The competitiveness pact has most likely been the reform with the largest impact on employment. The pact reduced labour costs and thereby increased the demand for labour. The reduction in unit labour costs turned out to be long-lasting as wage increases did not undo the effects of shifting the burden of payroll taxes from employers to employees. Neither did the reduction in holiday bonuses or extension of union contracts lead to more rapid wage increases after contracts had expired. As a result of moderate wage growth and reduction of mandatory employer contributions, the cost competitiveness of Finnish firms clearly improved compared to its previous trend.

The Council has repeatedly criticized the Ministry of Finance for using estimates for elasticity of labour demand that are unrealistically high and not consistent with quasi-experimental empirical research. However, even more realistic estimates indicate that the competitiveness pact might have increased employment by more than 20 000.

In addition to boosting demand by reducing labour costs, the government has implemented several reforms that are likely to contribute towards increasing the supply of labour. Cutting the maximum duration of unemployment benefits in 2017, improving incentives to work by containing the growth of benefits, reducing day care fees and cutting taxes on labour in-

come, introducing mandatory regular interviews for the unemployed in 2017 and the activation model implemented at the beginning of 2018 all potentially contribute to employment growth. Unfortunately, reliable ex post evaluations of the magnitude of the effects of these reforms are not yet available.

The pension reform of 2017 is estimated to increase the employment rate by almost two percentage points in the long term according to the Finnish Centre for Pensions. The reform agreement is from the fall of 2014, i.e. before the term of the current government, but nevertheless the pension reform implemented in 2017 is in a long-term probably the largest employment increasing policy change that has taken place during the term of the current government.

1.3. Social and health care reform

The key aims of the social and health care reform are to reduce costs by EUR 3 billion through increased productivity; to improve access to healthcare; and to reduce health inequality.

Cost savings. The justification for the EUR 3 billion savings target for the social and health care reform remains unclear. The government proposals do not specify clear mechanisms leading to such cost savings. If productivity does not increase as expected, there is a risk that adhering to the savings target may compromise the quality of care. Since the cost savings associated with the reform are highly uncertain, it is questionable to highlight costs savings as a key argument for the reform proposals.

Public-private-mix and productivity. The government expects the social and healthcare reform to increase productivity via increased competition through entry of private providers. Neither economic theory nor empirical research provide clear predictions on whether private providers yield better quality and lower costs in healthcare than public providers. Evidence on the effects of the public-private mix or competition in primary care provision is scarce, and the existing evidence suggests at best modest effects. The proposed system creates incentives that may lead to inefficiency, e.g. for shifting costs from private providers to public sector. There is relatively good evidence from numerous contexts that healthcare providers react to such incentives.

Provider reimbursement. Provider reimbursement potentially affects access to and quality of social and healthcare as well as costs. If the reimbursement rules do not adequately reflect costs of individual patients, there will be an incentive for patient selection leading to unequal health care access. Experience from other countries shows that problems of cream-skimming can be significant and persistent. On the other hand, if the rule reflects cost factors which the provider can manipulate, this will drive costs upwards. The quality of care may also be compromised if the selection of treatments is based on profitability and not on medical need.

Designing the reimbursement rule for providers is a difficult task that requires expertise, data, and resources. It is problematic that work on designing the rules has only recently started, with insufficient time before the planned start of the freedom of choice pilots, and that availability of all necessary data has not been ensured.

Occupational healthcare and duplicate coverage. The role of occupational health care and duplicate health insurance coverage remains an unresolved issue in the reform proposals. Duplicate insurance coverage has three potential effects. First, there is an increase in public sector costs when patients currently covered by occupational healthcare or private insurance enrol as customers of publicly funded healthcare centres, unless lower need for services is adequately taken into account in provider reimbursement. Second, duplicate insurance coverage also tends to increase demand for healthcare services. Such behavioural effects may cause further cost increases. Third, potential demand shifts from private insurance to publicly funded services would increase (public sector) costs further.

The first issue can potentially be addressed in the providers' reimbursement rule, but this is currently hindered by data problems. The possibility of mandating employers to provide data on the coverage of occupational healthcare contracts should be examined. In the meantime using proxy measures, for example based on employer-specific average occupational healthcare costs, can be considered.

Access to services. Whether the reform will improve access to services depends on how the tension between the savings target and access will be resolved. If there is adequate entry of new providers, the reform is likely to improve access to healthcare in the sense of reduced queuing. The quality (and range) of services provided, however, will depend on the level and

structure of provider reimbursement. The tight savings target associated with the reform may compromise positive effects on access.

Effects of the reform on equality of access are unclear. Shifting the responsibility for social and health care from municipalities to counties is likely to reduce differences in access across regions. On the other hand, more focus on private provision and competition raise regional equity issues, since the market mechanism is more likely to work in urban areas. The reform may fail to increase equality of access between socioeconomic groups e.g. due to duplicate coverage provided to individuals with occupational healthcare and private insurance.

Regional reform and county funding. In addition to potentially reducing regional disparities in access to health care, transferring responsibility for organizing health care from municipalities to larger organisations may lead to some productivity improvements if counties are able to exploit returns to scale in service provision.

The arguments in support of giving counties the right to taxation are stronger than those against it. The lack of tax autonomy is, however, not an urgent issue as taxation rights can be granted to counties at a later stage.

Implementation. Given the magnitude of the proposed changes to healthcare provision, and the uncertainties involved in the effects of the reform, a more cautious approach with phased-in implementation would be advisable. In particular, it would be prudent to expand freedom of choice in a more gradual fashion, for example by extending freedom of choice to cover different services one at a time. The coupling of the simultaneous implementation of the regional reform with extensive freedom of choice arose because of a political deal and is not justified solely by arguments related to achieving the best possible outcome for the healthcare sector.

1.4. Use of experiments in policy design

The government has implemented a number of experiments during its term. The Basic Income experiment has attracted most attention, but experiments have been used also for assessing employment policies and in health care. Creating a culture of experimentation was mentioned already in the government program.

The Council endorses the government's intentions of using experiments to test potential policies. However, such experiments should test feasible policy options, and be designed in a way that enables reliable evaluation of the effects of these policy options.

The design of recent experiments severely hinders their use in policy design. In most cases the experiments are conducted without a proper comparison group, making evaluation of the effects of the experiment impossible or, at a minimum, very difficult. In cases where a proper comparison group exists, the policies under experimentation differ from feasible policies to the extent that benefits of experimental results are limited.

Various experiments testing the elements of social and health care reform, as well as, experiments transferring the responsibility of employment policies to municipalities, fall under the first category. These experiments, or rather pilots, have been conducted at a number of sites around the country. None of these have a proper comparison group to which developments within the experimental group could be compared to. Hence, evaluating the impact of the experiment is based on surveys on perceptions of participants or self-evaluation by agencies conducting the experiments, or comparisons to non-comparable groups. Needless to say, such evaluations can be severely biased. Often the experiments also lack controlled variation in the sense that each experiment involves a mixture of various policies. In such cases, it is typically impossible to disentangle which feature of the experiment is causing the observed effects.

The Basic Income experiment on the other hand is a flagship example of a carefully designed, large-scale randomized controlled trial. Randomization of potential participants to treatment and control groups, and a sufficiently large sample size guarantee that the results of the experiment provide reliable evidence on the effect of the policy under experimentation within similar circumstances. Unfortunately, the Basic Income experiment differs from realistic policy options as it provides net benefits also for high income earners and does not take into account the economy-wide implications of financing such a scheme. Therefore, knowing the effects of the basic income experiment provides limited guidance for design of social insurance policies.

In addition to experimentation, ex-post evaluation of reforms also generates information to support decision-making. Prospects of a credible ex-post evaluation largely depend on how a reform is implemented. If, for example,

the timetable of the implementation of a reform varies by region, this often generates comparable treatment and control groups. Possibilities of an ex-post evaluation of reform proposals should be presented in the government proposals, alongside evaluation of effects on the economy, on the environment, and other such items already included in the proposals.

1. Yhteenveto

Suomen talouden kasvuvauhti hidastuu vähitellen tulevina vuosina. Talous kasvoi nopeasti vuosina 2017 ja 2018 kasvuvauhtien ollessa 2,8 % ja 2,5 % tasolla. Kahden vuoden nopean talouskasvun jälkeen BKT:n odotetaan kasvavan 1,5 prosenttia vuonna 2019. Nykyisten ennusteiden mukaan kasvuvauhti hidastuu vuoden 2020 jälkeen kohti noin yhden prosentin keskipitkän ajan kasvuvauhtia.

Nopea kasvu viimeisten kahden vuoden aikana on helpottanut hallitusohjelmassa asetettujen politiikkatavoitteiden saavuttamista. Työllisyysastetavoite saavutettiin jo marraskuussa 2018. Jos kasvu jatkuu odotetusti, työllisyysaste pysyy 72 prosentin yläpuolella hallituskauden loppuun, kevääseen 2019 saakka.

Nopea talouskasvu ja hallituksen päätökset ovat edesauttaneet finanssipolitiikalle asetettujen tavoitteiden saavuttamista. Hallituskauden ensimmäisessä Julkisen talouden suunnitelmassa tavoitteeksi asetettiin julkisyhteisöjen alijäämän poistaminen hallituskauden loppuun mennessä. Lisäksi hallitus asetti Vakaus- ja kasvusopimuksen mukaisen keskipitkän aikavälin tavoitteen rakenteelliselle alijäämälle 0,5 prosenttiin suhteessa BKT:hen.

Nykyisten ennusteiden mukaan nämä finanssipolitiikan tavoitteet lähes saavutetaan vuoteen 2019 mennessä, jolloin julkisyhteisöjen alijäämän arvioidaan olevan 0,4 prosenttia ja rakenteellisen vajeen 0,8 prosenttia suhteessa bruttokansantuotteeseen. Valtiovarainministeriön viimeisimmän ennusteen mukaan paikallishallinnon vaje saavuttaa tavoitteensa (0,5 %), valtionhallinnon vaje (0,7 %) on hieman yli tavoitteen (0,5 %) ja sosiaaliturvarahastojen ylijäämä (0,8 %) jää hieman alle tavoitteen (1 %). Myös julkisen talouden bruttovelka suhteessa bruttokansantuotteeseen on laskenut alle 60 prosen-

tin kynnysarvon jo vuonna 2018, ja sen ennustetaan olevan 58,4 prosenttia vuonna 2019.

Sekä työllisyystilanne että julkisen sektorin rahoitusasema ovat merkittävästi paremmat verrattuna vuoden takaiseen ennusteeseen. Nopea kasvu vuonna 2017 ja vuoden 2018 alkupuoliskolla oli positiivinen yllätys ennustelaitoksille.

Huolimatta näistä positiivisista yllätyksistä julkisen talouden pitkän aikavälin näkymät pysyvät huolestuttavina. Valtiovarainministeriön arvion mukaan kestävyysvaje on yhä lähes 4 prosenttia suhteessa bruttokansatuotteeseen. On kuitenkin huomioitava, että viimeinen arvio sisältää väestöennusteen muutosten vaikutukset ikäsidonnaisiin menoihin, mutta ei huomioi sote-uudistuksen potentiaalisia vaikutuksia eikä puolustusmenojen suunniteltua kasvua.

Valtiovarainministeriön kestävyysvajearvio olettaa, että työllisyyden viimeaikaisen kasvun taustalla ovat pääasiassa suhdannetekijät. Laskelmissa työllisyysaste kasvaa 73 prosenttiin vuoteen 2023 mennessä, mutta kääntyy laskuun saavuttaen 70,8 prosentin tason vuonna 2033.

Optimistisempi laskelma, joka olettaa, että työllisyyden viimeaikainen kasvu on pysyvää ja työllisyysaste nousee tulevaisuudessa eläkeuudistuksen myötä, pienentää kestävyysvajetta 1,4 prosenttiyksiköllä nykyisiin arvioihin verrattuna. Myös tässä skenaariossa menojen tai tulojen säätö on tulevaisuudessa välttämätöntä.

Hallitusohjelmassa sitouduttiin tekemään päätöksiä, jotka johtaisivat kestävyysvajeen poistamiseen. Suuri osa kestävyysvajeesta oli tarkoitus kattaa parantamalla tuottavuutta terveydenhuollossa. Sote-uudistus on edelleen eduskunnan käsittelyssä. Vaikka uudistus hyväksyttäisiin, on epätodennäköistä, että se tulee johtamaan tavoiteltuun kustannusten alenemiseen.

1.1. Arvio finanssipolitiikasta

Edellisessä raportissaan neuvosto kritisoi hallitusta ekspansiivisesta finanssipolitiikasta noususuhdanteen huipulla, vuonna 2018. Jälkeenpäin arvioituna tämä kritiikki on edelleen aiheellinen. Rakenteellinen alijäämä oli 0,4 prosenttia vuonna 2017 ja kasvoi 1,1 prosenttiin suhteessa bruttokansantuotteeseen vuonna 2018. Samanaikaisesti BKT kasvoi 2,5 prosenttia ja tuo-

tantokuilu kääntyi positiiviseksi. Näin ollen suhdanteen tasoittamisen sijaan hallituksen finanssipolitiikka oli suhdannevaihtelua kärjistävää vuonna 2018.

Vuoden 2019 budjetti on paremmin linjassa vallitsevan suhdannetilanteen ja keskipitkän aikavälin näkymien kanssa. Finanssipolitiikkaa kiristetään hieman ja rakenteellisen jäämän odotetaan pienentyvän 1,1 prosentista vuonna 2018 0,8 prosenttiin vuonna 2019. Valtiontalouden vajetta pienennetään 1,5 miljardilla eurolla. Myös paikallishallinnon alijäämä pienenee. Eläkerahastojen ylijäämä pysyy lähellä sen nykyistä tasoa, mutta muut sosiaaliturvarahastot kääntyvät alijäämäisiksi. Tämä johtuu pääasiassa työttömyysvakuutusmaksujen pienentämisestä.

Neuvosto arvioi hallituksen nykyisen finanssipolitiikan virityksen olevan kutakuinkin sopiva. Samalla se huomauttaa, että suurin yksittäinen finanssipoliittinen päätös tehtiin budjettiprosessin ulkopuolella. Työttömyysvakuutusmaksujen pienentäminen yhteensä 0,8 prosenttiyksiköllä vähentää julkisen sektorin tuloja 600 miljoonalla eurolla, mikä ajoittuu suhdanteen kannalta huonosti. Työllisyysrahastolla on puskurirahasto, jolla voidaan tasoittaa maksuprosentin muutoksia. Puskurirahaston koko on toistuvasti osoittautunut riittämättömäksi ja työttömyysvakuutusmaksuja on jouduttu muuttamaan suhdannetta vahvistavalla tavalla, jotta puskurirahasto pysyy sille asetettujen rajojen sisällä. Viimeisin maksuprosentin alentaminen tehtiin, kun ennusteet osoittivat puskurirahaston lähestyvän ylärajaansa vuonna 2019 ja todennäköisesti ylittävän sen vuonna 2020.

Hallituksen finanssipolitiikka on ollut lähes riittävän kireä keskipitkän aikavälin politiikkatavoitteiden kannalta. Jos nykyinen ennuste osoittautuu oikeaksi, hallituksen asettamat keskipitkän aikavälin tavoitteet saavutetaan vuonna 2020.

Nykyiset finanssipolitiikan keskipitkän aikavälin tavoitteet ovat kuitenkin riittämättömiä varmistamaan julkisen talouden kestävyyden pitkällä aikavälillä. Koko kestävyysvajeen kattaminen julkisia menoja ja tuloja sopeuttamalla vaatisi rahoitusjäämän pysyvää kohentumista neljällä prosenttiyksiköllä bruttokansantuotteeseen suhteutettuna. Julkisen talouden välitön täysi sopeuttaminen tulevaan ikääntymisestä johtuvaan menojen kasvuun ei todennäköisesti olisi parasta mahdollista politiikkaa, mutta kuitenkin pidemmällä aikavälillä julkisen talouden sopeutus on välttämätön-

tä. Mitä kauemmin sopeutusta lykätään, sitä suuremmaksi sekä ongelma että tarvittava sopeutus kasvavat.

1.2. Arvio työllisyyspolitiikasta

Kautensa alussa hallitus asetti erittäin kunnianhimoisen tavoitteen työllisyysasteen nostamisesta 72 prosenttiin. Useimpien talouden seuraajien, mukaan lukien Talouspolitiikan arviointineuvosto, yllätykseksi tavoite saavutettiin jo marraskuussa 2018.

Myönteinen taloussuhdanne on luonnollisesti ollut keskeinen syy työllisyyden kohentumiselle. Suomen talouden kasvuvauhti ei kuitenkaan ole ollut poikkeuksellisen korkea muihin maihin verrattuna viimeisten kahden vuoden aikana. Pikemminkin Suomi erottuu vertailussa maana, jossa kasvu käynnistyi myöhemmin kuin muualla.

Hallitus on tehnyt politiikkavalintoja, joilla on luultavimmin ollut positiivinen vaikutus työllisyysasteeseen. Hallituksen politiikkatoimien ja suhdannetilanteen kohentumisen vaikutusta työllisyyteen on vaikea arvioida, eikä sitä toistaiseksi ole tehty vakuuttavalla tavalla.

Hallituskaudella tehdyistä uudistuksista kilpailukykysopimuksella on todennäköisesti ollut suurin vaikutus työllisyyteen. Sopimus vähensi työvoimakustannuksia ja siten lisäsi työvoiman kysyntää. Yksikkötyökustannusten pienentyminen osoittautui olevan kestävää, sillä palkankorotukset eivät ole kumonneet niitä vaikutuksia, joita aiheutui sivukulujen siirrosta työnantajilta työntekijöille. Myöskään lomarahojen vähentäminen tai työehtosopimusten pidentäminen ei johtanut nopeampiin palkankorotuksiin sopimusten päätyttyä. Maltillisten palkkojen nousun ja pakollisten työnantajamaksujen pienentymisen seurauksena suomalaisten yritysten kustannuskilpailukyky parani selvästi verrattuna sen aiempaan tasoon.

Neuvosto on toistuvasti kritisoinut valtiovarainministeriötä epärealistisen korkeiden ja kvasi-eksperimentaalisen empiirisen tutkimuksen kanssa ristiriidassa olevien työvoiman kysyntäjoustojen käytöstä. Realistisimpienkin arvioiden mukaan kilpailukykysopimus on voinut lisätä työpaikkojen määrää yli 20 000:lla.

Hallituksen politiikka on lisännyt työvoiman kysyntää yksikkötyökustannuksia pienentämällä. Hallitus on lisäksi toteuttanut useita uudistuksia, jot-

ka lisäävät työn tarjontaa. Ansiosidonnaisten työttömyyskorvausten enimmäiskestoa leikattiin vuonna 2017. Työnteon kannustimia on lisätty keventämällä työn verotusta, hillitsemällä etuuksien kasvua ja alentamalla varhaiskasvatusmaksuja. Työttömien pakolliset ja säännölliset haastattelut otettiin käyttöön vuonna 2017. Aktiivimalli toteutettiin vuoden 2018 alussa. Kaikki edellä mainitut toimet myötävaikuttavat potentiaalisesti työllisyyden kasvuun. Valitettavasti luotettavia empiirisiä arvioita näiden uudistusten vaikutusten suuruudesta ei vielä ole saatavilla.

Eläketurvakeskuksen arvion mukaan vuoden 2017 eläkeuudistus kasvattaa työllisyysastetta pitkällä aikavälillä melkein kahdella prosenttiyksiköllä. Sopimus eläkeuudistuksesta tehtiin syksyllä 2014 eli ennen nykyistä hallituskautta. Tästä huolimatta vuonna 2017 voimaan astunut eläkeuudistus on todennäköisesti suurin työllisyyttä pitkällä aikavälillä lisäävä politiikkatoimenpide, joka on tehty kuluneella hallituskaudella.[1]

1.3. Sosiaali- ja terveydenhuollon uudistus

Sosiaali- ja terveydenhuollon uudistuksen päätavoitteet ovat hillitä menojen kasvun kolmella miljardilla eurolla sekä palvelujen saatavuuden parantaminen ja terveyserojen kaventaminen.

Kustannussäästöt. Perustelut uudistuksen kolmen miljardin euron kustannussäästötavoitteelle ovat edelleen epäselvät, eivätkä hallituksen esitykset täsmennä niitä mekanismeja, joilla kustannussäästö saavutetaan. Säästötavoitteesta kiinnipitäminen voi johtaa palveluiden laadusta tinkimiseen, mikäli tuottavuus ei kasva odotetulla tavalla. Koska kustannussäästöt ovat hyvin epävarmoja, niiden käyttäminen uudistuksen tärkeänä perusteena on kyseenalaista.

Julkinen ja yksityinen tuotanto ja tuottavuus. Hallitus odottaa sosiaali- ja terveydenhuollon uudistuksen parantavan tuottavuutta, kun kilpailu kiristyy lisääntyneen yksityisen palvelutuotannon myötä. Talousteoria ja empiirinen tutkimus eivät anna selkeitä vastauksia siihen, onko yksityisen

[1] Tämän kappaleen viimeinen virke kuului aiemmassa, 23.1.2019 julkaistussa käännöksessä seuraavasti: "Tästä huolimatta vuonna 2017 voimaan astunut eläkeuudistus on todennäköisesti suurin työllisyyttä lisäävä politiikkatoimenpide kuluneella hallituskaudella.". Virkettä muokattiin väärintulkintojen välttämiseksi vastaamaan tarkemmin englanninkielistä tekstiä. Selvyyden vuoksi todettakoon vielä, että eläkeuudistus ei ole tähän mennessä juurikaan vaikuttanut työllisyyskehitykseen.

palveluntuotannon laatu parempaa tai kustannukset matalampia verrattuna julkisen sektorin omaan tuotantoon. Evidenssi julkisen ja yksityisen tuotannon tai kilpailun vaikutuksista perusterveydenhuollossa on vähäistä ja viittaa parhaimmillaankin maltillisiin vaikutuksiin. Ehdotettu valinnanvapausmalli luo kannustimia jotka voivat johtaa tehottomuuteen, kuten kustannusten siirtoon yksityiseltä julkiselle sektorille. Lukuisista maista on saatavilla verrattain hyvää tutkimusevidenssiä, joka osoittaa että terveydenhuollon tuottajat reagoivat tällaisiin kannustimiin.

Tuottajakorvaukset. Tuottajakorvaukset vaikuttavat palveluiden saatavuuteen, laatuun ja kustannuksiin. Jos korvaussäännöt eivät riittävästi heijastele yksittäisten asiakkaiden kustannuksia, tuottajilla on kannustin asiakkaiden valikointiin, mikä lisää eroja palvelujen saatavuudessa. Kokemukset muista maista osoittavat, että ns. kermankuorinnan ongelmat voivat olla merkittäviä ja pitkäaikaisia. Toisaalta jos korvaussäännöt liittyvät tekijöihin, joihin palveluntuottajat voivat itse vaikuttaa, tämä kasvattaa kustannuksia. Hoivan laatu voi myös kärsiä, jos hoitoratkaisuja määrittää taloudellinen kannattavuus lääketieteellisen tarpeen sijasta.

Tuottajien korvausmallien suunnitteleminen on vaikeaa. Se vaatii asiantuntemusta, kattavia aineistoja ja resursseja. Ongelmana on, että näiden sääntöjen suunnittelu on alkanut vasta hiljattain, vain vähän aikaa ennen valinnanvapauspilottien suunniteltua alkua, eikä tarvittavan aineiston saatavuutta ole saatu varmistettua.

Työterveyshuolto ja päällekkäiset vakuutukset. Työterveyshuollon rooli ja päällekkäisten vakuutusten kysymys jäävät ratkaisematta nykyisessä uudistuksessa. Päällekkäisillä vakuutuksilla on mahdollisesti kolme vaikutusta. Ensinnäkin julkisen sektorin kustannukset kasvavat, kun työterveyshuollon ja yksityisten vakuutusten piirissä olevat ihmiset listautuvat sote-keskusten asiakkaiksi, ellei heidän alempaa palveluiden tarvettaan oteta huomioon riittävällä tavalla tuottajakorvauksissa. Toiseksi päällekkäisillä vakuutuksilla on taipumus lisätä palveluiden kysyntää, mikä voi edelleen kasvattaa kustannuksia. Kolmantena tekijänä julkisen sektorin kustannuksia kasvattavat mahdolliset siirtymät yksityisesti rahoitetusta julkisesti rahoitettuun terveydenhuoltoon.

Palvelujen saatavuus. Se, parantaako uudistus palvelujen saatavuutta, riippuu siitä, miten tavoitteet kustannusten alentamiseksi ja saatavuuden parantamiseksi sovitetaan yhteen. Mikäli markkinoille tulee uusia tuottajia

riittävästi, uudistus todennäköisesti parantaa palvelujen saatavuutta jonojen lyhentyessä. Palvelujen laatu ja kattavuus sen sijaan riippuvat tuottajakorvausten tasosta ja rakenteesta. Uudistukselle asetettu tiukka säästötavoite voi vaarantaa saatavuuden parantumisen.

Uudistuksen vaikutukset saatavuuden eriarvoisuuteen ovat epäselvät. Järjestämisvastuun siirtäminen kunnilta maakunnille todennäköisesti vähentää eroja alueiden välillä. Toisaalta yksityisen tuotannon ja kilpailun korostumisessa on myös alueellinen ulottuvuus, koska markkinamekanismi toimii paremmin kaupunkialueilla. Uudistus voi epäonnistua saatavuuden sosioekonomisten erojen kaventamisessa esimerkiksi yksityisten sairausvakuutusten ja työterveyshuollon tarjoaman päällekkäisen vakuuttamisen vuoksi.

Alueuudistus ja maakuntien rahoitus. Sosiaali- ja terveydenhuollon järjestämisvastuun siirtäminen kunnille voi vähentää palvelujen eriarvoisuutta ja johtaa tuottavuusparannuksiin, mikäli maakunnat pystyvät hyödyntämään tuotannon skaalaetuja.

Argumentit maakuntien verotusoikeuden puolesta ovat vahvempia kuin argumentit sitä vastaan. Verotusoikeuden puute ei ole kuitenkaan kiireellinen kysymys, koska verotusoikeus voidaan myöntää maakunnille myös myöhemmässä vaiheessa.

Toimeenpano. Koska ehdotetut uudistukset ovat merkittäviä ja vaikutukset epävarmoja, olisi kannatettavaa edetä varovaisemmin ja enemmän asteittain. Erityisesti valinnanvapautta olisi syytä laajentaa porrastetummin kuin nykyisessä esityksessä tehdään esimerkiksi laajentamalla valinnanvapaus koskemaan yksittäisiä palveluita kerrallaan. Maakuntauudistuksen ja laajamittaisen valinnanvapauden yhtäaikainen toimeenpano on saanut alkunsa poliittisesta sopimuksesta, eikä sitä voida perustella yksinomaan terveydenhuoltosektorin kehittämisen edun näkökulmasta.

1.4. Kokeilujen käyttö politiikan tukena

Hallitus on toteuttanut useita kokeiluja kautensa aikana. Näistä perustulokokeilu on saanut eniten huomiota, mutta kokeiluja on käytetty myös työllisyyspolitiikan ja terveydenhuollon arviointiin. Kokeilukulttuurin käyttöönotto mainittiin jo hallituksen ohjelmassa.

Neuvosto pitää hallituksen pyrkimystä käyttää kokeiluja politiikkamuutosten testaamisessa erinomaisena. Kokeiluissa pitäisi kuitenkin testata realistisia politiikkavaihtoehtoja ja ne tulisi suunnitella niin, että kokeilujen vaikutuksia voidaan arvioida uskottavalla tavalla.

Viimeaikaisia kokeiluja on vaikea hyödyntää päätöksenteossa. Useimmissa tapauksissa kokeilut on toteutettu ilman asianmukaista verrokkiryhmää, minkä vuoksi kokeilun vaikutusten arviointi on mahdotonta tai vähintään hyvin haastavaa. Niissä tapauksissa, joissa asianmukainen verrokkiryhmä on olemassa, kokeiltava politiikka on niin kaukana toteuttamiskelpoisesta uudistuksesta, että kokeilun tulosten perusteella on vaikea tehdä arvioita mahdollisten tulevien uudistusten vaikutuksista.

Lukuisat sosiaali- ja terveydenhuollon uudistukseen liittyvät kokeilut sekä kuntien työllisyyskokeilu kuuluvat ensimmäiseen kategoriaan. Näitä kokeiluja on toteutettu useissa paikoissa eri puolilla maata. Missään näistä kokeiluista ei ole asianmukaista verrokkiryhmää, johon kokeiluun osallistuvien alueiden kehitystä voitaisiin verrata. Kokeilujen vaikutusarviot perustuvat osallistujien tai kokeiluja hallinnoivien viranomaisten näkemyksiä selvittäviin kyselyihin, tai vertailuihin ei-vertailukelpoisten ryhmien välillä. Lienee selvää, että tällaiset arvioinnit voivat antaa kokeilujen vaikutuksista harhaisen kuvan. Usein kokeiltavana on myös samanaikaisesti monia eri politiikkavaihtoehtoja. Tällaisissa tapauksissa on mahdoton tietää, mikä piirre kokeiluissa aiheuttaa havaittuja muutoksia.

Toisaalta perustulokokeilu on lippulaivaesimerkki huolellisesti suunnitellusta ja laajamittaisesta satunnaiskokeesta. Potentiaalisten osallistujien satunnaistaminen kokeilu- ja verrokkiryhmiin sekä riittävän suuri otoskoko varmistavat sen, että kokeilu tuottaa luotettavaa ja samankaltaisiin olosuhteisiin yleistettävää tietoa kokeiltavasta politiikasta. Valitettavasti perustulokokeilu ei ole realistinen politiikkavaihtoehto, koska se tuottaa nettohyötyjä myös suurituloisille eikä huomioi vaikutuksia, jotka syntyisivät kokeiltavan perustulon rahoittamisesta. Näin ollen perustulokokeilun hyöty sosiaaliturvajärjestelmän kehittämisessä on rajallinen.

Kokeilujen lisäksi päätöksenteon tietopohjaa voidaan parantaa kehittämällä toteutettujen uudistusten jälkikäteisarviointia. Mahdollisuus uskottavaan jälkikäteisarviointiin riippuu paljolti siitä, miten uudistus toteutetaan. Esimerkiksi ajallinen ja alueellinen porrastaminen luovat vaihtelua, jossa vertailun mahdollistavia kokeilu- ja verrokkiryhmiä syntyy usein ikään kuin

luonnostaan. Lakimuutosten jälkikäteisarvioinnin mahdollisuudet tulisi esittää hallituksen esitysten yhteydessä taloudellisten vaikutusten, viranomaisvaikutusten, ympäristövaikutusten ja muiden yhteiskunnallisten vaikutusten rinnalla.

2. Recent economic developments

The upswing in Finland's business cycle started in 2016 and continued through 2017. In 2018 annual growth rate decreased, but still exceeded 2 per cent.

Private consumption and net exports have been the main contributing factors behind economic growth. Higher growth has increased demand for labour, and the employment rate increased rapidly in the first half of 2018. The unemployment rate has also started to decline, but at a slower pace since previously inactive unemployed people have started to search for jobs. With increasing labour demand, labour mismatch problems seem to be worsening.

Many forecasts anticipate that growth will decelerate in 2019 and 2020 towards the long-term growth of potential output. However, the rate of growth is forecast to remain above that of potential output.

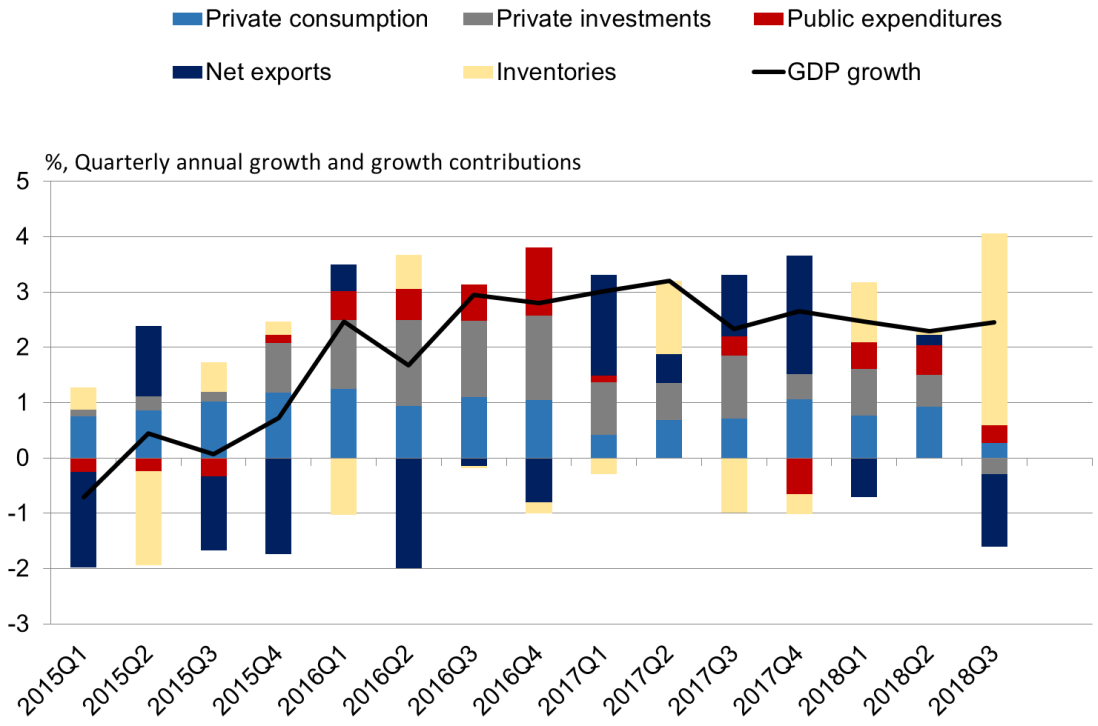
This chapter discusses recent economic developments and their implications for the appropriate fiscal policy stance. The latest developments in the labour market are discussed in Chapter 3 together with employment policies.

2.1. GDP growth and its components

Finland's economy started to grow surprisingly fast from the end of 2015. According to the latest National Accounts statistics, growth peaked in the spring of 2017. According to the latest quarterly National Accounts, net exports were the main contributor to growth in 2017. In 2018, however, ex-

ports have declined while imports have continued to grow. Domestic demand has also continued to grow. Private investment and both public and private consumption were the main drivers of growth in 2018. According to the latest quarterly National Account statistics, inventories increased significantly in the third quarter of 2018 and net exports declined. The growth numbers for 2018 contain a lot of uncertainty and they are revised retrospectively as Statistics Finland obtains more information. According to our calculations, half of the quarterly year-on-year growth rates have been revised by at least by 0.3-0.4 percentage points within a year of them first being released. The latest developments in the main sources of growth on the demand side are depicted in Figure 2.1.1.

Figure 2.1.1: Domestic demand was the main contributor for growth in 2018.



Sources: Statistics Finland and EPC calculations.

All the main forecasting organisations predict that growth will slow gradually towards the long-term growth rate in 2018-2020. In 2019 the economy is forecast to grow by 1.5%, with private consumption and net exports as the main sources of growth. The high level of consumption has been partly supported by improved employment and increasing wages and by low interest rates. The main risks surrounding growth projections are related to the uncertainty of export demand and possible slower growth in domestic consumption due to a decrease in confidence or higher interest rates.

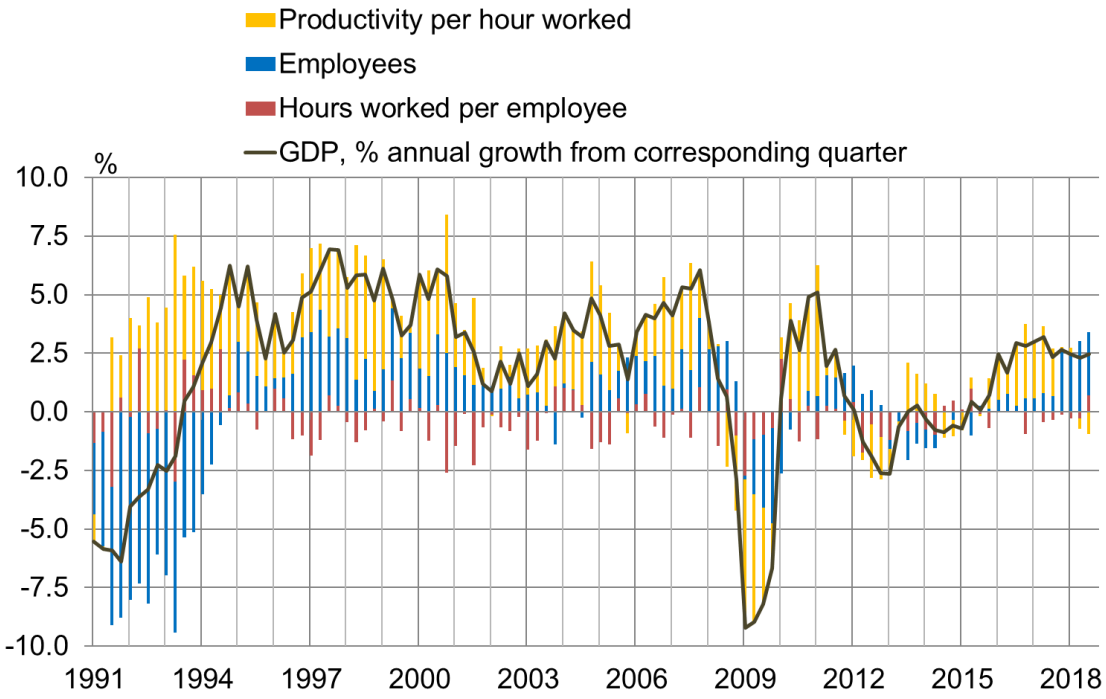
The growth forecasts of various national and international organisations are summarised in Table 2.1.1. During the fall of 2018, the growth expectations were revised slightly downwards. Compared to other forecasts, the forecast by the Ministry of Finance indicates slightly lower growth rates. One explanation is that Ministry of Finance forecast is based on more recent data than other forecasts listed in Table 2.1.1. All forecasts expect that the GDP growth rate decelerates in 2020.

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

	2018	2019	2020
Bank of Finland (18 Dec 2018)	2.7	1.9	1.7
Ministry of Finance (17 Dec 2018)	2.5	1.5	1.4
OECD (21 Nov 2018)	2.8	1.8	1.6
European Commission (8 Nov 2018)	2.9	2.2	1.9
IMF (9 Oct 2018)	2.6	1.7	1.6
PTT (13 Sept 2018)	2.6	2.4	
PT (11 Sept 2018)	2.7	2.3	
ETLA (Sept 2018)	2.8	2.2	1.6

Growth in productivity per hour worked was the main driver of GDP growth in 2016-2017. The demand for labour increased in the last quarter of 2017. Since then the number of employed persons has increased at an annual rate of almost 3%. Figure 2.1.2 decomposes annual GDP growth from the point of view of factor inputs and production technologies into growth in employment, hours worked per employee and productivity per hour worked. According to the quarterly national accounts, growth in labour productivity stalled in 2018. Closer analysis shows that growth in labour productivity has slowed in manufacturing while labour productivity in trade and services has declined. As employment has increased, especially in social services, in manufacturing and in wholesale and retail trade, it is quite possible that the slowdown in productivity is a transitory phenomenon. Naturally there is a lot of uncertainty involved in the most recent figures.

Figure 2.1.2: GDP growth contributions by employment, hours worked by employee and productivity per hour worked.



Sources: Quarterly National Accounts, Statistics Finland and EPC calculations.

2.2. Potential output

From the production function perspective, potential output is driven by changes in the growth of labour force, productivity and growth of physical capital. Slow growth in the total capital stock dampened growth in potential output in 2013-2016. After three years of decline, private investment started to grow again in 2015 and the private sector's productive capital has grown since 2016. While the capital stock was growing, its utilization rate also started to increase in 2016. As existing resources were being used more extensively, the economy was able to grow at a faster pace and the demand for labour increased. In 2018 the capacity utilisation rate has reached the levels that prevailed in 2015-2016. From now on the rate of growth will depend more extensively on investments in productive capital.

To complement the increasing capital stock, more labour is needed. In 2017 employment started to increase, and unemployment declined. The Ministry of Finance forecasts that the unemployment rate will be 7.5% in 2018, 6.9% in 2019 and 6.7% in the beginning of 2020s. Between 2016 and 2018 the

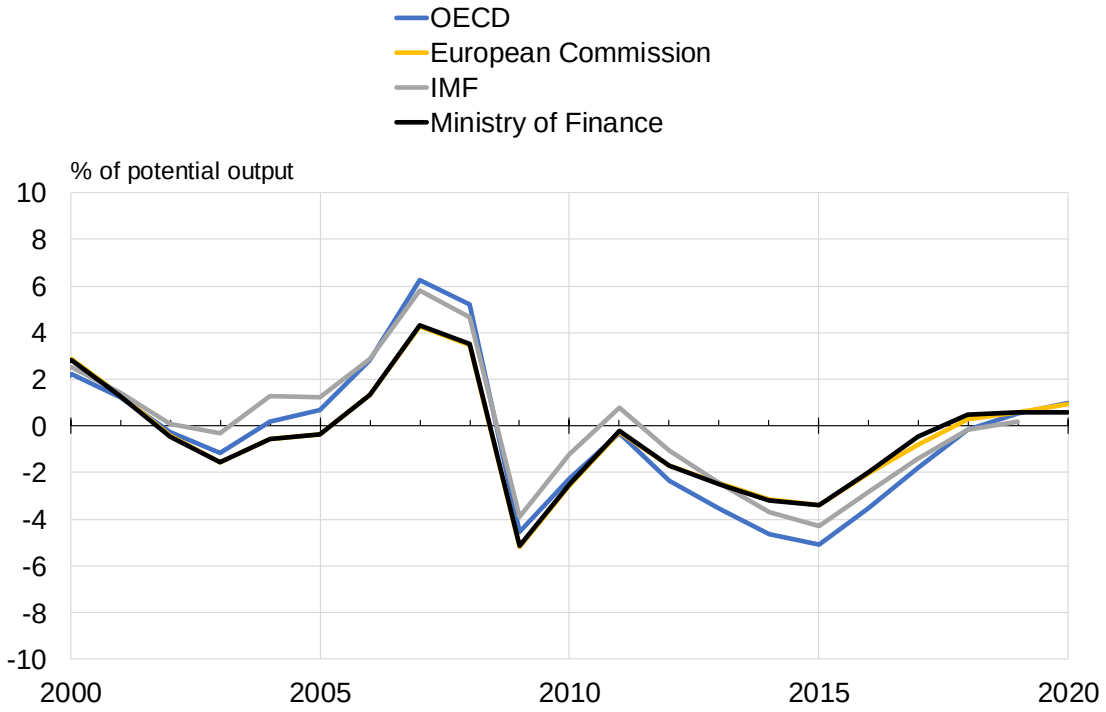
number of employed people has increased by 100,000 persons. This rapid growth indicates that the unemployment rate has been above its structural rate. After unemployment reaches its structural level, there will are additional labour input costs. These costs may come in different forms, e.g. higher wage demands, lower productivity or it may be necessary to increase job-specific training. At the time of writing, there are no signs of increasing pressures for higher wage inflation. The structural rate of unemployment is discussed in more detail in Chapter 3.

The reasoning above leads one to conclude that gross domestic product has reached its potential and economic growth is likely to slow in future years. According to the autumn forecast, the economy reached its potential level in 2017 and the positive output gap will increase until 2020, when it will reach 0.6%. In the following years the output gap will slowly close. From the business cycle perspective this means that the peak of the cycle will be reached in 2020. However, one should keep in mind that business cycle peaks are usually associated with high real wage inflation or unusually high productivity.

Assessing potential output and the output gap involves uncertainties arising from both methodological issues and forecasts that the output gap estimations are based on. While potential output and the output gap are theoretical concepts, they can be used as indicators of the phase of the business cycle and of the overall economic situation. For fiscal policy, the output gap is used in calculating the structural deficit. Furthermore, the structural deficit at the end of the medium-run forecast is used as a starting point for the assessment of long-term fiscal sustainability. Thus all the uncertainty involved in forecasts over five years and in the methodology of assessing the output gap is also present in long-term fiscal sustainability calculations.

Only five organisations publish their estimates of potential output and the output gap for Finland. Some of these estimates are collected in Figure 2.2.1. The output gap estimates by the Ministry of Finance (MoF) and the European Commission (EC) are produced using the same methodology, thus their views on the output gap in previous years do not deviate from each other. Both the OECD and the IMF estimate a larger negative output gap after 2014. These institutions thus estimate the potential output of the Finnish economy to be higher than the EC or the MoF do. A larger output gap would also mean a larger cyclical adjustment when calculating the structural balance.

Figure 2.2.1: Output gap estimates by different organisations.



Sources: Ministry of Finance Winter Forecast 2018, IMF, OECD and European Commission.

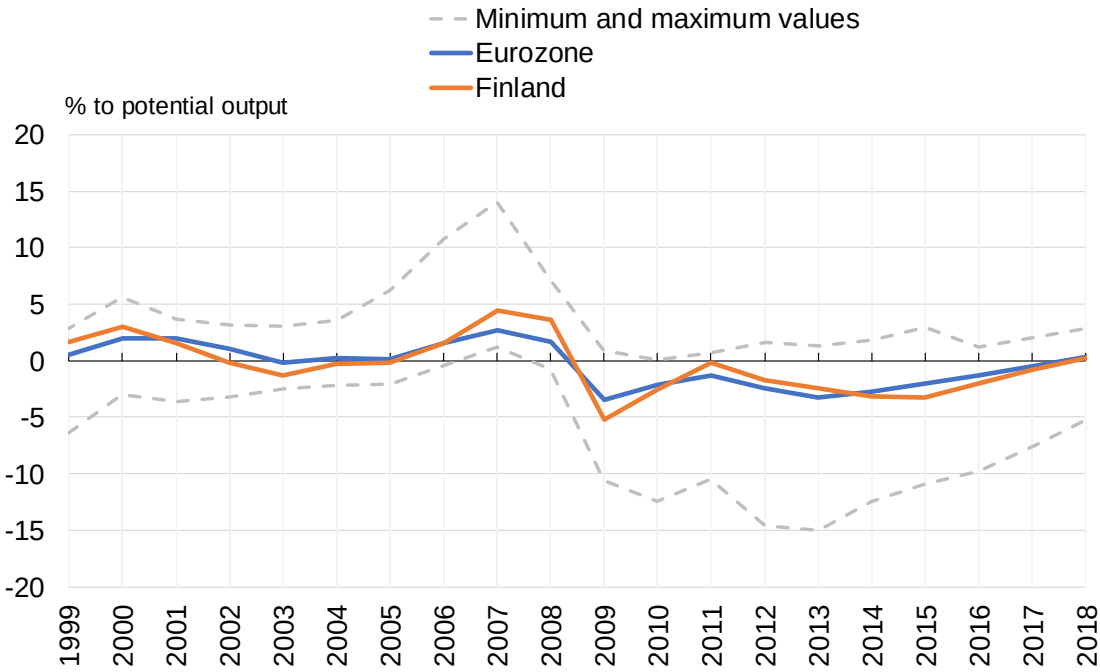
Compared to other European countries, the upswing in Finland's business cycle was delayed a few years. According to estimates by the European Commission, Finland's output gap was among the most negative in Europe in 2017. In the European Union the phase of the cycle had turned already in 2014, and by 2018 most of the EU countries will have a positive output gap.

2.3. The international economic situation and cost competitiveness

According to estimates by the European Commission, the output gap is closing in almost every country in the Eurozone. The output gap in the Eurozone is estimated to turn slightly positive in 2018. The variance in output gaps in the Eurozone countries is the smallest since 2004 (Figure 2.3.1). In its 2018 report, the European Fiscal Board (2018) recommended neutral or slightly contractionary fiscal policy for the Eurozone countries. As the phase of the business cycle in Finland is not much different from that of the other countries in the currency union, the overall recommendations for the fiscal stance also apply to Finland. The reasons for the concurrent economic

growth in the Eurozone countries have been supportive monetary policy and growth in net exports. As inflation is expected to pick up in the coming years, monetary policy is expected to tighten. Since Finland's business cycle situation is near the Eurozone average, tightening monetary policy will not cause country-specific problems needing to be corrected through fiscal policy.

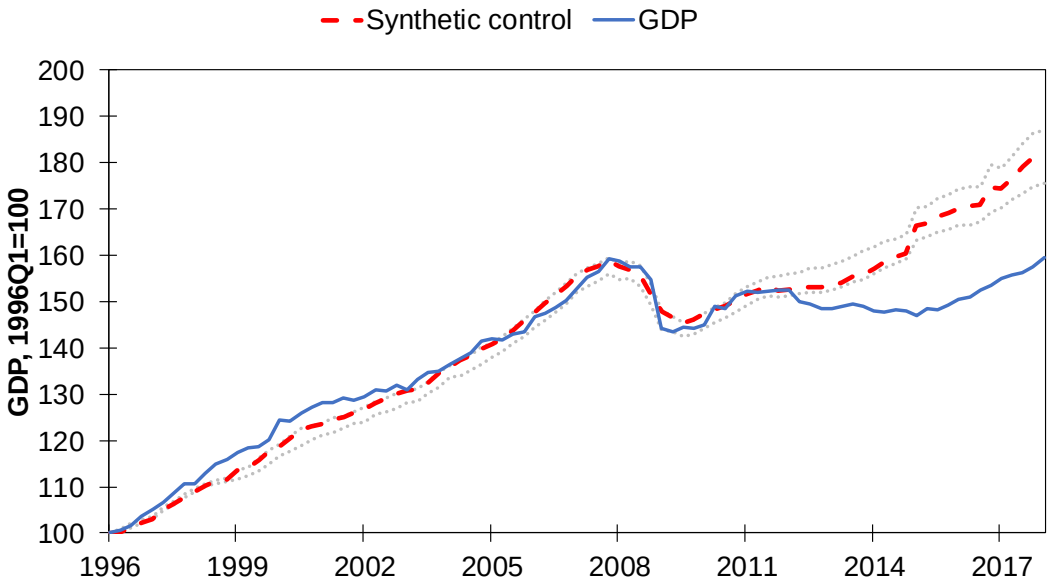
Figure 2.3.1: Output gaps of European countries are turning positive.



Source: European Commission, AMECO database.

Usually economic developments in Finland are compared with our Nordic peers or Germany. However, these countries are also affected by country-specific policies and economic developments. One way to ease this comparison is to construct a synthetic control from other industrial countries (see box 2.1). Figure 2.3.2 compares Finnish GDP growth to a synthetic control constructed from nine industrial countries. The figure shows that output calculated with the synthetic control started to recover in 2013. The main reason for this difference was Finland's poor export performance and differences in the dynamics of household consumption.

Figure 2.3.2: Finnish GDP growth and its synthetic control.

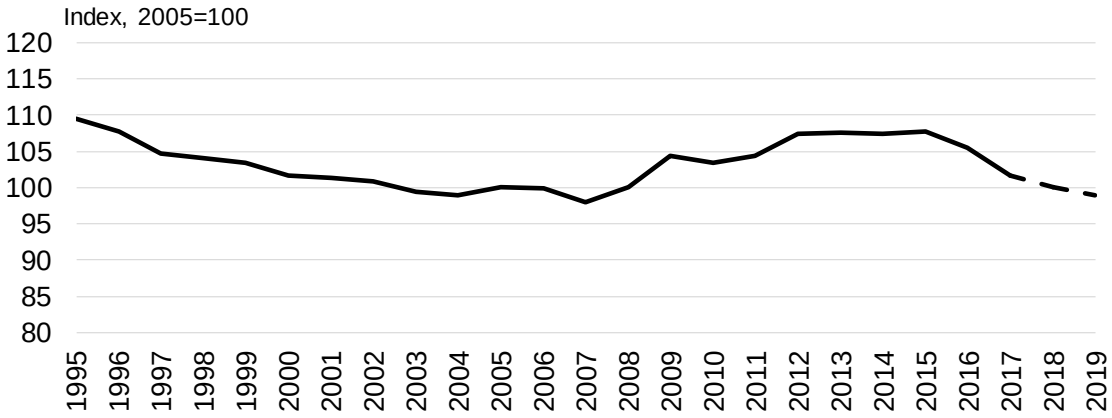


Sources: OECD and EPC calculations.

Note: Dashed grey lines represent the results with estimation periods ranging between 1996Q1 to 2010Q1 and 1996Q1 to 2014Q1.

In 2012-2015, output decreased in most manufacturing industries. The decrease in manufacturing was compensated by increases in services. As a result, the share of manufacturing of total output fell from 31% in 2011 to 28.5% in 2017.

Figure 2.3.3: Cost competitiveness has returned to the level of the 2000s.



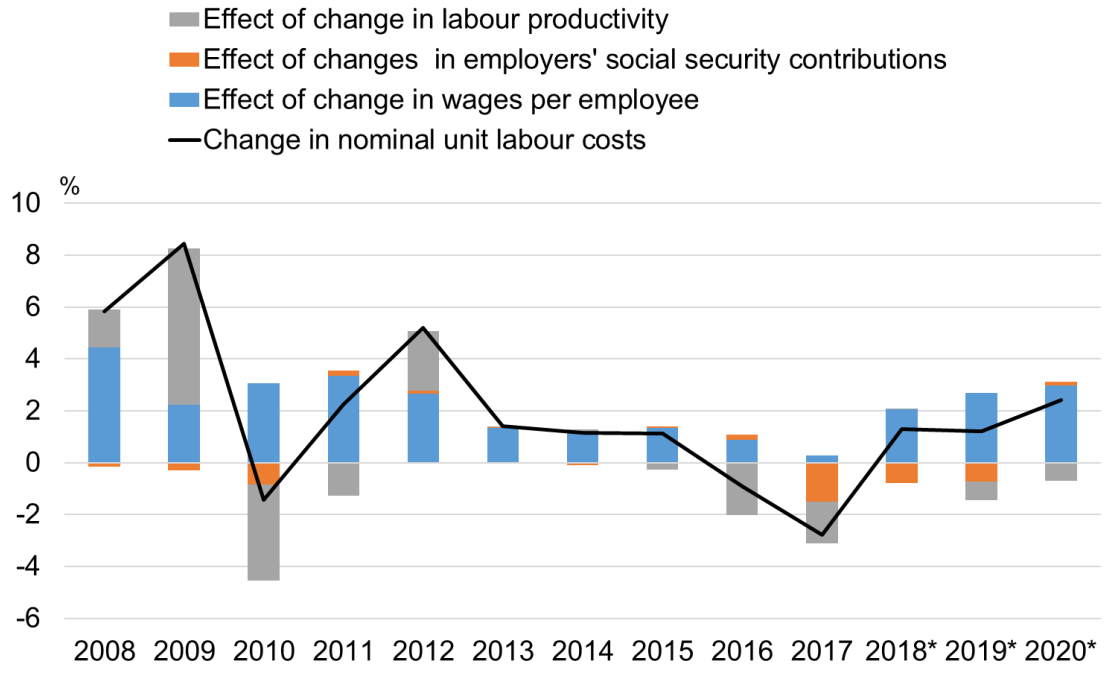
Sources: European Commission, AMECO database.

Compared to other industrial countries, nominal unit labour costs increased rapidly in 2008-2012, see Figure 2.3.3. Economic growth, associated increases in productivity and moderate growth of wages have enhanced Finn-

ish cost competitiveness after 2015. The European Commission forecasts that Finnish cost competitiveness will continue to improve in future years.

Figure 2.3.4 decomposes the changes in nominal unit labour costs in Finland into changes in labour productivity, changes in wages per employee and changes in employers' social security contributions. Immediately after the financial crisis labour productivity decreased, but the economic recovery in 2010 and 2011 increased both productivity and nominal wages. In 2011-2015 nominal unit labour costs increased faster in Finland than in the Euro-zone on average. The economic upturn increased productivity in 2016 and 2017. Half of the decrease in nominal unit labour costs in 2017 was due to decreases in employers' social security contributions associated with the competitiveness pact, with the other half being increases in labour productivity not compensated by wage increases. As agreed in the competitiveness pact, employers' social security contributions will decrease further in 2018 and 2019. The competitiveness pact helped to bring down growth in unit labour costs.

Figure 2.3.4: Drivers of growth in nominal unit labour costs in Finland.



Sources: Statistics Finland, Ministry of Finance Winter Forecast 2018 and EPC calculations.

The improvement in cost competitiveness is likely to increase export demand for Finnish goods and services and demand for labour. The competitiveness pact reduced unit labour costs in the short run. Whether this will translate into a permanent increase in exports and employment and the level of per capita GDP depends on the effect of increased external demand on wage formation.

Box 2.1 Synthetic control method

To assess the impact of country-specific shocks on gross domestic product which caused the prolonged recession in Finland between 2013 and 2016, we need a reference to which Finland's actual growth experience can be compared. Finland's GDP growth is often compared to our closest trading partners such as Sweden and Germany. In the short run this comparison is reasonable as the business cycles of these countries are fairly highly correlated. For a longer run comparison, however, the determinants of economic growth in these countries may differ considerably. For example, Sweden has its own monetary policy, and the structural reforms implemented in Germany turned it from "the sick man of Europe" at the turn of the century into the main driver of Europe's growth in the 2010s.

The synthetic control method was introduced by Abadie and Gardeazabal (2003) in a study on the effect of terrorism on per capita GDP in a region of Spain, the Basque country. This method focuses on the construction of an artificial control by searching for a weighted combination of the GDPs of other related countries or regions. These control countries are chosen to match as closely as possible the characteristics of the country in question, and then the weighted sum of their GDPs is used to form a set of predictors for the outcome variable. The evolution of the outcome for the synthetic control group is an estimate of the counterfactual showing how the outcome variable would have developed for the country concerned without country-specific disruptions.

In our analysis the evolution of Finland's population structure, employment, the size of the public sector, the share of manufacturing and exports of value

added, and educational attainment, in the period from 1996 to 2011 is compared to data for other OECD countries. When the optimal basket of countries is selected by the statistical method, their weights are fine-tuned with data on the target variable, i.e. GDP. The estimation result, the synthetic control for Finland, is a basket of nine countries with non-negative weights summing to one. The countries and their weights are presented in Table A.

Table A. The composition of the synthetic control

Country	Weight
France	0.3449
Sweden	0.2781
Latvia	0.1058
Ireland	0.0965
Greece	0.0544
Canada	0.0387
United States	0.0371
Slovenia	0.0284
Portugal	0.0162

The estimation result, the GDP of the synthetic control, is presented in Figure 2.3.2. In principle, the synthetic control method requires a known occurrence of a country-specific disturbance, which cannot be defined in this analysis. As the estimation results depend on the matching period used for the fine-tuning of the weights, we check the robustness by varying the end of the matching period between 2010Q1 and 2014Q1. The synthetic controls acquired using different matching periods vary between the dashed grey lines in Figure 2.3.2. The estimation results allow us to state with some confidence that the Finnish country-specific disturbances took place in 2012-2013, which is in line with the weak competitiveness in 2012-2015 (see Figures 2.3.3 and 2.3.4). At the start of 2018 Finland's GDP was 10 to 14 per cent below its synthetic comparison.

2.4. Council views

Economic growth accelerated in 2017 and the peak of the business cycle is expected to be reached in 2020. The upturn has increased productivity and demand for labour, and estimates of potential output have been revised upwards.

While growth is likely to slow towards the long-run average in 2019-2020, aggregate output in Finland is expected to stay above potential output. As the output gaps are turning positive throughout the Eurozone, there is no need for stabilisation policies in Finland, from the business cycle perspective.

It seems that the economic cycle has turned into an expansion in all EU countries. The increase in external demand has also boosted Finnish economic growth. Compared to the other industrial countries, the recovery was delayed.

It should be borne in mind that the positive outcomes in the labour market and public finances are partly due to the positive phase in the business cycle. There are remaining structural problems in the labour market.

Finland's competitiveness has improved compared to other industrial countries. The improvement is due to decreases in unit labour costs caused by increases in labour productivity, cuts in employers' social security contributions, and moderate wage growth.

Forecasts involve uncertainty, which should be taken into account in formulating appropriate fiscal policy. Maintaining and increasing fiscal buffers will improve the government's ability to support the domestic economy when necessary.

3. Employment policy

At the beginning of its term, the government stated that reaching an employment rate of 72% was its key policy target. At the time when the government programme was published this goal seemed highly unrealistic as it required an increase in employment of 110,000 persons.

However, the employment rate started to increase rapidly in 2017. The employment rate target was reached in November 2018. Current forecasts predict that in 2019 the employment rate will be 72.4 per cent.

The growth in employment has been the result of both active economic policies and favourable economic developments. As demonstrated in the previous chapter, the competitiveness pact helped to decrease unit labour costs and has most likely increased demand for labour. A number of policies have also been implemented with the aim of increasing transitions from unemployment to work. These include cuts in unemployment benefits, more active implementation of job search requirements, improved incentives to search for work and to take up job offers, as well as more effective guidance during regularly scheduled interviews with the unemployed.

As a result of economic growth, employment has increased in all sectors. The fastest-growing sectors are already reporting shortages of skilled labour.

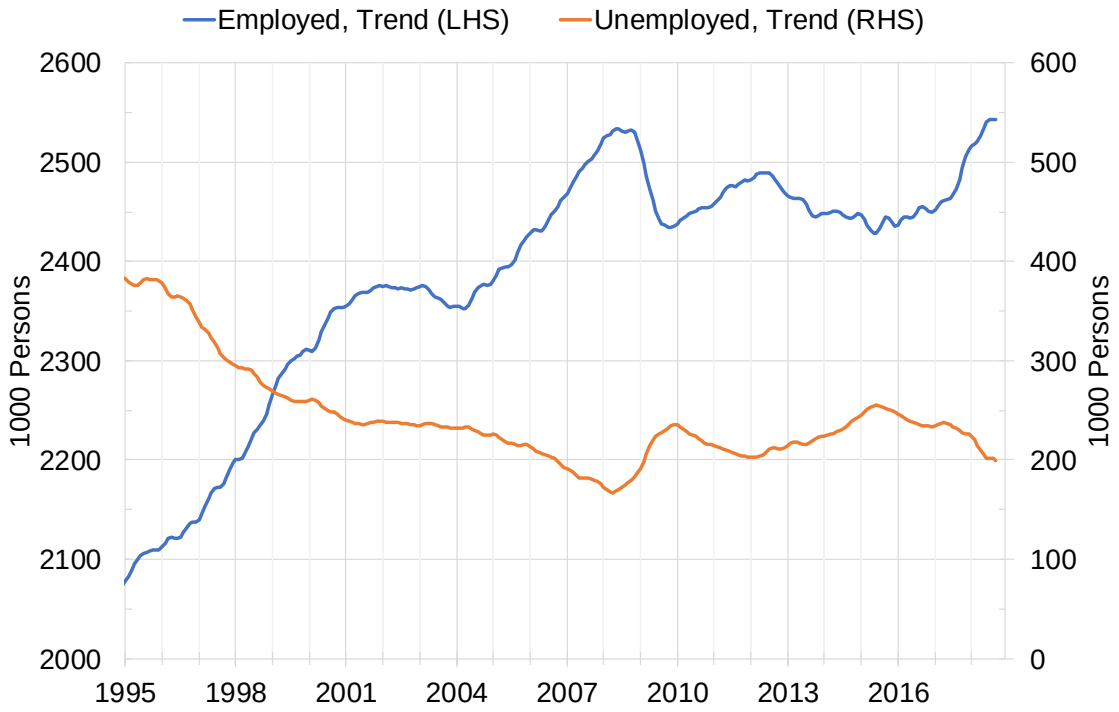
A proper analysis of the contribution of active economic policies vs. a favourable business cycle situation is a difficult task that we will not be able to perform in this report. Instead, this chapter reviews labour market developments over the past four years and assesses the effects of government policies on employment.

3.1. Labour market developments

According to the Labour Force Survey by Statistics Finland, there were on average almost 2.5 million employed persons in the first half of 2018. Over the past three years, employment has increased especially in construction, professional and administrative services and in public sector activities.

Figure 3.1.1 depicts the numbers of employed and unemployed persons. Compared to June 2015, employment has increased by 123,000 persons and unemployment has decreased by 59,000 persons, indicating that a large fraction of the newly employed were previously outside the labour force.

Figure 3.1.1: Employment of 15-74-year-olds has increased faster than unemployment has decreased.

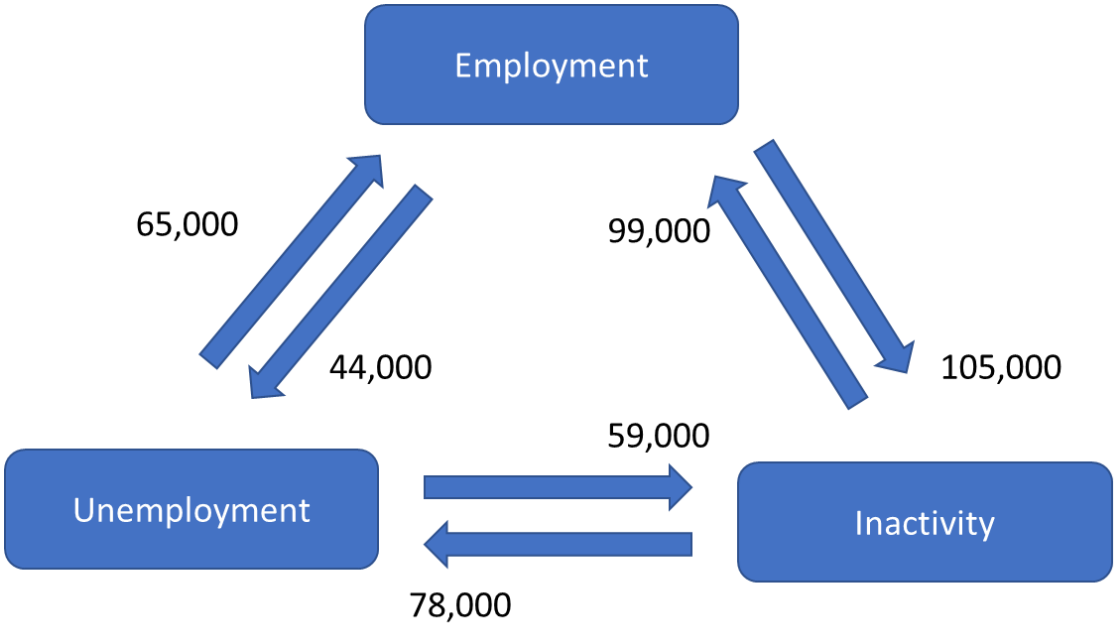


Source: Statistics Finland: Labour Force Survey and EPC.

The Labour Force Survey data by Eurostat also reports the quarterly numbers of transitions between unemployment, employment and inactivity. The Eurostat data goes from 2010 to 2018 and covers the population aged 15-74 years. In 2017, an average of 150,000 persons moved from employment to either unemployment or outside the labour force in each quarter, while 163,000 persons moved from these groups into employment. The flows between employment and inactivity are substantially larger that the flows between employment and unemployment. Hence, changes in the number of

unemployed persons do not give a full picture of the labour market situation. The flows are illustrated in Figure 3.1.2.

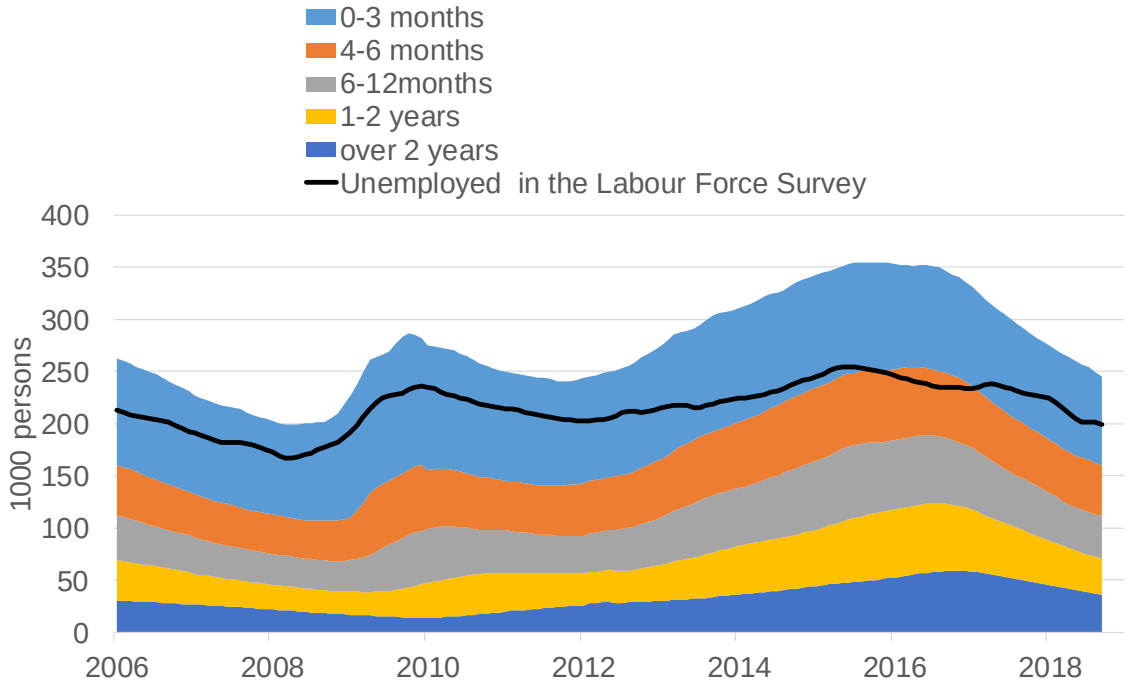
Figure 3.1.2: Average quarterly flows between employment, unemployment and inactivity in 2017.



Sources: Eurostat Labour Force Survey and EPC.

The poor labour market situation after the financial crisis increased long-term unemployment. Even in the short recovery period in 2011 the number of persons who had been unemployed over a 12-month period kept increasing (see Figure 3.1.5.). Long-term unemployment started to decrease in 2017; eight months after aggregate unemployment had started to go down. As usual in recoveries, the number of unemployed persons with shorter unemployment periods has declined faster than the number of long-term unemployed.

Figure 3.1.3: The stock of registered unemployed persons by the duration of unemployment and number of unemployed according to the Labour Force survey, trends.



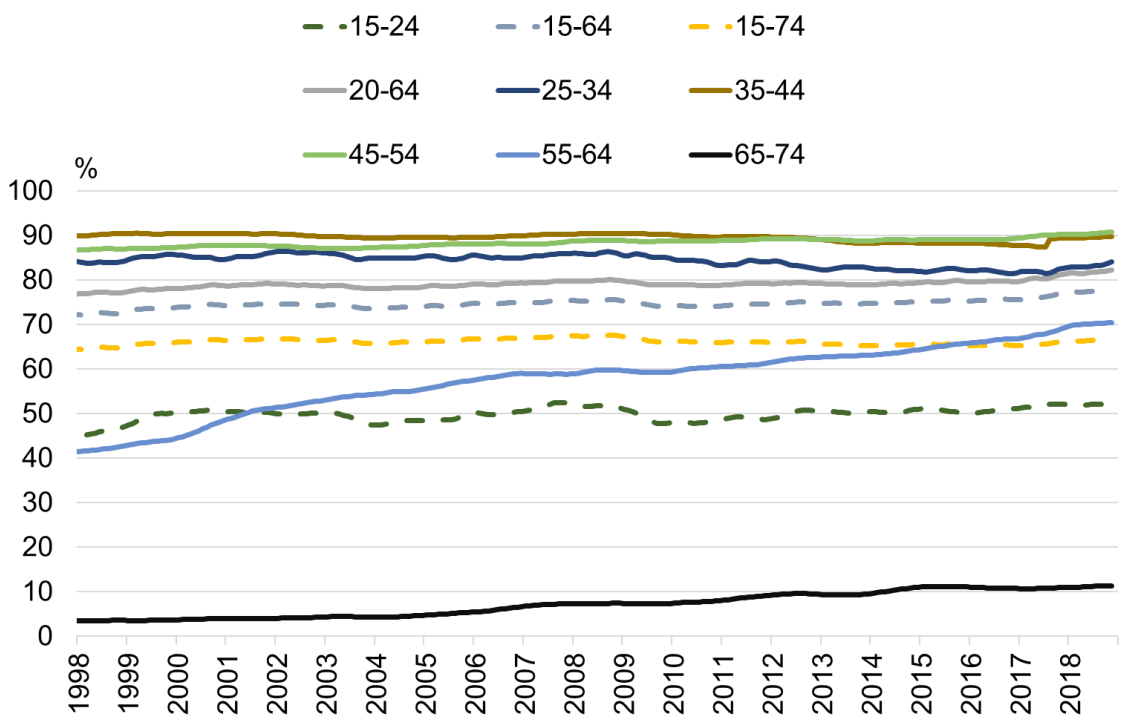
Sources: Ministry of Economic Affairs and Employment; and Statistics Finland. Trend adjustment by the EPC.

In 2018 the labour force participation rate of 20-64-year olds reached 81.5%, which is well above its previous record value of 80.3% in 1989. Although the labour force participation rate is already high, there is still room for improvement as the participation rates of 25-44-year-olds are below the level of 2008.

In 2018 the participation rate of 15-74-year-olds was 66.6%, one percentage point lower than in 2008. Interpreting the changes in participation rates between 2008 and 2018 is not straightforward as the age structure of the Finnish population has changed. In 10 years, the population share of the age group with the lowest participation rate, i.e. 65-74-year-olds, has increased and the population shares of age groups with higher participation rates, i.e. 35-44 and 45-54-year-olds, have decreased. By decomposing the change in the participation rate into effects of changes in population shares of age groups and changes in labour force participation within each age group, we may conclude that labour force participation within age groups has in-

creased by 2.1 percentage points, but changes in the age structure have reduced the aggregate participation rate by 3.2 per cent.[2]

Figure 3.1.4: Participation rates in different age groups, trends.



Sources: Statistics Finland and EPC.

At the end of 2017 and the first half of 2018 the employment rate of 15-64-year-olds increased rapidly and has now crossed the 72% threshold. The current employment rate is the highest since 1990.

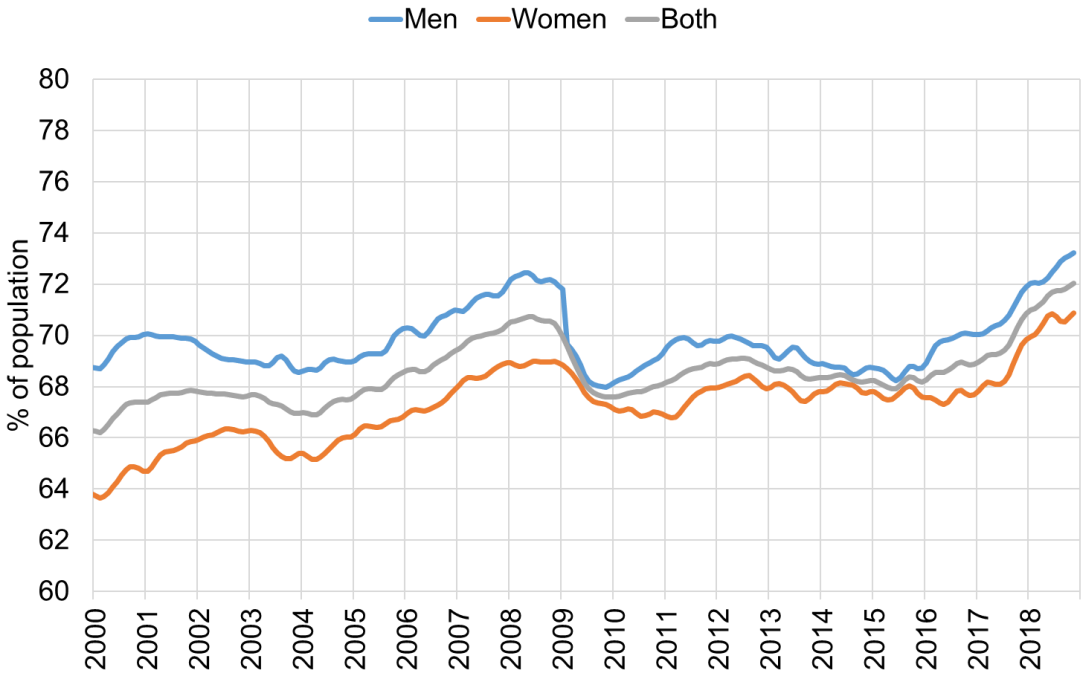
Figure 3.1.5 depicts the evolution of the employment rate by gender. The employment rate of both genders decreased during the financial crisis, although more so for men. By 2018, the employment rate of men increased to the previous peak in 2008, and the employment rate of women is currently 2.5 percentage points higher than in 2008.

In the beginning of 1990, the employment rate reached almost 75 per cent. Compared to the numbers reached in 1990, the employment rate of women is already at the same level while the employment rate of men is over 5 percentage points below the record. A closer look shows that for both genders,

[2] For technical details of the calculations see e.g. Kinnunen and Orjasniemi (2013).

the employment rates of both age groups 25-34 and 35-44-year-olds are well below the levels reached in years 1990 and 2008.

Figure 3.1.5: Trend of employment rates of 15-64-year-old men, women and both genders.



Sources: Statistics Finland and EPC.

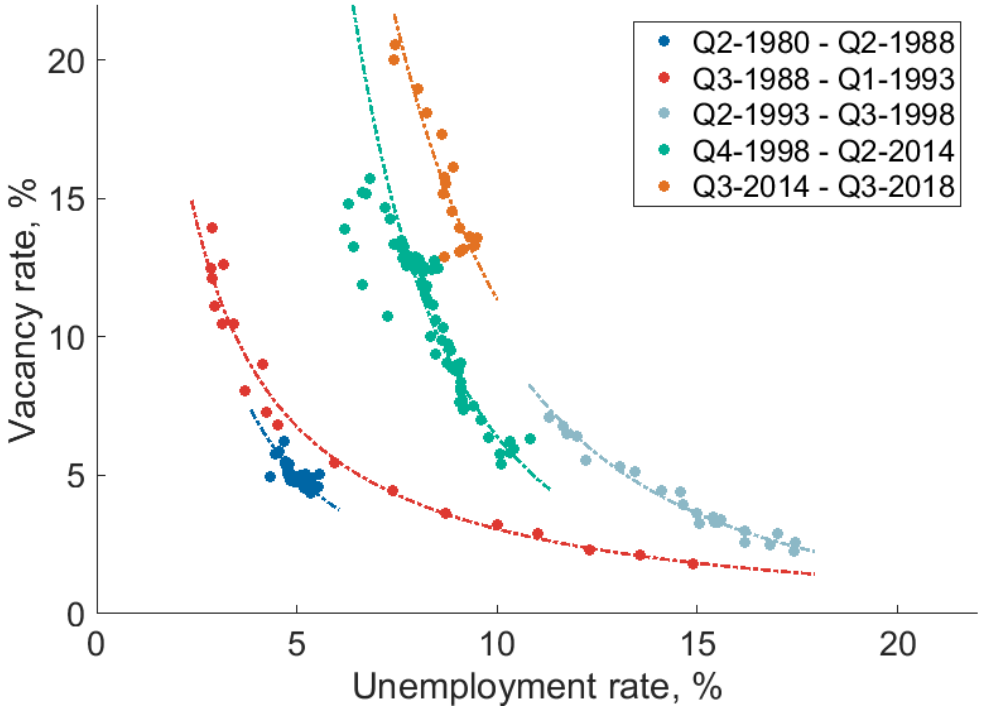
A commonly used indicator for the efficiency of labour markets is the Beveridge curve, which plots the relationship between the vacancy rate (vacant jobs/labour force) and the unemployment rate. In a recession the number of vacancies decreases and the unemployment rate increases, while in expansions vacancies increase and unemployment decreases. However, the relationship is not stable over time and it tends to change as the structure of the economy changes.

Most often shifts in the Beveridge curve take place during the peaks and troughs of business cycles. In Figure 3.1.6 the green dots represent quarters in years from 1999 to 2014. The latest outward movement of the curve in 2013-2014 indicates increasing problems in matching vacant jobs and potential workers.

In statistical terms, the relationship in the Beveridge curve in 2014-2018 is different from that in the years 1999-2014. The mismatch problems have remained similar in 2018, although unemployment has started to decline. As

the Finnish economy is now at the peak of the business cycle it is too early to say whether the relationship between unemployment and vacancies will remain unchanged in the near future.

Figure 3.1.6: Unemployment rate and vacancy rate, 1977Q1–2018Q2



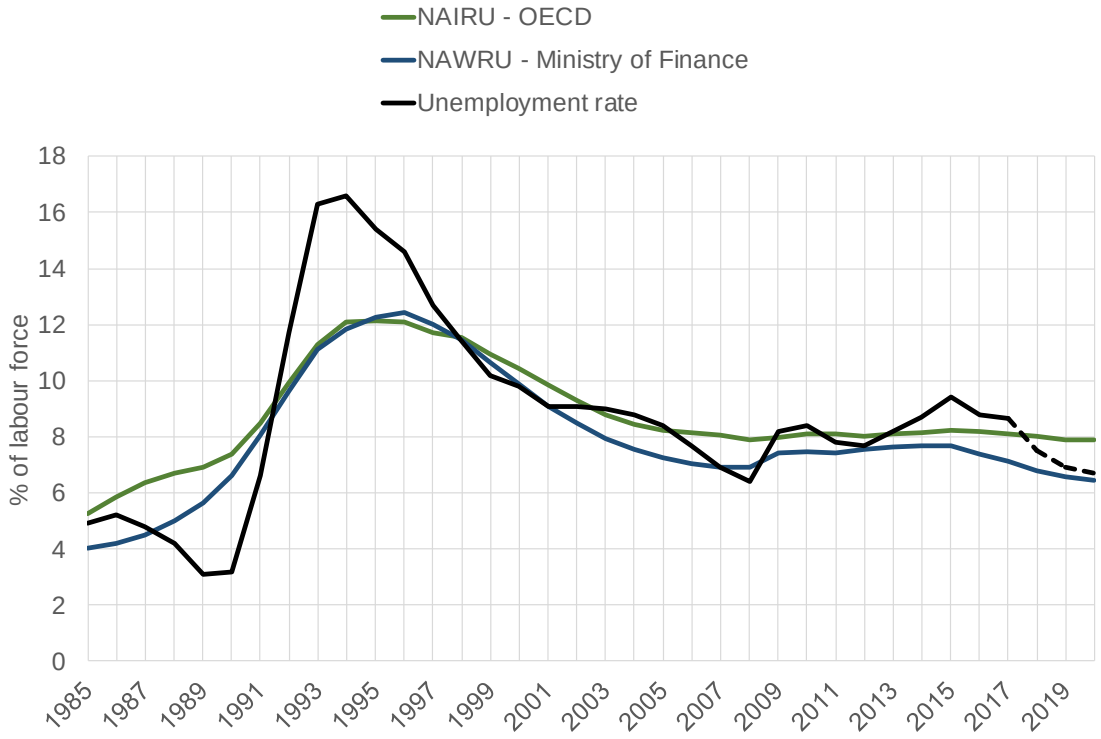
Sources: Labour Force Survey, Ministry of Economic Affairs and Employment, OECD and EPC calculations.

The number of vacant jobs had started to increase already in 2016, while the unemployment rate stayed rather stable. After 2016 the unemployment rate has decreased along the Beveridge curve marked with dashed orange line.

Figure 3.1.7 shows the current estimates of structural unemployment by various institutions. Estimates for the structural unemployment in 2018 vary from 8.0% by OECD to 6.8% by Ministry of Finance. According to these results the actual unemployment rate is declining towards the structural rate. This is partly due to the estimation methodology. The structural unemployment rate, namely NAWRU or NAIRU, is usually estimated as a smoothed path of the actual unemployment rate with wage or price inflation taken into account in the smoothing process. Recent decline of unemployment has taken place without excess increases in real wages over productivity, which indicates that also the structural unemployment rate has decreased.

The factors contributing to the small decline in the rate of structural unemployment are cuts in unemployment benefits and a decrease of the tax wedge. The decreases in employees' unemployment insurance contribution rates in 2019 decrease the tax wedge so that the structural unemployment rate is likely to continue its slow decline. As there are no signs of intensifying real wages growth in 2019, the reduction of unemployment may be long lasting.

Figure 3.1.7: Estimates of the structural unemployment rate by the OECD and the Ministry of Finance.



Sources: Ministry of Finance Winter 2019 forecast and OECD.

Box 3.1 Drivers of structural unemployment

The method used by the Ministry of Finance to estimate the structural unemployment rate is based on a method developed by the European Commission. The approach decomposes the unemployment rate into cyclical and structural components using an unobserved components model. The method relies on the relation between the unemployment rate and unit labour costs, a wage-Phillips curve, to identify the cyclical component in unemployment. When the cyclical component is removed from the actual unemployment rate, the remaining trend is the structural unemployment rate. As noted by Orlandi (2012), this method merely provides a proxy for structural unemployment – and might still be influenced by temporary shocks.

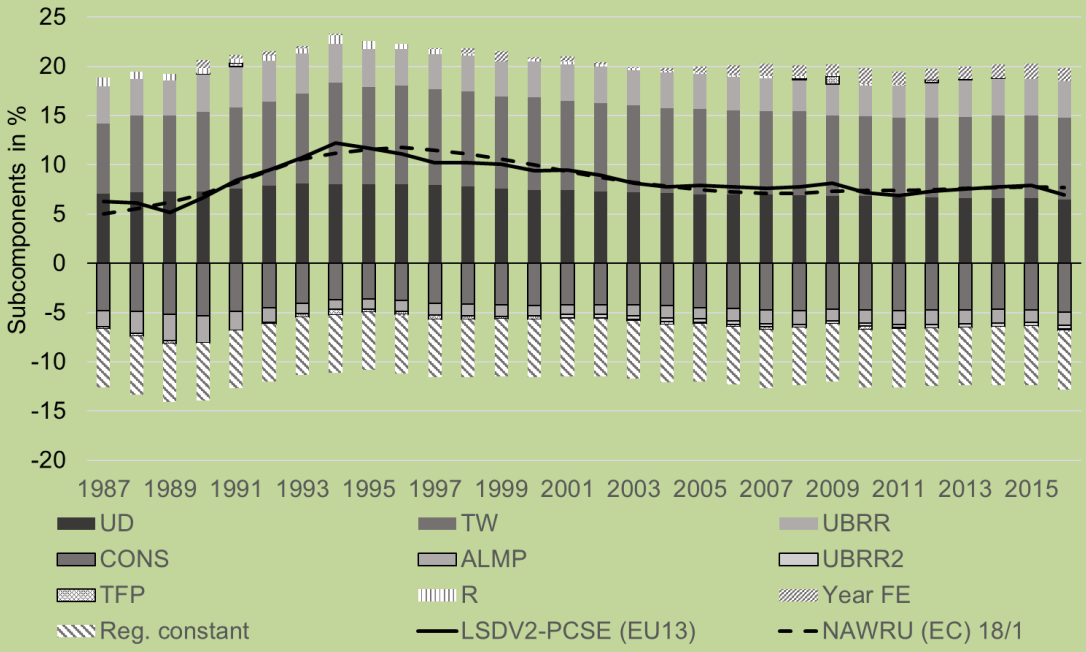
While the estimation method of the structural unemployment rate defined as non-accelerating wage rate of unemployment (NAWRU) has no theoretical background relating the structural rate to economic indicators, there is an empirical literature that explains the developments in NAWRU with structural variables. Referring to this literature, Orlandi (2012), Havik et al. (2014) and Hristov et al. (2017) explain the different developments in and levels of NAWRU between European countries. The explanatory variables include labour market indicators, and thus reflect the impact of labour market reforms on NAWRU. In addition, persistent demand shocks, such as crisis events or construction cycles, are also used to capture changes in the level of NAWRU. The real interest rate and total factor productivity growth are used to capture shocks on the production side of the economy. The methodology is used by the European Commission to assess the long run rate of structural unemployment.

Although the methodology by Orlandi (2012) and Havik et al. (2014) has been criticised e.g. by Heimberger et al. (2017), it can be used to assess changes in the Finnish structural unemployment rate. Our results differ slightly from those of the European Commission (EC) as we have updated the original panel data maintained by the EC to acquire more observations where possible, see Gäddnäs (2019).

In the panel estimation the first set of variables is a mixture of four labour market indicators: trade union density (UD), tax wedge (TW), unemployment benefit replacement rate (UBRR and UBRR2) and active labour market policy (ALMP). The second set of variables includes total factor productivity (TFP), the real interest rate (R) and the ratio of construction workers to total employment (CONS).

The results indicate that the main factors increasing structural unemployment in Finland are high union density, the tax wedge between labour costs and household net earnings and the replacement rate of unemployment benefits. The main factors decreasing structural unemployment are dynamics in the construction sector and active labour market policies, see Figure A.

Figure A: Determinants of the Finnish structural unemployment rate according to the method used by the European Commission.



Source: Gäddnäs (2019)

3.2. Employment policy measures

3.2.1. Competitiveness pact

One of the major policy initiatives of the current government was the competitiveness pact formally negotiated between the employer and employee organisations but strongly advocated by the government. In the pact, part of the mandatory employer contributions was shifted to employees, collective agreements were extended by twelve months with zero wage increases, holiday bonuses were temporarily cut and working hours extended without compensation. The government compensated the increases in mandatory employee contributions with a roughly equivalent income tax cut. According to calculations by the Ministry of Finance, the competitiveness pact implied a 4.2 per cent reduction in labour costs in 2018.

In a previous EPC report we concluded that the effect of the competitiveness pact on labour costs is likely to be temporary. Eventually market forces will determine wages, and, for example, shifting the nominal incidence of payroll taxes to employees will simply lead to an equivalent increase in nominal wages. As demonstrated in the previous chapter, this has not happened, at least not by the time of writing this report. Instead, nominal wage growth in Finland has been slower than in competitor countries, which, together with the decrease in employer contributions, has led to a lasting reduction in labour costs.

A plausible interpretation of developments is that wages were well above the equilibrium level at the time of agreement on the competitiveness pact. Wages are in general sticky downwards. A decrease in productivity and high unemployment after the financial crisis had not lowered wages to the market-clearing level. Hence the reduction in labour costs in the competitiveness pact merely brought wages closer to the equilibrium and the reduction in employer contributions did not cause pressure to increase nominal wages.

This interpretation also allows an examination of the effects of the competitiveness pact on employment using a simple labour demand framework. As long as supply does not constrain growth in employment, the change in employment can be simply be evaluated by multiplying the change in labour costs implied by the competitiveness pact by an estimate of the price elastic-

ity of labour demand with respect to labour costs. Such calculations have been performed by ETLA (Kaitila et al. 2018) with a resulting employment effect estimate of 15,000 to 25,000 jobs by 2018, and 23,000 to 42,000 jobs within five years.

It should be noted that the ETLA estimates are not based on empirical data but rather on simulations that use existing estimates of the elasticity of demand for labour. ETLA uses demand elasticities ranging from 0.3 to 0.7. In its 2016 report (EPC 2017), the Council argued that the lower end of this range is more consistent with empirical research and criticised the Ministry of Finance for using unrealistically high demand elasticities in its calculations. More importantly, the demand effects should not simply be added to the estimates of increased labour supply due to improved work incentives, as was done in the ETLA report[3]. An increase in supply enables an increase in employment due to a reduction in labour costs. However, as long as employment is constrained by demand, an increase in supply has no effect on employment.

A final caveat is that this type of an analysis naturally cannot be interpreted as providing a causal estimate of the policy. It is based on a simulation using average elasticity estimates from earlier literature, which may or may not be an accurate description of individual and firm reactions to this particular policy. Given that credible causal estimates are not yet available (and are indeed challenging to obtain), a simulation analysis is nevertheless a valuable exercise.

3.2.2. Activation model

Perhaps the most controversial employment policy initiative of the current government was implementing a new activation model that encourages the unemployed to take up short-duration jobs and to participate in labour mar-

[3] ETLA (Vihriälä 2018) published later a revised version of its calculations. In the new version the employment effect is smaller. However, even in this version supply effects due to improved work incentives are added to an estimate of demand effects due to a reduction in labour costs. The Council agrees that supply-side reforms have most likely had positive employment effects but still holds the view that the issue is more complicated and that a proper evaluation of the employment effect of government policies would require simulations within an internally consistent model that incorporates both supply-side and the demand-side interventions. An alternative adopted in this chapter is to discuss separately the effects of individual policy interventions without an attempt to calculate the aggregate employment effects of government policy.

ket training programmes. In contrast to existing programmes, which pay additional unemployment benefits to the program participants, the activation model cuts the unemployment benefits of unemployed persons who fail to demonstrate sufficient activity.

The programme was launched on 1 January 2018. The activity of unemployed persons is monitored over 65 compensated days. Unemployment benefits are cut by 4.65% (one day without benefits per month) for the following 65 days unless unemployed persons have worked for a minimum of 18 hours, participated in a training programme for a minimum of 5 days or earned a minimum of EUR 241 in entrepreneurial income during the 65-day monitoring period.

The reform was inspired by a recent reform in Denmark, which aims to increase incentives for the unemployed to accept jobs either of a short duration or at lower wages than the previous job. This reform was based on proposals by Dagpengekommissionen (2015). However, the Danish reform also included other key elements in addition to benefit cuts. In Denmark, the uptake of unemployment benefit is now measured on an hourly basis. All unemployed persons have an account which is debited during unemployment on an hourly basis, and credited when employed. Thus short-term jobs allow the benefit period to be extended from the normal two years to a maximum of three years. The benefit level is computed on the basis of wage income over 12 months and highest income within the last 24 months. Moreover, after each benefit spell of four months, one day of benefit entitlement is lost. The Danish reform was implemented in 2017, and has therefore not yet been evaluated.

Evaluation of the effects of the activation model is difficult as it was implemented at a time when employment was growing rapidly. Between the third quarter of 2017 and the third quarter of 2018, employment increased by 70,000 and unemployment decreased by 28,000 persons. Separating the effects of the activation model from increased employment opportunities without proper comparison groups is challenging.

Both the Social Insurance Institution (Kela), which administers basic benefits and the Financial Supervisory Authority (FIN-FSA), which collects data on earnings-related benefits, actively follow the effects of the activation model. In August 2018, 38% of the recipients of basic benefits and 33% of the recipients of earnings-related benefits received reduced benefits due to

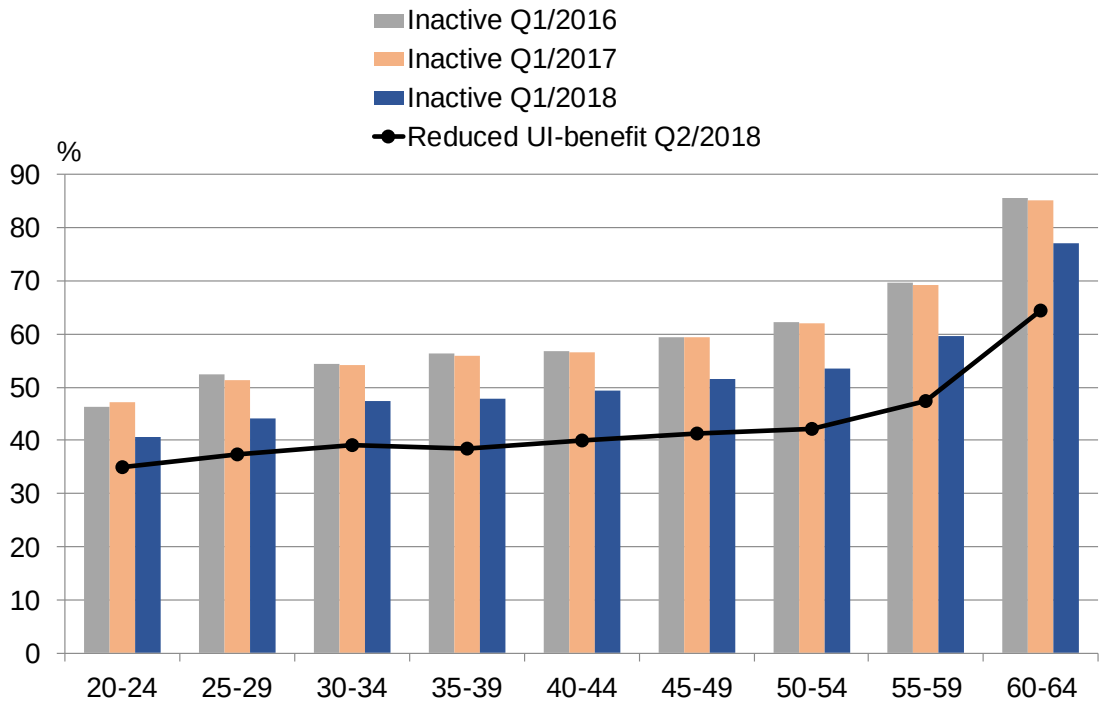
not fulfilling the activation criteria. However, these numbers should not be interpreted as the effects of the activation model. Most unemployment spells are relatively short, so many benefit recipients at any given time have not been unemployed for sufficiently long for their activity to be monitored. Also, unemployed persons who have been active enough to find employment and have left the benefit recipient register are missing from these calculations.

Following those who were unemployed on 1 January 2018, i.e. at the time when the reform was introduced, provides a better picture of the "bite" of the activation model.

In Figure 3.2.1 we show the percentage of unemployed who fail to fulfil activation criteria out of those who were receiving earnings-related unemployment benefits on January 1st. We perform same calculation for years 2016, 2017 and 2018 and report the results by age group. The line illustrates the percentage of unemployed whose benefits were reduced because of inactivity. The difference between fraction inactive during the first quarter of 2018 and fraction experiencing benefit cuts in the second quarter is due to missing data on short employment spells and on specific conditions under which workers are protected from benefit cuts (e.g. pending disability application).

As shown in the Figure, the activation model has more bite in the oldest age groups. The finding is not surprising as the benefit spells tend to be longer for the older groups. The younger groups find new employment, on average, more rapidly and hence often do not remain on benefits until their benefits would be reduced. Interestingly the fraction inactive decreases in all age groups between 2017 and 2018 indicating that the activation model might have had intended effects. It has to be kept in mind though that there may also be other reasons that cause differential trends in unemployment at the beginning of 2017 vs. 2018, and therefore the difference cannot necessarily be contributed solely to the activation model.

Figure 3.2.1: Inactive as a fraction of those unemployed at the beginning of the year.



Source: Calculations based on data from Financial Supervisory Authority, by Roope Uusitalo as a part of an ongoing research project evaluating the impacts of the activation model at VATT Institute for Economic Research. Inactivity classification is based on number of days on UI-benefits, number of days in labour market programs, and recipiency of partial UI-benefits, all measured during the first quarter of each year.

3.2.3. Extended unemployment benefits near retirement age

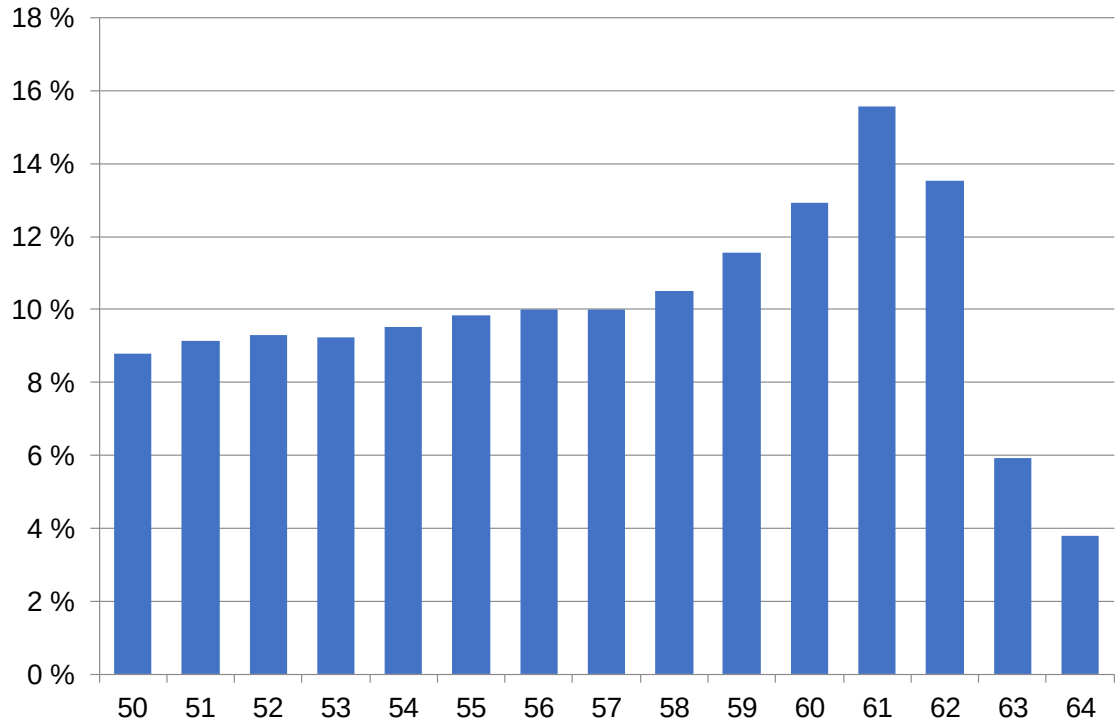
One of the peculiar features of the Finnish unemployment insurance system is payment of extended earnings-related benefits to unemployed persons who are close to the retirement age. Under the current rules, the unemployed are entitled to extended unemployment benefits if they turn 61 before the maximum duration of normal benefits expires (Act on Unemployment benefits, Section 9). In practice, this implies that those who become unemployed after the age of 59 can receive earnings-related unemployment benefits until retirement.

This system, which is commonly known as “unemployment tunnel”, has been widely used at times when a firm needs to reduce its workforce. As the incentives to search for new work are reduced, crossing the age limit has

both increased the incidence of unemployment and extended the duration of unemployment.

Figure 3.2.2 shows the fraction of unemployed persons by age cohort at the end of 2017. A rough calculation based on these numbers reveals that if the fraction of the cohort unemployed in the age groups between 59 and 62 could be reduced to the level prevailing among 58-year-olds, aggregate unemployment would be reduced by 8,500 persons.

Figure 3.2.2: Fraction of unemployed in each age cohort at the end of 2017.



Source: Statistics Finland, Employment Statistics, preliminary data, table updated on Dec 17 2018

The eligibility age limits for extended benefits have been gradually increased since the mid-1990s. Under the pension reform agreement made by the labour market organisations (26.9.2014), the age limit will be further increased to 62 for cohorts born in 1961 or later if - according to the parties' own evaluation – the unemployed have managed to renew their right to earnings-related benefits through subsidised employment or by participating in labour market programmes.

The increases in the eligibility age for entitled benefits have reduced entry into unemployment in the age groups affected by these changes (Kyyrä & Wilke 2007). However, as the old-age retirement age is gradually increasing,

the maximum length of extended benefits and its effect on the unemployment rate is likely to increase in the future. Hence, a further increase in the eligibility age for extended benefits or removal of the entire system would be a timely reform.

Other options to lessen the incentives to use eligibility for extended unemployment benefits would be to increase the degree of experience-rating in unemployment benefits or to introduce seniority rules to layoffs due to economic and production-related reasons. Both policies would reduce the incentives to target dismissals at workers close to retirement age (Hakola & Uusitalo 2005, Böckerman et al. 2018).

3.2.4. Basic income experiment

In its programme, the current government also promised to launch a basic income experiment. The experiment started at the beginning of 2017 and lasted until the end of 2018. During the experiment, 2000 recipients of basic benefits were transferred to a basic income system and could keep their EUR 560 monthly basic income until the end of 2018 irrespective of their labour market status, income or job search activities.

The basic income experiment has received wide attention both in the Finnish and international media. Unfortunately, the system experimented with is far from realistic or even roughly budget-neutral and hence provides little guidance for future policy decisions. In a more realistic system proposed by the advocates of basic income, the basic income would be taxed at a marginal rate in a range between 40 and 50 per cent from the first euro earned.

Hence, the main lesson to be learned from the basic income experiment has more to do with the constitutional feasibility of large-scale randomised field experiments than with the incentive of the bureaucracy-reducing effects of basic income. Apparently, it is possible to implement randomized experiments in cases where the treatment and control groups are treated differentially during the experiment.

The first results of the basic income experiment will be published in March 2019. It would be equally important to release anonymised data on the experiment for future research purposes as the experiment is likely to draw broad interest among researchers across the world.

3.2.5. Employment policy experiments

Between August 2017 and the end of 2018 a policy experiment (*työllisyyden kuntakokeilu*) took place in which responsibility for certain activation policies was transferred from central government to municipalities in some regions. No additional central government funds were allocated to the experiment, and the experiments did not require additional funds from the municipalities either. The experiments' institutional context is unusual as a planned regional reform will shift responsibility for activation policies from central government to the counties.

Since 2006 Finnish municipalities have co-funded the unemployment benefits of the long-term unemployed. This responsibility was expanded in 2015, and currently municipalities cover 50 to 70% of the unemployment benefits of the long-term unemployed.[4] The purpose of these reforms has been to incentivise municipalities to reduce unemployment. In total the municipalities' bill for unemployment benefits in 2017 was EUR 433 million.

Responsibility for organising and funding activation policies is largely the responsibility of job centres (*TE-toimistot*), which are funded by central government. Municipalities' responsibility for activation is more limited.[5] The most important activation tool of the municipalities is arguably directly employing long-term unemployed persons, which is co-financed by central government through employment subsidies.

Statistics by the Ministry of Economic Affairs and Employment indicate that activation rates have increased in the municipalities participating in the experiment relative to those municipalities that are not. This suggests that the reform has indeed had some effect on activation policies on the ground. The effects on employment outcomes, however, are not known at this stage.

[4] Specifically, municipalities are responsible for 50% of the labour market subsidy (*työmarkkinatuki*) paid to those who have received this benefit for 300–999 days, and 70% for those who have received the benefit for at least 1000 days. The labour market subsidy is intended for unemployed persons who do not meet the work requirement for basic or earnings-related allowances, or those who have already exhausted their right to basic or earnings-related allowances.

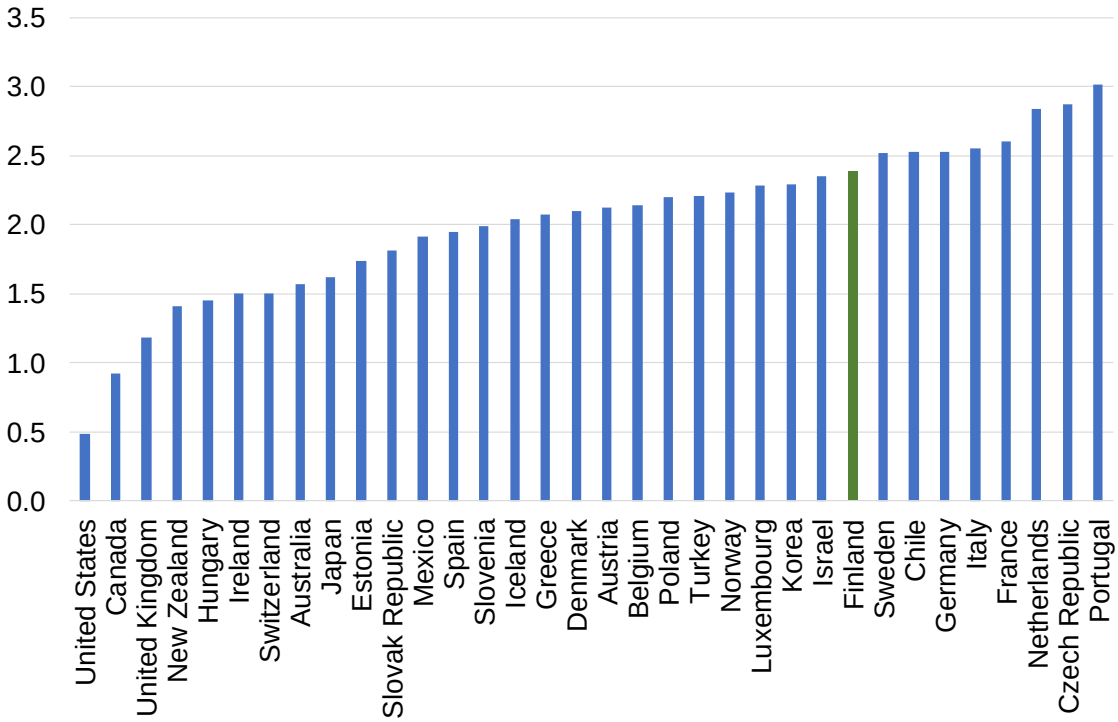
[5] The municipalities have some responsibilities. Most importantly, they are responsible for organising rehabilitation services as part of their social services, and together with the job centres they draft activation plans for the long-term unemployed.

3.2.6. Employment protection

The most recent employment policy initiative of the current government was to relax the rules regarding employment protection in small firms. The aim of the proposal was to encourage new hires by reducing the cost of dismissals. Eventually, the government withdrew its initial proposal. In the revised proposal there are no strict limits on the size of firms to which the more lenient rules would apply. Instead, the proposal only notes that the size of the firm should be taken into account in determining whether the employer has just cause for dismissals.

Employment protection legislation is not particularly strict in Finland. Most international comparisons are based on the employment protection index regularly published by the OECD. This index suggests that employment protection rules in Finland are less strict than in the OECD countries on average. This is largely due to the relatively lenient rules regarding collective dismissals in Finland. In comparisons of the strictness of rules related to individual dismissals – perhaps more relevant for the proposed policy change – Finland ranks above the OECD average (see Figure 3.2.3).

Fig 3.2.3: Employment protection index - individual dismissals, regular contracts.



Source: OECD Employment Protection Database.

The proposed changes are unlikely to have a major impact on dismissals, hiring or employment. The changes to the current legislation are small, and interpretation of the changes is eventually up to the courts to decide. Even if the changes were more significant, their impact on employment would be unclear.

Economic theory contains clear predictions on the effects of employment protection on labour market flows. Relaxing restrictions on the termination of employment increases both dismissals and new hires. A large body of empirical research confirms these predictions (Skedinger 2011). Theory has no predictions on the effects on aggregate employment. Also, empirical research has produced conflicting results on the employment effects.

At the stage of submitting its draft proposal for comments, the government published three fairly extensive surveys on the effects of employment protection by Antti Kauhanen (2018), Merja Kauhanen (2018) and by the Ministry of Finance (2018b). These surveys were very much in line with existing research, and conclude that the employment effects of relaxing employment protection rules are uncertain and most likely very small. Kauhanen and Kauhanen (2018) provide a good summary of this discussion.

3.2.7. Other changes in social security and income taxation

In addition to those policies discussed above, the government has made numerous changes to social security and income taxation, such as reducing daycare fees, shortening the maximum duration of unemployment insurance benefits, reducing income taxes, and cutting the real value of index-linked benefits by delinking them from the underlying indices.

A simulation-based evaluation of the employment effect of these policies has been provided by Kärkkäinen & Tervola (2018). Using a register-based sample from 2015 and the Finnish microsimulation model SISU the authors evaluate how government's policies have changed the average participation tax rate in the economy. The participation tax rate summarizes how the tax-benefit system changes the monetary gain of moving from unemployment to employment, as the increase in earnings is partially offset by increased taxation and reduced benefits.

The individuals in the sample are typically either employed or unemployed, so incomes in the non-observed state must be imputed. For the employed this is relatively straightforward, as benefit levels are mechanically determined by background characteristics or pre-unemployment earnings, with the exception of discretionary items such as social assistance. For the unemployed, their earnings in employment are predicted by regressing earnings on observed background characteristics in the sample of employed individuals.

The effect of policy changes on the participation tax rate can then be evaluated by simulating disposable incomes using a counterfactual tax-benefit system of no policy changes. Overall the simulations suggest that government policies have increased incentives for work by reducing incomes in non-employment and increasing them in employment.

The employment effect of government's policies is then obtained by simply multiplying the average relative change in the participation tax rate by a behavioral elasticity which describes how much individuals' employment outcomes react to financial incentives to work. Kärkkäinen & Tervola (2018) use an elasticity value of .25 for their headline figures, which suggest that government's policies have increased employment by 33,000 – 42,000, depending on what exactly is considered to be a policy change.

There are many caveats to this approach, and how it should be interpreted. The estimated increase in employment is based on a simulation and not on any observed changes in employment outcomes during the government's term. The estimated employment effect does not indicate that the policy changes have been welfare-improving or optimal in any sense. What the exercise of Kärkkäinen & Tervola (2018) does, however, indicate is that the effect of government's policies on employment has plausibly been quite significant.

3.3. Council views

Increasing employment has been one of the key aims of the current government, and the government has indeed consistently worked towards this goal.

Competitiveness pact in 2016, cutting the maximum duration of unemployment benefits in 2017, improving incentives to work by containing the growth of benefits, reducing fees in early education and cutting taxes on labour income, introducing mandatory regular interviews for the unemployed in 2017 and the activation model implemented at the beginning of 2018 all potentially contribute to employment growth.

Reaching a clear conclusion on whether each of the individual measures is part of an optimal employment policy package would require further analysis. Unfortunately, credible ex-post evaluations of the effects of the policies are not yet available. For this reason, we are also not able to provide a welfare assessment that would take into account possible effects on equity, in addition to employment effects. The assessment in this chapter was based on two different approaches: either simulations using elasticity estimates from previous research; or descriptive analysis of the development of key economic variables before and after a given reform. These approaches have their limitations. Simulations depend on an assumption that an average elasticity estimate from earlier literature is applicable to the given situation it is applied to. Descriptive analysis may not be able to disentangle the effects of the policy under study from other factors that affect developments in the economy.

4. Fiscal policy

At the beginning of the government's term, the economy was in recession. At the same time, the general government deficit was almost 3% of GDP, and fiscal sustainability pointed to the need for fiscal consolidation. The conflicting pressures on fiscal policy were resolved by opting for a consolidation programme that implied a gradual tightening over the government's term. This gradual tightening continued until 2017. In 2018 the fiscal policy stance was expansionary because of income tax cuts, but will become contractionary again in 2019.

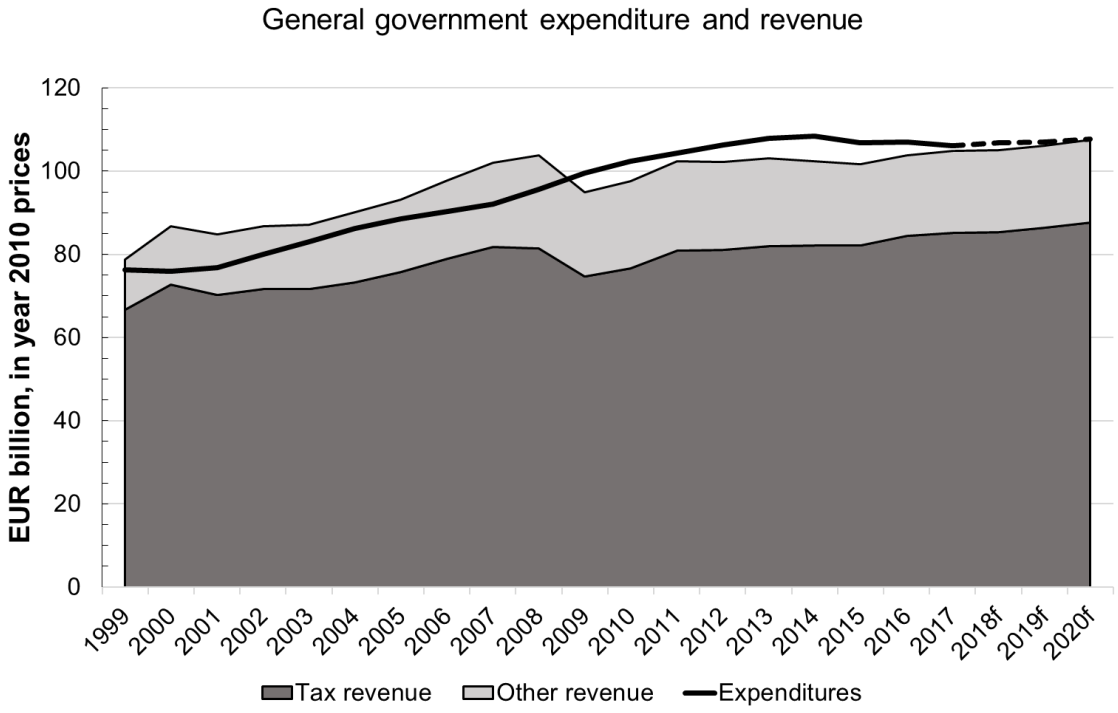
The unforeseen improvement in the business cycle situation has improved public finances. Years of recession left public finances with a burden of accumulated debt, increased long-term unemployment and a structural deficit. Fiscal policy in the current more favourable business cycle situation should focus on issues related to fiscal sustainability in the medium and long term. Hence a neutral or preferably a somewhat tighter fiscal policy would be appropriate.

In the government's program it is stated that under its economic programme, the GDP-to-debt ratio will level off by the end of the government term and living on debt will be brought to an end in 2021. More exact formulation can be found in the General Government Fiscal Plan for 2016-2019, which sets net lending targets for the sub-sectors, so that they sum to zero at the General Government level. According to forecasts published in the autumn of 2018, this goal will almost be reached. The current forecast for the structural balance for 2019 is -0.8% of GDP, while the government restated in its budget bill for 2019 that the structural balance should reach -0.5% of GDP in 2019. In future years, the structural balance is forecast to remain negative, underlining the persistent difficulties in balancing general government finances.

According to current forecasts, general government expenditures are forecast to grow more slowly than nominal GDP. General government expenditures will be below 52% of GDP in 2019, a 2 percentage point decrease from 2017. After a decline in 2017 and 2018, the tax to GDP ratio is forecast to remain close to 42% in 2019-2020. In real terms general government expenditures declined in 2017 but are forecast to increase slowly in coming years (Figure 4.1).

The general government debt to GDP ratio started to decline in 2016. In 2018 the debt to GDP ratio is expected to be slightly below the 60% threshold. This decline is forecast to continue in future years, mostly due to improvements in central government finances.

Figure 4.1: General government finances are in balance in the medium term.



Sources: Statistics Finland and Ministry of Finance Winter Forecast 2018. Deflated with GDP deflator.

Given the latest forecasts, Finland will comply with the EU budget rules. However, in 2018-2019 the structural balance will be below the medium-term objective (MTO) of -0.5% of GDP set by the government. The general government structural balance will also remain slightly below the current MTO in the medium run, indicating that public finances still have structural imbalances.

In this chapter we describe the government's discretionary fiscal measures and assess the fiscal policy stance. We also discuss the fiscal risks and the sustainability of public finances.

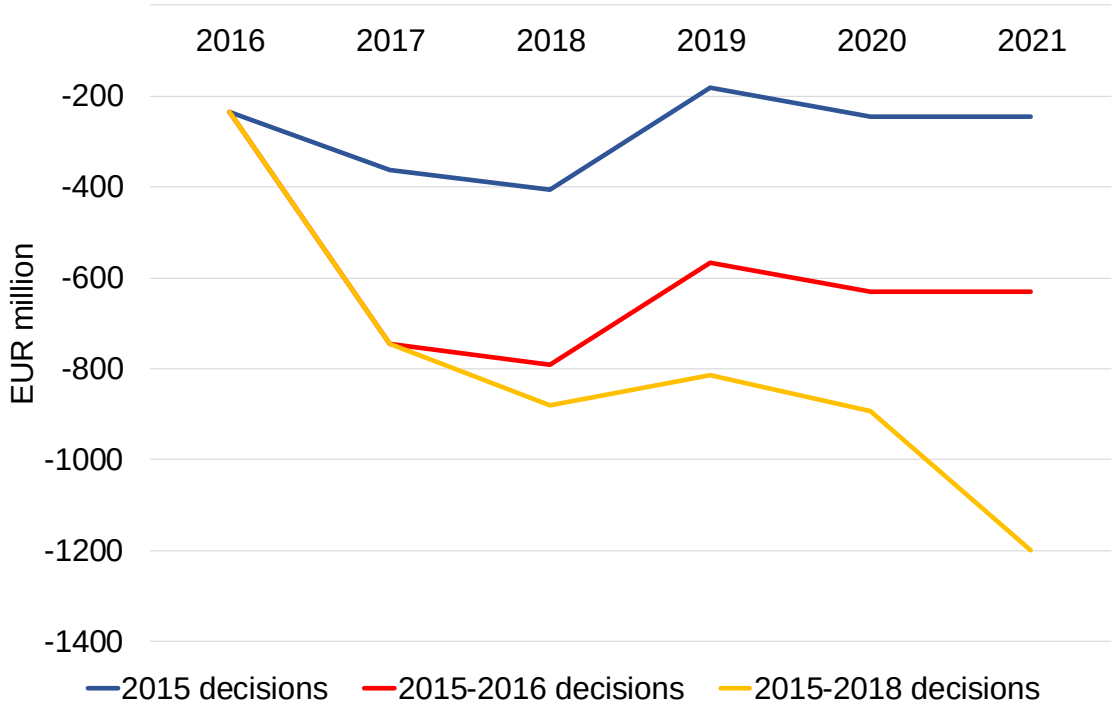
4.1. Discretionary fiscal measures and fiscal policy stance

In 2015, Prime Minister Sipilä's government launched a consolidation programme to reduce public sector deficits and to stop the growth in public debt. The consolidation programme mainly consisted of expenditure cuts. Overall, the expenditure adjustments during the government's term have rather closely followed the original plan presented in the government's programme.

Figure 4.1.1 illustrates the budget impact of the government's tax policy measures. Adjustments to the income tax schedule due to inflation and wage growth are not included in the Figure.[6] The blue line shows the static effect of the discretionary tax policy measures decided in 2015 on revenue in 2016-2021, compared to a situation with no tax changes. The main reason for the reduction in revenue in 2016 was the increase in the earned income tax deduction. The deduction for entrepreneurial income and the removal of taxes on sweets and ice cream were expected to cut revenue further from 2017 on. In 2019, tax revenues are expected to increase due e.g. to the gradual increase in the cigarette tax and the reduction in the mortgage interest deduction. The tax policy decisions made in 2015 were mildly expansionary, with a static revenue loss in 2020 of almost EUR 250 million.

[6] All numbers presented refer to static estimates, i.e. direct effects of tax changes on revenue, in the absence of any behavioural effects.

Figure 4.1.1: Net effect of revenue adjustments on the central and local government budget balance (EUR million).



Sources: Appendix 1 of the government programme (May 2015) and additional information provided by the Ministry of Finance; calculations by the Economic Policy Council.

The tax policy decisions implemented in 2016 increase the deficit in every year in 2017-2020, (the red line in Figure 4.1.1). The main reason for this change was the tax cuts due to the competitiveness pact. Although shifting payroll taxes from employers to employees is neutral with respect to general government finances, the compensation of increases in employees' employment pension contributions and unemployment insurance contributions with income tax cuts implies that the net effect is a reduction in revenue.

The net effect of the tax policy decisions made in 2017 (the yellow line in Figure 4.1.1) on tax revenue in 2018 was EUR -141 million. New tax cuts related to the competitiveness pact were estimated to reduce tax revenue by EUR 295 million. This reduction was partially compensated by increases in alcohol and energy taxes.

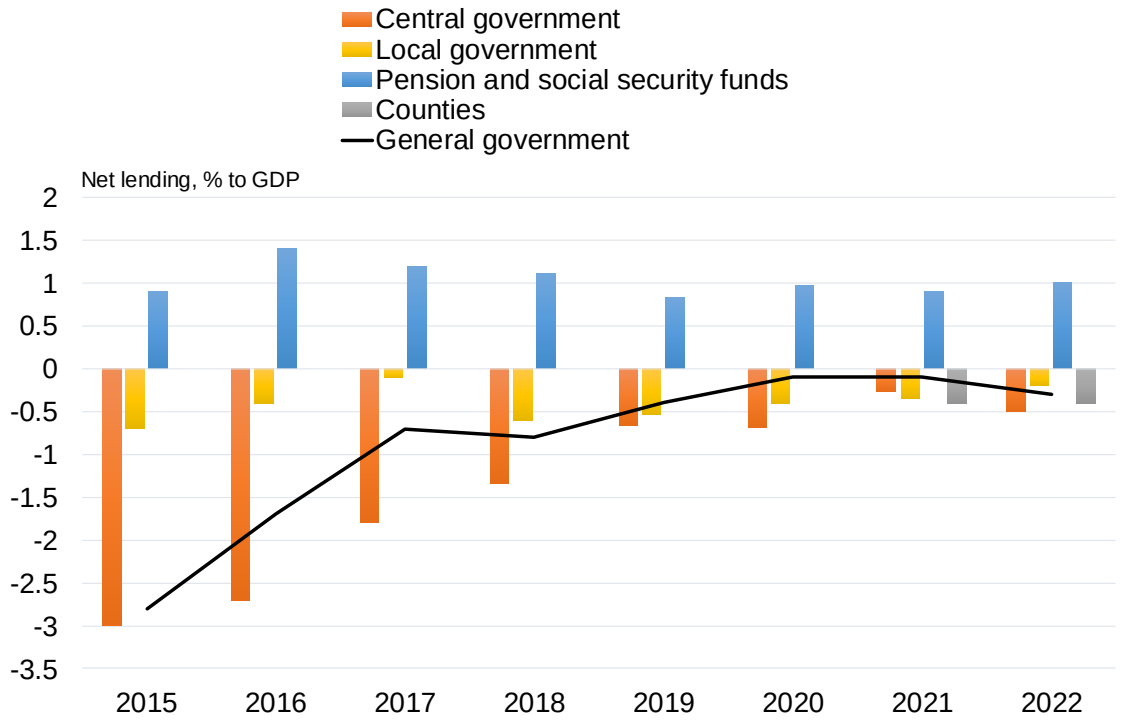
The net effect of the tax policy decisions made in 2018 on tax revenue in 2019 is neutral. The decreases in income tax rates in the lowest income bracket together with decreases in vehicle tax and railway tax were offset by increases in excise taxes on alcohol and soft drinks. The reduction in vehicle tax will decrease tax income in 2020 by EUR 50 million.

The discretionary tax policy decisions made in 2015-2018 imply an estimated reduction in tax revenue of EUR 890 million in 2020. The overall scale of these tax reductions is large, especially given the general need for fiscal consolidation.

The regional reform will change the allocation of tax revenue between central and local governments in 2021. At the same time the government has declared that the reform should not increase income taxes for anyone, and the tax changes should be as neutral as possible in other ways as well. It is difficult to implement a significant change in the structure of taxation without changes in anyone's tax liabilities. To achieve neutrality in the structure of income taxation, the reform involves adjustments to the central government tax schedule could eventually lead to a decrease in tax income by EUR 300 million.

The general government's net lending to GDP ratio has been improving since 2015. Part of this improvement is due to economic growth in 2016 and 2017, while the remainder is due to the consolidation measures discussed above. In 2019 the improvement in the general government balance is forecast to be reduced by decreases in the surpluses of pension and social security funds (see Figure 4.1.2). One reason for this sharp reduction is the decision to lower the contribution rates of the unemployment insurance fund. This issue is discussed in more detail in section 4.5.

Figure 4.1.2: General government net lending and net lending by government sectors.



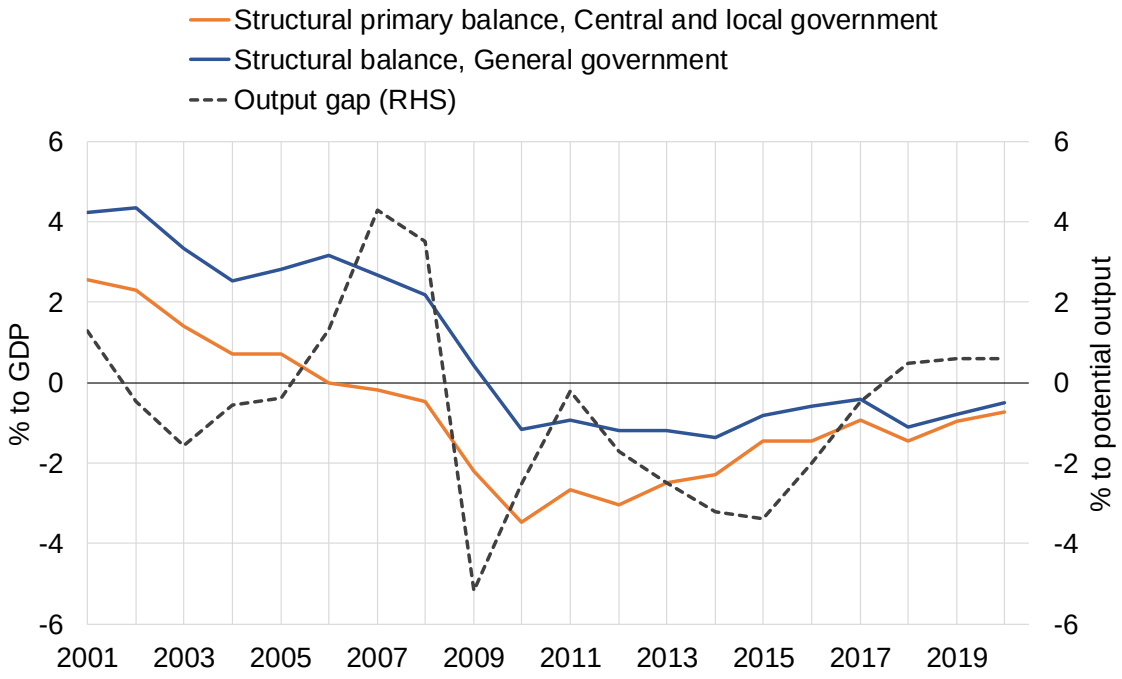
Sources: Statistics Finland and Ministry of Finance Winter Forecast 2018 and EPC calculations.

An indicator of the effect of government decisions on general government net lending can be derived by removing the effect of the business cycle and one-off revenues and expenditures from the actual net lending figures. Changes in the resulting structural balance are often used as an indicator of the fiscal stance: the fiscal policy stance is expansive when the structural balance is worsening, and vice versa.

Figure 4.1.3 shows the evolution of the general government structural balance (blue line). According to the Winter forecast by the Ministry of Finance, the general government structural balance worsened by 0.7 percentage points in 2018 and improves by 0.3 percentage points in 2019 and 2020. The Figure also shows that the economic situation worsened in 2012-2015. While the general government structural balance indicates a broadly neutral fiscal policy in this period, the structural primary balances of central and local government indicate a contractionary fiscal policy. The reason behind the difference between these indicators is the increase in the surpluses of pension and social security funds. In 2013-2015 fiscal policy was pro-cyclical rather than counter-cyclical.

The economic situation started to improve in 2016. According to both indicators, fiscal policy was slightly contractionary in 2017 but turned expansionary in 2018. As the economy expanded strongly in 2018, fiscal policy was pro-cyclical in 2018. Current forecasts indicate that fiscal policy will be slightly contractionary 2019 and neutral in the medium term.

Figure 4.1.3: Fiscal policy was expansionary in 2018.



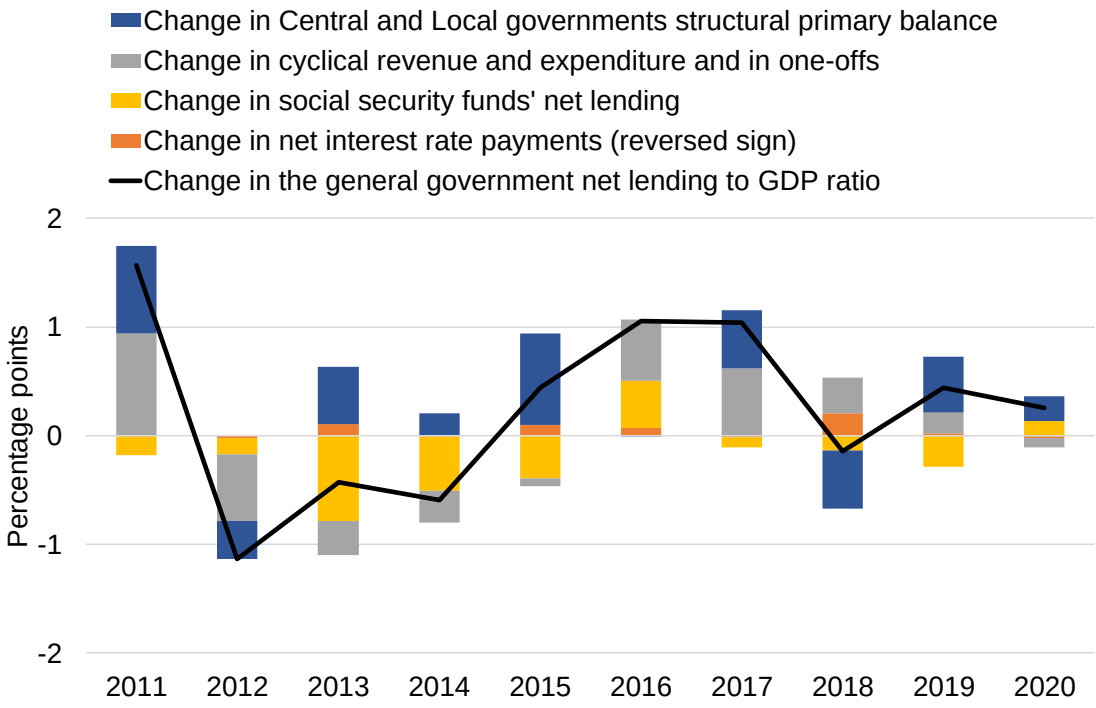
Sources: Ministry of Finance Autumn 2018 forecast and EPC calculations.

Measuring the fiscal stance by the change in the structural balance is not straightforward, as there are several factors affecting its development. The cyclical adjustment is based on the output gap estimate, which is then subtracted from the corresponding annual net lending to GDP ratio using a semi-elasticity estimated by the OECD (2014). The rationale behind this method is to reduce the cyclical components of revenue and expenditure items from the headline net lending figures. The output gap estimates tend to be revised annually, which naturally also affects the estimates of the structural balance. Also, it is not certain how the changes in unemployment benefits affect the semi-elasticity parameter used.

Figure 4.1.4 decomposes the changes in general government net lending into changes due to policy measures, cyclical effects, 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. During the government term, in 2016-2019, both an improvement in the cyclical situation and increases in net lending by social security funds have contributed positively to general government net lending. However, in 2018 fiscal measures will net out the improving effect of the economic boom. The main determinant that caused the structural primary balance to deteriorate in 2018 is the income tax cuts.

Figure 4.1.4: Drivers of change in general government net lending.



Sources: Ministry of Finance and calculations by EPC.

4.2. Fiscal rules and the government's objectives

According to the government's objectives laid out in its fiscal plan for 2016-2019, the central government budget deficit should be at most 0.5% of GDP, the local government deficit at most 0.5% of GDP, the earnings-related pension fund surplus around 1% of GDP, with the other social security funds being approximately in balance at the end of the parliamentary period. These sectoral targets add up to balanced general government finances.

As required by the Stability and Growth Pact, the government has set a medium-term objective (MTO) for the general government structural balance at

-0.5% of GDP. The government's aim was to achieve the objective no later than in 2019. As the MTO is set in terms of the structural balance, whether it is attained depends on the output gap estimate and on the nominal balance. Currently the Ministry of Finance predicts the structural balance to be -0.8% of GDP in 2019 and -0.5% in 2020. The government must reset the MTO target in 2019 for the following three years. Although the structural balance is almost at the current target and is set to improve in 2020, from the point of view of fiscal sustainability the new MTO target should be set tighter than the current one. Fiscal sustainability is discussed in more detail in section 4.4.

New annual objectives for public finances were published in the general government fiscal plan for 2018-2021. These aim at reaching the MTO in 2019. The annual objectives are given in Table 4.2.1.[7]

Table 4.2.1: Annual objectives as published in the Stability Programme in April 2017.

General Government,% to GDP	2017	2018	2019	2020	2021
Structural balance	-1.7	-1.1	-0.5	0.0	-0.3
Net lending	-2.3	-1.6	-0.8	-0.2	-0.3
Expenditures	55.2	53.9	52.5	52.1	52.1
Gross debt	64.7	64.5	63.8	62.7	61.9

Source: General Government Fiscal Plan 2018-2021.

The economic recovery has improved the general government financial situation. According to the Ministry of Finance Winter forecast, the nominal annual objectives will be reached. However, attaining the target path of the structural balance depends on the output gap. Publishing both structural and nominal targets is troublesome as the output gap estimate tends to be revised substantially. As the main argument for these annual targets is to indicate the consolidation necessary to reach the MTO target, the nominal targets should be revised as the underlying estimates for potential output and output gap change.

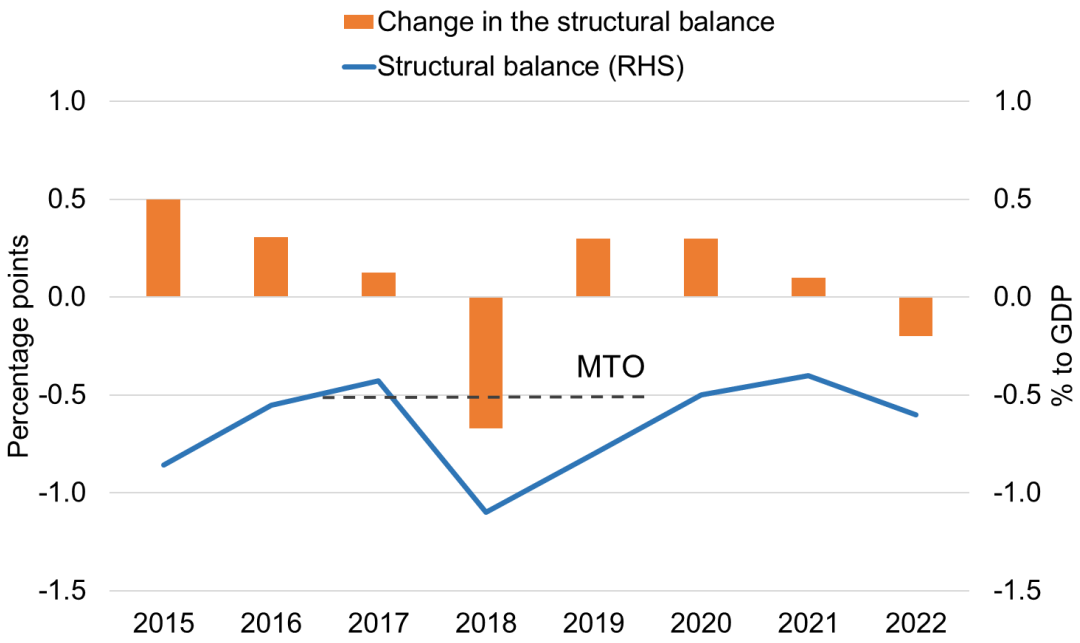
Recent statistics show that the debt to GDP ratio started to decline already in 2016, and the decline is forecast to continue. With improving general government revenues and slow growth in expenditures there is no danger of

[7] The annual objectives were set in the spring of 2017. After this, the level of GDP was revised upwards in the National Account statistics for 2016 and onwards, which has reduced the gross debt to GDP ratio.

breaching the 3% deficit threshold in the EU fiscal rules. Also the debt to GDP ratio is forecast to decrease below the 60% threshold in 2018.

Recent estimates by the Ministry of Finance show that the MTO was reached temporarily in 2017, when the structural balance was -0.4% of GDP (see Figure 4.2.1). Due to the tax cuts that have been implemented and the narrowing output gap, the structural deficit increased again in 2018. In 2019 the output gap is forecast to remain unchanged and the improvement in general government net lending will improve the structural balance overall.

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



Source: Ministry of Finance Winter Forecast 2018.

In 2018 the structural balance worsened by 0.7 percentage points to -1.1% to GDP, which was a significant deviation from the MTO of -0.5% to GDP. According to the Stability and Growth Pact, the structural balance should be at or above the MTO or on the required adjustment path towards it. According to latest forecast, the structural balance improves by 0.3 percentage points in 2019, which is less than would be required. However, as Finland has implemented major structural reforms, i.e. pension reform and the competitiveness pact, it is allowed to deviate temporarily from the MTO. This flexibility was granted by the European Council in the spring of 2017 based on the Regulation (EC) 1466/97. The flexibility was granted for a period of

three years. In total the flexibility decreases the MTO target by 0.5 percentage points, i.e. the structural balance can worsen to -1.0% of GDP.

The pension reform and the implementation of the competitiveness pact did not cause increases in expenditure. While both reforms increased the long-run growth potential, the income tax cuts associated with the competitiveness pact have a negative effect on the general government budget both in the short run and in the long run. With the current view on economic growth, the flexibility in the EU fiscal rules allowed for pro-cyclical fiscal policy in 2018.

In the budget bill for 2019 the government repeated its commitment to reaching the MTO target of -0.5% by 2019. Given the current forecast for the structural balance, reaching the MTO target would require further adjustments by 0.3% of GDP in 2019.

4.3. Central government spending limit decision and budget bill for 2019

Central government on-budget spending, i.e. spending by ministries, government institutions and agencies, is partly constrained by spending limits.[8] The spending limits include about 80% of budgetary items excluding expenditures that depend on cyclical conditions, interest on central government debt, financial investment expenditure and expenditures related to technically transmitted payments and external funding contributions. Changes in the criteria for cyclical expenditures, e.g. unemployment benefits, housing allowances and basic social assistance, are included in the spending limits. Compensation to municipalities for tax policy changes that affect their revenue, e.g. changes in the labour or income tax bases, are excluded from the ceiling.

Each year the government makes a spending limit decision for central government spending for the following four years. These decisions follow spending limit rules, which are defined in the government's programme.

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

Current spending limits ensure that central government spending will be EUR 1.2 billion (in real terms) lower in 2019 than in the last ceiling decision made by the previous government.

On 13 April 2018 the government fixed the spending limits for the period 2019-2022. For 2019, the spending limit is set at EUR 44.6 billon, which is at the same level as was budgeted for 2018. The ceiling decisions for 2019 are summarised in Table 3.3.1.

The ceiling decision allocates an expenditure ceiling to each administrative branch. The government can reallocate spending between government branches, but overall expenditure may not exceed the ceiling. To allow a small amount of flexibility, each ceiling decision includes a supplementary budget provision that is allocated later. The ceiling decision for 2019 also included an unallocated reserve of EUR 107 million, with the supplementary budget provisions for 2019 being EUR 300 million. If the spending limits are not completely exhausted, a maximum of EUR 200 million may be transferred to be spent in the following year.

Table 4.3.1: Ceiling decisions for 2019 and the budget bill for 2019.

EUR million		**2019**
Ceiling decision, 28.4.2017	**Administrative ceilings (in 2018 prices)**	**56,483**
	Price and structural adjusted ceilings*	**44,045**
Ceiling decision, 13.4.2018	**Administrative ceilings (in 2019 prices)**	**44,578**
	Price and structural adjusted ceilings	**44,408**
Budget Bill for 2019, 14.9.2018	**Expenditure inside the ceilings**	**44,001**
	Supplementary budget reserve	300
	Unallocated reserve	107
	Expenditure outside the ceilings	**11,346**
	Central government expenditures	**55,347**

* The postponed regional reform is removed from the administrative ceiling for 2019.

The ceiling decision included an expenditure increase in 2020 due to the regional reform. After the ceiling decision, the regional reform was postponed to 2021. The regional government, health and social services reform will increase central government spending by almost EUR 12.5 billion. As expenditures by municipalities are expected to decrease by an equal amount, the regional reform is supposed to be neutral in terms of general government spending and the overall tax burden. The expenditures inside the ceilings are expected to increase from 2021 onwards, mostly due to defence-related spending. In 2022 the spending limits are expected to reach EUR 57.4 billion.

Expenditures outside the spending limits, EUR 11.3 billion in 2019, are forecast to increase slowly in the next few years.

After the regional reform, the share of central government expenditures under the spending limit of total on-budget expenditures will rise to 83%. The health care and regional reforms will increase the effectiveness of spending limits in controlling future growth in general government expenditures. On the other hand, if social and health care expenditures continue their increasing trend, tight central government spending limits will force cuts in spending on other items. This could be avoided by leaving a sufficiently large unallocated reserve in the central government ceilings.

The government submitted its 2019 budget proposal to parliament on 14 September 2018. Expenditures are EUR 55.3 billion, which is EUR 467 million less than in the budget for 2018. At constant prices and without structural changes, total appropriations will decrease by approximately 2%.

The decrease in spending inside the ceiling is due to key government projects coming to an end and spending cuts decided in the government programme. The government's key projects for the years 2015-2018 were announced in the programme. Conclusion of these projects will decrease central government expenditure by EUR 740 million in 2019. Spending cuts announced in the government programme increase by EUR 300 million from 2018. Increasing employment is expected to decrease unemployment-related spending by EUR 300 million. These reductions in expenditure are partly offset by wage increases and higher pension expenditures.

The budget for 2019 includes some minor changes in the structure of central government spending. Appropriations for the Ministry of Finance are increased by EUR 275 million, mostly due to increasing pension expenditures and increases in transfers to the European Union. Appropriations for the Ministry of Defence are increased by a total of EUR 266 million to finance strategic projects. These and other minor increases in appropriations are offset by decreases in appropriations for the Ministry of Education (EUR 183 million), the Ministry of Economic Affairs and Employment (EUR 322 million), and the Ministry of Transport and Communications (EUR 514 million). Most of these cuts are related to key government projects coming to an end and the improved employment situation. Debt-servicing costs are almost EUR 1.2 billion. The central government debt total is estimated to increase to EUR 109.3 billion.

In the budget, central government revenue is estimated to be around EUR 55.5 billion while tax income is expected to increase by 4%, other income is decreasing because of the repayment of export credits in 2018. To cover the deficit of approximately EUR 1.7 billion, new debt must be issued.

4.4. Fiscal sustainability and fiscal risks

Fiscal sustainability can be defined as the ability of a government to maintain its fiscal policy, i.e. current spending, taxation and other policies, over a given period without threatening government solvency. The precise definition is that the government satisfies its intertemporal budget constraint, i.e. the projected present value of revenue should at least be able to cover the projected present value of expenditures and the initial net debt.

In the spring of 2015 the government estimated the long-run sustainability gap to be approximately 5% of GDP at the 2019 level. The long-run sustainability gap indicates the permanent adjustment of the primary budget balance (in % of GDP) needed to ensure that the present value of future taxes can cover the present value of future expenditures (plus the cost of serving initial net debt). The sustainability gap depends on the population growth projection and various other assumptions, and thus the gap estimate needs to be updated regularly.

One of the main fiscal policy goals of the current government is to ensure fiscal sustainability, i.e. to ensure that commitments to education, health care and pensions can be financed from government revenues, also in the future. According to the government's own assessment, a permanent adjustment of the public budget in the order of 4% of GDP is still required. In its programme, the government has committed to making the necessary savings and structural changes to close the sustainability gap. Postponing adjustment increases the adjustment required in the future, shifts the burden to future generations, and generally reduces the credibility of economic policy.

The long-term sustainability gap, the S2 indicator, can be divided into 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 given in Table 4.1.

Table 4.1: Decomposition of the S2 sustainability indicator.

Present value of interest expenditure on initial debt	0.5
Primary deficit in base year	-0.5
Change in capital income	-0.1
Changes in aged-related expenditure	3.9
S2 sustainability gap	**3.8**

Sources: Supplementary material in the Ministry of Finance Winter Forecast 2018.

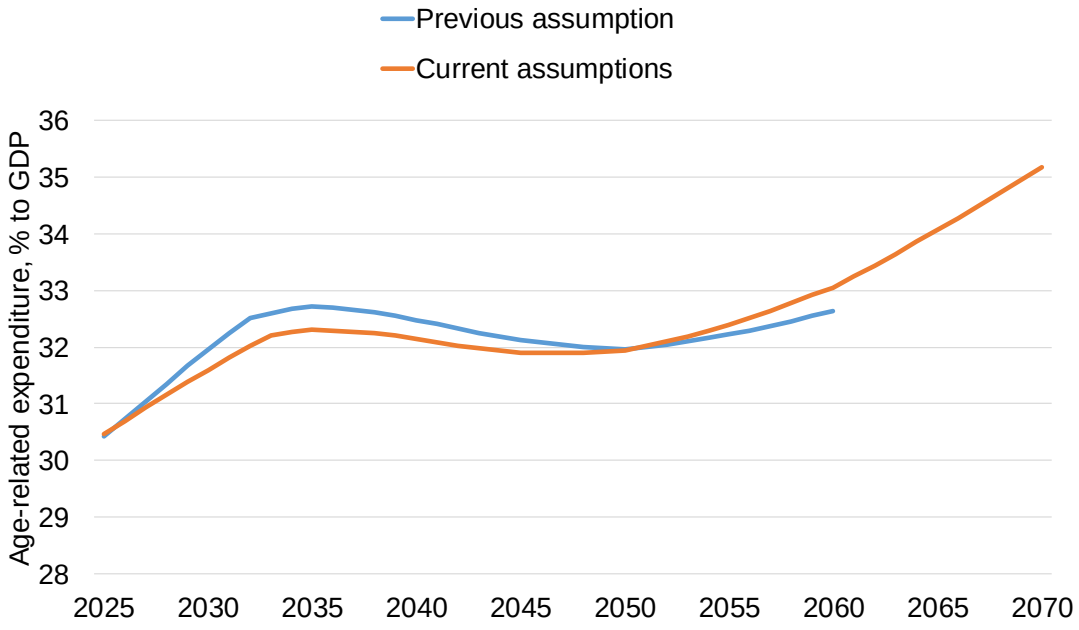
The table shows that the growth in age-related expenditure causes almost the entire sustainability gap. Naturally, its weight in the government's structural reform programme is also large. One goal of the social and health care reform is to reduce the sustainability gap by EUR 3 billion, or by 1.5 percentage points. This is set to be achieved through a reduction in the growth rate of social and health care spending in the first 10 years after the reform. In its previous report, the EPC (2018a) showed how the effect of the reform on the sustainability gap depends on its implementation in the long-run. If the share of age-related expenditure of GDP were to return to the path projected without the reform, the sustainability gap would remain essentially unchanged. This emphasizes the general principle that temporary adjustments to expenditure levels have only small effects on the sustainability gap.

Compared to previous assessments the MoF has changed its assumptions related to the effective interest rate on public debt and returns on assets. The long-run effective real interest rate on government debt has been revised to 2% from 3% in previous assessments.[9] While causing interest expenditure to decrease, this change in assumptions also decreases the yield from bonds owned by central and local governments. The assumption on the effective interest rate on government debt is also used as the discount factor to calculate the present value of future expenditure, and because of this a decline in the interest rate increases the sustainability gap. Altogether, these adjustments in assumptions have only a minor effect on the sustainability indicator. In its latest sustainability calculations, the Ministry of Finance also extended the projection horizon to 2070 from 2060, which was used in the previous calculations. The GDP share of age-related expenditure is expected to increase between 2060 and 2070. As the sustainability gap model assumes no changes in age-related expenditure after the end of the projection horizon, extension of the projection horizon also increases expenditure lev-

[9] Interest rates are projected to gradually converge to their long-run levels from their current, lower levels, by 2031.

els in the very long run. According to calculations by the MoF, this technical change alone increased the sustainability gap by one percentage point. The opposite could happen, i.e. the extension of the projection horizon leads to a smaller long-run sustainability gap, if the added years decrease expenditure relative to the GDP. The latest sustainability gap calculations are also based on the latest population forecast and on new assumptions on education expenditure. Figure 4.4.1 illustrates the effects of these changes in technical assumptions on age-related expenditure in the years 2020-2070.

Figure 4.4.1: Current and previous estimates of age-related expenditure in the years 2020-2070.



Sources: Ministry of Finance.

Although the S2 sustainability gap has decreased from the 2015 estimates only by roughly one percentage point, the indicator figures are not directly comparable.

A key determinant of the sustainability gap is the employment rate. According to MoF calculations, a permanent one percentage point increase in the employment rate reduces the sustainability gap by 0.4 percentage points. Indeed, one key motivation behind government's employment policies has been to improve fiscal sustainability.

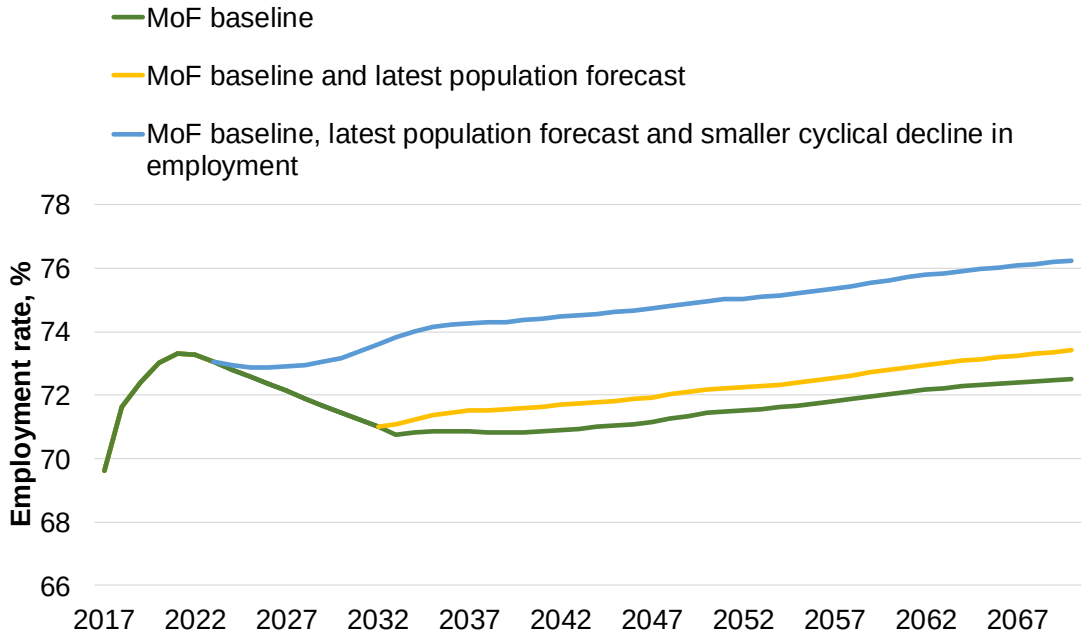
The employment rate has increased significantly during the government's term, but as discussed in section 3, it is not easy to tell how much of this is

structural. Evaluating the sustainability gap, however, requires an answer or at least an educated guess.

The current medium-term forecast of the MoF extends until 2023, at which point the employment rate is expected to reach 73.0%. In the sustainability gap calculations, the employment rate will then decrease until reaching 70.8% in 2033, after which its evolution will be determined by an increasing pension age and the changing age structure of the working age population. The 2.2 percentage point decline in 2023-2033 implies an assumption that 73% employment rate is well above its long-run equilibrium value. Changes in the age structure during this period should increase employment by about 0.5 percentage points. This suggests that the sustainability gap calculation assumes that the structural employment rate is now slightly above 70%. This again implies that employment reached its structural level already around the beginning of 2018.

Figure 4.4.2 presents three different scenarios for the employment rate for 2017–2070. The green line is the employment path of the MoF sustainability gap calculations. An "employment bubble" in 2017–2033 is quite visible in this employment path.

Figure 4.4.2: Different assumptions on age structure and the cyclical component of employment lead to different paths of employment rate.



Sources: Sustainability calculations in the Ministry of Finance Winter Forecast 2018 and calculations by the EPC.

The series depicted in yellow takes into account the update of the population forecast. For its updated sustainability gap assessment, the MoF has included the effect of the latest population forecast on the growth in age-related expenditure, but not its effect on the employment rate. As different age groups have different employment rates, any changes in the projected age structure of the working age population will have an effect on employment rate forecasts. The latest population forecast improves the outlook for the employment rate as the share of young people in the working-age population is smaller than in the earlier forecast. The sustainability gap is 0.3 percentage points smaller in this scenario than in the MoF baseline.

Finally the blue line assumes that after 2023 the evolution of the employment rate is determined by the pension system and the age distribution (taking into account the latest population forecast). This assumes that by 2023 the employment rate is at its structural level. In this scenario the employment rate ends up almost 4 percentage points higher in 2070 compared to the baseline. This is reflected in the sustainability gap, which is reduced by 1.4 percentage points.

As noted above, in its most recent medium-term forecast the Ministry of Finance projects employment rate to be at 73% in 2023. However, it also projects GDP to be 0.4 percent above its potential in that year. This suggests that employment rate may also still be above its potential in 2023, in which case the blue line in Figure 4.4.2 would be overly optimistic. On the other hand, the MoF assumption regarding the employment rate seems quite pessimistic: if output is projected to be only 0.4 percent above its potential in 2023, it is peculiar that the employment rate would be as much as 2-3 percentage points above its structural level. The Ministry of Finance should scrutinize more carefully its assumptions regarding the output gap and the employment rate, and the internal consistency of the assumptions. It should be emphasized, however, that even in the more optimistic employment scenario the sustainability gap is still quite significant.

Fiscal sustainability is connected to the debt level by the interest costs. While there is no consensus on the optimal level for the public debt to GDP ratio, there may be a limit on the share of income that taxpayers are willing to pay in interest payments. Given the current long-run growth and interest rate forecasts alone, the current debt to GDP level could be stabilised by running central and local government, i.e. the sectors accumulating the debt, with a 0.5% deficit in total. However, this simple calculation neglects the

growth in age-related costs that are projected to increase from 2030s onwards.

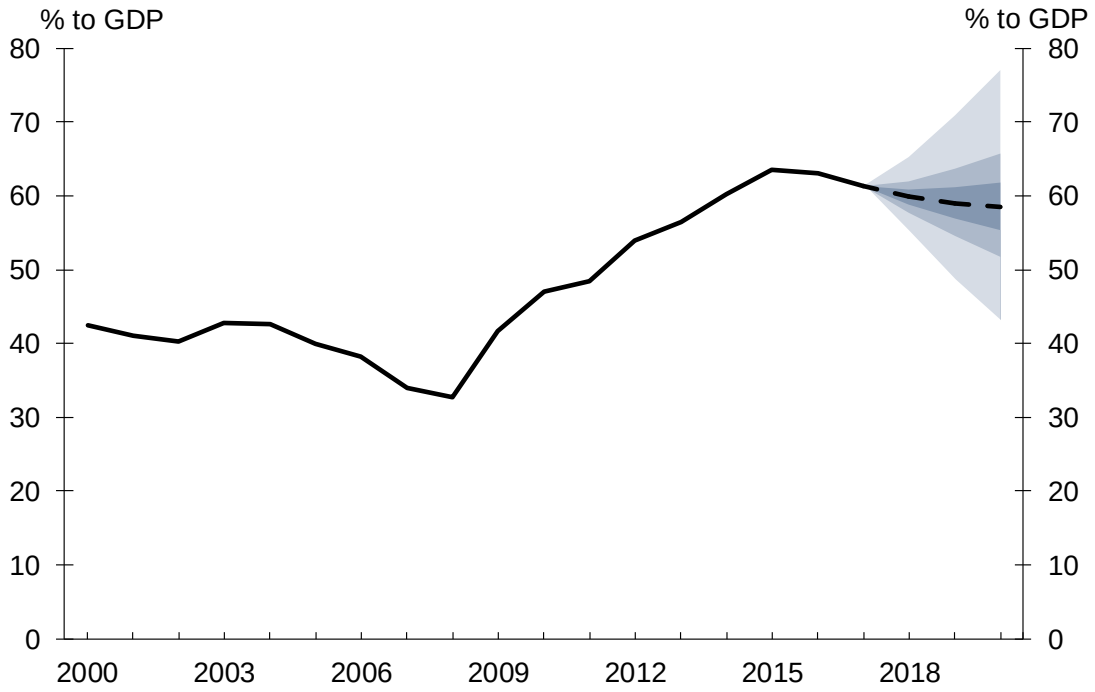
In the medium term, fiscal sustainability can be defined as the required consolidation to ensure that the debt to GDP ratio is at a given level at a given time. No such threshold is defined for Finland, although the 60% limit set in the Maastricht Treaty can be considered as being one. According to the latest forecasts, the debt to GDP ratio has decreased below this threshold in 2018. As this decrease is expected to continue, the debt limit set in this Treaty does not indicate a need for immediate consolidation.

Even when government finances are managed in a sustainable way, fiscal outcomes usually differ from forecasts. The reasons behind such departures can be a deviation of economic growth from forecasts, exchange rate shocks, foreign demand shocks, natural disasters, calls on government guarantees, or unexpected legal claims on government entities. Deviations of fiscal outcomes from what was expected at the time of the budget or at the time the forecast was made are defined by the International Monetary Fund (2008) as fiscal risks. To assure long-run sustainability, fiscal risks should be managed in a consistent manner.

In the short and medium term, the main risks are associated with flows of revenue and expenditures, i.e. risks associated with unexpected economic events. Normally these risks are modelled as macro risks to fiscal variables and they can be illustrated with a vector autoregressive model. Our model (see EPC 2018 for details) forecasts 2.4%, 1.8% and 1.8% annual real GDP growth for the years 2018-2020. These growth rates deviate slightly from published forecasts by forecasting institutions as they are generated directly by a statistical model.

The probability distribution of the general government debt to GDP ratios under exogenous fiscal policy is presented in Figure 4.4.3. The fan chart based on the simulated paths shows how uncertainty increases with time. The simulations show the debt to GDP ratio to be below 60% in 2020 with a probability of 56%. Also, there is a 70% probability that general government net lending will be above the -3% threshold.

Figure 4.4.3: A model-based forecast for the general government debt to GDP ratio in 2018-2020 and the respective 25%, 50% and 90% confidence intervals.

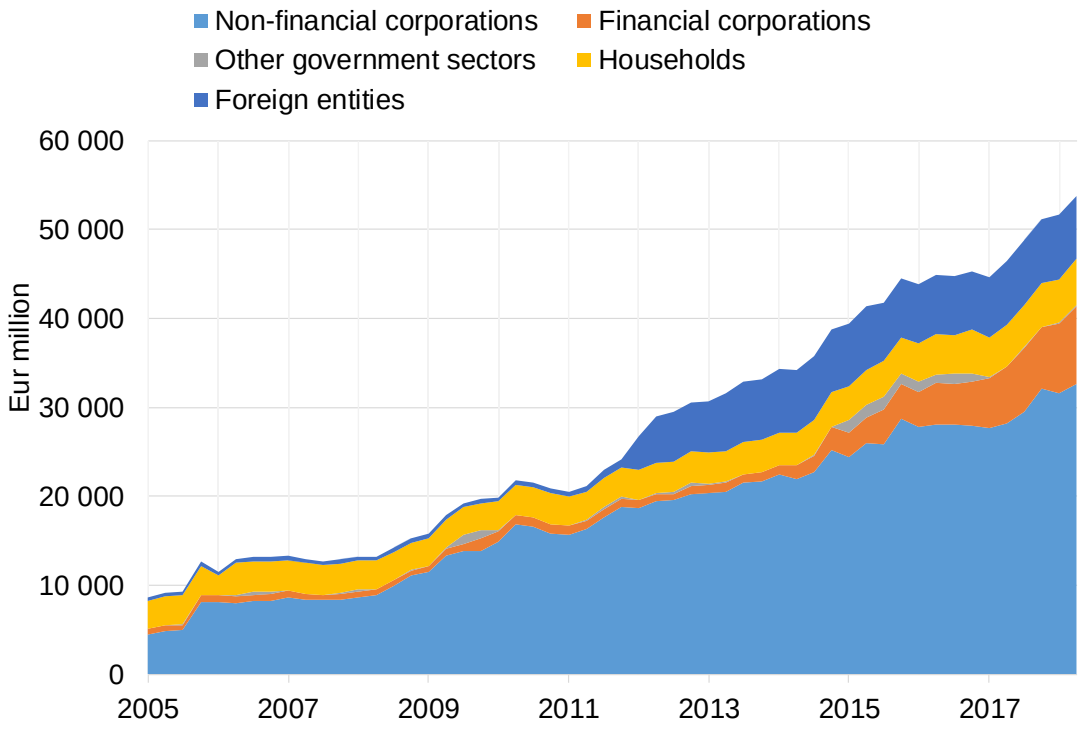


Sources: Statistics Finland and EPC calculations.

Two important items are not considered in the analysis above: general government real assets and contingent liabilities. While real assets, consisting mostly of land, buildings and infrastructure, are also subject to risk, the risks associated with contingent liabilities are more difficult to measure.

Quarterly data by Statistics Finland shows that growth in central government guarantees accelerated in the second half of 2017 and this growth has continued in 2018. At the end of 2017, central government guarantees were EUR 51 billion or 23% of GDP. Figure 4.4.4 depicts the composition of the stock of central government guarantees. In the second quarter of 2018, guarantees to non-financial corporations amounted to over EUR 36 billion, mostly consisting of guarantees to Finnvera. The data also include the guarantees given to the European Financial Stability Facility (EFSF) from 2012 onwards, which increased the stock of guarantees by approximately EUR 6.4 billion.

Figure 4.4.4: Central government guarantees have increased in the 2010s.



Sources: Statistics Finland and EPC calculations.

The risks associated with public sector assets and liabilities are reported annually in the government's annual reports, see e.g. Prime Minister's Office (2018). In that report the discussion is based only on the values of assets and liabilities. A somewhat deeper evaluation of the risks faced by central government is presented in an annual risk report by the Ministry of Finance (2018a). Despite these efforts, no measure of the fiscal risk faced by central or general government has been presented. So-called macro risks can affect both general government expenditure and revenue items, but also the value of assets and contingent liabilities.

In the Finnish framework, contingent liabilities and guarantees are managed as budget-neutral, and while the risks of these are discussed it is not ensured that appropriate buffer funds are built up. When policy decisions associated with risk, e.g. decisions on guarantees or on the size of buffer funds, are made, the policy maker should have information on government risk position that is as complete as possible. In sum, this could mean a value at risk (VaR) analysis of government assets and liabilities.

4.5. The Employment Fund

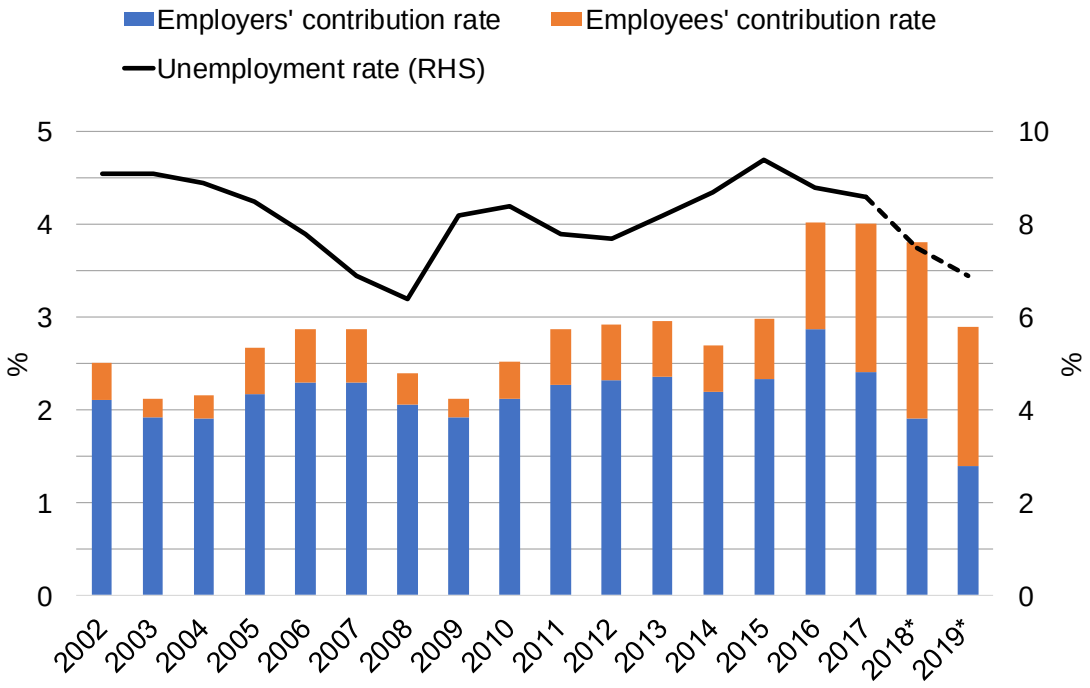
Automatic stabilisers, such as unemployment benefits and other social benefits, are an essential part of fiscal adjustments to economic fluctuations. Compared to active policy stabilisation decisions such as increasing or decreasing government consumption or relaxing or tightening taxation as a response to changes in the economic climate, automatic stabilizers can react without delay. In the Finnish fiscal framework, unemployment benefits, social assistance, and housing allowance are outside the spending limits, which allows expenditure on these items to grow without limits set beforehand. However, budgetary effects of any changes in the parameters of the social security legislation are compensated with decreases or increases in the spending limits.

Finland is one of the few countries where unemployment insurance is based on voluntary membership of unemployment insurance funds. Earnings-related benefits are mainly financed through the Employment Fund[10] (*Työllisyysrahasto*), which collects contributions from employers, employees and the government, and pays contributions to unemployment funds that then pay the benefits to their unemployed members.

As the fund's revenue is procyclical and expenditures countercyclical, the required changes in contribution rates to keep the fund in balance are highly procyclical. To avoid the need to raise insurance contributions in recessions when expenditures are high, the Employment Fund has a buffer fund. The buffer is symmetric, so that the fund can have assets up to the maximum or an equal amount of debt. Currently the maximum size of this buffer corresponds to the annual unemployment insurance expenditures that would finance UI benefits when the unemployment rate is 7%, which corresponds approximately to EUR 2 billion.

[10] In January 2019 the Unemployment Insurance Fund (*Työttömyysvakuutusrahasto*) and the Education Fund (*Koulutusrahasto*) were merged as the Employment Fund.

Figure 4.5.1: Changes in Unemployment Insurance contribution rates have been procyclical.



Sources: Employment Fund and calculations by the EPC based on the Ministry of Finance Winter Forecast 2018.

Over the past 10 years the total contribution rate has varied between 2.1% and 4% (see Figure 4.5.1). The fund exceeded its maximum size in 2008 after a growth surprise even though the contribution rates for 2008 were reduced from 2007 by almost 0.5 percentage points. When forecasts in 2008 also indicated a surplus for 2009, contribution rates were reduced further. However, the fund ran a deficit in 2009 and 2010 and contribution rates were increased again. The sudden worsening of the unemployment situation in 2013-2015 increased unemployment expenditure and the net wealth position of the fund turned negative. To slow down the forecast debt accumulation in 2016 contribution rates were again increased for 2016 and 2017, the total increase being one percentage point. However, the unemployment situation started to improve, and the current estimate indicates that the fund's net wealth will reach almost EUR 1 billion in 2018. To slow this wealth accumulation, contribution rates for 2019 were reduced by a total of 0.8 percentage points, which translates to a 0.3 percentage point cut in the tax to GDP ratio.

The revenue and expenditure of the fund are driven by developments in the business cycle. Unfortunately, over history business cycles have not been

symmetric. Large negative shocks are more common than positive ones and forecasting turning points in a cycle is difficult. There are two possible ways to cope with the asymmetry of business cycles: an asymmetric buffer to allow the accumulation of wealth and running the fund on positive net wealth in the long term or allowing the accumulation of debt.

In the past 10 years Finland's economy has experienced a steep recession and an unforeseen fast recovery. At the same time the buffer fund has come close to both its upper and lower limits. While use of the buffer has smoothened changes in contribution rates, it is fair to ask whether its limits are set too tight. Naturally wider limits would allow more fluctuation in the net wealth of the buffer and more stability in the contribution rate. However, if a fund is assumed to change its contribution rate only when necessary, short planning horizons tend to drive the buffer to its limits. This result is independent of the size of the limits.

Instead of discretionary decisions made each year, the contribution rates could be determined by a rule. On average the contribution rate should be set at a rate that would keep the fund in balance when unemployment is at its structural level. Variation around this average should be based on the net wealth compared to the buffers and on the forecast changes in net wealth. In such a set-up, the net wealth of the fund would fluctuate around zero, and the minimum and maximum values would depend on the parameters of the rule. However, to allow the buffer to operate freely, the limits should be wider in this case too.

Compared to other policy decisions made in 2018, the cut in unemployment security contribution rates was the largest discretionary fiscal policy decision. The contribution rates of both employees and employers are proposed by the board of the Employment Fund to the Ministry of Social Affairs and Health. The government then proposes the required changes in legislation. In 2018, the decision to reduce the contribution rates for 2019 was reasonable as the buffer is reaching its upper limit. With larger limits, the required cut in contribution rates would have been smaller. In the public debate the decision was tied to a possible cut in income tax rates. After the cuts in unemployment insurance contribution rates, the government withdrew the plan to cut income tax rates. Although the board of the fund ought not to take other taxation issues into account when deciding on its contribution rates, its decisions are likely to affect other fiscal policy measures.

4.6. Council views

Tax policy decisions for 2018 loosened fiscal policy relative to the plan in the government's programme. However, the faster than expected economic growth increased tax revenue. Current fiscal stance implied by budget decisions for 2019 on the other hand appears broadly appropriate given the state of the business cycle.

The government has implemented its medium-term consolidation objectives in the government programme. As a result, central government net lending approaches its target of -0.5% to GDP in 2019 while the other nominal deficit targets set by the government in 2015 are likely to be met. According to current estimates, the structural balance is slightly below its medium-term objective of -0.5% to GDP in 2019.

The long-term sustainability gap has decreased during the government term, mostly due to consolidation efforts that have led to a reduction in the structural deficit. The effect of the on-going major structural reform, i.e. the social and health care reform, on the long-term sustainability gap is still uncertain.

The government has consistently followed its programme of expenditure consolidation, while the income tax reductions implemented during the government's term have made the goal of fiscal sustainability harder to attain.

The problem of long-term fiscal sustainability remains. The sustainability gap indicates that there is still a need to consolidate public finances in order to keep the debt to GDP ratio on a stable path in future.

5. Regional Government, Health and Social Services Reform

The regional government, health and social services reform is arguably the government's largest single policy initiative. At the time of writing, in January 2019, it still has to be brought to the vote in parliament before the elections in April.

The two main components of the reform are (i) a regional government reform that transfers responsibility for organizing health care and social services from over 300 municipalities in primary care (20 hospital districts in specialised care) to 18 counties, and (ii) a freedom of choice reform that expands patients' and social service users ability to choose between health and social care providers; the proposals will be reviewed in more detail below. The government has set several goals for the reform: to reduce inequalities in citizens' health and welfare, and in service provision; to improve access to and effectiveness of services; and to contain expenditure growth. The last of these targets has been defined in more detail, as social and healthcare expenditures are targeted to be EUR 3 billion lower than under current projections by 2030. The policy goals are ambitious, as the reform seeks to achieve sizeable savings while improving quality.

In our previous report (EPC 2018a) we discussed the reform from the point of view of public expenditure and fiscal sustainability. We provided further comments on the reform from this perspective during 2018 in statements e.g. for the Parliament's Social Affairs and Health Committee and the Finance Committee (EPC 2018b, 2018c, 2018d).

Revisions to the reform proposals made since our previous report have been relatively small from the point of view of addressing the concerns that we

raised regarding expected cost savings. The government has not justified the specific cost savings target set for health care and social services, and the government proposals do not adequately describe the mechanisms by which the reform will increase productivity so that the intended cost savings do not lead to negative effects on quality of services. The freedom of choice reform also contains elements that are more likely to increase than decrease expenditure. Common pool problems imply that providers face incentives to shift costs from primary to specialised health care (provided by the county), or from the county to the national level. Overall, it is highly uncertain whether the health care and social services reform will produce savings for the public sector.

The inherent tension between the tight savings target and the goal of improving access to and the quality of care thus remains essentially unresolved in the latest version of the reform proposals. Since the cost savings associated with the reform are highly uncertain, it is questionable that cost savings are used as a key argument for the reform. Additional structural reforms or budget consolidation is required to achieve sustainability in public sector finances.

We now turn to a discussion of those features of the reform that we noted in our previous report as requiring further attention, notably the role of private provision in a publicly funded health and social care system, and the question of designing the system of provider reimbursement. In the latter context, we will also discuss the challenges related to the special role of occupational health care in the Finnish system.

In subsection 5.1, we review the current social and health care system and the proposed reform. Subsection 5.2 discusses the key characteristics of health and social care, as a background for discussing the implications for and evidence on competition as well as the public-private mix in service provision. In subsection 5.3 we focus on provider reimbursement and in subsection 5.4 on occupational health care and duplicate coverage. Subsection 5.5 discusses the implications of the reform for access to services, while subsection 5.6 discusses the implementation of the reform and the freedom of choice experiments that are already ongoing. Subsection 5.7 focuses on counties and their funding. Subsection 5.8 summarizes the Council's views.

Our analyses in this Chapter are supported by several background reports. Luigi Siciliani of the University of York has surveyed the literature on private

vs. public provision in health care. Olli Karsio of the University of Tampere has surveyed the literature on freedom of choice in social services. Unto Häkkinen of the National Institute for Health and Welfare, Mika Kortelainen and Kaisa Kotakorpi from VATT Institute of Economic Research, and Taru Haula, Satu Kapiainen, Merja Korajoki, Suvi Mäklin, Mikko Peltola, and Tuuli Puroharju of the National Institute for Health and Welfare provide a survey of practices and research regarding provider compensation, as well as an empirical analysis using Finnish data. Mika Kortelainen and Simon Lapointe of the VATT Institute of Economic Research have compiled a literature review on fiscal federalism to support analysis of the regional reform. Finally, Siiri Naumanen produced a report on county funding while working as a trainee in the Council Secretariat.

5.1. Social and health care: current institutions and the government's reform proposal

In this section, we briefly describe the current social and healthcare institutions in Finland, and provide an overview of the key features of the government's reform proposal. There are other important, concurrent changes that also concern the social and health care sector, most notably a reform of the Act on client fees and another concerning the criteria for providers of non-urgent surgical care. These proposals are separate from but connected to the government's health care and social services reform. Although they are likely to be important for the health and social care system, we will not discuss them in this report.

Organising health care and social services is currently the responsibility of the 311 Finnish municipalities. Municipalities may provide the services themselves, or they may outsource some of them to private firms or third-sector providers. With respect to specialised health care, the country is divided into 20 hospital districts, and all municipalities must organise their specialised health care through their own hospital district.

In primary health care, citizens have the right to choose their public health care centre, and they have the right to switch providers once a year. In specialised health care, for elective (i.e. non-urgent) procedures citizens may, in agreement with their referring physician, choose where to be treated in Finland. In addition to these rights guaranteed by law, many municipalities have expanded freedom of choice in social and health care using service

vouchers. Therefore various types of freedom of choice already exist in the current health and social care in Finland.

Service vouchers are most commonly used in social services, especially in home help and assisted housing. In health care they are more common in specialised health care, where they are granted for appointments and procedures. In primary health care vouchers are typically used to provide home visits, therapy services, and dental care. (Kuntaliitto 2018.) Furthermore, if a person uses private health care services without a voucher, the person is entitled to a sickness insurance reimbursement for part of the costs of that medical care.

Finally, the Finnish occupational health care sector is large in international comparison (Rantanen et al. 2017) and an important part of the health care system. The legally required minimum level of occupational health care is rather low, and there is extensive variation in the level of coverage provided by different employers. Kela reimburses occupational health care costs to employers, and these reimbursements are funded mostly by social insurance contributions by employers and employees.

Assessing the performance of the health and social care system is very difficult. Finnish people do, however, report relatively high rates of unmet need due to waiting times, and this also varies more by income than in other countries.[11] This is likely to be at least partially due to the strong role of the occupational health care system, which provides better access to health care to those in employment (see also Teperi et al. 2009). Although out-of-pocket payments make up a larger share of health care financing in Finland than in other Nordic countries, self-reported unmet need for financial reasons is actually higher in Sweden and Denmark and varies more by income (OECD Health Statistics 2018). Municipal autonomy over health and social care is considered to be in tension with equal access to services guaranteed by the constitution (HE 15/2017, Lavapuro et al. 2016) as public spending, out-of-pocket payments, waiting times, quality of care, and cost of production are considered to vary quite significantly from one municipality or hospital district to another.

[11] Comparisons based on Eurostat's Unmet health care needs statistics, specifically series hlth_silc_08.

In the proposed reform, responsibility for organising health and social care will be transferred from the municipalities (and hospital districts) to regions (counties). The counties, unlike municipalities, will not have tax autonomy, and they will rely on central government for their funding, with a minor share of funding drawn from client fees. The reform therefore involves setting up a new level of sub-central government in Finland.

Primary health care will be organised into health and social services centres (*sosiaali- ja terveyskeskus)*. In addition to primary health care services (such as health inspections and general practice) the centres are required to offer specialised health care services from at least two medical specialities. These specialities are decided by the county and will generally be the same for all producers within the county.[12] The centres will also offer some services by social service professionals. Primary-level oral health services will be organized along similar lines in dental clinics. Health and social services centres and dental clinics are referred to as providers of direct choice services. All residents may register with a health and social services centre of their choice (if they do not register, they will be assigned to the nearest public provider in the first years following the reform, and after this to any nearest provider).

The reform will mean that publicly funded health and social services centres can be operated either by the public sector (the county), by private firms, or private non-profit organisations. Public and private providers in direct choice services will therefore be placed on an equal footing in the sense that they will all be publicly funded via the same system (more on provider compensation below), and will be subject to the same regulation under the freedom of choice legislation.[13] In essence, therefore, the proposed reform extends freedom of choice in primary health care from the possibility to choose between public healthcare centres, to a choice between private providers.

[12] The county can, however, set certain requirements for service providers which apply only in certain parts of the county, for example providers operating in an area where a large share of residents has an immigrant background.

[13] The freedom of choice law makes a serious effort to ensure neutrality e.g. such that public sector providers would not obtain an advantage over private entrants. In practice of course there are numerous differences between public and private providers, which may affect competition and other outcomes in the health care sector. This is discussed in more detail below.

The health and social services centre will refer patients in need of further or extensive care and aid to the unincorporated county enterprise (*maakunnan liikelaitos)*. The county unincorporated enterprise is an organisation owned by the county and it will be responsible (in addition to operating health and social services centres) for providing those services that do not fall under the direct freedom of choice, mainly specialised health care and most social services. The county has an obligation to offer health and social services vouchers (*palveluseteli)* for certain services, such as home help, physiotherapy, and dental prosthetics. A voucher must also be offered if the county cannot provide specialised health care within the statutory care guarantee (a certain time limit). The county may, at its own discretion, expand freedom of choice to include certain forms of specialised health care and social services by issuing county funded vouchers, with which the patient can purchase these services from private providers.[14]

In addition to vouchers, the enterprise will also issue personal budgets (*henkilökohtainen budjetti)* for individuals requiring long-term, intensive, or wide-ranging care. This form of freedom of choice is designed especially for older and disabled persons with extensive care needs. The services covered by the personal budget are outlined in a client care plan, which the unincorporated county enterprise will draw up after assessing the citizen's needs.

The compensation schemes for providers of direct choice services will be set by the counties, although within relatively tight bounds set by central government. At least two thirds of the compensation of health and social services centres must be allocated based on capitation (this figure is 50% for dental clinics). This capitation compensation does not depend on the services provided, but on the individual's characteristics such as age, gender, socioeconomic status, and existing diagnoses for illnesses. The weights of the different factors in the capitation formula (so called risk adjustment) are defined centrally. The rest of the compensation may be allocated based on area characteristics (e.g. population density), services provided, and incentive schemes.

[14] The public sector can also provide voucher services, if an incorporated public firm is set up for this purpose. The customer can also decline the voucher, in which case the county has to provide the service. Similar rules apply for services provided through personal budgets, discussed in the next paragraph.

The unincorporated county enterprise will pre-specify the value of the voucher and the maximum acceptable price for the services covered by the personal budget, although users may top up these services with their own money (out-of-pocket payments). Provider compensation is further discussed in subsection 5.4.

The health and social care budgets of counties are estimated to be EUR 18.6 billion in total in 2016 levels. Of this, 17 billion will be granted by central government and the rest comprises client fees. Of this, direct choice services are estimated to amount to EUR 2.3 billion, voucher services EUR 1.6 billion, and the personal budget services EUR 1.5 billion. The rest, EUR 13.2 billion, is calculated to be the unincorporated county enterprise's own provision, although it can also use subcontractors for some services. Although publicly funded health and social services will continue to be provided mostly by the public sector, private provides' share is expected to grow significantly, especially in primary health care. In social services the respective share is already much higher than in health care.

Table 5.1 presents estimates by the Ministry of Social Affairs and Health (2018a) concerning the increase in private provision in publicly funded health and social care. After these figures were published it has been announced that the reform will be postponed by one year (see section 5.6 for the current timetable of the implementation of the freedom of choice reform).

Table 5.1: The projected increase in the share of private provision in publicly funded social and health care.

	Private sector share		Expenditure in 2016, EUR billion
	2016 (realized)	2024 (projected)	
All publicly funded social and health services	17%	24%	18.5
Social services	32%	39%	7.9
Health services	6%	13%	10.6
Primary health care	7%	26%	3.7
Specialised health care	5%	6%	6.9

Source: Ministry of Social Affairs and Health (2018a). Item "All publicly funded social and health services" does not include environmental health services.

In the county funding plan, social and health care expenditure is set to increase on average by 0.9% annually in real terms between 2021 and 2030. Funding for 2021 will be based on realised costs (in 2019 and 2020). Starting in 2022 funding will increasingly be granted based on computational costs, as opposed to realised costs. Computational costs are obtained by multiplying cost factors by pre-specified cost coefficients for each factor.[15]

Cost factors in the counties' funding formula include the number of citizens in different age categories, the number of citizens with certain illnesses, and socioeconomic factors, among other things. By 2026 funding will be granted based entirely on computational costs. Growth in the level of funding is capped so that it cannot exceed the change in the county funding index plus 0.5 percentage points (1 percentage points for 2022–2023). The county funding index is comprised of the index of wage and salary earnings (with a weight of 0.45 in the county funding index), the consumer price index (weight 0.4) and changes in county employers' social security payments (weight 0.15). The estimate of 0.9% average annualized growth between 2021 and 2030 is obtained from forecasts for these subindices. Possible changes in service requirements mandated by the central government are taken into account in the level of funding. (HE 15/2017, Social Affairs and Health Committee 2018.) As the growth rate in real GDP is expected to exceed 0.9 per cent in the future, the counties' funding plan implies a decline in the GDP share of health care expenditures in the coming decades. This is a good indication of the considerable tightness of the funding plan.

The Constitutional Law Committee of the Parliament raised concerns (PeVL 15/2018) about the tightness of the counties' funding plan, and noted that the adequacy of funding for health care and social services has to be ensured under the new legislation. This led to amendments to the government's proposal, with less ambiguous provisions which state the conditions under which counties can receive additional funds.[16] In effect, these new provi-

[15] Computational costs are based on average past healthcare costs associated with a certain characteristic. For example if the cost coefficient of a diabetes diagnosis is 1000 euros, and the county has 20,000 citizens with diabetes, the county will receive 20 million euros of additional funding based on this cost factor.

[16] If funding is evaluated to be insufficient in more than seven counties or in counties whose population is at least 40% of the total population, funding is increased for all counties. If this problem concerns fewer counties and a smaller population share, the counties with insufficient funding will receive additional funds or a short-term loan from central government. The evaluation of the sufficiency of funding is done by the Ministry of Finance, with Ministry of Social Affairs and Health also

sions serve to make the soft budget constraint of the counties vis-à-vis central government explicit, i.e., if the level of services appears to be compromised, more funding will be granted to the county by central government (for further discussion on soft budget constraints, see subsection 5.7). However, since assessing adequacy of care is difficult and necessarily subject to discretion, it is not clear whether the provisions are sufficient in all cases to eliminate the risk of quality reductions in the face of the tight savings target. Therefore, the inherent tension between the tight savings target and improving access to and the quality of care remains essentially unsolved.

5.2. The market mechanism in health and social care

5.2.1. Information asymmetries in health and social care markets: rationale for public intervention

Health and social care services are regulated and subsidised more extensively than other goods in the economy. A right to adequate health and social care is established in the Constitution of Finland and in numerous health and social care laws. The public sector provides three quarters of all funding for health care and 90 per cent of funding for social services.[17] It is also a major provider of these services, producing around 70% of both value added and employment, even as its role has steadily diminished over time (see Figure 5.2.1). OECD collects data on hospital beds, and these series show a similar trend of a decreasing (but still large) role of the public sector at the international level.[18] Further, numerous regulations exist regarding worker competence and product safety in health care. In Finland, as in other developed countries, government participation in the social and health care sector is thus substantial.

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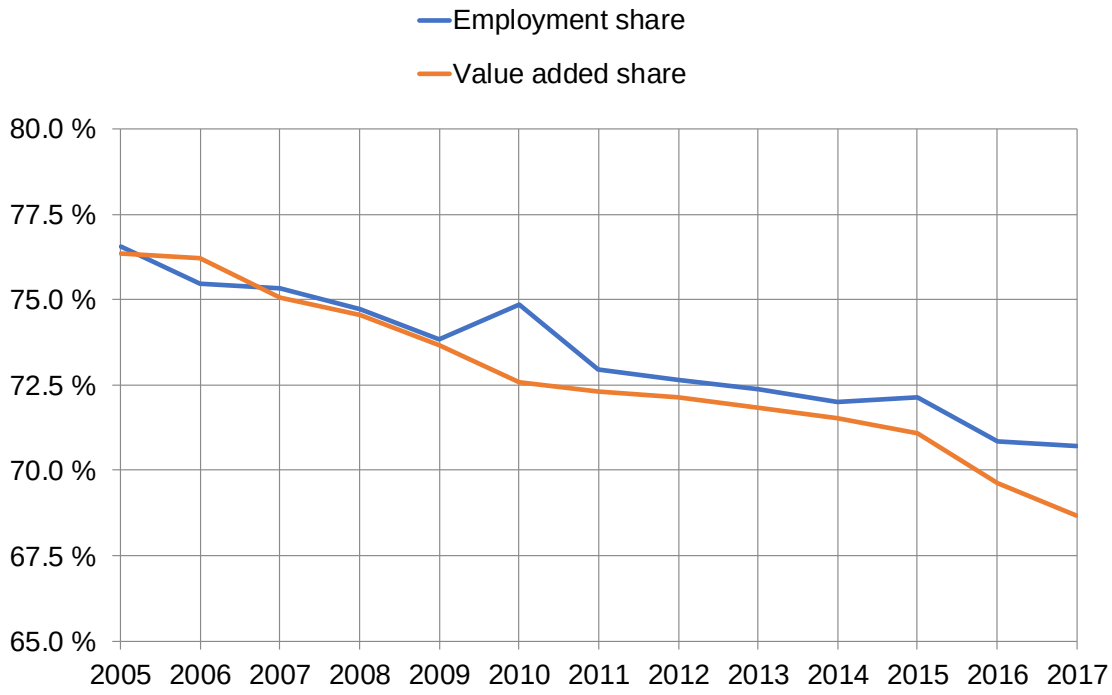
appointing members to the evaluation group. Additionally, the amendments loosen the conditions required to obtain additional funding. (Social Affairs and Health Committee 2018.)

[17]The rest are mostly out-of-pocket payments, which in some cases may be covered by the public sector through social assistance (Hetemaa et al. 2018).

[18] This is based on an evaluation of those 14 countries (Australia, Austria, Chile, Denmark, Finland, France, Greece, Israel, Korea, Lithuania, Mexico, New Zealand, Poland, and Turkey) which have data for 2000–2015.

Figure 5.2.1: Public sector's share of employment and value added in Finland in the social and health care sector, 2005-2017.



Source: Statistics Finland (National Accounts and Labour Force Survey)

Government intervention in health care is justified by the special features of the healthcare sector. In addition to the government's role in organizing health care, it is important to distinguish between the government's role in funding vs. provision (or production) of services: a publicly funded service may be produced by either public or private providers. Government intervention in both funding and provision is (potentially) justified by information asymmetries, but the nature of the information problem is different in either case.

First, information asymmetries about consumer health risks, and consequent potential market failures in private health insurance, provide a rationale for public funding of health care. In short, insurance market failure implies that not all individuals would be able to purchase adequate insurance in the private market. Incomplete insurance leads to inefficiency and welfare losses. Availability of private insurance may also be limited by credit constraints, as it would be difficult to borrow for such expenditures in the capital market. Public funding is also justified for equity reasons: allocation of care on the basis of non-medical merits, such as ability to pay, is usually regarded as undesirable. Allocation based on need, on the other hand, is a

widely shared societal goal. A crucial question is who evaluates this need and how.

Second, asymmetric information about provider behaviour regarding quality and costs is a rationale for public sector involvement in production (either through public in-house provision, or through regulation of private providers). Customers (patients) rely on experts to diagnose and provide treatment, which results in an informational asymmetry between the two parties. This informational asymmetry may result in overprovision (unnecessary treatments), underprovision, or overcharging, depending on the specifics (McGuire 2000, Dulleck & Kerschbamer 2006). Further, asymmetric information between the government (regulator) and private providers may lead to other types of problems, such as excessive incentives to cut costs at the expense of (non-contractible) quality. Such problems may provide a rationale for public provision rather than regulation (Hart et al. 1997).

Regarding health care funding, the public-private mix has not been extensively discussed in the context of the current reform.[19] Simplifying the funding system for health care was mentioned as a key goal in the government's programme. Partial public reimbursement of the out-of-pocket costs of private health care visits will no longer be possible after the reform, and this change will admittedly reduce the number of funding channels. However, a significant part of healthcare funding will continue to be channelled through the occupational health care system. Occupational healthcare will be left untouched at least in the near future, and remains a major unresolved issue in the implementation of the reform (see also subsection 5.4).

Regarding health care provision, on the other hand, the reform will imply important changes in the role of the private sector, as indicated in Table 5.1. Next, we turn to a discussion of competition and the public-private mix in health care provision. Subsections 5.2.2 and 5.2.3 will focus on health care, and freedom of choice in social services is discussed in subsection 5.2.4.

[19] The structure of funding within the public sector – transferring responsibility for health and social care from municipalities to counties – on the other hand is a major part of the reform. Such changes are best analysed using literature on fiscal federalism, rather than any health-specific research. This analysis is left to section 5.7.

5.2.2. Health care provision: competition and choice

A key mechanism through which the government expects the reform to increase productivity in health care is through more competition in service provision. The key vehicle for promoting competition in primary care is opening up publicly funded primary care to entry by private health centres, and thus expanding freedom of choice from the current choice between public providers. In direct choice services and for service vouchers, prices will be set by the government.[20] This means that providers will compete for customers on non-price factors. This is often called competing on quality, although quality in this instance includes all non-price factors relevant to consumers, including for example location.

One consistent finding from the research literature is that people value choice. There is at least some evidence that freedom of choice increases users' satisfaction, sense of control, and their feeling of empowerment (see the background report by Karsio (2019) for a review). Aside from individuals valuing freedom of choice as such, the effects of choice and competition depend on how individuals make their choices, and on the institutional environment the providers compete in.

Competition ideally provides good incentives for cost-efficiency.[21] There is a commendably large literature focusing on competition in health care, although this literature mostly focuses on specialised health care in the US and in the UK. Bloom et al. (2015) find evidence that competition between hospitals improves management practices, hospital quality and productivity. Other studies also tend to find positive effects of hospital competition on productivity and quality (Gaynor et al. 2015, Gaynor et al. 2016).[22] This is the body of research the government refers to in its proposal when arguing that the reform will increase productivity and quality.

[20] For services covered by personal budgets the unincorporated county enterprise sets maximum prices it will compensate to the provider, but individuals have an incentive to select providers with lower prices as they can use any savings obtained in one service to other services specified in their client care plan.

[21] A recent strand of research has documented the positive effect of competition on productivity across the economy, and found that to a large extent this effect comes from improved managerial practices (van Reenen 2011).

[22] Although see also Moscelli et al. (2016).

Without more careful analysis, however, this evidence is not directly applicable to an assessment of the likely effects of the Finnish reform, and it is problematic that the government refers to this evidence without discussing its applicability.[23] Its applicability may be limited in some respects.

The evidence cited by the government concerns competition in specialised care, while the Finnish reform introduces competition to primary care. Dietrichson et al. (2018) is one of the few[24] papers analysing the effects of competition and choice in primary care. The Swedish reforms of 2007–2010 facilitated competition and choice in primary health care by reducing barriers to entry and lowering the costs of switching and comparing providers. The authors find that the reforms led to small improvements in patients' overall satisfaction, but they find no consistently significant effects on avoidable hospitalisation rates.[25]

The institutional environment of the cited evidence for hospital competition is also different from Finland. In the UK primary care general practitioners (GPs) act as gatekeepers to specialised healthcare services, and they have an important role in providing information to aid patients in choosing between hospitals and treatments. The situation is different from the case of direct choice of provider, where informational asymmetries may limit the effectiveness of choice in ensuring favourable outcomes.[26] For example, the concern regarding potentially excessive referrals to specialised care, which has often been raised in the context of the proposed system, is one way in which this problem may manifest itself: easy referrals may be an inefficient way of competing for customers, and customers may choose a poor-quality provid-

[23] E.g. the statement of the Ministry of Social Affairs and Health (2018b) to the Social and Health Committee of the Finnish parliament refers to the U.K evidence reviewed in Propper (2018), with no discussion whatsoever of the nature of the evidence reviewed in that paper or its applicability to the Finnish reform.

[24] In another paper studying competition in primary care under administrative prices, Gravelle et al. (2018) study GP practices in England between 2005-2012. They find small but positive effects of competition on customer satisfaction and quality of care. GP practices are usually small and numerous, implying a market structure that is likely to be quite different from Finnish social and health care centers.

[25] Hospitalisation rates are measured by hospital admissions for patients with ambulatory care sensitive conditions (ACSC). These are conditions for which emergency admissions could be reduced with good-quality primary care, such as asthma and anemia.

[26] Surveys in various countries indicate that individuals choose their provider based on location, waiting time, reputation, and price. There are fewer studies using data on observed choices, some of which may not be directly applicable to the case of direct choice (e.g. Gaynor et al. 2016 analysing hospital choice in England).

er, when quality is understood as providing exactly the right treatment, no more and no less.[27] Excessive referrals are a form of overprovision which customers may accept if they have incomplete information about the right treatment and/or because they are fully insured by public insurance and do not care about public sector costs.[28]

Furthermore, much (though not all) of the U.K. evidence relates to competition between public providers, whereas the objective of the Finnish reform is to introduce competition through private entry, and therefore a more careful examination of the existing evidence would be warranted. Competition and private provision are not necessarily synonyms, and it also is possible to implement freedom of choice – and potentially competition –between public providers. Indeed, direct freedom of choice between public health care centres has been in place in Finland since 2014, but its effects on outcomes in health care have not been properly evaluated to date.[29] An evaluation of the effects of these earlier Finnish reforms should be a priority, and it would be advisable to draw on lessons from this evaluation when discussing how the Finnish system should be developed to realise potential gains from competition.

Finally, a simple but fundamental point is that opening up a market to potential entrants does not imply that there will in fact be enough entry to ensure effective competition. The extent of competition and its productivity-enhancing potential will in many areas be limited by sparse population density, as well as potentially high fixed costs of entry. How competitive the social and health care market will be after the reform is difficult to evaluate at this point.

5.2.3. Healthcare provision: public-private mix

The freedom of choice reform implies a major change in the role of private providers in health care in Finland, especially in primary care. The legisla-

[27] Even if all treatments are not necessary or cost-effective, they may create an impression of active and good quality care for the patient.

[28] Patients changing their behaviour in the presence of insurance (i.e. not taking proper care to avoid falling ill) is referred to as moral hazard. Doctors changing their behaviour when patients are insured and are likely to accept cost-ineffective treatments is referred to as second-degree moral hazard (Balafoutas et al. 2016).

[29] For a discussion of the reforms, see Sinervo et al. (2016).

tion strives to put private and public producers on an equal footing in primary health care. The government estimates that this will increase the share of private provision significantly (Ministry of Social Affairs and Health 2018a).[30] What effects, if any, can we expect from such changes for outcomes in health care?

Pita Barros and Siciliani (2012) list ways in which public and private providers may differ, and two of these are potentially particularly relevant for the Finnish reform. First, public and private providers differ in terms of who is the residual claimant for the organisation's profit. In private firms the residual claimant is the shareholder.[31] For public organisations the residual claimant is the government (in post-reform Finland this would be the county). In most cases the government will be less insistent on generating profit than private shareholders, which will in turn dampen the effects of market incentives on the organisation.[32]

Second, the inverse of the residual claimant question is the budget constraint. The public provider may have a softer budget constraint than its private counterpart if it is shielded from bankruptcy. That is, if costs are higher than expected (either due to exogenous shocks or poor management), the question is whether a public sector provider will be bailed out by additional funds, while a private provider would face bankruptcy. Such protection from bankruptcy may also lower the cost of funds raised from the credit market.

Another characteristic of the health and social care sector is the notable role played by private non-profit organisations, which produced 7% of gross value added in social and health care in 2017 in Finland. These are closer to

[30] The share of private provision in publicly funded social and health care in general is expected to increase from 17% to 24% in 2024. Note that these items do not directly correspond to those in Figure 5.1. The largest change is anticipated in primary health care, where private providers' share is expected to almost quadruple from 7% to 26%. It is not clear whether these estimates assume continuation of the present state, or the current trend whereby the role of the private sector increases over time.

[31] For non-profit organisations no residual claimant exists, as these organisations are not meant to produce any residual after expenses.

[32] In Sweden, where a similar freedom of choice reform was passed a decade ago, the government of Stefan Löfven proposed a cap on health care providers' profits last year. This was, in effect, a call to make private firms act more like public entities. The proposal did not pass, as the government did not have a majority in parliament.

private for-profit providers in some respects (e.g. lack of bankruptcy protection), and closer to public providers in others (e.g. lack of profit motive).

The organisation's objective – whether there is a profit motive or not – and its constraints – whether there is a real prospect of bankruptcy – will ultimately manifest themselves in the incentives and behaviour of providers and individual physicians. This may further be amplified by physicians' self-selection into different sectors. If the public provider has lower profit demands, this leaves room for physicians' internal incentives, which may attract "altruistic" types to work for the public provider.

Economic theory does not provide clear-cut answers to how the behaviour and performance (regarding costs and quality) of public and private health care providers will differ. The differences will depend on the institutional context, and are ultimately an empirical question. In many cases public and private providers have different tasks (e.g. whether there is a requirement to provide emergency services), different rights (e.g. the right to refuse patients), and different compensation systems. All of these are relevant factors to control for when making efficiency comparisons between different types of providers.

Overall, increased reliance on private provision is an important aspect of the reform. The government proposal acknowledges some risks associated with increased private provision and that competition will not automatically yield good outcomes in health care (HE 16/2018). It is somewhat unclear how the conclusion that under the current proposal competition will yield efficiency improvements has been reached. There is evidence of more effective management practices in private care (Angelis et al. 2017), for example, but also some evidence that private providers may be more likely to respond to financial incentives in undesirable ways (e.g. choosing treatments based on private profitability, and cream-skimming the most profitable customers) (e.g. Duggan 2000, Dafny 2005).

In his background report for the Council, Siciliani (2019) reviews the research evidence concerning differences in quality and efficiency between private and public providers. The research is regrettably limited and only concerns specialised health care, which in Finland is set to remain mostly under public provision. Nonetheless this evidence does not suggest any systematic differences in quality or efficiency between provider types, especially when they are subject to the same compensation systems. Notable caveats

are again that (i) the evidence concerns specialised health care, and that (ii) regarding health care quality, most of the evidence is from the U.K., and applicability to the Finnish case may be limited as discussed above in the context of evidence on competition. The (mixed) evidence on the implications of provider type on efficiency, on the other hand, comes from various countries.

After the reform in Finland different types of providers will co-exist in primary health care, for which we do not have much evidence. To the extent that one can extrapolate from evidence regarding specialised health care, and considering that different types of providers will be set on an equal footing regarding payment systems, regulation, etc., a prospective increase in the share of private providers as such will not necessarily have a significant impact on the quality or efficiency of health care, and the direction of any potential effect is unclear.

In sum, an increased role for private providers is unlikely to result in the kind of efficiency gains required for the savings target for the reform to materialise. Public and private providers will differ with respect to the strength of the profit motive and the softness of the budget constraint for public providers. How pronounced this difference is going to be will depend on how counties manage the public providers, and how providers react to regulation, in particular the reimbursement rule, which we turn to in the next subsection.

Finally, there are reasons to believe that the effect of organizational type (public vs. private) on any single provider do not give a full picture of the effects of increased reliance on private provision in health care. The public sector still maintains its organizing role in health care, and increased private provision potentially affects this role too. The first set of issues relate to the role of the public sector as the provider of last resort. There is a constitutional requirement to provide care, which ultimately falls on the public sector and public providers. Private firms, especially under a reimbursement system based mainly on capitation payments, have incentives to shift costs to the public sector, and the public sector has to handle any patients referred to them. The public sector may also need to maintain spare capacity to guarantee an adequate level of care in case a private provider exits the market. This may lead to inefficiencies. These factors imply that it is very difficult overall to place private and public providers on an equal footing (a stated purpose of the proposed legislation). Second, the public sector will of course

be in charge of regulating health care markets. To the extent that competition is less than perfect, a need for regulation remains to ensure good outcomes. Regulation will also be necessary to ensure that any potential productivity improvements are translated into savings for the public sector, rather than simply showing up as excess profits for private firms. Overall, the costs of extensive and complex regulation and information systems contribute to increase expenditures.

5.2.4. Freedom of choice in social services

Freedom of choice in social services differs to some extent from freedom of choice in health services. This is partly due to the essence of social services. Some social services include involuntary interventions – for instance, children are in some cases taken into care by public authorities. Second, in social services choice does not refer simply to a choice of a provider or a professional, it also might include a choice between a service-in-kind and a cash benefit. This type of choice is not typical in health care. Third, service or user fees are usually defined differently from health care; user fees might depend on users' ability to pay (income-testing/means-testing). This is most typically the case in services that are needed for long periods of time and around the clock, e.g. long-term care in institutions and hospitals. Thus, in social services, it is not possible to limit choice only to a choice of a provider (Karsio 2019). This is to some extent taken into account in the government proposal for freedom of choice legislation.

Customer choice models gained a fairly strong foothold in many European countries over the last two decades. Compared to health care, however, much less systematic research has been done regarding freedom of choice in social services (Karsio 2019). Customer choice models vary a lot between and even within countries. For instance, a system of personal budget has been in use in the Netherlands since 1996 but it has gone through a large number of changes. For some time the Dutch personal budget was a very generous system granted to a large number of users. Since 2014, a personal budget has been granted only to those people whose care needs are so extensive that they would otherwise need to move to an institution (Gadsby 2013).

Personal budgets are one of the tools used to promote customer choice in social services and most particularly in situations where care needs are very

extensive. They offer customers a budget to use for purchasing appropriate assistance and services. The budget can be entrusted entirely to the customer who is responsible for its use or it can be managed by a social worker who, together with the customer, decides how to spend the budget. In social services choice has also been promoted by long-term care insurance (Germany and Japan), a direct payment system (UK) and a voucher system (Finland) or a customer choice system without a voucher (Sweden). In the Swedish customer choice model introduced in 2009, an eligible service user can choose a provider (e.g. home help or a nursing home) from a list of authorised public of private service providers after a needs assessment by the public authorities. Here we focus on the types of personal budgets and service vouchers in the government's proposal.

Direct payments and insurance-based compensations are often flat-rate payments with the same monetary value for eligible beneficiaries in a defined group or category. There may be many categories depending on the level of help needed. A personal budget, in turn, is granted after a careful needs assessment process, its value is defined individually depending on the care and assistance needed and available resources, and it is consumed in many different ways (purchase of services, hiring of personal assistants and so on). It can be means-tested or income-tested. All variations are in use. A service voucher resembles a personal budget, but most typically a voucher is granted for a more limited purpose (purchase of home help or respite care services). Its value might be the same for a given care situation, but it can be income-tested as is the case for instance in Finland in most service categories under the current legislation.

In Finland personal budgets have only been experimented with during the very last years. Instead, individual choice has been promoted through a voucher system first piloted in the 1990s (Vaarama et al. 1999). Vouchers were then integrated into social service legislation (2004), and in 2009, a specific law - the Act on Health and Social Service Vouchers (*Laki sosiaali- ja terveydenhuollon palvelusetelistä* 569/2009) - was passed to further enhance customer choice and to improve the effectiveness of services through competition. This act made it possible for municipalities to organise most social and health services through a voucher model. Although the use of vouchers is increasing, it is still modest even in social care, where vouchers are used more extensively than in health care. The Association of Finnish Local and Regional Authorities surveyed Finnish municipalities and found that in 2018

less than half of all municipalities used vouchers in more than two of the ten social service types listed in the survey.

There are some possible problems in the way in which the government's reform implements freedom of choice in social services which need to be more carefully monitored and researched. The first problem has to do with the limited resources available in health and social services centres. If only "guidance and advice" (concerning social services) are available, there is a risk that a large share of customers will first have to turn to the centre but will then be directed to the unincorporated country enterprise, where the actual need assessment takes place and a decision is then made on services or vouchers or a personal budget. Second, as customers with extensive care needs obtain services from several providers, the county's task in ensuring integration of care will be challenging. A third problem might arise from the principle that private providers can refuse to service personal budget customers. This mechanism is different from registering with a health and social services centre. Finally it might also be a challenging task for the unincorporated country enterprise to define the monetary value of personal budgets and vouchers. If the value is too low, service users have to use their own money, which might increase inequality among citizens. Finally, a new kind of expertise is needed among social service professionals when it comes to assessing the value of the budget and managing the budget together with customer.

Previous research provides some evidence that service users are fairly satisfied with increased choice in social services. Younger and disabled people seem to benefit more from these kinds of choice tools (personal budget and vouchers) than older people. For some older people it might be difficult to make a choice between competing providers. Informed choice is always based on the information available for users. Research evidence and experiences from other countries can help to design customer choice models but differences in provision, funding and rights are all too extensive to draw systematic conclusions on the benefits and drawbacks in these models.

5.3. Provider compensation

5.3.1. Proposed legislation on provider compensation

Provider compensation will be a crucial element of the reform, as it will potentially affect all key outcomes in the health care sector – quality, costs and access to services. In this subsection, we discuss the proposed design of provider compensation after the reform. The discussion relates to compensating providers of direct choice services, i.e. funding of the health and social services centres and dental clinics.

Providers of direct choice services will receive their funding from the counties.[33] The counties will design compensation schemes for the providers, within limits outlined by central government.[34] All providers within a county must be treated equally, i.e. the compensation scheme will be the same for all providers.

Compensation will be mainly based on capitation payments. This means that providers will receive compensation for every individual who registers as their customer, and the size of this compensation will depend on the customer's background characteristics (and possibly in some cases on regional characteristics), which reflect the customer's health risk. The parameters of the risk adjustment formula, i.e. the weight of various individual characteristics in the capitation rule, are set by central government based on estimations by the National Institute for Health and Welfare.

The law stipulates that at least two thirds of the overall compensation for social and health care centres must take the form of capitation payments, with the corresponding figure being 50% for dental clinics. There is no upper limit on the share of capitation compensation, and the parameters of the capitation model will be set centrally. The remainder of provider compensation will be set by the county and can take the form of fee-for-service payments or different types of incentive-based payments, for example.

[33] Exceptions being out-of-pocket payments for cancelled appointments and payments for any additional services, i.e. services not funded by the government but offered by the provider.

[34] HE 16/2018, *Laki asiakkaan valinnanvapaudesta sosiaali- ja terveydenhuollossa*, § 65.

5.3.2. Setting provider compensation: key issues

In an ideal world, capitation payments give providers incentives to provide care efficiently. As providers cover, at the margin, all the costs of the care provided to the consumer, any productivity improvements will translate directly into higher profits (unless there is perfect competition). In addition, providers have an incentive to invest in prevention as healthier customers have less need for care. There are three caveats to this ideal case.

First, if providers have market power and consumers are less than perfectly informed, providers may cut down on costs by withholding services or reducing quality (underprovision). Second, if providers can shift the costs of some services (e.g. specialised health care) to third parties, they will overprovide these services. In the context of the current reform, providers may also use vouchers to channel primary care customers to their own specialised services, and the incentives to do so will depend on the profitability of those services. Note that under- and overprovision may occur simultaneously for different services. Third, if there is unpriced risk heterogeneity (discussed in more detail below), providers have an incentive to make socially inefficient investments in selection mechanisms, such as zero-sum competition for low-risk customers. Because of these issues it is typically optimal to combine capitation with other forms of payment, as counties will be licenced to do.

Fee-for-service payments are made based on the services provided. This payment type gives providers incentives to offer all services for which the fee exceeds the production costs. This is typically expected to generate potential overtreatment, as patients rely on the provider to evaluate the need for treatment, and do not face the full costs of the services provided to them (so called second-degree moral hazard, Balafoutas et al. 2017).

Choosing the mix between capitation and fee-for-service payments requires these threats of under- and overprovision to be balanced. This balancing act also has to take into account the institutional context (e.g. the size of the providers' customer pools) and societal goals (e.g. the emphasis on cost containment).

In addition to capitation and fee-for-service payments, counties may construct incentive-based payment schemes. These are a general category of payments where the compensation is tied to outcomes, for example some

measure of quality, or cost savings along the clinical pathway. While in principle this type of compensation is very useful and may help to prevent cost shifting or overprovision more generally, it is in practice often difficult to construct appropriate outcome measures. For example, in practice it will be difficult to disentangle useful referrals from unnecessary ones.

In sum, the large role of capitation payments is in line with the reform's objective of cost containment. There is empirical evidence that a higher share of capitation payments in overall compensation results in reduced service provision and increased cost-consciousness among physicians. There is also some evidence that this will not necessarily decrease the quality of care.[35] At the same time, it is good that the law leaves some discretion to the counties to experiment with different combinations of capitation and other forms of payment.

5.3.3. Setting the capitation rule: risk adjustment

A key challenge in designing capitation models is pricing risk heterogeneity. From the point of view of the providers receiving capitation compensation, individuals who are more likely than others to use their services are also more likely to generate costs for the provider and are thus termed high-risk individuals. This generates an incentive for the provider to select low-risk individuals into its customer pool.[36] If the provider is compensated simply per-capita, it will seek to attract e.g. younger people as customers as they tend to be more healthy.[37]

The solution to this problem is to compensate providers for high-risk customers. If providers are paid more for older customers than younger ones, and this price differential accurately reflects the cost differential to the provider, they no longer have an incentive to select between these two groups.[38]

[35] See Kortelainen et al. 2017 and references therein.

[36] In general, there is also a corresponding risk of inefficient self-selection by individuals into different plans. In the Finnish case, however, all providers offer the same plan.

[37] Providers are prohibited from refusing patients, but this does not solve the selection problem as providers can differentiate location decisions, service quality, and marketing by risk groups. For a discussion of mechanisms and empirical evidence see the background report by Häkkinen et al. (2019).

[38] This ignores the non-trivial task of setting the payment at an appropriate level. If providers are overcompensated for certain high-risk individuals, they of course have an incentive to select those individuals as customers.

They do, however, still have an incentive to select lower-risk individuals within these groups. In principle, incentives for selection remain until all risk is priced into the compensation model. There are several factors which pose limits on how much risk can be priced.

First, some risk adjustments are not feasible as the risk factors are not observed by the government (even if they are to some extent observed by the providers). One pertinent example in the Finnish case is information regarding duplicate coverage, which will be discussed below.

Second, some risk adjustments are subject to manipulation by the providers. Actual service use reflects risk very well, but the problem is that service use is determined not only by the health status of the customer, but also by the actions of the provider. Risk adjustment factors should be exogenous to the provider.

Third, constructing appropriate risk weights for a capitation scheme is not merely a technical exercise of predicting costs. Historical service use data may reflect inequities in access rather than need, as well as other inefficiencies. Society may also want to actively direct more care to certain groups and increase compensation for these groups to advance this goal.

The strong reliance on capitation in the proposed Finnish system creates pressure to find the right model and set its parameters well to avoid selection problems due to incorrectly priced risk. It is highly problematic that work on designing the reimbursement rule has only recently started in Finland, with insufficient time before the planned start of the freedom of choice pilots. The background report by Häkkinen et al. (2019)[39] discusses the issues to be considered when designing capitation compensation, especially risk adjustment. The report also reviews the experience from other countries (Netherlands, Germany and Sweden), and provides a first implementation with Finnish data. Experience from other countries shows that designing the reimbursement rule for providers is a difficult task. This relates in particular to finding the right risk-adjustment factors, so that the rule adequately reflects healthcare costs in order to eliminate incentives for selection, but does not rely on endogenous factors that can be manipulated

[39] THL will also be responsible for designing the actual capitation formula and risk adjustment to be used in the freedom of choice pilots, and after the actual reform.

by providers. Based on international experience, problems of cream-skimming may remain after decades of development of the system.

A model that predicts health care costs very well at the individual level can be highly complex. This is not necessarily a problem, and complexity can even be an asset if it makes the system more difficult to manipulate. New techniques, such as machine learning, should make the problem manageable, even though they have not yet been extensively used in designing risk adjustment rules, and they have not to date achieved notably higher prediction accuracy. The majority of the work on estimating capitation model parameters has been based on linear regression models. Besides choosing an estimation method, another choice in designing capitation models is whether to adopt the traditional approach of focusing on predicting health care costs as accurately as possible, or whether to go towards the so-called optimal risk adjustment approach, where the exercise focuses on choosing parameter values to maximize some objective function for healthcare performance. (Ellis et al. 2018.) In Finland, the first analyses follow the majority of earlier work in employing linear regression models and the traditional approach of predicting costs. Other approaches can be considered in further development of the system. (Häkkinen et al. 2019)

In the empirical exercise documented in Häkkinen et al. (2019), individual morbidities are measured by entitlements to so-called special reimbursement medication, i.e. medication for certain conditions (e.g. diabetes, cancer, heart and cardiovascular diseases) that are either fully or partially reimbursed from public funds. Other controls are age group identifiers and various individual background characteristics, including e.g. family and employment status.

The current exercise is limited by data availability. First, cost data is obtained from two sources – from a consulting group (FCG) and from one particular healthcare district – but the two data sources give a very different picture of the overall level of costs (which on the other hand does not appear to affect the actual weights received by different risk factors in the analysis very much). This is unsatisfactory, and the development of adequate cost accounting in healthcare should be a key priority. Second, the choice of sickness indicators is also limited by data availability, and the exercise focuses on indicators that can currently be operationalized in determining actual payments to providers by the Social Insurance Institution. It turns out that these variables do not perform very well in predicting costs, and future work

should focus on finding suitable sickness indicators that can be operationalized with Finnish data. (Häkkinen et al. 2019.)

According to the results in Häkkinen et al. (2019), a significant part of individual health risk would therefore be left unpriced with current data. Individuals with high past healthcare costs would remain undercompensated (unless past costs are included in the formula, which is not desirable due to potential manipulation over time) and considerable incentives for selection would remain. A particular problem in the Finnish system relates to overcompensation of individuals who have access to occupational health care, as data on occupational healthcare contracts is not currently available. Overall, occupational health care is a special feature that brings additional challenges for implementing freedom of choice and finding a well-performing capitation formula in the Finnish system. We discuss this issue in more detail in the next subsection.

Designing the reimbursement rule for providers is a difficult task that requires extensive expertise, data, and resources. The size of a typical county is small relative to the gravity of the task, and because of this it is good that responsibility for administering the task is taken centrally (i.e. not left to individual counties as in Sweden for example).

5.4. Occupational health care and duplicate insurance coverage

We noted in our previous report that the role of occupational health care is a major unresolved issue associated with the reform, and it remains so.[40] In addition to health and social services centres, many citizens will have access to health care via private health insurance or occupational health care. These are forms of duplicate coverage, meaning that the individual has coverage from other sources besides the direct choice service provider.

Duplicate coverage affects the design of capitation payments and health care costs through three channels.

[40] The government programme of 2015 stated that in the reform "a single-channel funding will be introduced, taking into account the position of occupational health care". In the end no changes were made regarding occupational health care, and the only changes were eliminating reimbursements for private health care fees and partially transferring travel reimbursements to counties.

First, all citizens will enlist as customers of health and social services centres, and will therefore be covered by regular public health insurance regardless of whether they have alternative insurance coverage or not. The provider will receive a capitation payment for these individuals, even though they are likely to have less need for services from the health and social services centre. This leads to a mechanical increase in public sector healthcare costs, unless the capitation model risk-adjustment formula takes this adequately into account.

Second, in addition to the potential mechanical cost increase, duplicate coverage is likely to cause behavioural changes that increase healthcare costs further: better insurance coverage causes individuals to change their behaviour, and more coverage therefore leads to more service use. This is an instance of moral hazard, and there is ample evidence that it is a relevant phenomenon in health care in general (Einav and Finkelstein, 2018) as well as in the context of duplicate coverage (Buchmuller et al., 2004, Vera-Hernández, 1999). In practical terms this means that an individual who is covered by occupational healthcare or private insurance might seek treatment for the same condition from the health and social services centre too, which causes duplication of healthcare costs.

Third, depending on the quality of care and length of queues at public health care centres, there may be shifts away from private coverage towards publicly funded services. Such shifts would cause further increases in public sector costs. The Ministry of Social and Health Affairs (2018b) has assessed the magnitude of these shifts to be in the order of 2-5% in the short run and at most 10% within the next five years, but it is not clear how this assessment has been made. It is of course clear that making an accurate assessment at this stage is very difficult.

How can these three challenges be taken into account and mitigated in designing the capitation formula, or otherwise?

First, avoiding the potential mechanical cost increase associated with occupational health care customers and privately insured patients enrolling as customers of health and social services centres would require appropriate adjustments to the capitation formula: the capitation payment would have to be lower for individuals with alternative coverage, and the difference in compensation should reflect the extent of the alternative coverage. For occupational healthcare customers, employment status can be used as a first

proxy for duplicate coverage in the capitation formula, as it of course correlates with access to occupational health care. The correlation is short of perfect however, as most self-employed people without employees, and many employees in small firms have no occupational health care.

More problematic is variation in the level of coverage. The legal minimum for occupational health care depends on the industry but is generally quite low. Its main component is a workplace check-up, with health check-ups also mandatory in some industries. From there on, occupational health care takes the form of a continuum of plans extending up to many forms of specialised health care. Table 5.2 presents the distribution of employees according to the average occupational health costs of the employer (those costs for which the employer has received a reimbursement from the Social Insurance Institution).

Table 5.2: Distribution of employees by average occupational health costs of the employer.

Average occupational health costs, € per year per employee	Number of employees
0-100	109 972
100-200	108 351
200-300	175 064
300-400	368 182
400-500	435 890
>500	638 486
Total	1 835 945

Source: Kela

The problem is that information regarding occupational health care plans is not collected by the government, and as such it cannot be included in the capitation model. Moreover the plans are multi-dimensional and summarizing them in a single number for the capitation model could be quite difficult. In any case the issue is of such importance that the government should look into mandating employers to provide some information regarding the scope of their occupational health contracts.[41] At a minimum, developers of the

[41] Obtaining an estimate of the potential additional costs (overcompensation in the capitation model) if this issue is not taken into account is subject to a lot of uncertainty. Häkkinen et al. (2019) assess the overcompensation per employed individual to be over 30 % if employment status (as a proxy for access to occupational health care) is not included in the capitation model. On the other hand, it is not possible to directly examine how much using employment as a proxy for access to

capitation model should experiment with using existing data regarding employer-level applications for compensation from Kela, together with linked employer-employee data containing information on place of work for each individual.

Second, since the behavioural effects caused by duplicate coverage relate to incentives for and actions by the patient, they cannot be solved by adjusting the capitation payments paid to providers. A potential solution would be to provide a limited set of services in the health and social services centres to individuals with other types of coverage. Even though a customer of occupational health care would still register as a customer of a health and social services centre, the set of services offered would be more limited than otherwise, i.e. it would be limited to those services not covered by his/her existing alternative contract. If such a solution is not feasible, duplicate coverage inevitably leads to higher health care costs. The feasibility of this solution is however limited by (i) the availability of information on occupational health care contracts; and (ii) incentive effects, as this strategy would very likely amplify effects through the third channel, i.e. shifts from private coverage (health care funding) to public coverage.

Third, dealing with shifts between different types of insurance is a particularly thorny issue, as the magnitude of such developments is very hard to forecast. If occupational health care and other duplicate coverage is inadequately taken into account in the capitation formula (e.g. only through a proxy related to occupational status), then changes in duplicate coverage should be reflected in the weight of the corresponding variables in the capitation formula. (That is, if occupational health care customers initially receive a low weight and therefore low compensation in the formula, this weight should increase if occupational health care contracts become more limited in coverage).[42]

In sum, the capitation payment would need to be lower for individuals with duplicate coverage, and the payment should reflect the extent of the alterna-

occupational health care reduces the overcompensation of these individuals. Further, the estimate naturally only accounts for the direct cost, and not e.g. for potential inefficiencies arising from the behavioural effects of duplicate coverage or from patient selection.

[42] On the other hand, if the different features and dimensions of occupational healthcare contracts are initially accurately reflected in the capitation formula, then changes in occupational healthcare contracts do not necessarily require changes in the capitation formula itself, but will only be reflected in the individual the payments determined based on the formula.

tive coverage. The correct level of the capitation payment does not depend only on the extent to which occupational healthcare customers use public healthcare services in the current system – this would only take into account the aforementioned mechanical effect on health care costs. The level of the capitation payment would also have to reflect how the level of different types of coverage develops in the new system.

5.5. Access to services

Alongside achieving cost savings, the reform seeks to improve access and reduce inequalities in services. The government proposal states that differences in access by region and socioeconomic status have increased to a point at which they are now significant from the point of view of the constitution.

A major effect of the reform is to reduce barriers to entry in the provision of primary health care. In Sweden, freedom of choice reforms have been associated with an increase in the number of providers (Burström et al. 2017). The Swedish freedom of choice reforms also improved overall access measured by the number of visits to primary care providers, but it should be noted that cost savings were not a central aim of these reforms (Jonsson 2017).

In the Finnish reform containing expenditure growth takes centre stage. Currently projected increases in social and health care costs reflect increases in demand due to an ageing population. If cost savings are not fully realised through productivity improvements, cost containment will impair access to or quality of care, even if aggregate expenditure will increase from current levels. Thus even maintaining access at current levels in the face of increased demand pressures and a shrinking labour force would be challenging.

Besides the overall level of access, equity of access is also an important consideration. It is a primary objective of the welfare state to provide equal access to health care and social services for all citizens based on need rather than ability to pay (universalism). The reform may affect equality of access in several ways, both regionally and across different socioeconomic groups.

Shifting the responsibility for social and health care from municipalities to counties is likely to reduce differences in access by region. As the decision regarding the level of expenditure is centralised, expenditure is equalized. If

counties are able to gain increasing returns to scale in service provision, this will especially benefit citizens in smaller municipalities. On the other hand, more focus on private provision and competition raise geographical issues, since market mechanisms are more likely to work in urban areas with a high population density than in rural areas with a low population density. At a more macro level, counties naturally have a huge responsibility over the functioning of the entire system. The proposals leave room for counties to make their own decisions e.g. regarding incentive and other types of payments to providers (which comprise up to 1/3 of the overall compensation), the use of vouchers, and numerous other issues of importance for overall performance of the system. To the extent that counties make different decisions and have different levels of expertise, equality of access may be adversely affected.

Thinking about equality of access across population groups, a key factor in achieving an equitable allocation of primary care is the capitation model for health and social services centres and dental clinics. Anell et al. (2018) show that risk adjustment in the compensation of Swedish primary care centres has indeed had an effect on how the centres are distributed between different areas.

Constructing a workable model is a difficult technical task, but it is crucially also a political question. Simply using parameters estimated from historical service use data will help maintain any historical inequities in access to care. In an earlier empirical study on improving the municipal grant system, Vaalavuo et al. (2013) suggest that normative criteria should be taken into consideration in drafting the model. The same applies in this case as well. Politicians should explicitly address existing inequities in access to primary health care in the compensation model for direct choice providers. In general, specific measures should be directed at groups that are judged to be in a particularly disadvantaged position regarding health care access. The same applies to social services.

The problem of duplicate coverage discussed in the previous subsection is a potential source of major inequality in the new system. In general, occupational health care is the major source of unequal access to healthcare in Finland. If the capitation model does not reflect duplicate coverage in an adequate way, this will exacerbate existing inequalities in access and cause overprovision of services to population groups who already have superior coverage.

Finally, if projected productivity improvements do not fully materialize, this may have adverse effects on the allocation of services as it may result in an increase in client fees. Although there is some progressive income contingency in client fees, they are regressive overall. This scenario would be in tension with a traditional welfare state objective of providing equal access to health care for all citizens based on need rather than ability to pay (universalism).

5.6. Experimenting and phasing in the reform

Preparation and implementation of the freedom of choice reform is supported by experiments, which will take place both before and after the legislation is set to be adopted by parliament. Additionally, the reform itself will be phased in over a period of four years.

Service voucher experiments are being carried out under existing (pre-reform) legislation, and funded by central government with some own funding required from the municipalities involved. Central government funds were granted in two rounds based on applications, and not all applicants received funding. The experiments began at the beginning of 2017 and will continue into 2019, after which they will be continued as freedom of choice pilots based on the reformed legislation.[43]

There are currently 10 ongoing service voucher experiments. The experiments are termed this way because they are being implemented under the law on service vouchers. None of the experiments actually involve the post-reform voucher system. Instead each project has one of the other elements of the freedom of choice reform as a theme: health and social services centres, dental clinics, and personal budgets.

Even within a single theme, the experiments are quite different from each other. To take the six health and social services centre experiments as an example, three of them involve social services in addition to primary health care, one of them experiments with fee-for-service compensation and one with incentive payments. In one experiment citizens are informed of their right to choose a private provider with a personal letter, in another experi-

[43] The freedom-of-choice pilots are set to take place in 2019-2021. Our analysis concerning the service voucher experiments is largely applicable to the freedom-of-choice pilots as well.

ment citizens cannot choose their own occupational health care provider as a provider for primary health care, and so on.

The service voucher experiments have, broadly speaking, two stated purposes: administrative improvement and impact evaluation. In the former category the experiments provide information to support the development of information system infrastructure for the freedom of choice legislation. This is a worthwhile goal. Although we are not in a position to assess how useful the experiments actually are in this regard, it is at least possible to learn something from the experiments in terms of administrative improvement.

The same cannot be said about impact evaluation. The reform website states that the reform will evaluate "effects of clients' freedom of choice on access to health and social services and on their quality", and "how different service pricing and reimbursement models affect the total expenditure on health and social services". Impact evaluation requires a clear policy intervention and a control group, both of which are lacking in the service voucher experiments.

An ideal experiment randomly assigns participants (individuals, municipalities, etc.) into treatment and control groups. Without random assignment (or some other way of forming a credible control group, as discussed below in the context of so-called natural experiments), many factors which cannot be observed may be correlated with both the intervention and the outcome, with the result that we cannot be sure whether the outcomes are a result of the intervention or the unobserved factors. This is a typical problem in situations where participants self-select into the study, such as the service voucher experiments. In the on-going experiments one cannot for example rule out the possibility that municipalities which applied for the programme are forward-thinking organisations which would have implemented changes to contain costs and improve quality even in the absence of the experiments.

Another problem is that the service voucher experiments do not constitute a proper policy intervention. As the municipalities are free to implement different types of experiments, any changes in outcome between these municipalities and a control group could not be mapped to any single intervention even if there was a control group. The only thing one can learn from such experiments is the effect of the experiment itself, which is hardly interesting from a policy point of view.

Whenever a reform is being planned, the reform itself is a natural candidate for an intervention in an impact evaluation experiment. If this is not feasible, for example due to constitutional limits on unequal treatment, the key mechanisms of the reform should be identified and experiments should be designed to test these mechanisms.

As experiments with a randomized intervention are scarce in social sciences, researchers often rely on what are called natural experiments, in which the implementation of a policy creates a control group even when there is no explicit randomization. Natural experiments are good alternatives to randomized experiments if randomization is too costly, cumbersome to implement, or raises ethical concerns. A common way in which a natural experiment arises is gradual implementation, under which citizens in different areas are exposed to the policy at different times, allowing researchers to trace out the effects of the policy. A notable Finnish example of this is the comprehensive school reform which was implemented gradually across the country between 1972 and 1977. This enabled an evaluation of the effect of the reform on outcomes such as intergenerational income mobility, and more generally provided information on the effects of tracking[44] (Pekkarinen et al. 2009).

Regarding the freedom of choice reforms in Swedish health care, the effects of provider reimbursement have been studied exploiting regional variation between counties and across time in the reimbursement rule (Anell et al. 2018). Evaluation of the outcomes of the reform in general, however, has mainly been based on simple before-after comparisons that are less reliable from the point of view of assessing the causal effects of, say, increased competition, because there is no counterfactual to which e.g. the evolution of costs after the reform could be compared.

The freedom of choice reform in Finland will be phased in gradually, but without geographical variation. Personal budgets and the service voucher are set to be implemented by July 2020, with health and social services centres operating by January 2021[45] and dental clinics by January 2022.

[44] Tracking separates pupils into different tracks of education, in the Finnish context most importantly to vocational and general tracks in secondary education.

[45] Based on an assessment of the county's readiness, the central government can allow the county to bring this date forward, or to postpone it by one year at most.

We want to emphasize that impact evaluation is not the sole purpose of experimentation with and gradual phase-in of reforms. Experiments lacking a proper control groups and interventions may still be useful in terms of administrative development, which is valuable. Gradual phase-in helps to manage the risks associated with large reforms, allowing policy makers to steer the reform away from emerging problems. It is commendable that the freedom of choice reform includes these elements.

Even without considering impact evaluation, it would have been advisable to implement the freedom of choice reform in a more gradual fashion by extending freedom of choice to cover different services and producers one at a time. This would have reduced the risks of the reform and given more time for counties to adjust. This type of alternative is discussed briefly in the government proposal. The current arrangement was chosen because of a political deal whereby a comprehensive freedom of choice reform and the regional reform were to be decided upon at the same time. However, such a linking would not have been necessary for organizing social and health care in an efficient and equitable manner.

Impact evaluation is a stated goal of the service voucher experiments. The experiments inevitably fail to achieve this goal as their design does not include a proper control group or a proper policy intervention. The service voucher experiments are part of an unfortunate tendency to assign impact evaluation goals to experiments which cannot produce credible information on the effects of a policy. Future policy experiments should either be designed properly to allow an impact evaluation, or refrain from promising any evaluation of the impacts.

A regional element to the phase-in of the freedom of choice reform would have been one way in which the effects of the reform could possibly have been evaluated in the future. Such an evaluation could also have provided valuable information for the future development of publicly funded social and health care.

5.7. Counties and their funding

5.7.1. The principles of county funding

The regional reform will establish 18 counties, which will be responsible for organizing social and health care. Counties will also have certain other responsibilities, for example employment and business promotion and fire and rescue services.[46] Although these are not trivial tasks, we will focus here on counties' role in providing social and health care as it is by far the counties' most important responsibility.[47]

The counties differ from one another by population, income, age structure, and health. The most populous county, Uusimaa, is 24 times as large as the smallest county, Central Ostrobothnia (less than 70,000 inhabitants). In 2014 average taxable income in Uusimaa was 19,800 euros per inhabitant, whereas in North Karelia it was 12,500 euros. The share of over-84-year-olds ranges from 6% to 12%, and the share of citizens with blood pressure medication varies from 5% to 12%.

Variation between counties is naturally smaller than between municipalities, and this is one of the reasons for transferring responsibility for social and health care from the latter to the former. Organizing social and health care into larger units has been a reform goal in Finland for a long time. It has been argued that numerous autonomous municipalities lead to variations in access to and the quality of care which is in conflict with societal goals and constitutional requirements of equality. Many municipalities have also been seen as too small to even out the effects of stochastic variation in health conditions and for to achieve economies of scale in production.

The government has decided not to grant taxation rights to the counties. With the exception of out-of-pocket payments and client fees, counties are set to receive all of their funding from central government as a block grant. Because of this the central government bears significant responsibility for

[46] As is the case for the reform as a whole, there is currently also uncertainty on whether laws on the various tasks of the counties will be passed during the current government's term, in particular due to time constraints.

[47] Throughout this chapter when referring to the counties' funding, we are referring to the counties' funding for social and health care. Funding for other tasks differs in some details.

how well the publicly funded social and health care system will work in the future.

The law establishes a cap which determines how much counties' aggregate funding is revised annually. We described the counties' funding plan and the how the evolution of the overall level of funding is determined in Section 5.1.

Regarding the allocation of funding to the counties, the counties are set to receive their funding on a per-capita basis with adjustments for age, socio-economic standing, sickness, and certain regional variables (e.g. population density). The funding model is built on the system currently applied in municipality funding. It is based on a study by Vaalavuo et al. (2013), who estimate the determinants of social and health care costs at the individual level, similar to what Häkkinen et al. (2019) do in their background report in the context of provider reimbursement.

The funding model for the counties and the compensation model for private providers do not need to be the same, however. The most obvious reason is that the counties overall and private providers within them provide different services, as the counties are responsible for specialised care. But beyond this the issues involved are also different. Controlling for risk factors is less important for the counties as they are larger than the private providers and therefore less susceptible to stochastic variations in health conditions. The selection problem is also less serious for the counties, as getting individuals to change counties is harder than it is to get them to change provider within a county.

This difference points to two conclusions. First, the optimal funding model for the counties is probably simpler than that for the providers. We encourage future developers of the counties' funding model to test to what degree counties' allocations would change if the model were simplified by excluding the sickness indicators, for example.[48] Second, getting the funding model of the providers right is bound to be at least as important and probably more difficult than getting it right for counties. This should be reflected in the re-

[48] Excluding the sickness indicators from the current model while keeping the other parameter values constant would change the counties' budgets by 1% on average (2,5% at most), or EUR 34 per inhabitant (EUR 79 euros at most). If other parameter values were not fixed they would capture some of the variation in sickness indicators. See also the estimations in the background report by Naumanen (2019).

sources devoted to these two tasks. It also seems plausible that the counties' funding model need not be updated very often.

5.7.2. Arguments for and against tax autonomy

There are various arguments for and against tax autonomy being granted to subnational governments. The arguments revolve around strategic interactions between different levels of government.

We first turn to the arguments for tax autonomy. First, the counties' reliance on central government creates an obvious risk of a soft budget constraint, as acknowledged in the government proposal. The government cannot commit to not bailing out counties that run out of funds, as health care is a basic right with strong constitutional protections. The counties are aware of this, and it may change their behaviour in a number of ways: counties may overspend, and they may invest in riskier projects or in lower-priority services (knowing the central government guarantees the provision of higher-priority services).

There is empirical support for the overspending mechanism, reviewed in the background report by Kortelainen & Lapointe (2019). An interesting case is that of Norwegian hospitals, documented by Tjerbo & Hagen (2009). From the late-1990s, the 19 counties responsible for funding hospitals received their revenues from the government through block grants, activity-based funding, and a share of local taxes (at a tax rate fixed by the central government). The authors argue that this resulted in a problematic "blame game", where the counties claimed that their deficits were a result of insufficient funding, demanding additional transfers from central government.

The soft budget constraint problem gives rise to an externality: a bailout of one county will be funded by all counties. Tax autonomy would mitigate this externality as the county would impose the costs of budgetary overruns on its own citizens in the form of tax increases. This would improve the incentives of both county officials and county citizens to maintain fiscal discipline.

The severity of the soft budget constraint problem may be limited by the following factors. Reputational concerns among local politicians may moderate counties' incentives to overspend. The current reform proposal also includes a system of fiscal steering, overseen by the Ministry of Finance. As the coun-

ties receive their funding from central government, their expenditure is contained within the general government fiscal plan. As part of the process of drafting the general government fiscal plan, negotiations will be held between central government and the counties every year. These negotiations will be led by the Ministry of Finance, and the government proposal (HE 15/2017) states that the goal of the negotiations is above all to ensure that costs are contained in the counties.

The government proposal specifies the cases in which counties can obtain additional funding. If funding is evaluated to be insufficient in more than seven counties or in counties whose population is at least 40% of the total population, funding is increased for all counties. If this problem concerns fewer counties and a smaller population share, the counties with insufficient funding will receive additional funding or a short-term loan from central government. The evaluation of whether funds are sufficient or not is carried out by the Ministry of Finance.

Further, the reform establishes the threat of an evaluation procedure for budgetary overruns. The Ministry of Finance can initiate an evaluation procedure if a county receives additional assistance. An evaluation group will draft a proposal for rebalancing the county's finances. As an ultimate threat, the ministry can initiate a process of mergers to ensure that all counties are viable.

The proposed framework for fiscal steering to accompany the system of intergovernmental grants appears sensible. Empirical evidence supports the notion that this type of fiscal steering mitigates the problem of soft budget constraints (see Kortelainen & Lapointe 2019 for a review), but of course much will depend on how the framework is put into practice.

It should also be emphasized that budgetary overruns are not necessarily due to fiscal profligacy and are not necessarily indications of the counties responding to a soft budget constraint. The cost containment goal is very ambitious and there is a very clear possibility that funding will simply prove to be insufficient. In this sense, a "soft" budget constraint provides insurance to counties against cost shocks; this is more likely to be important for small counties. This is also the essence of the new provisions related to guaranteeing additional funds to counties in case adequate provision of services is in jeopardy. As with any type of insurance, the other side of the coin is that cost shocks are difficult to disentangle from lax fiscal governance.

Second, tax autonomy gives positive incentives for improving productivity. In the proposed system, a county that increases its productivity can expand its services. Under tax autonomy, the county could also produce the same amount of services with less resources and decrease taxes. If publicly provided health care and money are not perfect substitutes for citizens in a county, as they surely are not, tax autonomy improves the incentives to invest in productivity increases.

A third, related argument for tax autonomy is that autonomy would allow flexibility for counties to adjust to potential differences in local preferences regarding the level of services. This is a common general argument in the fiscal federalism literature in favour of de-centralization. However, it is likely to be less important in the case of health care than some other kinds of services, as health care is regarded as a basic right of citizens and emphasis is therefore usually on equity as a key societal goal, as we discuss below.

A number of arguments have also been put forward against tax autonomy. First, tax autonomy may create so-called vertical tax externalities between different levels of government, which may lead to higher-than-optimal tax rates. A vertical externality arises if a tax increase by one level of government leads to a reduction in the tax base of another level of government. For example, if two (or more) levels of government tax labour income, then a tax hike by one level of government may lead to a decrease in labour supply, which will reduce tax revenue of other levels of government.[49] If counties do not take into account this negative effect of tax increases on central government's tax revenue, the aggregate tax rate may end up being inefficiently high. The prospect that tax autonomy may lead to a higher aggregate tax rate is a key argument against tax autonomy in the government's proposals.

On the other hand, tax autonomy could also lead to tax competition between counties, which involves horizontal externalities. A county that reduces its tax rate would attract citizens from other counties, which would then see their revenues decrease. This "race to the bottom" can in principle lead to lower-than-optimal tax rates and underfunded local services, and might therefore counteract the vertical externality. Lyytikäinen (2012), however, finds no evidence of such behaviour among Finnish municipalities.

[49] The tax bases need not be the same. A decrease in labour supply will result in reduced household incomes, which will in turn reduce consumption. Thus an increase in labour income taxes by one level of government will reduce consumption tax revenue of another level of government.

Second, tax autonomy supports county autonomy in general, and this is likely to increase variations in outcomes between counties. Some counties will be more productive than others, and their citizens will have lower taxes and/or better service than citizens in other counties. The government has emphasised these types of arguments in its proposal. As in many policy areas, there is a trade-off between incentives provided by tax autonomy (i.e. avoiding the soft budget constraint issue) and inequality. We do not want to take a stand on value judgements, but would nevertheless like to point out factors that appear to reduce the weight of the argument related to regional disparities. Disparities between counties can be mitigated by intergovernmental grants, as they are in the current system of municipal funding. Even if counties had the same degree of autonomy as municipalities do, variations in access would be likely to be smaller due to the smaller number and larger size of the counties.

Third, the government argues against tax autonomy on the grounds of avoiding excessive tax complexity, arguing that giving taxation rights to counties would be "a significant change which would complicate the tax system", as taxpayers' wage income is "already subject to 7-8 different taxes". This argument does not seem very relevant. While the number of taxes is sometimes included in measures of tax system complexity, this has more to do with its measurability than its relevance (see e.g. Tran-Nam & Evans, 2013).

To sum up, the question whether counties should have tax autonomy is a challenging one. It involves value judgements, as well as efficiency mechanisms pointing in different directions, which are difficult to quantify. In the end, the arguments in favour of tax autonomy appear to be stronger than those against it.

Tax autonomy would provide valuable incentives for counties – their legislators and citizens – to maintain fiscal discipline and improve productivity in service provision. The government's cost containment goal is very ambitious. If counties had their own tax revenue, they would have more latitude to experiment with different ways of organising production, and more incentives to adopt practices that work. If the counties are nominally autonomous but lack their own sources of revenue, the risk of a blame game between different levels of government is obvious if the cost containment goals are not reached.

Vertical tax externalities are a possible issue when creating an additional layer of taxation. It is possible that tax autonomy would raise aggregate tax rates relative to the current plan, although increased tax rates could also reflect demand for health care not satisfied by central government funding. If county tax autonomy increased tax rates, it would be inefficient only to the extent that it reflects vertical tax externalities. As we discussed in our 2015 report, it is the overall structure of tax and expenditure policies and not the aggregate tax rate which is relevant for economic performance.

Evidence suggests that the behavioural responses central to the inefficiency caused by vertical tax externalities are relatively modest (see the survey by Matikka et al. 2015). These tax externalities may also be mitigated by requiring different levels of government to rely on different revenue sources (e.g. increasing reliance on property taxes rather than income taxes at the municipal level). This may work if there are no strong linkages between different tax bases (i.e. in the context of the above example, if increasing property taxes does not significantly affect labour supply incentives).

Finally, a system of tax autonomy would necessarily be complemented by intergovernmental grants as in the current system of municipal funding. An optimal structure for funding sub-central governments would be likely to involve a mixture of instruments (rights to taxation combined with intergovernmental grants) rather than being restricted to using intergovernmental grants only. Intergovernmental grants give insurance to counties against cost shocks, while tax autonomy mitigates the incentive problems associated with providing such insurance.

5.8. Council views

The key aims of the social and health care reform are to reduce costs by EUR 3 billion through increased productivity; to improve access to healthcare; and to reduce health inequality.

Cost savings. The justification for the EUR 3 billion savings target for the social and health care reform remains unclear. The government proposals do not specify clear mechanisms leading to such cost savings. If productivity does not increase as expected, there is a risk that adhering to the savings target may compromise the quality of care. Since the cost savings associated

with the reform are highly uncertain, it is questionable to highlight costs savings as the key argument for the reform proposals.

Public-private-mix and productivity. The government expects the social and healthcare reform to increase productivity via increased competition through the entry of private providers. Consequences of a considerable and abrupt increase in reliance on private providers in a publicly funded health care system, or the applicability of international evidence on the effects of competition in health care to the proposed reform, have not been given adequate consideration in the preparation of the reform. Neither economic theory nor empirical research provides clear predictions on whether private providers yield better quality and lower costs in health care than public providers. Evidence on the effects of the public-private mix or competition in primary care provision is scarce, and the existing evidence suggests at best modest effects. The proposed system creates incentives that may lead to inefficiency, e.g. for shifting costs from private providers to public sector. There is relatively good evidence from numerous contexts that health care providers react to such incentives.

Provider reimbursement. Provider reimbursement potentially affects access to and quality of social and healthcare as well as costs. If the reimbursement rules do not adequately reflect costs of individual patients, there will be an incentive for patient selection leading to unequal health care access. Experience from other countries shows that problems of so-called cream-skimming can be rather significant and persistent. On the other hand, if the rule depends on cost factors which the provider can manipulate, this will create an incentive to increase costs. The quality of care may also be compromised if the selection of treatments is based on profitability and not on medical need.

Designing the reimbursement rule for providers is a difficult task that requires expertise, data, and resources. It is problematic that work on designing the rules has only recently started, with insufficient time before the planned start of the freedom of choice pilots, and that availability of all necessary data has not been ensured. Designing and further developing the capitation formula is a key priority, and it is good that responsibility for administering the task is taken centrally (i.e. not left to individual counties).

Occupational healthcare and duplicate coverage. The role of occupational health care and duplicate health insurance coverage remains an unre-

solved issue in the reform proposals. Duplicate insurance coverage has three potential effects: First, there is an increase in public sector costs when patients currently covered by occupational healthcare or private insurance enrol as customers of healthcare centres, unless reduced need for services is adequately taken into account in provider reimbursement. Second, duplicate insurance coverage also tends to increase demand for healthcare services. Such behavioural effects may cause further increases in healthcare costs overall. Third, potential demand shifts from private insurance to publicly funded services would increase (public sector) costs further.

The first issue can potentially be addressed in the providers' reimbursement rule, but this is currently hindered by data problems. The possibility of mandating employers to provide data on the coverage of occupational health care contracts should be examined. In the meantime using proxy measures, for example based on employer-specific average occupational health care costs, can be considered.

Access to services. Whether the reform will improve access to services depends on how the tension between the savings target and access will be resolved. If there is adequate entry of new providers, the reform is likely to improve access to health care in the sense of reduced queuing. The quality (and range) of services provided, however, will depend on the level and structure of provider reimbursement. The constitutional law committee has mandated funding increases to counties if adequate care is compromised. Since adequacy of care is difficult to assess and subject to discretion, it is not clear whether the provisions are sufficient to eliminate the risk of quality reductions in the face of the tight savings target. Therefore the inherent tension between the tight savings target and improving access to and quality of care remains essentially unresolved.

The effects of the reform on equality of access are unclear. Shifting the responsibility for social and health care from municipalities to counties is likely to reduce differences in access across regions. On the other hand, more focus on private provision and competition raise geographical issues, since market mechanisms are more likely to work in urban areas.

The reform may not succeed in reducing inequalities in health care access across socio-economic groups, because it will involve (i) providing duplicate insurance to individuals with access to occupational health care, and potential overprovision to a group that already has a relatively good level of ser-

vices; and (ii) using past healthcare costs to estimate the provider reimbursement rule, which tends to maintain historical inequities in access to care. Overall, the effects on equality of access will depend on whether the capitation formula adequately compensates providers for treating high-cost patients.

Regional reform and county funding. Transferring responsibility for organising health care from municipalities to larger organisations may contribute to reduce inequalities in health care access across regions. Moreover, it may lead to some productivity improvements if the counties are able to exploit returns to scale in service provision.

The arguments in support of giving counties the right to taxation are stronger than those against it. The lack of tax autonomy is, however, not an urgent issue as taxation rights can be granted to counties at a later stage. If it is decided that counties should be granted taxation rights, possibilities for minimizing vertical tax externalities should be explored e.g. through reducing the role of income taxation at the municipal level through heavier reliance on other revenue sources (property income taxation and government grants for funding municipalities).

Implementation. Given the magnitude of the proposed changes to healthcare provision, and the uncertainties involved in the effects of the reform, a more cautious approach with phased-in implementation would be advisable. In particular, it would be prudent to expand freedom of choice in a more gradual fashion, for example by extending freedom of choice to cover different services one at a time. The coupling of the simultaneous implementation of the regional reform with extensive freedom of choice arose because of a political deal and is not justified solely by arguments related to achieving the best possible outcome for the health care sector.

The on-going service voucher experiments may be useful from the point of view of administrative development, e.g. in providing information to support the development of information system infrastructure. Impact evaluation is another stated goal of the service voucher experiments. However, the experiments inevitably fail to achieve this goal as their design does not include a proper control group or a clearly defined policy intervention. Implementation of service vouchers and personal budgets would benefit from a more gradual reform process.

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