Economic Policy Council: Next government needs a credible plan for fiscal adjustment and combating climate change

The Covid-19 pandemic and the current crisis have demonstrated that the government's ability to support the economy is crucial. Given the persistent deficit in public finances, the new government term should start with a credible fiscal adjustment plan. The tightening of EU-wide climate policy will also affect Finland.

The war on Ukraine created an energy crisis in Europe, which has also pushed up the overall price level. Because of these developments, the forecast for economic growth in Finland for 2022-23 has been revised down significantly.

Call for more targeted measures to alleviate the impacts of crises

Additional spending on military and other security-related uses has most likely been necessary whereas certain measures to boost purchasing power, such as the temporary VAT cut on electricity, have not. There is a need to assist severely affected households. However, it is not possible to permanently compensate all households and firms for the reduction in profitability or disposable income.

Expansionary policies are not well suited to dealing with adverse supply shocks like the current crisis. By boosting aggregate demand in the presence of supply shortages, expansionary policies can further feed inflation. In general, currently non-existent policy instruments that allow targeted, income-based, one-off payments should have been designed and been made available for political decision making on relief measures.

Given the persistent deficit in public finances, part of the additional spending should have been financed by cutting public expenditure elsewhere or by tax increases. Tax increases may be sought, e.g., by discontinuing taxing certain goods with lower VAT rates, by increasing property taxation and by reforming dividend taxation of unlisted companies.

New government term should start with a credible fiscal adjustment plan

Given the size of Finland's current deficit, a gradual and sustained adjustment should be implemented. The goal should be fiscal adjustment in the range of 0.4-0.6 percent of GDP annually for the duration of two government terms, which would turn the debt-to-GDP ratio onto a declining path.

It is important to secure future fiscal space, since Finland will likely face negative economic shocks during a long period ahead. If the economic conditions are not very unfavourable in 2024, one should start with sizable, front-loaded, adjustment, rather than postpone consolidation to the end of the next government term.

Given the required scale of consolidation, both expenditure and revenue measures are needed. The council proposes the establishment of a committee to assess how tax changes and prioritisation in public spending can contribute to the required consolidation while safeguarding the future development of the Finnish economy.

Employment targets met, but impact of the government's own measures yet to be seen

The employment target set by the current government was reached in 2022 in practical terms. The rapid labour market recovery is similar to experiences in most other EU countries after the pandemic. The good performance of the economy seems to be a crucial factor in explaining the improvement in employment.

The 2017 pension reform has had a major positive effect on employment in recent years. Similarly, some of the important measures decided by the current government will only materialise in coming years. However, achieving employment targets does not guarantee that the expected positive fiscal effects are reached.

Job vacancies started their rapid increase in 2021 and employers have repeatedly reported difficulties to recruit workers. Temporary issues may result from the pandemic. In some cases, short hours or low pay may explain the recruitment problems. In some sectors, too small initial intakes in the education system might be the cause. The cures need to reflect the differing causes of the mismatch or labour shortage problem.

The tightening of EU-wide climate policy will affect Finland

Finland aims to be carbon neutral by 2035 which is more ambitious than the overall EU target. In recent years, reported public expenditures and investments in green transition in Finland have been considerable. However, ex-ante evaluations on emissions reductions and actual policy measures are still missing. Agri-environmental policy has not resulted in any reductions in greenhouse gases. Forestry and land use policy have contributed to collapsing carbon sinks. Patenting in environment-related technologies has declined in the last 10 years.

In addition to relying on carbon sinks, the Finnish climate and energy strategies have been built on expected increase in inexpensive low carbon electricity supply, which has not materialised in projected pace. Following the 'Fit for 55' reform, the cost of carbon dioxide emissions is expected to increase. The economic impact of this together with phasing out of free allowances and other subsidies remains to be seen.

Finland needs a credible plan for combating climate change. Transport taxation should be reformed to improve incentives to reduce emissions and to accelerate electrification of transportation. Infrastructure investments are needed in the energy sector. Incentives for private investments should be provided by carbon pricing, regulation, and taxation. The distributional impacts of decarbonisation also need to be addressed. Non-distortionary lump-sum payments should be preferred to make carbon pricing reforms equity enhancing and pro-poor.