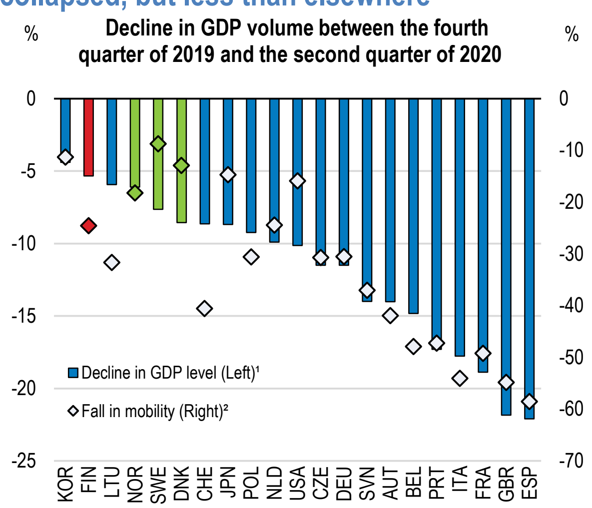
Executive Summary

The COVID-19 pandemic caused an economic slump

The COVID-19 pandemic plunged Finland into a deep recession. The government provided substantial financial support to protect jobs and help households and businesses get through the crisis. However, 25% of temporarily laid-off workers were not eligible for earnings-related unemployment benefits.

Finland's GDP contracted by 5% in the first half of 2020. While large by historical comparison, this economic contraction was among the smallest in the OECD, partly thanks to more targeted confinement measures and a relatively small loss of mobility (Figure 1). Finland managed to bring the first wave of the coronavirus under control quickly through a combination of voluntary mobility reductions and timely containment measures and is on track to do the same for the second wave.

Figure 1. Economic activity and mobility collapsed, but less than elsewhere



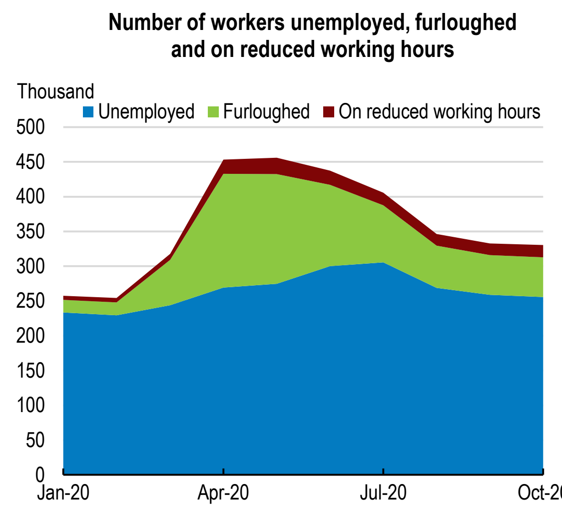
1. % difference between 2019Q4 and 2020Q2 GDP levels. 2. Fall in mobility from the baseline between 1st of March and 27th of June.
OECD, National Accounts database; Google LLC, Google COVID-19 Community Mobility Reports, https://www.google.com/covid19/mobility/.

StatLink https://stat.link/9h3x1s

The temporary layoff scheme played a key role in protecting jobs and incomes. Temporary layoffs increased far more than permanent layoffs during the first period when containment measures were implemented, limiting the increase in unemployment (Figure 2). Employers have few incentives to limit temporary layoffs to jobs they believe can be restarted after the crisis.

A weakness highlighted by the crisis is that only those people temporarily or permanently laid-off who are members of unemployment insurance funds are entitled to earnings-related unemployment benefits despite the funds only paying 6% of benefit costs. Non-fund members are entitled to flat-rate basic unemployment benefit (EUR 32.40 per working day) that can be supplemented by housing allowance and/or social benefits.

Figure 2. Temporary layoffs spiked



Statistics Finland's Px Web databases.

StatLink https://stat.link/pkjvq3

The government also mobilised financial support for SMEs and microenterprises and provided support for hard-hit industries. It also reduced firms' tax burdens and social security contributions temporarily, easing cash flow, and temporarily limited creditors' right to petition for bankruptcy on the basis of a debtor's temporary insolvency. These measures helped avoid mass bankruptcies.

Macroeconomic policies are supporting economic recovery

The general government budget deficit is projected to increase by 6.5% of GDP in 2020 and the European Central Bank (ECB) has supplied vast amounts of liquidity and supported increased bank lending. However, some of these measures risk reducing banks' risk-bearing capacity. Activity will gradually return to its pre-COVID-19 level by 2022.

Three quarters of the 3.5% of GDP in discretionary measures that increase the 2020 budget deficit were in response to COVID-19. As the measures unwind and the economy recovers, the budget deficit is projected to fall to 3.5% of GDP by 2022, with 40% of the decline reflecting automatic stabilisers. General government debt will increase sharply in 2020 and slowly thereafter.

To complement expansionary monetary policy measures, the ECB has lowered bank capital requirements, introduced flexibility in the treatment of non-performing loans, and reduced solvency and collateral requirements, enabling banks to accept lower quality collateral. While these measures have increased domestic lending capacity, they risk reducing banks' risk-bearing capacity.

Measures are being taken to slow the growth in household debt, 70% of which is housing loans (including rapidly growing housing company loans, which are ultimately a household liability). However, the recent reduction in loan-to-value ratios for housing loans was reversed this year to support recovery from the COVID-19 crisis.

Real GDP is projected to drop by around 3% in 2020 and to recover slowly, especially in light of the second coronavirus wave (Table 1). The recovery will be led by private consumption and exports. Unemployment and bankruptcies are likely to rise in the short run, as relief measures run out towards the end of 2020. Inflation pressure will be weak, reflecting the sizable output gap and labour market slack.

Table 1. Economic recovery will be gradual

	2019	2020	2021	2022
Real GDP	1.1	-3.3	2.1	1.8
Private consumption	0.8	-4.4	3.0	2.1
Exports	7.7	-10.8	3.7	4.7
Non-residential investments	-1.2	-4.5	1.0	6.2
Unemployment rate (% of labour force)	6.7	7.9	8.3	7.7
Core inflation	0.7	0.5	0.9	1.4

Source: Projection based on OECD Economic Outlook 108, updated for the National Account release on 27 November 2020.

The recovery would be delayed if the recent resurgence of coronavirus infections were not soon reined in or there were to be further serious outbreaks, external demand remained weak owing to a prolonged global pandemic or banking losses were greater than expected, leading to tighter credit conditions.

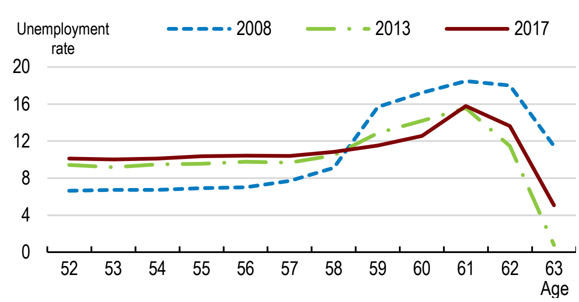
Fiscal consolidation is needed once the economic recovery is underway to stabilise debt

The government aims to stabilise the general government debt-to-GDP ratio by the end of the decade. A significant part of consolidation is to come from increasing employment. The rest will have to come from increasing productivity and consolidation measures, especially expenditure restraint as taxation is high.

Debt stabilisation will entail reducing the structural budget deficit by around 2% of GDP. Increasing employment by 80 000 by the end of the decade as foreseen by the government would contribute around 40% of this reduction. Extending working lives is critical to achieving this target.

The employment rate for older workers in Finland is much lower than in the Scandinavian Nordics, where access to early retirement schemes is considerably more limited. The extension of the unemployment benefit from age 61 until 65, combined with a longer entitlement to the unemployment benefit for persons aged 58 or more, results in a spike in layoffs from the late-50s (Figure 3). The other main early retirement route is disability benefit, for which the inflow probability soars when individuals turn 60 and more lenient eligibility criteria apply. To increase the employment rate of older workers, it is vital that routes to early retirement be progressively closed.

Figure 3. Extended unemployment benefit causes a spike in senior unemployment rates



Ministry of Finance, Ministry of Economic Affairs and Employment and Ministry of Social Affairs and Health (2019), Selvitys eläkeuudistuksessa sovittujen lisäpäiväoikeuteen ja ikääntyneiden aktivointiin tehtyjen muutosten vaikutuksista.

StatLink https://stat.link/iuty08

While reducing the home-care allowance for taking care of children aged less than three years at home would not contribute to fiscal consolidation – childcare and unemployment benefit costs would offset savings – it would contribute to reducing Finland's large gender wage-rate gap by shortening absences from the workforce that negatively affect career prospects and earnings mobility.

The health and social services reform before Parliament has considerable potential to contribute to fiscal consolidation by increasing efficiency in provision by centralising care chains at the regional level and reducing their fragmentation. There is also scope to increase the efficiency of public administration, including through greater digitalisation, and the cost-effectiveness of public expenditure.

Reducing subsidies and tax expenditures and increasing taxes that do not impose large economic distortions would also help. The standard-rate VAT tax base is narrower than in many countries and recurrent real estate taxation is lower. Peat (12% of greenhouse gas (GHG) emissions) is taxed at a lower rate than other fossil fuels used for heat production.

Stronger productivity growth will bolster the economic recovery

Productivity growth remains low. Skills shortages, high regulatory barriers to competition in some sectors and the exclusion of many firms from flexibility clauses in collective agreements are holding back efficient resource allocation.

Labour productivity growth fell to only 0.6% per year in the past decade, lower than in most other European economies. A factor that undermines productivity growth in Finland is skills shortages, largely resulting from relatively low tertiary education attainment. This makes it difficult for more productive firms to hire the qualified workers needed to innovate and expand market shares. Furthermore, relatively high regulatory barriers to competition in upstream service sectors, such as transport, energy and retail hold back incumbents' efforts to reallocate resources more efficiently.

To boost the supply of tertiary educated workers, the government plans to streamline the resident permit process to attract more high-skilled immigrants. While study places in the highly selective tertiary education admission system are being increased, many secondary graduates are rejected, slowing the transition from secondary to tertiary education.

Further measures are needed to meet greenhouse gas abatement objectives

Finland is on track to meet its 2020 EU-burden-sharing objective for reducing GHG emissions but will need to implement further cost-effective measures, including making full use of available flexibility mechanisms, to realise its future objectives.

The government plans to meet half of its 2030 EU-burden sharing objective from emissions reductions in the transport sector. To achieve this, additional measures need to be taken to reduce transport emissions by 30%. The main planned measure is to increase the bio-fuel content of road transport fuels. However, the share of electric vehicles will also need to rise markedly, noting that 78% of electricity production in Finland is from non-fossil fuel sources. There would also need to be an expansion in wind power generation, which is the most economical renewable energy source in Finland, both to meet increased demand for charging EVs and to enable the substitution of electricity for fossil fuels in residential and commercial heating and in industry. A factor holding back the expansion of the EV fleet is the shortage of recharging facilities.

Agriculture in Finland, which accounts for 20% of GHG emissions, receives amongst the highest support payments in Europe. Progressively replacing these subsidies by payments for environmental benefits, such as carbon sequestration, would reduce emissions and yield budget savings.

MAIN FINDINGS	KEY RECOMMENDATIONS
Ensuring fiscal sustainability and financial stability in the wake of the COVID-19 crisis	
The government has provided substantial fiscal support in 2020 to businesses and households in response to the COVID-19 pandemic.	Stand ready to provide further fiscal stimulus in case the economic recovery is delayed.
The government aims to stabilise the debt-to-GDP ratio by the end of the decade, which will entail reducing the structural deficit by around 2% of GDP. Increasing employment by 80 000 would contribute around 40% of this adjustment. Finland's tax burden is high. Social benefits would automatically compensate for an increase in VAT through indexation.	Once the economic recovery is underway, implement consolidation measures, mainly by reducing expenditure, including on subsidies and tax expenditures, and also by increasing taxes that do not impose large economic distortions, such as VAT (broadening the standard-rate base) and recurrent real estate taxes.
Care chains are currently highly decentralised and fragmented, resulting in inefficiencies and regional inequalities in care. The government plans to transfer responsibility for organising health and social services from municipalities to 18 autonomous counties and to focus more on prevention and basic services. There are no numerical targets for fiscal savings.	Enact the social and health-care reform before Parliament. Set numerical targets for fiscal savings to be achieved from these reforms to help the government plan reforms that maximise cost efficiency while ensuring equal access to quality services.
Housing loan maturities are long but interest rates are revised annually. Highly indebted households may have difficulty servicing debts when interest rates return from the current very low levels to more normal levels. Preferential tax treatment for investors buying rental property through a housing company and lower stamp duty on transfers of housing company shares than on direct property transactions boost housing company loans.	Introduce a maximum debt-to-income ratio for household loans and a maturity limit for housing loans. Remove the preferential tax treatment on capital repayments of housing company loans for investors and align the stamp duty rate on direct property transactions with that on transfers of shares in housing companies.
The measures adopted by the ECB and the Bank of Finland to boost banks' lending may reduce their risk-bearing capacity.	The prudential supervisors should monitor the effects of looser capital adequacy, regulations and criteria for NPLs and collateral eligibility and tighten them as the economy recovers.
Getting people back into viable jobs and increasing employment	
Employers have few incentives to limit temporary layoffs to jobs they believe can be restarted as those using the scheme pay no more in social security contributions than other employers.	Require employers to contribute to the unemployment benefit costs of hours not worked (in addition to employers' unemployment benefit contributions).
Only laid-off people who are members of unemployment insurance funds are entitled to earnings-related unemployment insurance benefits, despite the funds only paying 6% of such benefits.	Create a government unemployment insurance fund into which either all workers or those who are not members of another fund are automatically enrolled.
Individuals receiving unemployment benefit at age 61 can have the benefit extended up to the statutory retirement age of 65. This encourages older workers to retire early, by first receiving the unemployment benefit for up to 500 workdays and then the extension (unemployment tunnel).	Phase out extended unemployment benefit by progressively increasing the eligibility age to 65 by 2029, the maximum age for receiving the benefit, and then abolish it.
The probability of inflow into disability benefits increases when individuals turn 60, the age at which more lenient eligibility criteria for disability benefits, including non-medical factors, apply.	Align the conditions for awarding disability benefit to persons aged 60 or over with those for other applicants, notably by no longer taking into consideration non-medical factors.
The generous homecare allowance discourages work by mothers with young children. Long absences from the labour force negatively affect their career prospects and earnings mobility, contributing to a large gender wage gap.	Reduce the homecare allowance to increase incentives for mothers of young children to work.
Early childhood education and care (ECEC) services are not sufficient to meet some parents' needs in some municipalities, mainly due to a lack of convenient places available.	Improve access to ECEC services by ensuring that those municipalities that do not provide sufficient places in convenient locations with suitable opening hours do so.
Boosting productivity	
Skill shortages are growing, and the recent trend in graduation rates will further exacerbate them.	Ease the transition from secondary to tertiary education by reforming the highly selective tertiary education admission system and increasing the number of available study places.
Some rail-passenger reforms to promote competition were suspended. The retail sale of pharmaceutical products is subject to numerous constraints.	Reduce barriers to competition in transport, energy, and retail.
Sector collective agreements normally include flexibility clauses but the law prohibits employers from using them if they are not members of the employers' association that negotiated the agreement, reducing productivity.	Repeal the legal restriction that prevents some employers from using the enterprise-bargaining flexibility clauses in their sector collective agreement, as planned.
Achieving the government's greenhouse gas abatement objectives	
Finland aims to reduce GHG emissions in EU burden-sharing sectors by 39% from the 2005 level by 2030. The burden-sharing sectors with the greatest emissions are transport, agriculture and energy sectors not covered by the EU Emissions Trading Scheme, including heating. Taxes on the use of peat (12% of GHG emissions) are lower than for other fossil fuels for heat production.	Reduce GHG emissions in the burden-sharing sectors using the most cost effective abatement measures, including making full use of available flexibility mechanisms. Subject heat production using peat to the same tax regime as for other fossil fuels used for heating.
Support payments subsidies for agriculture (accounting for 20% of GHG emissions) are among the highest in Europe.	Progressively replace national agricultural subsidies by subsidies for environmental benefits.

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