

Publishable April 10, 2019

Economic Forecast 2019–2020

Uncertainty weighs on economic growth

Finland has adjusted well to occupational restructuring



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LABOUR INSTITUTE FOR ECONOMIC RESEARCH



Economic Forecast for 2019–2020

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Finland has adjusted well to occupational restructuring

The Labour Institute for Economic Research has lowered its forecast of Finland's economic growth for the current year from last autumn's 2.4 per cent to 1.4 per cent. Uncertainty in the international economic outlook will slow Finland's economic growth, particularly this year. If the worst threats do not materialise, growth will pick up slightly next year to 1.5 per cent. Export growth, which came to a halt last year, will recover and growth in private consumption growth will also provide support to economic growth. In general, Finland has adjusted well to occupational restructuring, but it may be difficult to find means to employ older workers who only have basic education.

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- » Uncertainty will slow down growth in exports and the economy.
- » Improving employment will increase private consumption
- » Construction investment is on the decline
- » A more analytical approach required in employment target debate

According to preliminary data released by Statistics Finland in March, economic growth last year would have been surprisingly low. Preliminary data is subject to a high degree of uncertainty, however, and the low growth in demand items relative to GDP growth suggested that some demand items would be revised upwards significantly. It now seems clear, however, that exports growth was weaker than expected at the end of last year.

UNCERTAINTY CONSTRAINS ECONOMIC GROWTH

Hard economic indicators, such as export order books currently provide a more optimistic picture of the economic outlook than soft indicators such as business tendency surveys. A survey conducted by the Confederation of Finnish Industries, for example, suggests that companies' export expectations have reduced, even though the export order books of technology industry companies have risen to pre-financial crisis levels.

The difference between hard and soft indicators indicates an increase in uncertainty. The possibility of a chaotic, no-deal Brexit has increased, as the original date (end of March) for the UK's departure from the EU

has come and gone. The unpredictable customs policy of the USA and the prospect of a new crisis in the euro area also overshadow the international economic outlook.

In our forecast scenario, uncertainty will continue in the forecast period, but the worst threats will not materialise. We expect that the average economic growth in Finland's most important export countries will continue to slow down this year, but will pick up slightly next year. In our forecast, exports of goods and services are expected to resume modest growth this year. In a separate part of our forecast, we examine worse and better alternatives to our basic scenario using a model calculation.

PRIVATE CONSUMPTION WILL GROW, INVESTMENT WILL DECLINE

Last year, the improvement in the employment situation and the consequent strong growth in household disposable income increased private consumption. Growth was constrained, however, by the fact that the savings rate, which had turned negative in 2016 and 2017, again turned positive.

In 2018, interest rates remained low as in previous years. It is not easy to identify a clear explanation for the rise in the savings rate last year, but lower consumer confidence may have partly contributed to the increased saving. In our forecast, interest rates will still not rise and the savings rate will no longer increase substantially, which will drive private consumption to grow faster than last year.

The upswing in the construction sector has now levelled off, and significantly fewer building permits were granted last year. In our forecast, construction investment growth will slow down this year and will con-



ract next year. Declining construction will also push total investment growth into negative territory, although R&D investment, for example, will remain quite strong.

MORE ANALYTICAL APPROACH CALLED FOR IN EMPLOYMENT RATE DEBATE

Both the employment rate and the number of the employed people rose sharply last year. In our forecast, the fastest growth will level off as economic growth slows, but even so the employment rate will rise to 72.7% next year.

A number of parties have demanded a much higher employment rate than the current government’s target of 72 per cent, and a contribution by officials of the Ministry of Economic Affairs and Employment has even proposed that the target should be an employment rate of 78 per cent in the 2030s. It is not always clear, however, why raising the employment rate would serve the purposes of those demanding it.

A separate part of our forecast shows that workers in shrinking occupational categories in Finland have for the most part succeeded well in re-employment. Nevertheless, people who are unsuccessful in repositioning often only have basic education and also, perhaps, shortcomings in learning skills.

The re-employment of people with a low level of education might require the use of wage subsidies or result in the creation of a group of “working poor” who receive social transfers in addition to pay. In either case, a higher employment rate would not solve the sustainability problems of public finances that it seeks to solve. There may be other reasons, however, in addition to fiscal grounds for seeking higher employment, such as preventing social exclusion, for example. There should therefore be a more analytical employment rate debate

that would consider what is sought by raising the employment rate and why.

BETTER PREPARATION OF REFORMS NEEDED BY THE UPCOMING GOVERNMENT

Finland’s two previous governments have pursued a pro-cyclical policy that enhanced cyclical fluctuations in the economy. In this policy, fiscal tightening

DEMAND AND SUPPLY

	2018	2018	2019f	2020f
	Bill. €	Percentage change	in volume (%)	
Gross Domestic Product	233.6	2.3	1.4	1.5
Imports	92.3	4.2	1.8	1.9
Total supply	325.9	2.9	1.5	1.6
Exports	91.0	1.5	3.0	2.5
Consumption	177.9	1.4	1.8	1.7
private	124.8	1.4	2.1	2.0
public	53.0	1.4	1.0	0.9
Investment	52.6	3.2	1.6	-0.3
private	42.9	3.3	1.9	-0.7
public	9.7	3.0	0.6	1.2
Total demand	325.9	2.9	1.5	1.6

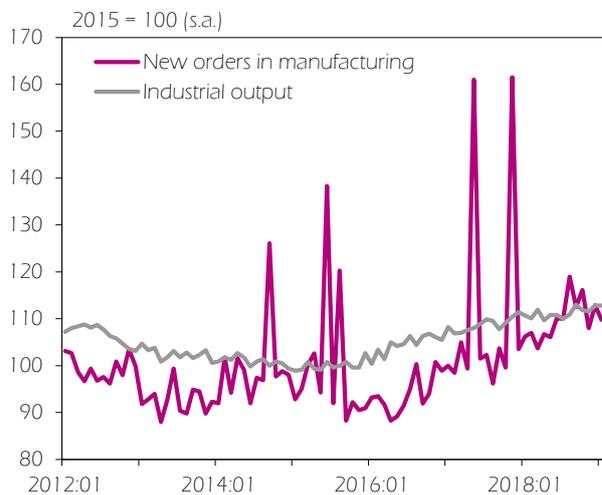
Source: Statistics Finland, Labour Institute for Economic Research

TREND INDICATOR OF OUTPUT 2009:01-2019:01



Source: Statistics Finland

INDUSTRIAL PRODUCTION IN FINLAND 2012:01-2019:01



Source: Statistics Finland



took place in the recession while a more expansionary policy was delayed until 2017, when the upswing was already under way. Now, as the upswing is waning, there is more justification than before for an expansionary policy. In our forecast scenario, the upcoming Government will implement expenditure increases and abandon the freezing of indices. Over the forecast period, rising tax revenue will improve the budgetary position of central government finances, but due to the anticipated expenditure increases, a surplus will not be attained.

The current Government did not succeed in implementing its planned regional government, health and social services reform. Preparation of the reform created incentives for municipalities to engage in harmful sub-optimization: municipalities outsourced their services and launched large-scale construction projects in order to secure services in the future for their own municipality and region, regardless of the economies of scale sought by the overall reform. It would be beneficial for

the next Government, in resuming preparation of the health and social services reform, to focus more carefully on the incentive problems associated with the reform and to present comprehensive cost-benefit calculations as justifications for the reform.

Alongside the reform of health and social services, the new Government formed after the elections should aim to reform social security. In addition to the financial incentive traps preventing employment, bureaucratic and information traps in employment also need to be removed. The EUR 300 protected component of unemployment benefit, which has been in use since 2014 has already improved financial incentives for the unemployed to accept temporary work, but it should be possible to use the national income register introduced at the beginning of the year to remove incentive traps. In addition, social security should be expanded to cover all forms of earnings and working career transition points. ■

A CHAOTIC BREXIT OR OTHER SERIOUS CRISIS WOULD WEAKEN FINLAND'S ECONOMIC GROWTH

At the time of writing (8 April 2019), the outlook for the international economy remains more uncertain than usual. A no-deal Brexit, after which only World Trade Organisation (WTO) rules would apply in trade between the United Kingdom and the European Union, could lead to significant customs barriers between the UK and Continental Europe. The free movement of labour between the UK and the EU countries would end in the event of a no-deal Brexit, and the closure of the land border between the Republic of Ireland and the UK might, alongside economic problems, cause serious political unrest.

The unpredictability of the US President's behaviour also overshadows the outlook for the international economy. Currently, the customs barriers between the USA and the rest of the world do not seem to be rising as high as it appeared possible last autumn, but the situation may change rapidly and a political crisis that led to a collapse of trade between Mexico and the USA, for example, could slow down economic growth significantly in other countries.

Our forecast is based on a scenario in which the uncertainty created by such threats will hold back global economic growth this year, in particular, but the worst possible trends will not be realised. The impact of alternative trends to our forecast scenario can be assessed using model calculations.

Empirical macro models, which are used also by the Labour Institute for Economic Research, are based on economic theory. The models aim to estimate from historical time series economic regularities that, it is assumed, will remain unchanged in the future. If the estimated connections remain stable, they can be used to make forecasts of future economic developments. The old saying that history is no guarantee of the future is worth keeping in mind, however, because the forecasting model is currently a simplification and an imperfect picture of reality.

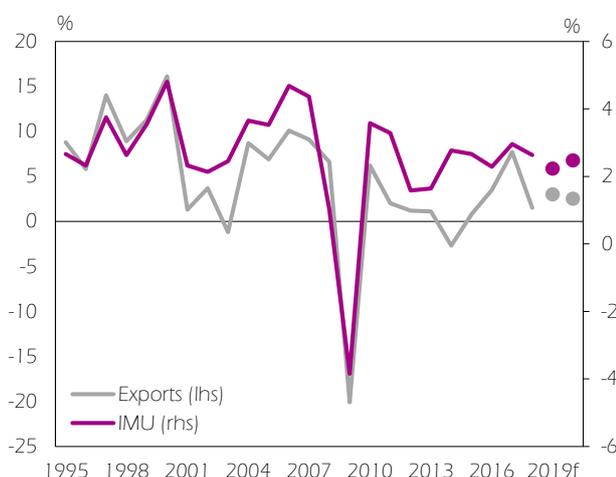
In addition, even in a good forecasting model, estimated connections do not necessarily represent actual causal relationships between variables, nor do they necessarily need to do so. Causality at the macro level of the economy is, unfortunately, complicated and unclear. Models can be used in forecasting if the strict requirement for causality is discarded. If, say, a connection is found between variables x and y, the connection can be considered to tell something about how variable x will probably change when variable y changes, and the connection can be used in forecasting, even though it does not represent a direct cause-effect relationship.

The model forecasts of the Labour Institute for Economic Research use an export demand variable (Imu30), which is an index formed from the gross domestic products of 30 important countries for Finland's goods and services exports. The index is weighted according to the countries' shares of Finland's exports. Figure 1, which presents the percentage growth of exports and the export demand variable, illustrates the dependence of export demand on the export countries' economic growth. The figure also shows that the average economic growth of the export countries slowed to some extent (0.4 percentage points) last year. In our forecast scenario, the export countries' growth will decline further this year, but will pick up slightly in 2020.

In the macro model of the Labour Institute for Economic Research, the export demand variable impacts Finland's exports and thereby economic growth. In alternative calculations, the variable has been set to grow more slowly or more quickly compared with our baseline scenario. Figure 2 illustrates the results of these calculations. If the export countries' economic growth would be half a percentage point lower than in our forecast, it would, according to our model, slow down Finland's economic growth by somewhat less than 0.3 percentage points per year, and one per cent lower economic growth in the export countries would result in just over half a percentage point lower annual economic growth in Finland. ■

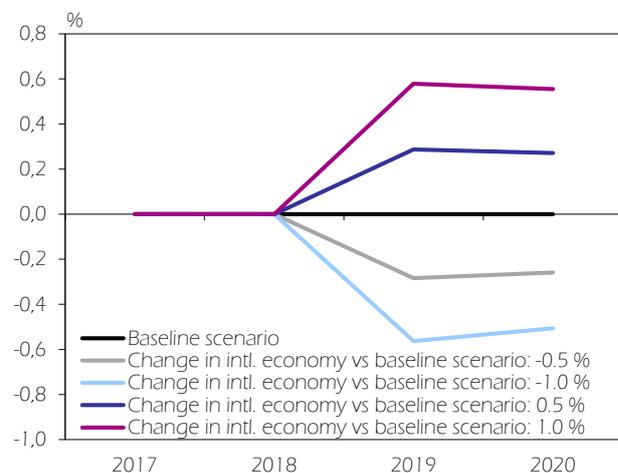
*Ilkka Kiema
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FIGURE 1. EXPORT VOLUME AND IMU VARIABLE 1995-2020



Source: Statistics Finland, Labour Institute for Economic Research

FIGURE 2. CHANGE IN GROWTH RATE 2017-2020



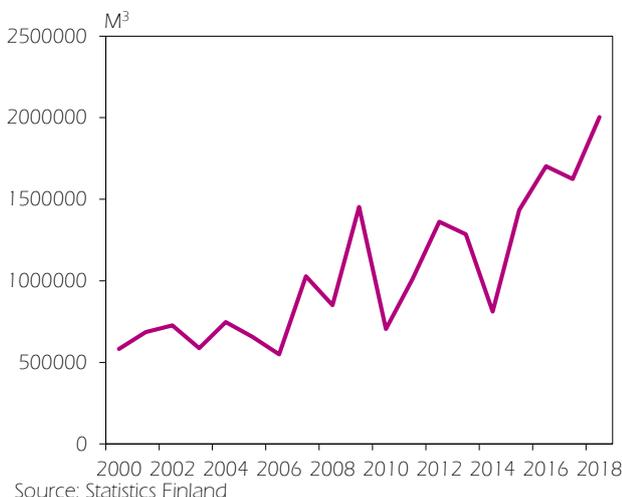
Source: Labour Institute for Economic Research

MUNICIPALITIES' PREPARATIONS FOR THE HEALTH AND SOCIAL SERVICES REFORM

According to the Government Programme, the regional government, health and social services reform ought to have entered into force in 2019 but, due to delays in legislative preparation and parliamentary proceedings, the reform had to be postponed to begin in stages from 2021. The counties to be established ought to have taken responsibility for the municipalities' healthcare and social welfare services as well as other duties such as fire and rescue services. Central government had intended to finance the activities of the counties 100 per cent, in which case the municipalities' responsibility for the financing of services would have been abolished completely with respect to the duties transferred.

The financing of the reform was intended to be implemented cost neutrally with respect to central government and local government and so that no additional tax burden on taxpayers would arise. The intention was to transfer from the municipalities to central government the full financial contribution for the responsibility to organise the services in question. In the year of entry into force, approximately 12.5 percentage points would have been cut from the municipal income tax rate of each municipality. This would have been incorporated into central government earned income taxation, from which the counties' duties would have been financed in the future. Approximately EUR 600 million in corporate tax revenue would have been cut from the municipalities. A share of taxation costs for an equally large a proportion of tax revenue would also have been collected from the municipalities. In addition, central government transfers allocated for all of these services would have been removed from the municipalities.

FIGURE 1. CONSTRUCTION PERMITS GRANTED TO PUBLIC SECTOR OPERATORS FOR HEALTHCARE BUILDINGS (CUBIC METRE VOLUMES) 2000-2018



18 COUNTIES AND FREEDOM OF CHOICE

The Sipilä Government began to prepare the reform immediately after it took office. In November 2015, it agreed a county model in which the number of counties would be 18 and, in the same context, freedom of choice would be increased. In practice, the regional division into larger responsible entities, i.e. the counties, was aimed at centralising the hospital network in response to urbanisation and the age structure of the population (so-called 'broader shoulders'). Originally, the intention was only to explore an increase in freedom of choice during the parliamentary term, but the decision was made as a compromise with the county model. The provision of services by private companies and third sector operators would be facilitated by increasing residents' freedom of choice.

The municipalities and joint municipal authorities therefore had a few years to adapt to this major administrative reform and change in the system of financing.

EVERYONE WANTED THEIR SHARE

During the drafting of the healthcare and social welfare legislation, some of the municipalities sought to ensure the continuation of their own municipal service provision within the county model by outsourcing services on long agreements and by selling key healthcare and social welfare properties. There was a desire to rein in this suboptimisation, however, and for this reason legislation valid for a fixed period was enacted to temporarily restrict outsourcing of services related to the health and social services reform as well as larger construction and investment projects. Due to the postponement of the health and social services reform, the validity period of the legislation was extended and tightened (to the end of 2022 and 2021). The tightening of the legislation meant that the permission of the Ministry of Social Affairs and Health was required for large investments.

The purpose of the restrictive legislation was to prevent county decision-makers' hands being tied by investments and properties poorly suited for their purpose, because joint municipal authorities' properties and their loan capital would be transferred directly to the counties. Most construction projects, moreover, are implemented with loan financing, which would have burdened the counties' finances for decades to come.

The transfer of healthcare and social welfare properties to the ownership of the counties only applied to the properties of joint municipal authorities or hospital districts. The transfer would not apply, on the other hand, to the properties of individual municipalities; these properties would only be leased from the municipalities for a period of 3 years + 1 (option year). After that, the county would have had no obligation to lease these former healthcare and social welfare facilities.



In the case of individual municipalities, outsourcings of healthcare and social welfare services and sales of properties were used to ensure the availability of services to residents after the regional government reform. The sale of properties to private operators is advantageous because the price obtained for them is at least equivalent to the market price of the building and, at the same time, the municipality avoids costs incurred from maintaining the properties in the future. The municipality also avoids the risk of the premises falling vacant. Private sector real estate operators, in turn, receive for their activities a building suitable for their purposes more often than not in an excellent location in the centre of the village or town, in which case the investment will be profitable in the long term. The acquisition of a municipality's only property intended for this particular use would also have created a good basis for a regional monopoly position in the future freedom of choice model.

BOOM IN CONSTRUCTION INVESTMENT

Figure 1 shows that the cubic metre volumes of public sector construction permits for healthcare buildings have increased sharply since

2014. The number of permits granted is, of course, also explained by the fact that the existing building stock is partly out-dated. The Counties' Service Centre for Facilities and Real Estate Management has estimated that in the period 2017–2025 hospital district and special care district construction projects amounting to a total value of approximately EUR 5 billion are planned or under construction. In addition to this EUR 5 billion, municipalities and private operators also have many construction projects related to healthcare facilities in the pipeline, but no statistics are available as to their value. Thus the figure only shows permits granted to the public sector for healthcare buildings.

As rational actors, it was advantageous for municipalities and joint municipal authorities to manage matters so that their financial position and availability of services after the reform would be as good as possible. What remains to be seen is how much money was wasted in this race in addition to the preparations for the regional government, health and social services reform, which ended up costing taxpayers, according to estimates, approximately EUR 200 million. ■

Elina Pylkkänen

WHAT HAPPENS TO WORKERS IN SHRINKING OCCUPATIONS?

Labour market polarisation is a key theme in empirical labour economics. Technological development, in particular, has displaced routine jobs characterised by high repetition of the same tasks, easily programmable and able to be performed by robots. These jobs are generally situated in the middle of the salary distribution, and they include various kinds of office positions (routine and cognitive) and many occupations (routine and physical) in traditional industries. In addition to technological development, outsourcing of operations may also result in significant occupational restructuring in Finland.

At the same time as the number of routine jobs in the economy has declined, employment in low-wage service occupations and high-wage expert positions has increased. Labour market polarisation has become a common phenomenon in advanced societies such as Finland. Although there has been much research on labour market restructuring in recent decades, little is known about the effects of the phenomenon at an individual level: Where do the workers of displaced occupations end up? The international literature has mainly addressed the impact of globalisation, such as cheap Chinese imports, on the pay and employment of industrial workers. A new study by the Labour Institute for Economic Research examines the mobility between different occupations and non-employment of those working in shrinking and routine occupations, utilising Finnish aggregate data for 1970–2014. The study will be published shortly in the working paper series of the Labour Institute for Economic Research.

Figure 1 presents the percentage shares of experts (abstract) and those employed in routine work and

service occupations between 1970 and 2014. The figure shows that the proportion of people employed in routine occupations has fallen by around 20 percentage points over the last 45 years, while the proportion of those in abstract positions has risen by almost the same extent. The proportion of people in service occupations has grown slowly since 1985. The change in occupational structure is therefore not a modern trend; robots have been taking Finnish jobs for several decades now. Where are these people? The media, in particular, paint threatening images of potential mass unemployment, but a look at history does not support this view.

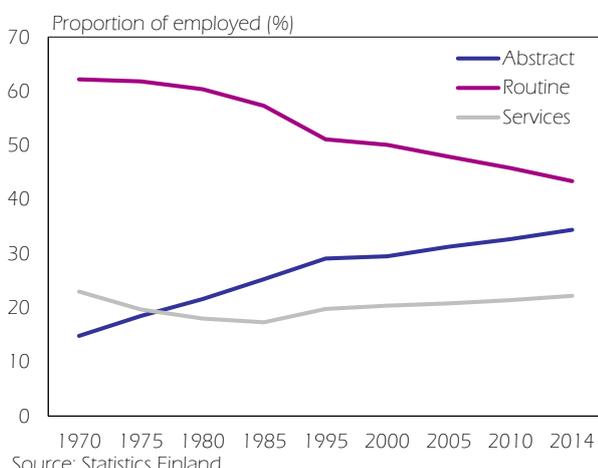
Table 1 presents transition matrices for employed people by occupational category as averages for five-year periods. The calculations were made separately for the periods 1970–1995 (panel A) and 1995–2014 (panel B). Based on a descriptive examination, the shift away from routine occupations has increased slightly over the past 20 years. On the other hand, occupational mobility into low-wage service occupations or transfers to unemployment or outside the labour force have remained fairly constant throughout the entire 45-year examination period. It is interesting that upward occupational mobility has increased significantly, particularly among office workers. For example, 15 per cent of people employed in routine and cognitive (RC) work have transferred to high-wage expert work within five years.

According to the first main result of the study, the increase in the proportion of high-wage abstract jobs in the economy is mainly due to the fact that people have shifted upward along their career paths from routine jobs. The level and field of education of workers are strongly linked to these shifts. In particular, workers employed in routine jobs who have education in business, technology or natural sciences have a higher probability of transferring to expert positions.

According to the second main result of the study, office workers do significantly better in occupational restructuring than workers in traditional industries. Differences between categories of workers remain significant when the model standardises differences between individuals in terms of important background characteristics, or when analysing only those individuals who have to change jobs as a result of an exogenous unemployment shock. In that case, workers in traditional industries, and women in particular, drop with a higher probability into low-wage service occupations or unemployment compared with office workers.

Workers in mid-wage, shrinking occupations have mainly adjusted well to occupational restructuring in Finland. A significant proportion of them have managed to climb into high-wage expert positions, and these shifts are strongly linked not only to the level of education, but also to the field of education. A key tool of education policy would be to increase the number of education places, particularly

FIGURE 1. PERCENTAGES OF EMPLOYED PEOPLE IN DIFFERENT OCCUPATIONAL CATEGORIES 1970–2014



Source: Statistics Finland



in fields from which it is easier to move to another job after the potential loss of a job.

The flip side is that particularly (female) workers who do routine and physical (RP) work are less successful than office workers in the occupational restructuring process. It is a matter of concern that many of them are older workers with only basic

education, which suggests that it may be difficult to propose effective measures, for example with the aid of conversion training or adult education, to close possible skills gaps. ■

Terhi Maczulskij

TABLE 1. TRANSITION MATRICES FOR EMPLOYED PEOPLE BETWEEN DIFFERENT LABOUR MARKET POSITIONS

		Year t+5				
		Abstract	RC	RP	Services	Unemployed / outside labour force
Panel A: 1970-1995						
Year t	Abstract	78 %	8 %	4 %	4 %	6 %
	RC	10 %	72 %	5 %	4 %	9 %
	RP	5 %	3 %	78 %	4 %	10 %
	Services	4 %	6 %	8 %	69 %	13 %
		Abstract	RC	RP	Services	Unemployed / outside labour force
Panel B: 1995-2014						
Year t	Abstract	82 %	6 %	4 %	2 %	6 %
	RC	15 %	67 %	4 %	5 %	9 %
	RP	7 %	4 %	75 %	3 %	11 %
	Services	7 %	6 %	4 %	73 %	10 %

Source: Statistics Finland, Labour Institute for Economic Research