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This survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

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This Survey is published on the responsibility of the Economic and Development Review Committee (EDRC) of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of Finland were reviewed by the Committee on 30 March 2006. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 6 April 2006.

The Secretariat's draft report was prepared for the Committee by David Turner, Åsa Johansson and Laura Vartia under the supervision of Peter Hoeller.

The previous Survey of Finland was issued in December 2004.

BASIC STATISTICS OF FINLAND (2005)

THE LAND

Area (1 000 km^2)	338.1
of which:	
Agricultural	22.2
Forests	263.2
Lakes	33.7

Major cities (thousand inhabitants, end 2004):	
Helsinki	559.0
Espoo	227.5
Tampere	202.9
Vantaa	185.4

THE PEOPLE

Population (thousand, end 2004)	5 237
Number of inhabitants per km^2 of land area	17.2
Net natural increase (thousand, end 2004)	10.2
Net migration (thousand, end 2004)	6.7

Labour force (thousand)	2 620
Employment (thousand)	2 405
Employment (% of total):	
Agriculture, forestry and fishing	4.9
Industry and construction	25.9
Services	69.2

PARLIAMENT AND GOVERNMENT

Composition of Parliament (number of seats):	
Centre Party	55
Social Democratic Party	53
National Coalition Party (conservatives)	40
Left Alliance	19
Green League	14
Swedish People's Party	8
Christian League	7
Other	4
Total	200

Government, number of ministers from:	
Centre Party	8
Finnish Social Democratic Party	8
Swedish People's Party	2
Total	18

Last general elections: 16 March 2003

PRODUCTION AND PUBLIC SECTOR

Gross domestic product (billion EUR)	155.1
GDP per head (EUR)	29 572
Gross fixed capital investment:	
% of GDP	19.2
Per head (EUR)	5 663

Public consumption (% of GDP)	22.6
General government (% of GDP):	
Current and capital expenditure	50.2
Current revenue	52.5

FOREIGN TRADE

Exports of goods and services (% of GDP)	38.8
Main exports (% of total):	
Metals, machinery and transport equipment	31.1
Electrical and optical equipment	28.0
Wood, pulp and paper	20.9
Other goods	20.1

Imports of goods and services (% of GDP)	35.2
Main imports (% of total):	
Intermediate goods	36.7
Consumer goods	27.0
Capital goods	22.4
Energy	13.9

THE CURRENCY

Monetary unit: Euro

Currency units per USD, average of daily figures:	
Year 2005	0.8046
March 2006	0.8312

Executive summary

Growth performance has been among the best in the OECD, underpinned by a strong innovation performance and high educational attainment. The unemployment rate, currently at 8%, has dropped below the euro area average, employment rates, particularly among the old workers, have been increasing rapidly, inflation is among the lowest in the OECD and the government surplus sizeable. Yet, there is considerable scope for further improvement as GDP per capita is still only close to the OECD median. This largely reflects a subdued productivity performance in the sheltered sectors, including in the provision of public services, as well as unused labour resources, especially of young and older workers. With population ageing imminent and pronounced, both growth prospects and fiscal sustainability could be undermined. Against this background, policymakers will need to address the following challenges:

- *Ensuring the sustainability of public finances. This will require: i) the maintenance of a sizeable fiscal surplus over the remainder of this decade; ii) the phasing out of early retirement schemes; and iii) efficiency gains in public services, greater use of fees in their provision and more supply of such services by the private sector, for which there is scope while respecting equity objectives. The medium-term goal must be to reduce the high tax wedges on labour further, despite the spending pressures from ageing.*
- *Raising employment. Lowering taxation, especially on labour, is one way to raise labour supply and achieve the government's ambitious medium-term employment target. But more is needed. The tax-benefit system leads to unemployment and poverty traps and active labour market policy should be better focused on the most vulnerable groups. Moreover, the central wage agreements, while serving the country well in terms of restraining wage inflation, have compressed the earnings distribution, which reduces demand for the low-skilled. Strong employment creation recently makes it likely that the short-term employment target of creating 100 000 jobs over this electoral period might be achieved. Nevertheless, further reform needs to be undertaken to achieve the more ambitious long-term objective of a 75% employment rate.*
- *Boosting productivity and enhancing resilience. The considerable productivity boost from information and communication technology (ICT) products is likely to wane, and more emphasis should be put on utilising ICT elsewhere in the economy, particularly in both private and public services. Measures to raise competition in the service sectors, including in the public sector are needed. The housing market has been very volatile in the past, though current house prices seem to be closely aligned with fundamentals. But house price inflation has picked up and credit demand is strong. Now is an opportune time to introduce reforms to curb future risks stemming from the housing market. Labour market mobility would be enhanced and public money saved by reducing the support to social housing, the extent of which currently goes beyond that required to satisfy equity objectives.*

A comprehensive reform package is needed to meet these challenges and ensure a continuing strong growth performance.

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Assessment and recommendations

Despite a solid growth performance there is both scope and need for further improvements

Growth over the past decade has been among the strongest in the OECD. Finland also ranks highly as regards innovation performance and educational attainment, both of which are key drivers of productivity. However, there has been a marked weakening in growth performance since the turn of the millennium; the contribution from the ICT sector to aggregate productivity has been much smaller and increases in the employment rate have been meagre, though the employment rate among the old has been increasing rapidly from a low level. Moreover, income growth could fall further because over the next 25 years population ageing is among the most rapid in the OECD; the number of employed workers for each welfare benefit recipient, including those on unemployment benefit and all forms of pensions, could drop from 1.7 currently to about 1.0 by 2030, if current age-specific employment and benefit recipiency rates are maintained. The main challenges facing policy-makers are to sustain the growth in living standards by boosting productivity, especially in the sheltered sector and in public services, by realising the government's ambitious employment targets as well as by ensuring fiscal sustainability and reducing future pressures on taxation, especially those on labour.

The short-term macroeconomic outlook is promising

Growth in 2006 is likely to exceed 3%, which according to OECD estimates will take output clearly above potential for the first time since the global downturn in 2000. The growth figure for this year partly reflects a bounce-back from the coincidence of a labour dispute in the paper industry and a temporary lull in the electronics industry in the first half of 2005, although with output growth picking up strongly in the second half growth in 2005 was still 2%. Employment growth picked up surprisingly strongly through 2005, raising the possibility that if it continues at this rate the government might meet its objective of raising employment by 100 000 over the electoral period. Inflation as measured by the harmonised consumer price index (CPI) is currently about 1%, the lowest in the euro area and mostly accounted for by higher energy prices. Rises in non-oil import prices, especially for intermediate goods, as well as demand pressures, are likely to push up inflation somewhat; however, the central wage agreement which runs to mid-2007 will ensure that any pick-up will not feed into higher wage inflation and so keep price inflation below 2%.

The fiscal surplus needs to be maintained to cope with the future pressures of ageing

The general government surplus was around 2½ per cent of GDP in 2005. It is easily the largest in the euro area, although this is entirely accounted for by the pension funds, whereas the combined central government and municipalities financial balances are roughly in balance. The combined balance of central government and the municipalities should remain in surplus on a cyclically-adjusted basis for the rest of this decade. This would imply a general government surplus of 3-3½ per cent of GDP. Maintaining such a large general government surplus, while desirable to prepare for the fiscal pressure from imminent population ageing, will be difficult given the government's promise of tax cuts on earned income and strong spending pressures at the municipal level. With the recovery firming, there is no need for additional fiscal stimulus from a macroeconomic perspective, and further tax cuts on labour should be matched by spending restraint or revenue-neutral changes to the structure of taxation. Moreover, given past actions, the room for tax cuts seems exhausted.

With rapid ageing, it is essential to re-balance public and private provision to cope with rising service demand. If not managed well, current spending pressures may force municipalities to continue raising their income taxes thereby neutralising the income tax cuts by the central government. Cost-efficiency of health care and social services is of strategic importance due to the prospective increase in the demand for them. There is scope to raise the efficiency of health care provision, which is largely a municipal competence, as evidenced by the wide variation in the cost of hospital services. The government has launched an ambitious programme for reforming the structure of local government with the aim of increasing the cost efficiency of municipal services. It is important that this programme is carried out vigorously. Reducing or eliminating the municipal share of corporate tax revenues would also improve the overall control of aggregate public finances by reducing cyclical fluctuations in municipal revenues which have tended to ratchet up municipal spending. Introducing tertiary education fees for all students while developing the loan system (perhaps with income-contingent repayments) would not only be more equitable but also more efficient. Higher tuition fees would make students' demands for education attentive to the quality and subjects being offered, with subsequent effects on their supply.

To ensure that the pension reform is a success pathways to early retirement must be further restricted

A major achievement has been the introduction of a wide-ranging pension reform from the beginning of 2005. It comprised a complex package of measures that achieved a broad degree of national consensus. The government is relying on this reform to make a major contribution to raising the length of working lives by two-three years through improved incentives to work longer, especially from higher accrual rates for older workers (63-67) and the abolition of the cap on the maximum pension. While the reform package includes many innovative features, notably linking pensions to changing life expectancy, it also includes a number of features which unnecessarily add to future pension costs. Thus, while the reform will improve the financial sustainability of the pension system,

contribution rates for the private sector – which are already very high by international standards – were still estimated to have to rise by 6 percentage points by 2030. Recent measures to increase the return on the pension funds are likely to alleviate this pressure by 1 to 2 percentage points. But more is needed. There is understandably little appetite to revisit this issue again so soon after a major reform, although implementing many of the changes more quickly rather than phasing them in gradually could lower pension costs. In addition, some elements of the reform – in particular the accumulation of pension rights during non-work periods (*e.g.* during study) and the higher rate of accumulation from age 53, only partly compensated by a higher contribution rate by employees in this age group – are costly and serve little economic purpose. They should be reconsidered.

The area which should be considered most urgently to ensure that the old-age pension reform is a success in encouraging longer working lives is alternative pathways to early retirement. Currently nearly 7 out of 10 new retirees retire early on some form of unemployment or disability benefit. Cross-country evidence suggests that, if these pathways to early retirement remain, they will blunt the increased incentives to work longer that are provided by the old-age pension reform. Indeed, Finnish experience over the past decade when the increase in the employment rate of older workers has been among the most rapid of any OECD country, demonstrates the importance of limiting pathways to early retirement. The current reform package includes a postponement of the age at which the unemployment pathway (or so-called "unemployment pipeline") can be used from 55 to 57, but the objective should be much more ambitious: the unemployment and disability benefits should be re-focused on their original purpose. The unemployment pipeline has been moved from the pension system to the unemployment insurance. Normal activation principles should apply or even better, the scheme should be phased out.

Increased efforts should be made to help the disabled into work

The proportion of the population who are inactive and on disability benefits is among the highest in the OECD with nearly half of all new retirees retiring on a disability pension. While abolishing the previous "individual early retirement pension", the reform still allows for "social factors" (as opposed to just medical conditions) to play a stronger role after the age of 60 when assessing eligibility for a disability pension. Concerns about this change are increased by evidence from the 1990s of switching between unemployment and disability pathways to early retirement as the relative ease of using one pathway changed. Eligibility for a disability pension should be evaluated entirely on medical grounds, and should be assessed in the first instance by an independent physician rather than one of the applicant's choosing.

Once on a disability pension there is little likelihood of regaining employment. While the activation rate among the disabled unemployed is just below that for all unemployed, the number of disabled that are classified as "jobseekers" and are thus considered for active labour market support measures is a small proportion of those on a disability pension. This is despite the fact that a large proportion of those retiring on a disability pension have less serious conditions (like back pain and less serious mental health problems). This might, with appropriate medical treatment, mean not only that work is possible but also that work might contribute to an improvement in their medical condition. The large and

growing proportion of those retiring on a disability pension for reasons of mental health raises wider issues of well-being as the number of deaths attributed to mental health conditions (including suicide) is proportionately much higher than in any other OECD country. It also appears that those with mental health conditions make surprisingly little use of available treatments, although these are generally considered effective, free and not in short supply. In these circumstances there may be considerable gains from both an economic and wider well-being perspective, in activating those on disability benefits by adopting a similar approach to the successful pilot programme in the United Kingdom. Under the UK's *Pathways to Work* scheme, participation in work-focused interviews and training or activities to help the person better manage their health condition is mandatory for all except the most severely disabled. In addition a back-to-work credit is paid for those taking up employment.

Efforts to raise the employment rate for the young should not focus exclusively on the transition from studies to work

There is considerable scope to raise the employment rate of young people. One important policy response, which is recognised by the government, is speeding up the transition from studies to work by reducing study times (which are among the longest in the OECD), simplifying admission procedures to universities which contribute to delaying entry into higher education, as well as by making the 3-year bachelors degree a more attractive study alternative. There may also be a role for strengthening links between education and the labour market through increasing the possibilities for work experience embodied in the curriculum.

Greater flexibility needs to be introduced into the next central wage agreement

Centralised collective agreements have probably resulted in aggregate wage moderation, but this has been at the cost of reducing relative wage flexibility. Wage compression, especially at the lower end, is strong because of high minimum wage floors. Consequently, employment in low-skill industries is weak and unemployment is particularly high among the unskilled. Regional wage flexibility is also low despite wide and increasing disparities in employment performance across regions. The government has traditionally been involved in centralised wage negotiations, often making tax cuts contingent on the outcome. While the merits of such involvement is unclear the government should use any leverage (as through tax cuts) to promote greater wage flexibility in future central agreements. This could be achieved by making more use of the so-called "union allowance", whereby employers and unions have greater flexibility in allocating a portion of the centrally-agreed wage increase at the local level. Also the use of opt-out clauses allowing for local wage agreements with lower wages than the central agreement if employers and employees agree should be made easier. To raise employment of younger and low-skilled workers, minimum wages, determined by collective wage agreements, could be better differentiated by age and skills. Future central wage agreements should avoid building in clauses allowing for supplementary wage increases contingent on CPI

inflation surpassing a threshold in such a way that they would imply a risk of magnifying the consequences of an adverse supply shock, such as an oil price shock.

Active labour market measures should focus on older workers, but without increasing their overall scale

After declining for some years the number of long-term unemployed started rising again in 2004 and has continued rising during most of 2005. The government's goal is to raise the activation rate of active labour market programmes (ALMPs) to 30% by the end of 2007, from 23% currently, which would imply an increase by around 35 000 participants. While there is scope for improving the mix of ALMPs in favour of those that are most effective by providing more wage subsidies in the private and less in the public sector, it is not clear on the basis of current evaluations that an expansion will have a significant effect on regular employment. ALMPs should also be better targeted on older workers. The recent and planned expansion of the public employment service (PES) offices is to be welcomed if it leads to greater emphasis on job search support, counselling advice and obligations to participate in programmes after a period of job search. The performance of PESs should be monitored in these respects. A particular weakness of current ALMPs is the low coverage of older workers despite the government's goal that older workers who became unemployed during or after 2000 should be encouraged to take up regular employment through training and rehabilitation measures. Also the activation of persons on disability schemes should be raised. In addition marginal effective tax rates when moving from unemployment to employment are high in international comparison. They should be reduced by tapering unemployment benefits at longer durations which are currently among the most generous in the OECD, unless obligations to participate in ALMPs are more strictly enforced.

Measures should be taken now to prevent the housing market becoming a source of future macroeconomic instability

Although there is no sign of imminent macroeconomic instability stemming from the housing market, the Finnish housing market has historically been amongst the most volatile in the OECD. While the level of household debt is currently low in international comparison, it has been growing rapidly in recent years, and mortgages are overwhelmingly financed at short variable rates, so that household disposable income is vulnerable to changes in interest rates. The government currently operates a mortgage loan guarantee scheme, which in 2004 covered one-quarter of all new mortgage loans. Consideration should be given to phase out or better target this scheme in such a way that it will not undermine the risk awareness of home buyers. While the restricted deductibility of mortgage interest expenses is intended to facilitate access to home ownership, the effect is probably capitalised in higher house prices and it may also add to housing market volatility. Furthermore, as the imputed rental income and capital gains from home ownership are not taxed, while property taxes are relatively low, the deductibility of mortgage interest expenses favours home ownership over other forms of investment. The government should therefore take advantage of the currently low level of interest rates to

begin scaling back mortgage interest deductibility, possibly in the context of a more comprehensive reform of housing policies and taxation.

Housing policy should become more effective

The shortage of building land in the fast-growing regions may partly reflect municipalities' disincentives to provide land for new housing, since municipalities are responsible for financing the expensive infrastructure and services in urban areas required to support population growth. One way to encourage municipalities to provide more building land is to promote the use of the property tax as a source of tax revenue and to extend the tax base to undeveloped land, which is currently not taxed. This would require further easing the limits imposed on municipal property tax rates. This might have the further advantage of shifting the burden of taxation away from labour towards property which is currently at a low level by international standards. In order to further enhance the incentives of municipalities, property tax revenues could be exempted from the fiscal equalisation scheme. The incentives could also be promoted by allowing municipalities to tax the increase in the value of building land provided for housing or by making more effective use of the options for the municipalities to use their preferential right to buy land and to charge building developers for the costs of new infrastructure.

Another factor restricting the supply of new housing is lengthy and bureaucratic planning procedures. In particular, there are multiple possibilities to appeal over the decisions concerning building permits and local plans. The applicants and third parties have the right to challenge the decisions in both the regional and supreme administrative court and the average length of proceedings is relatively long. The multiple possibilities to appeal over the decisions concerning building permits and local plans should be constrained without hampering the due process of planning.

Nearly three-quarters of Finland's population is eligible for social housing programmes and even relatively high income earners live in government subsidised housing. Limiting the eligibility to social housing would save money, with probably little implication for social objectives, while stimulating the private rental sector. The housing allowance system should also be reformed. The magnitude of the allowance should be linked to the average rent in the region, rather then the actual rent paid, which would reduce the cost of the scheme and allow households to choose the quality and price of the housing.

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Chapter 1

Recent performance and key challenges

After assessing Finland's recent performance, this chapter discusses the key challenges of ensuring the sustainability of the public finances, of raising the employment rate and of enhancing growth potential. In addition, the challenges facing policy in respect of housing, the subject of the in-depth chapter, are considered from the perspective of macroeconomic stability and whether the current generous level of public support should be reduced and better targeted. Finally, an illustrative medium-term scenario is used to argue that unless the main challenges are successfully tackled, growth in living standards over coming decades will be sluggish.

Finland can lay claim to being the world's leading knowledge-based innovation-led economy. On a range of indicators for innovation and educational attainment, it is always near to, or at, the top. It also took first place in the *World Economic Forum's* ranking as the world's most competitive economy.[1] Growth has, however, slowed considerably since the turn of the millennium and the future growth contribution from information and communication technology (ICT) production is unlikely to be as strong as over the late 1990s. Weak growth in 2005 is explained by the coincidence of a dispute in the paper industry and a downturn in the electronics industry, from which there is likely to be a strong "bounce back" in 2006 with growth likely to exceed 3%. However, this also illustrates the degree of specialisation in production as well as potential future vulnerability. Above all, population ageing is imminent and will be pronounced, which will undermine growth prospects and fiscal sustainability. Against this background the key challenges are:

- *Ensuring the sustainability of public finances,* which is threatened by the interaction of comprehensive public welfare provision and population ageing which is among the earliest and most rapid in the OECD.
- *Raising the employment rate*, which is low compared to other Nordic countries and to levels achieved during the 1980s. Moreover, lengthening working lives will be essential to cope with population ageing and increased longevity.
- *Broadening and enhancing growth potential*. While productivity in the manufacturing sector is among the leaders, in the sheltered sector it is poor and has even been falling in many public services recently.

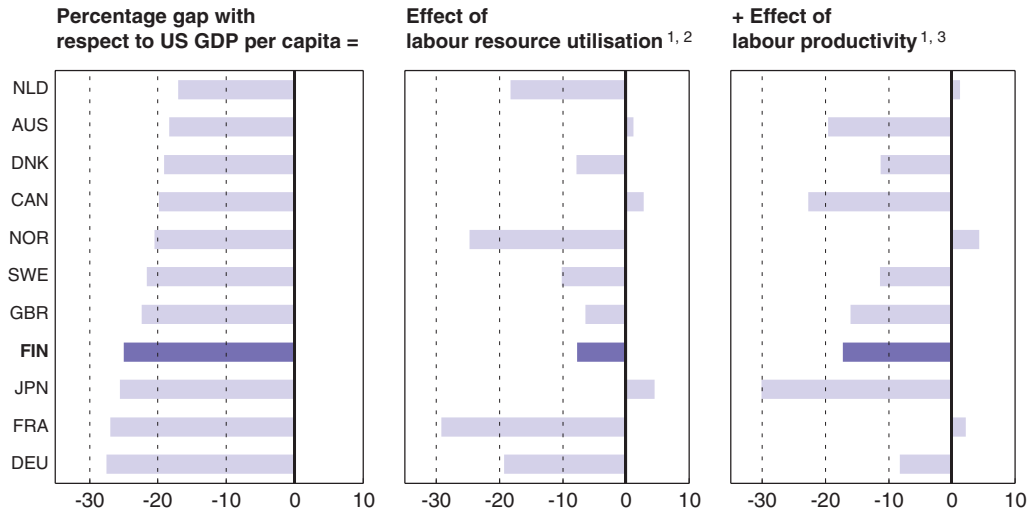
The current high ranking in the *World Economic Forum's* competitiveness indicator may not mean much for future developments as it has not always been a good predictor of future performance; among OECD countries the competitiveness ranking in 1995 has a negative correlation with growth in gross domestic product (GDP) per capita over the subsequent decade.[2]

An assessment of recent performance

Progress has slowed since 2000

The level of GDP per capita ranks just above the median (thirteenth) among all OECD countries, with about one-third of the gap with the United States explained in terms of lower labour utilisation and two-thirds in terms of lower labour productivity (Figure 1.1). Following the recession in the early 1990s growth in GDP per capita was relatively rapid and Finland's relative position, especially against other European economies, improved due to rapid growth in productivity, as well as through better labour utilisation (Figure 1.2). The contribution of the ICT manufacturing sector to aggregate productivity growth over this period was higher than in the United States, and in the OECD it was only exceeded by Ireland. This was in large part due to the success of Nokia, the world leader in mobile telephony, and an associated cluster of smaller ICT manufacturing firms (Box 1.1).

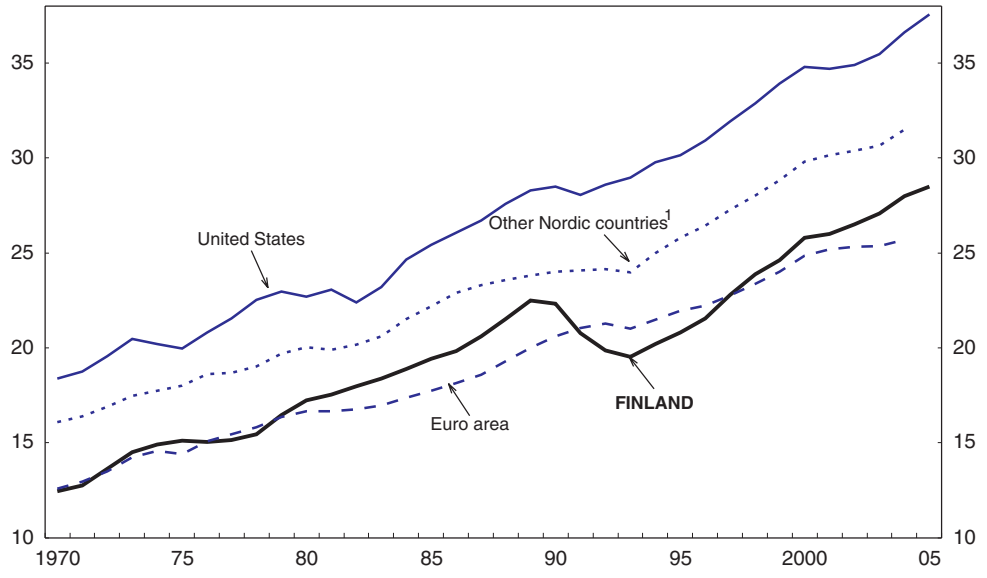
Figure 1.1. **The sources of differences in income**
2004, in current USD PPPs



1. Percentage gap with respect to the US level.
2. Labour resource utilisation is measured as total number of hours worked divided by working-age population.
3. Labour productivity is measured as GDP per hour worked.

Source: Statistics Norway; OECD, *National Accounts*; *Labour Force Statistics*.

Figure 1.2. **GDP per capita**
Thousand USD, 2000 PPPs



1. Weighted average of Denmark, Iceland, mainland Norway and Sweden.

Source: OECD, *National Accounts*.

However growth in GDP per capita has slowed since 2000 from over 4% *per annum* over the previous five years to about 2% *per annum* in the subsequent five years. Hourly productivity growth averaged about 1¾ per cent over 2000-05, compared to over

Box 1.1. **Nokia**

Nokia is the world's leading producer of mobile phones. Mobile phones account for about three-quarters of its sales, while networks account for most of the rest. Nokia managed to continually increase its world market share in mobile telephones over the 1990s, from just over 20% in the mid-1990s to about 35% at the end of the decade. In the face of increasing competition the global market share fell to around 30% in 2004, however helped by new products as well as some reduction in margins this decline has been halted and for 2005 is estimated to have been about 32%. Global competition has also put pressure on prices and squeezed profit margins. One reason for the fall in prices is that an increasing number of mobile phones are being sold to buyers in developing countries who ask for cheaper models. In the past three years Nokia's average selling price of mobile phones has fallen by 20%.

Reflecting these developments the share price of Nokia relative to the global telecommunications sector declined by about 60% from the beginning of 2003 to mid-2004, but has since gained about 40% relative to this benchmark to the end of 2005.

Currently, the European market accounts for 55% of its sales followed by the Asian-Pacific markets which account for 25%. Recently, Nokia has announced it will expand mobile device production in China, providing more capacity and flexibility to meet growing demand, while at the same time reducing costs and stabilising profit margins. The share of Nokia's exports in total Finnish exports was about 20% in 2004.

At the peak of the last ICT cycle in 2000, Nokia is estimated to have accounted for 2.8% of Finnish GDP and over 1.6 percentage points of GDP growth. However, following the subsequent slump in ICT, the contribution to GDP growth was only 0.04% in 2004 with Nokia's share of Finnish GDP little changed at around 3%.

In 2004 Nokia's share of total research and development (R&D) spending was 32%, and just under one-half of all private sector R&D. The bulk of Nokia's research is carried out in Finland, but an increasing share of it is done overseas. During 2004, Nokia's investment in R&D amounted to € 3.7 billion, representing 12.8% of net sales. In 2004, 20 700 persons were employed in R&D centres in 12 countries which represents approximately 37% of Nokia's total workforce. But even without Nokia, R&D in Finland would be a higher share of GDP than in many European countries. Overall R&D spending in Finland is very high in international comparison, amounting to 3.5% of GDP. Public R&D spending amounts to 1% of GDP.

While Nokia accounts for a large share of GDP, exports and R&D, its direct impact on employment is much smaller. In 2004, the number of Nokia employees in Finland fell marginally to 23 000, around 1½ per cent of total employees in the business sector. Around 35% of its staff works in R&D, but the share of overall Finnish personnel declined to 42% from 51% in 1998. Nokia paid € 0.7 billion taxes in Finland in 2004, which is around 3% of total taxes received by the general government.

Source: Figures on Nokia's contribution to aggregate output, employment, R&D, and taxes were supplied by Jyrki Ali-Yrkkö, ETLA (The Research Institute of the Finnish Economy). See also Ali-Yrkkö, J. and R. Hermans (2004). Figures on global market share are from Gartner online at *www.gartner.com*. Relative share price figures are OECD calculations based on data supplied by Datastream.

2½ per cent in the previous five years, mainly reflecting a much smaller contribution from the ICT sector. There has also been little improvement in aggregate labour utilisation since 2000.

Short-term prospects

According to the preliminary estimate, GDP growth in 2005 was 2.2%. This was achieved despite a labour dispute which reduced output in the wood and paper industry by 10% on the previous year, and hence GDP by just under 1%, as well as a temporary lull in the first half of 2005 in the electronics industry which is prone to short production cycles. Following the resolution of the labour dispute, output in the wood and paper industry recovered and together with a pick-up in the electronics industry, GDP in the second half of 2005 grew rapidly. Growth in 2006 will be boosted to around 3½ per cent given underlying momentum, prospects for a pick-up in export demand and the artificially depressed level of GDP in the first half of 2005 (Box 1.2). This will take the economy clearly above potential output in 2006 according to OECD estimates

Terms-of-trade effects further weaken comparisons of income growth

An important feature of recent macroeconomic performance, which is likely to continue into the medium-term, is the decline in the terms of trade. This is mainly explained by the importance of electronics goods in exports, although movements in the export price of paper and wood products, which are another major export, may also be exacerbating this trend (Box 1.3). Among other OECD countries the extent of this continuous trend decline in the terms of trade is only common to other major ICT exporters, Sweden and Korea. It explains why the growth rate of the consumption deflator has consistently exceeded that of the GDP deflator, on average by around ½ of a percentage point *per annum* since 2000, while the terms of trade has declined by around 2½ per cent *per annum*. If a correct measure of living standards reflects consumption possibilities, then arguably the conventional measure of GDP per capita should be adjusted to reflect this differential. An alternative measure is "command GDP",[3] which includes export volumes but deflates nominal exports by the import deflator (on the argument that the purpose of exports is to provide for imports). It results in a downward adjustment to growth by about ¾ percentage point *per annum* since 2000 and considerably weakens Finland's recent performance relative to other OECD countries (Figure 1.4).

Investment income from abroad strengthens performance

On the other hand, a partially offsetting positive effect emerges, when considering national income, which includes property income from abroad, rather than an output measure, such as GDP. Currently the balance of investment income from abroad is close to zero, but this represents a massive improvement from the mid-1990s when the deficit on investment income exceeded 5% of GDP. On average the improvement in the balance of investment income has added around 0.4% of GDP *per annum* since the mid-1990s, which is among the largest improvements of any OECD country over this period. However, it is unlikely that this trend improvement will continue into the future. Over the boom and bust of the ICT cycle, movements in the share price of Nokia were a dominant factor in determining the net foreign asset position.[4] However, over the longer term, movements in the trade balance should drive the net foreign asset position and investment income. There has been a marked change in the trend of the trade balance since 2000, largely reflecting a weaker export performance as well as a continuation of the deterioration in the terms of trade; following a steady increase in the trade balance over the 1990s, the trade balance peaked at 9½ per cent of GDP in 2000, since which time it has steadily declined to 4% of

Box 1.2. **Short-term macroeconomic prospects**

The composition of growth has been particularly dependent on public and private consumption and housing investment since the downturn in 2000, although this pattern may be set to change. Finland's export markets will experience their most sustained pick-up since the end of the 1990s, because of the strong penetration of the fastest growing markets in Asia and in Russia. However, reflecting outsourcing of production and increased competition in the electronics industry, losses in export market share, as already experienced over recent years, are likely to continue. Business investment has recently been weak, particularly in plant and machinery, and is only expected to strengthen gradually, following the pick-up in exports. On the other hand, a lower GDP share of business investment is partially compensated by a higher share in R&D, which remains among the highest in the OECD. Growth in household disposable real income in 2005 was much lower than consumers' expenditure. However strong consumer confidence, employment gains and an increase in household's borrowing helped maintain consumption growth. This trend is set to continue in 2006-07 but at a lower pace. The government has pledged to cut taxes on earned income, amounting to 1% of GDP until 2007 which strengthens household's purchasing power and during 2006 the wealth tax will be abolished. Employment growth picked up surprisingly strongly through last year. At the same time the labour force increased as older workers remained in the labour force longer, which dampened the decline in unemployment; the unemployment rate fell to 8.4% last year and is expected to continue to decline as employment increases (Table 1.1).

Table 1.1. **The outlook to 2007**[1]

Percentage changes

	2005	2006	2007
GDP, volume	2.2	3.4	2.8
Harmonised consumer price index	0.8	1.1	1.4
GDP price deflator	1.6	0.5	0.9
Employment rate (level)[2]	68.2	68.4	68.7
Unemployment rate (level)[3]	8.4	8.0	7.8
Government net lending (level, % of GDP)	2.3	2.1	1.7
Output gap (level)[4]	0.5	1.5	2.1

1. Outturn figures for 2005; projections for 2006 and 2007 are based on preliminary *Economic Outlook No. 79* projections.
2. As a percentage of the working-age population.
3. Per cent of the labour force.
4. Per cent of potential GDP.

Source: OECD, *OECD Economic Outlook No. 79,* preliminary projections.

Inflation according to the harmonised consumer price index was 1.2% in March 2006, the lowest in the euro area and almost entirely accounted for by higher energy prices. Inflation is about 0.5% lower than the euro area average because of falling telecoms prices related to increased competition in the sector, 0.3% lower because of a smaller pass through from energy prices and 0.2% lower because of lower inflation on food products. Non-oil import prices, especially for intermediate goods, as well as demand pressures, are likely to push inflation up in the future. However, the central wage agreement (discussed in detail in Chapter 4) which runs to mid-2007, will ensure that any pick-up is not reflected in higher wage inflation and so keep price inflation well below 2%.

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GDP, while improvements in the investment income balance have also slowed (Figure 1.5). The decline in the trade balance partly reflects a marked change in export performance since 2000; the volume of Finnish exports grew on average 2½ per cent *per annum* faster than export markets in the five years to 2000, but 2½ per cent *per annum* slower in the subsequent five years.

Performance on measures of equality and poverty is strong

On broader measures of well-being, Finland, like the other Nordic countries, ranks highly among OECD countries as regards equality of income, lack of income poverty and the absence of child poverty (Boarini *et al.*, 2006). Given the many common institutions and features shared by these countries (to which the Netherlands is often added),[5] they represent a natural benchmark against which other measures of economic performance or well-being can be compared. The high level of taxation corresponding to more comprehensive welfare provision in the Nordic countries means that the gap of these countries with the United States in terms of per capita disposable income is much greater than the gap in per capita GDP, although if greater weight is put on aversion to inequality in income, this gap narrows considerably (Figure 1.6).[6] However, among the Nordic group of countries, Finland consistently ranks the lowest in terms of household disposable income, whatever weight is given to equality, as well as in terms of per capita GDP.

Box 1.3. **The forest industry and the Finnish economy**

The forestry industry (wood, pulp and paper) is one of the largest industries and accounts for around 4% of GDP and employs some 3% of all employed persons (Table 1.2). High-quality printing and writing paper make up about half of the value added of the forestry industry, and sawn wood and paperboard a little more than 10%. In recent years the forestry industry has accounted for around 25% of Finnish exports. The share of printing and writing paper exports in the global export market is 20%, while paper and paper board and forest industry exports each account for about 10% of their respective global markets. *Stora Enso* and *UPM-Kymmene* are two of the largest firms in Europe and among the 10 largest firms in the world in the forest industry.

Table 1.2. **The share of the forest industry in the Finnish economy**

Percentage, 2004

	Share of GDP	Share of employment	Share of exports
Wood industry	1.0	1.3	5.3
Pulp and paper industry	2.8	1.5	18.7
Total forest industry	3.8	2.8	24.0

Source: Statistics Finland.

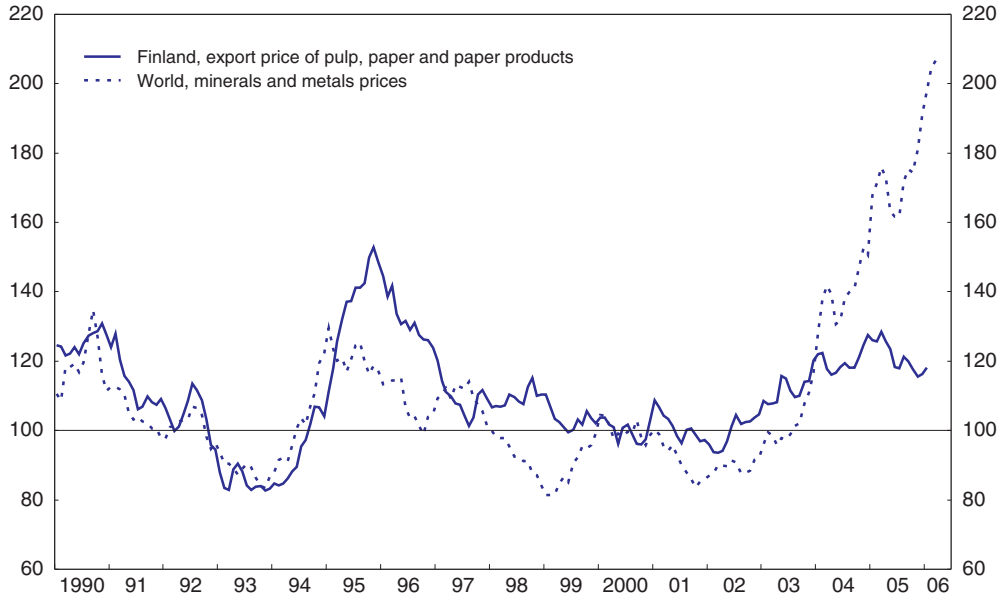
The labour dispute in the paper and pulp industry during the summer 2005 had significant effects on GDP growth and exports in 2005. The loss of production in the paper and related industries, such as the chemical industry and transportation, is likely to have reduced the overall annual growth rate by around 1% in 2005, but will increase growth by a similar magnitude in 2006 as output recovers from the artificially depressed level.

Box 1.3. **The forest industry and the Finnish economy** *(cont.)*

Although pulp and paper prices have in the past generally moved up with other commodity prices, there has been little increase in pulp and paper prices (in USD) in the last few years while mineral and metal prices have boomed (Figure 1.3). This may partly reflect the growing importance of electronic media, at the expense of paper, in OECD countries. There is, however, considerable potential for growth in demand from developing countries, particularly from Asia, but China already has one of the fastest growing paper industries in the world and labour costs are only a fraction of those in Finland. This highlights the importance of Finland's specialisation in the production of high-quality printing and writing paper for which competition from low-cost producers is less intense.

Figure 1.3. **Pulp and paper prices have remained weak**

In USD, index 2000 = 100



Source: Bank of Finland and OECD, Economic Outlook database.

Rapid ageing will have a substantial fiscal cost

The distinctive feature of future demographic trends compared with the other OECD countries is that ageing of the population is happening sooner (Figure 1.7); the latest official projections suggest that over the next 25 years, the size of the population aged over 65 will increase by 70% while the working-age population will fall by 10% (Statistics Finland, 2005). If the current aggregate employment rate is maintained then the number of employed workers for each person aged over 65 will halve from just under 3 to 1½. At this point the old-age dependency ratio (the ratio of those over 65 to the working-age population) at 45% will be the second highest in the OECD (after Japan), although thereafter the dependency ratio plateaus with other countries catching up and surpassing it, so that by 2050 Finland is below the EU average. The potential fiscal strain this may place on the economy – if it fails to adapt – is illustrated by the fact that if age-specific employment and

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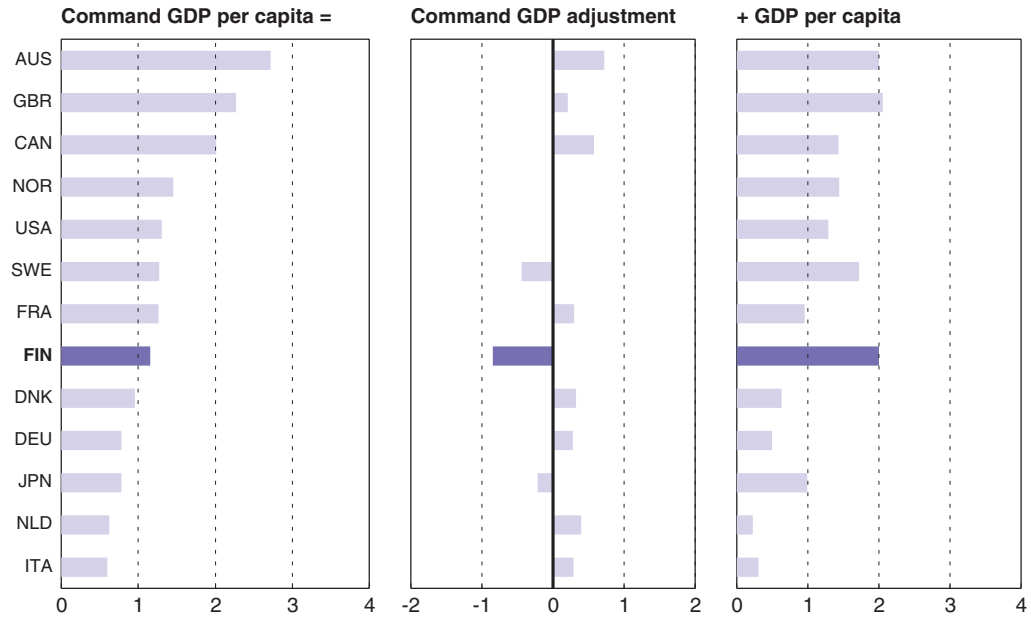
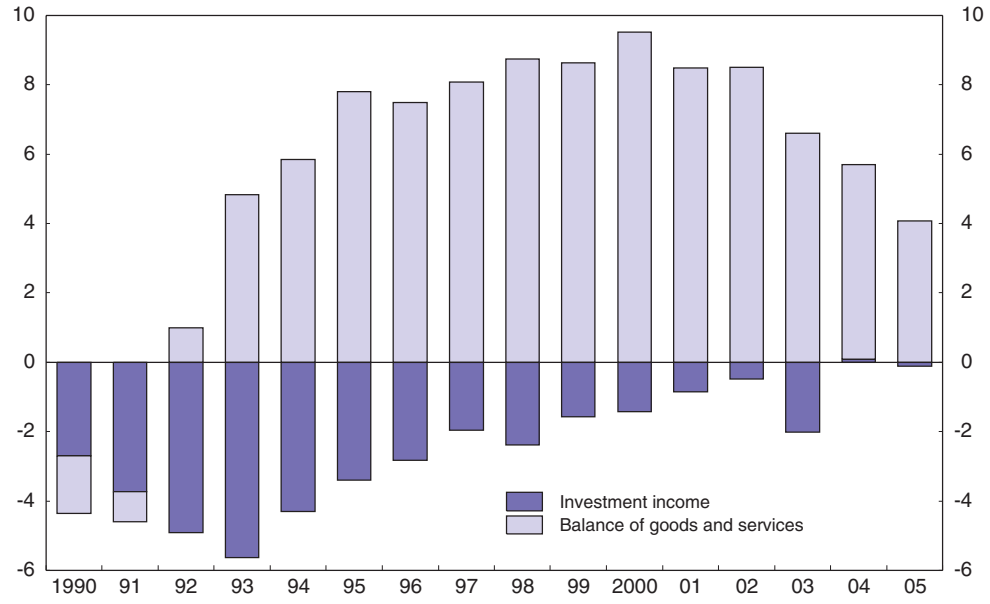
Figure 1.4. **Command GDP growth**
2000-04, annual average, per cent



Source: OECD, *National Accounts* and Economic Outlook database.

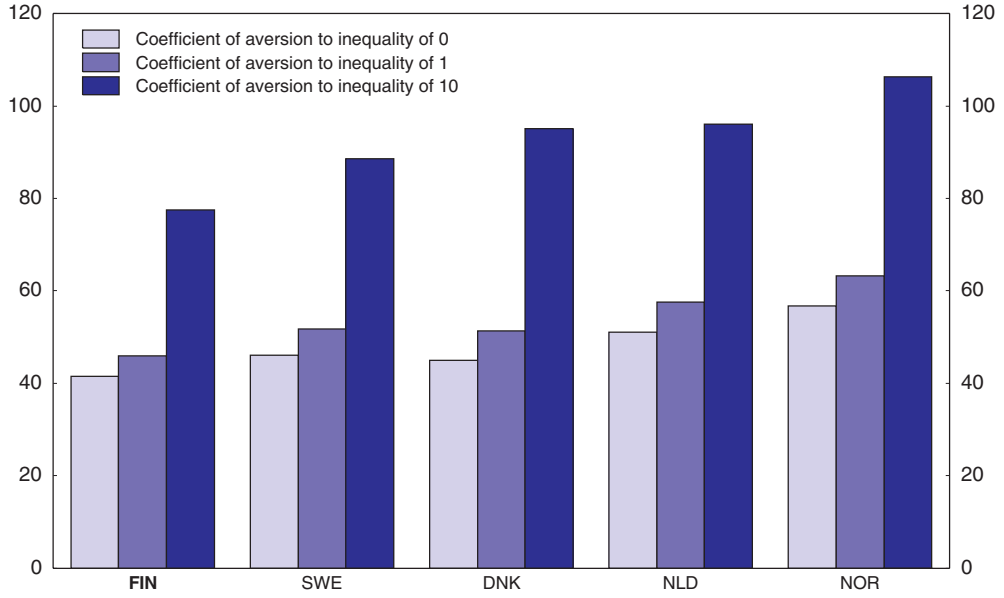
Figure 1.5. **The trade surplus has weakened since 2000**
As a percentage of GDP



Source: OECD, Economic Outlook database.

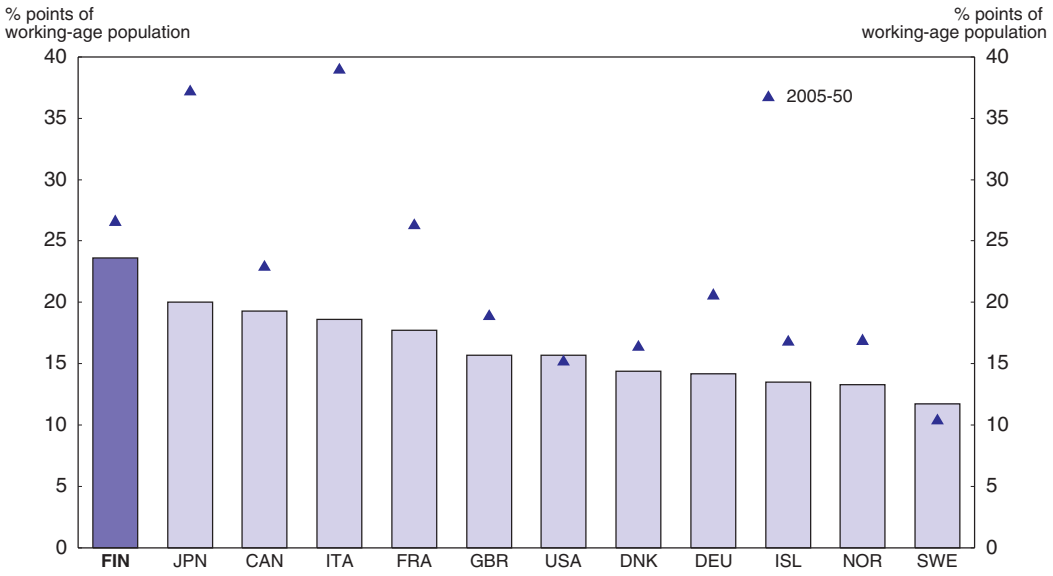
benefit recipiency rates remain constant, then the number of workers for each welfare beneficiary (those on old-age pensions, unemployment benefit, disability benefit and other early retirement pensions) will fall from 1.7 now to around 1 by 2030.

Figure 1.6. **Measures of disposable income adjusted for aversion to inequality**
2002, USD at current PPPs, USA = 100



Source: OECD (2006), *Economic Policy Reforms: Going for Growth*, Figure 6.6.

Figure 1.7. **Ageing occurs sooner**
Increase in old-age dependency ratio,[1] 2005-30



1. Ratio of population aged 65 and over to population aged 15-64.

Source: OECD (2006), "Projecting OECD Health and Long-Term Care Expenditures: What are the Main Drivers?"; *OECD Economics Department Working Papers*, No. 477.

The main additional fiscal costs from ageing will relate to health, long-term care and pensions. Recent OECD work (OECD, 2006) suggests that public expenditure on health and long-term care could increase by 3½ and 2½ per cent of GDP, respectively, by 2050, if, on top

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of demographic developments, expenditure grows in line with observed trends over the last two decades. Most of this increase is likely to be incurred by 2030. As regards pensions, even after the implementation of a wide-reaching reform in 2005, official projections suggest that pension expenditure are likely to rise by 2¾ per cent of GDP by 2030. The appropriate response of fiscal policy, including the need for reforms to ageing-related public services to constrain spending pressures, is discussed in Chapter 2. It will also be important to consider whether non-ageing related public spending can be reduced, to make room for additional age-related spending and to lower the tax burden.

Achieving the government's employment rate target requires a wider range of measures

Finland has made impressive progress in labour market performance over the last decade; the unemployment rate has fallen by 7 percentage points, which is only exceeded by Ireland and Spain, while the employment rate has risen by 7 percentage points. In part this reflects the continued recovery from the deep recession in the early 1990s and the exceptionally buoyant demand conditions in the second half of that decade, but is also due to wide-ranging and sustained labour market reforms. In a recent review of progress in labour market reforms since the original *OECD Jobs Study*, Finland, together with Denmark and the Netherlands, were singled out among all OECD countries as having had the most comprehensive labour market reform strategies (Brandt *et al.*, 2005).

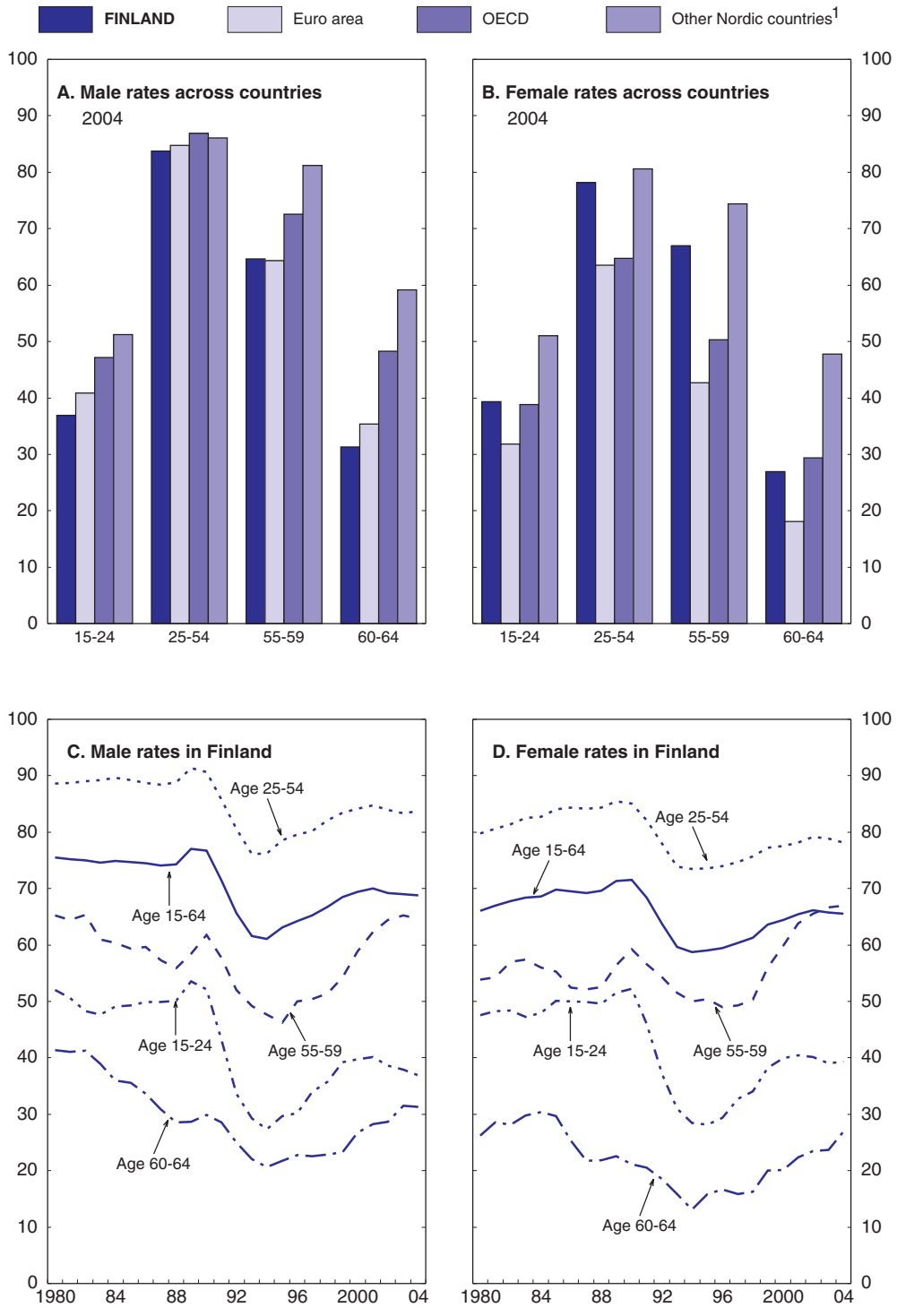
Progress has, however, slowed since 2000 and there remains substantial scope for further improvement. The employment rate has only risen 1 percentage point since 2000 and is only close to the median across all OECD countries and well below the levels in other Nordic countries (Figure 1.8). The unemployment rate at about 8½ per cent is well above the OECD median and that in other Nordic countries.

The major macroeconomic objective of the government is to raise employment by 100 000 between 2003 and the end of the current electoral period ending in March 2007 (at the latest), implying an increase in the employment rate from 68% in 2005 to about 70%, which is also the EU-wide Lisbon target. This target is an intermediate step towards realising the more ambitious objective of a 75% employment rate by the end of the following electoral period in 2011. Achieving this target is important to mitigate the shock to both living standards and fiscal sustainability from rapid ageing.

Total employment has picked up since mid-2004, raising hopes that if recent employment growth can be maintained, then the government's short-term target may be met (Figure 1.9, panel A). Much of the progress towards the employment objective has been in services and the construction sector (Figure 1.9, panel B). A surprising feature is that many of the additional service sector jobs have been in social services, education and health, despite the fact that overall public sector employment has increased very little, suggesting that many of the additional jobs may be in private sector services such as childcare or long-term care. While this would represent an encouraging development in terms of increasing the mix of providers in the provision of welfare services (as discussed in Chapter 2), to the extent that such jobs are dependent on public finding there may be a significant fiscal cost. Such fiscal costs, as well as an emphasis on future tax cuts and an expansion in active measures, highlight a possible future tension between the employment target and the government's fiscal objectives. On the other hand, benchmarking labour market performance against other countries suggests a range of structural labour market problems requiring a much broader range of reforms.

Figure 1.8. **Employment rates**

Employment as a percentage of population in the same age group



1. Weighted average of Denmark, Iceland, Norway and Sweden.

Source: OECD, Labour Force Statistics database.

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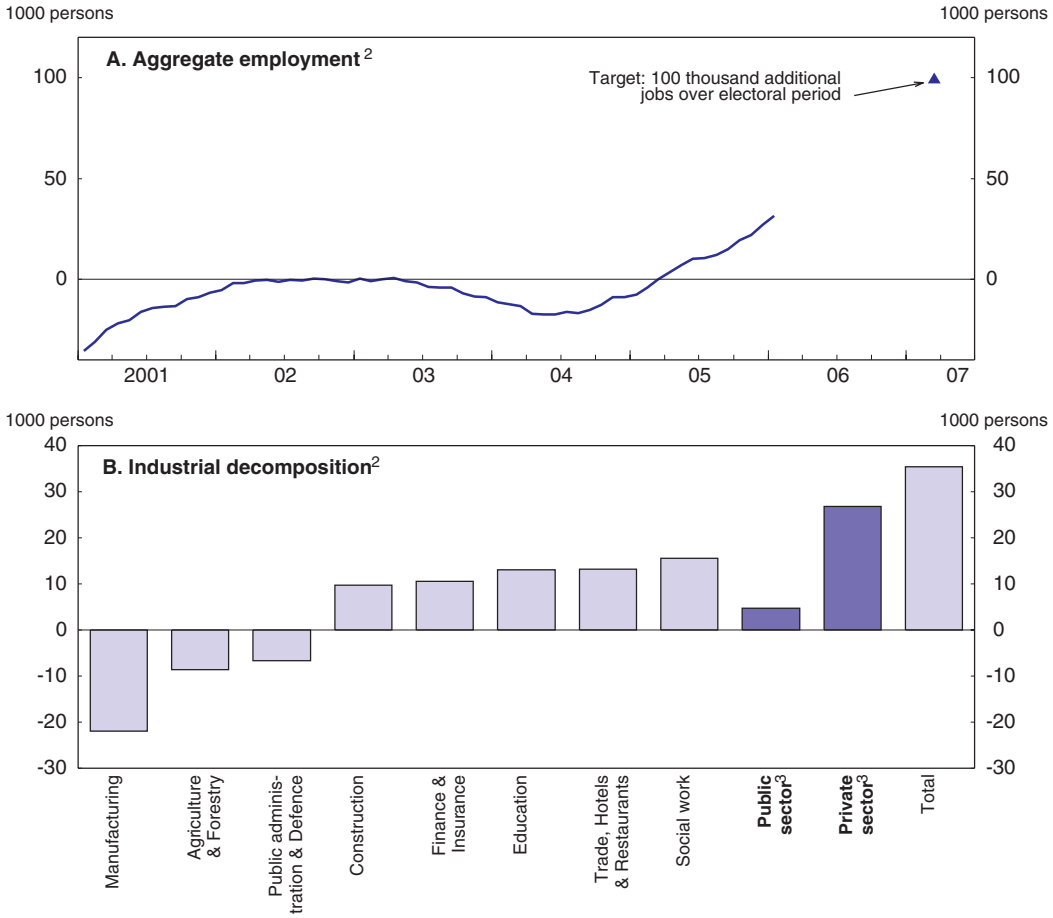
Figure 1.9. **Recent progress towards the employment target**
Change in employment relative to March 2003[1]



1. The last general election was in March 2003 and the election period is a maximum of 4 years.
2. Employment is measured as the average over previous 12 months to eliminate seasonal effects.
3. Data for the public and private sectors refer to the change to January 2006 while the industrial decomposition refers to the change to February 2006.

Source: Statistics Finland.

To raise the employment of older workers early retirement pathways need to be restricted

The employment rate of older workers (aged 55 to 64) has risen by a spectacular 16 percentage points over the last decade, the second highest increase in the OECD, much of which can be related to structural reforms, particularly through tightening access to early retirement schemes (OECD, 2004). Despite these improvements the employment rate for older workers is only close to the median across all OECD countries and well below levels in other Nordic countries (Figure 1.8). Much of the explanation for this difference is the widespread use of early retirement pathways, particularly through unemployment and disability; claimant-count unemployment rates for the elderly show a pronounced jump at those ages which qualify for continuous unemployment on relatively high benefit levels until an old-age pension is drawn; and the proportion of the working-age population in disability-related schemes is the highest in the EU15 (OECD, 2005a). Although the new reform to the old-age pension system substantially increases financial incentives for

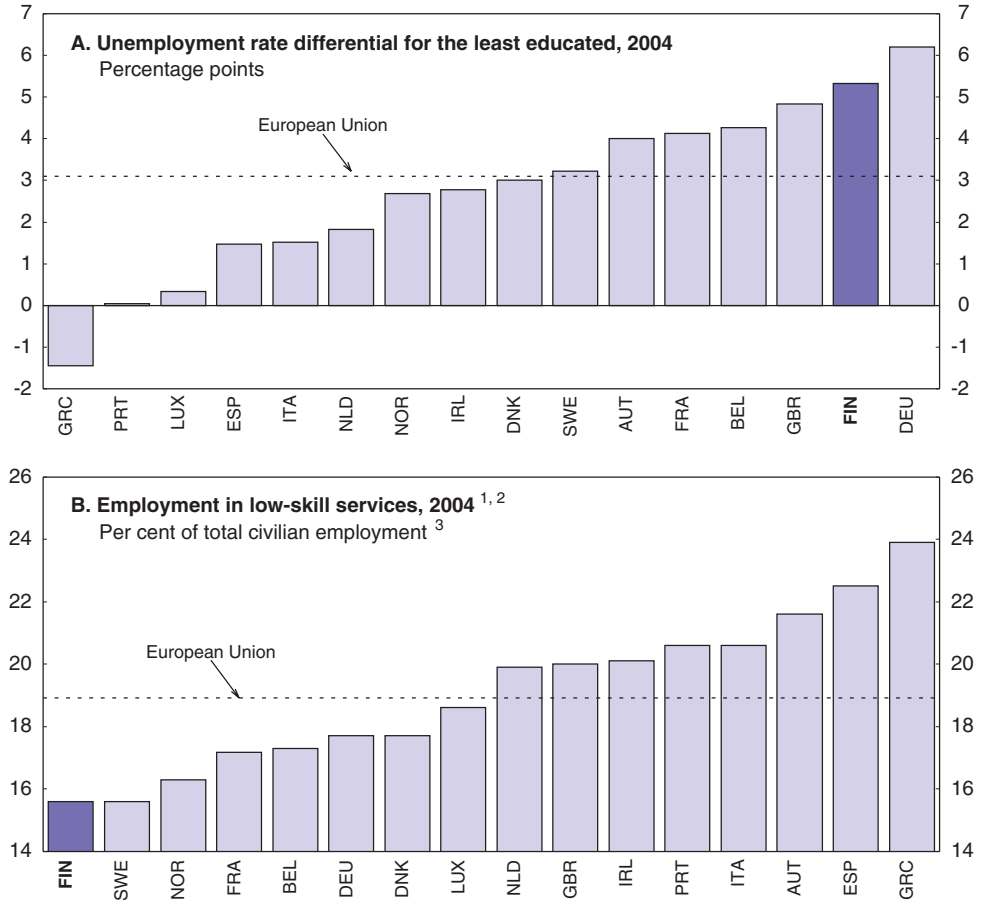
workers to lengthen their working lives, the continued availability of alternative early retirement pathways may blunt the effectiveness of the reform as discussed in Chapter 3.

Tackling job mismatch requires changes in the nexus of wage determination, taxes and benefits

Beveridge curves suggest that job mismatch has increased since the 1980s and early 1990s with the level of the unemployment rate consistent with any given level of the vacancy rate rising considerably. Perhaps the most striking example of mismatch is the shortage of opportunities in the low-skill service sector, coinciding with the highest differential between the unskilled and aggregate unemployment rate in the European Union (Figure 1.10). This suggests potential problems in wage determination, as well as the need to examine the role of passive and active labour market measures, which are discussed further in Chapters 4 and 5, respectively.

Figure 1.10. **Mismatch for unskilled labour**

Age 15-64



1. Or latest available data.
2. Wholesale and retail trade, repair of motor vehicles, hotels and restaurants.
3. Dependent employment for France.

Source: Eurostat; OECD, Labour Force Statistics database.

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The productivity gap highlights weaknesses in the sheltered sector

Mainly due to the strong performance of electronics, the overall level of hourly manufacturing productivity now exceeds that in the United States, having lagged behind by more than 20% in the mid-1980s (Jalava, 2004). Given the wide gap in aggregate productivity with the United States the implication is that productivity in the rest of the economy, mainly services, is poor. Given evidence of relatively high prices, weak import penetration, low inward investment and high concentration ratios, this is undoubtedly explained by weak competition in the sheltered sector, although how much this is due to Finland's remote geographic location and how much is due to policy failings is difficult to pin down. The previous *Survey* (OECD, 2004) concluded that among other factors, continued high levels of state ownership (Box 1.4), high levels of support for agriculture (Box 1.5) and regulation of the retail sector were areas of policy intervention which hindered competition. While the privatisation programme has resumed and support for agriculture is slowly diminishing, progress in these areas should be more rapid. Another area which is holding back productivity performance has been weak performance in public services, an issue which is examined further in Chapter 2 in the context of considering the fiscal challenges.

Box 1.4. **State ownership**

Public ownership of businesses is high, ranking 6th among all OECD countries, and is the main reason for the high ranking on the OECD's overall indicator of the stringency of state control. State ownership is particularly high in service sectors such as telecommunications, postal services, railways, and gas, as well in some manufacturing industries (Conway *et al.*, 2005). Today the State has holdings in 50 major companies and of these 31 are companies in which the state is the majority shareholder and 19 are associated companies. The net sales of the 10 largest state-owned companies accounted for some 13% of GDP in 2004.

There is, however, no clear evidence of improved financial performance or cost efficiency in recently privatised firms in Finland despite a stronger focus on profits after privatisation (Willner, 2003). In addition, over a range of profit indicators since 2001, there is little systematic evidence that the 13 listed companies in which the state is a majority shareholder have been out-performed by private listed companies (Ministry of Trade and Industry, 2005). Nevertheless, a high degree of public ownership may weaken competitive pressures in sheltered sectors and also deter foreign entry, thereby inhibiting competition in certain industries. In the last years the privatisation process resumed and in 2004 the proceeds from privatisation were more than 1¼ per cent of GDP which is the highest since the stock market peaked in 2000. During 2005, privatisation continued at the same pace with the State selling Sampo shares for € 430 million. Despite the recent privatisation efforts, public ownership remains relatively high in international comparison indicating that there is still scope for further privatisation of state-owned companies.

The housing market: strengthening resilience and the effectiveness of policy

While the Finnish housing market has been amongst the most volatile in the past, house prices are close to fundamentals currently. But they have accelerated recently and mortgage credit is expanding fast. Changes in housing wealth seem to have a considerably stronger effect on consumption than in the other euro area countries, which, combined

Box 1.5. **Agricultural support and restructuring**

Finland stands out as having high food prices, a high level of subsidisation and a low level of import penetration. The price level for food is 15% above the EU15 average and has shown little sign of narrowing over the last decade. Today some 70 000 farms receive a subsidy. In Finland support accounts for a larger percentage of farmers' income than in the other EU member states. Subsidies are crucial for Finnish farmers, because the harsh natural conditions keep the productivity well below the EU average. Agriculture is even more heavily subsidised than in other EU countries, as Finland was allowed to maintain a large amount of national aid after becoming a member of the European Union.

In 2004, a total of € 1 800 million was paid in agricultural subsidies in Finland, accounting for 45% of the total return on agriculture and horticulture (Finnish Agriculture and Rural Industries, 2005). The overall amount of support has remained constant over the past years at some 1¼ per cent of GDP with an unchanged split between EU and national aid programmes where national aid accounts for around 60% of total aid. The EU-funded aid consists of Common Agricultural Policy (CAP) support, compensatory allowances (LFA support) support and environmental support. The CAP support is fully funded by the European Union while LFA and environmental support is only partly financed by the European Union. Thus, additional national support amounts to a large proportion of an average farm income and reforms of national agricultural support could thus lead to considerable welfare gains. While the five year transitional period for national payments, which was granted to compensate for the effects of the unfavourable climate on productivity, ended as foreseen in 1999, the Commission authorised Finland to continue to pay national support due to the serious difficulties caused by the accession.

Despite rapid restructuring since EU membership – the number of farms declined from 100 000 to 68 300 between 1994 and 2005 – the sector continues to account for about 4½ per cent of overall employment which is almost twice as large as the corresponding share in other Nordic countries. Even though the structure of Finnish agriculture has changed quite rapidly in the last ten years, productivity growth has been relatively slow at 1% a year over the last decade. Import penetration in the sector is just above half of the average in northern Europe, pointing to limited pressures from abroad to accelerate the sector's restructuring process. Given that Finland does not hold a comparative advantage in agriculture, a further restructuring of the sector would reduce food prices and improve the budgetary situation.

with the overwhelming use of variable-rate loans, makes the economy more vulnerable to house price cycles. It would seem important to implement reforms to curb future risks stemming from the housing market as argued in Chapter 6.

House price cycles are exacerbated by shortages of building land and may also be affected by the tax-deductibility of mortgage interest payments. The shortage of building land in the fast-growing metropolitan areas reflects disincentives by municipalities to provide more building land as well as cumbersome planning procedures. Providing municipalities with better incentives, for instance by raising their possibilities to finance infrastructure investment as well as reforming planning procedures would help in this respect.

The public sector provides subsidies to build social housing, which provides homes to nearly 20% of the population, while housing allowances ensure the availability of

affordable housing for many people. Chapter 6 also considers whether there is scope for better targeting of public support for housing.

An illustrative medium-term scenario

To illustrate the potential effects which population ageing could have on the growth of living standards over the coming two decades, a medium-term scenario is constructed by separately projecting three components of GDP per capita:

$$\text{GDP per capita} = \text{output per head} \times \text{employment rate} \times \frac{\text{population of working-age}}{\text{total population}}$$

In this decomposition the employment rate and working population are defined relative to the age group 15 to 74, rather than the more usual definition of 15 to 64, for two reasons; firstly as the population ages, it will become increasingly important to encourage workers over 64 to stay in the labour force (as recognised by the recent pension reform which includes a flexible retirement age up to age 68); secondly, it makes it easier to relate the projections to recent OECD empirical work on labour force participation and the effects of pension reforms.[7]

Labour productivity is assumed to grow by 1¾ per cent *per annum* (the first row in Table 1.3), which is significantly less than the 2½ per cent growth experienced over the second half of the 1990s and more in line with productivity growth experienced since 2000, taking into account the temporary effect of the paper strike in 2005.[8] This might be consistent with assuming that the growth contribution from the ICT sector does not return to the rates experienced over the 1990s. While this may be unduly pessimistic, given Finland's high ranking in terms of innovation performance and educational attainment, it may be more prudent to base policy on assumptions that do not rely on the emergence of a "new Nokia".

The demographic projections in this scenario are the latest projections by Statistics Finland. Because the "demographic contribution" (the second row in Table 1.3), is defined as the change in the proportion of the total population aged 15 to 74 (rather than 15 to 64), the negative effect only becomes large beyond 2015, when GDP per capita growth is reduced by around ½ per cent *per annum*. Nevertheless, the impact of an ageing population shows up more immediately in the projection of the employment rate.

Table 1.3. **A medium-term scenario**

Average annual per cent change

	1995-2000	2000-05	2005-10	2010-15	2015-25
Productivity growth[1]	2.5	1.6	1.8	1.7	1.7
Demographic contribution[2]	0.1	0.0	0.1	–0.1	–0.5
Employment rate[3]	1.8	0.4	–0.4	–0.5	0.0
GDP per capita	**4.4**	**2.0**	**1.5**	**1.1**	**1.2**

1. Productivity growth is GDP per head of employment (aged 15-74).
2. The demographic contribution is the change in the ratio of the population aged 15 to 74 to the total population.
3. The employment rate is employment divided by the population aged 15 to 74.

The employment rate projections (third row in Table 1.3) are built up from a number of components, as shown in Table 1.4:

- The first (negative) component is the change in the aggregate employment rate resulting from the changing demographic structure, assuming age-specific employment rates

Table 1.4. **Contribution of employment to GDP growth**
Average annual per cent change

Employment rate, 15 to 74	2005-10	2010-15	2015-25
At 2005 age-specific employment rates	–0.7	–0.6	0.0
Cohort effect	0.1	0.1	0.1
Effect from lower unemployment rate	0.1	0.0	0.0
Effect of 2005 pension reform	0.1	0.0	0.0
Total[1]	**–0.4**	**–0.5**	**0.0**

1. Components may not sum to total due to rounding.
Source: OECD calculations based on Burniaux *et al.* (2003), "Coping with Ageing: a Dynamic Approach to Quantify the Impact of Alternative Policy Options on Future Labour Supply in OECD Countries", *OECD Economics Department Working Papers*, No. 371.

in 2005 remain unchanged. This reduces GDP per capita by as much as 0.7 percentage point *per annum* over the period 2005-10, and 0.6 percentage point *per annum* over the period 2010-15.

- A second (positive) component allows for recent OECD estimates of the cohort effect, the tendency for successive generations to have a higher participation rate at each age (Burniaux *et al.*, 2003).
- A third (positive) component provides a small boost to the employment rate through a fall in the unemployment rate to the estimated structural rate of unemployment of 8%.
- Finally, the projections incorporate an estimated effect of the 2005 pension reform. This effect is based on cross-country evidence regarding the effects of the financial incentives to continue working (Burniaux *et al.*, 2003). The effects of the reform are relatively modest, only raising the aggregate labour force participation rate by just over ½ a percentage point in total, mainly because, as discussed further in Chapter 3, many pathways to early retirement remain open and this will blunt the improved financial incentives to work longer which result from the reform of the old-age pension system.

On this basis, overall growth of GDP per capita is 1½ per cent *per annum* in the second half of this decade, slowing to only 1¼ per cent *per annum* over the following 15 years. This would represent a substantial deceleration compared to the experience of the last decade. It would also almost certainly mean that the gap with those OECD countries which currently have higher levels of GDP per capita would widen rather than narrow. The potential impact of ageing on the growth in living standards in coming decades, as well as the additional strains this would place on the fiscal position, demonstrate the urgency of further reforms to boost aggregate productivity, raise the employment rate and bolster the fiscal position, as discussed in the remainder of this *Survey*.

Notes

1. The World Economic Forum annually ranks economies on a range of criteria intended to capture the determinants of productivity and growth. In 2005 Finland was ranked in first place out of 117 countries assessed (World Economic Forum, 2005).
2. Among the 23 OECD countries which the World Economic Forum assessed in 1995 the correlation coefficient between the competitiveness indicator in 1995 and growth in GDP per capita over the subsequent decade was –0.39. Finland's competitiveness ranking in 1995 was only 13th, but its subsequent growth performance was 2nd among the 23 countries. Conversely Germany, Switzerland and Japan were ranked 2nd, 3rd and 4th according to the 1995 competitiveness indicator, but 20th, 23rd and 22nd on GDP per capita growth.

3. An approximate measure of command GDP can be calculated as:

$$\text{Command GDPV} = \text{TDDV} + \text{XGSV} * (\text{PXGS}/\text{PMGS}) - \text{MGSV},$$

where TDDV is real domestic demand, XGSV and MGSV are real export and import volumes and PXGS and PMGS are the export and import price deflators. See OECD (2004) for further discussion.

4. Finland's net foreign liabilities jumped from 73% to 177% of GDP in 1999 as the price of Nokia's shares (most of which are held by foreigners) boomed, following the subsequent decline in share prices net foreign liabilities fell to 37% of GDP in 2002. Since 2002 the annual decline in net foreign liabilities has borne a closer resemblance to the magnitude of the trade surplus.

5. The Nordic model is typically described as involving high public spending on social protection and universal welfare provision, coupled with unions that deliver a high degree of wage equality, and heavy use of active labour market policies (Sapir, 2004).

6. For details of how aversion to inequality is calculated see Boarini *et al.* (2006).

7. Note this is an important difference between the decomposition here and that undertaken in the previous Survey which used a definition of the employment rate and working-age population of 15 to 64.

8. If the paper industry strike lowered GDP by about 1% in 2005, this implies it lowers average annual productivity growth by around 0.2% *per annum* for the period 2000-05 and, assuming former production levels are recovered, raises it by a similar amount over the period 2005-10.

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ANNEX 1.A1

Progress in structural reform

This annex reviews action taken on recommendations from previous *Surveys*. Recommendations that are new in this *Survey* are listed in the relevant chapter.

Recommendations	Action taken since the previous *Survey* (December 2004)
Product market competition	
Enhance competition:	
• The Finnish Competition Authority should give greater priority to addressing cartels.	
• The market court should be freed from minor public procurement disputes by establishing a public procurement authority.	
• Stricter sanctions should be imposed to secure deterrence. Individual liability should be considered.	
• Remove the conflict between the state's regulatory role and its ownership interests, publicly-owned companies should be concentrated in a ministry without regulatory oversight. However, the preferred solution is an extensive privatisation programme.	In December 2005, the Government decided to centralise the management of state corporate ownership in one unit in the Prime Minister's Office. The new unit will start its activities in May 2007. Proceeds from privatisation were 1¼ per cent of GDP in 2004, the highest since 2000 and continued at a similar pace in 2005.
Increase competition in certain sectors:	
• The role of sector regulators should be enhanced. Non-discriminatory third party access charges need to be applied more effectively and formal separation of vertically-integrated companies pursued. As competition becomes viable in these sectors, the regulatory approach can be replaced by the application of general competition principles.	In March 2005, the Finnish Communications Regulatory Authority was given the powers to set a price ceiling for inter-operator network lease for an operator with significant market power on a fixed network, and to set a price ceiling in an individual case regarding the cost orientation of a telecomm operator.
• The reform process should be accelerated in the railway and postal sectors and the license system should be reviewed in the latter sector to ease entry. Competition in domestic air transportation should be promoted by setting individual airport charges to reflect the true cost of each individual airport and by introducing a market-based system for slot allocation.	
• Regulation of retail distribution should be relaxed; shop opening and zoning laws should be reviewed to facilitate entry.	
• Reduce national agricultural subsidies that come on top of those provided by the Common Agricultural Policy. Phasing them out could be accompanied with income support, if deemed necessary.	Agricultural support as a share of GDP has fallen, but only slightly.

Recommendations	Action taken since the previous *Survey* (December 2004)
Labour markets	
Raise the employment of the old and young:	
• Remove pathways to early retirement particularly through disability and unemployment benefit schemes. At a minimum this should involve an end to the preferential treatment of the older unemployed. The planned relaxation of medical assessments required to receive disability benefit should not be implemented, and instead more of those currently claiming disability benefits might be helped into work with active measures.	The minimum age to qualify for the "unemployment pipeline" has been raised to 57 years old and the unemployment pension will be abolished. The "individual early retirement pension" available for persons aged 60-64 years old, for which medical requirements were less strict, is being phased out.
• Demand-side barriers to the retention and hiring of older workers should be tackled, including the removal of the age-related component of social security contributions.	A temporary low-wage subsidy scheme started from the beginning of 2006; the experiment will last until the end of 2010. Under this scheme employers are eligible to receive a subsidy for all employees aged 54 or over who earn 900-2 000 euros a month for a full-time job. The subsidy is highest (220 euros per month) when the wage is 1 400 euros per month. The subsidy supports the employment of older workers in low-paid jobs.
• Reduce the average age at which young people begin to work. Replace grants with fees and loans in tertiary education should also be considered.	A tax deduction on study loans for students completing a university degree within given time limits will be introduced for students enrolling from autumn 2005.
Introduce greater flexibility into the system of centralised wage determination and avoid specifying minimum absolute changes in wages. Exempt younger workers from the wage floors.	A part of the overall wage increase from the central general wage agreement for 2005-07 was delegated to the local level (union allowance) but currently it is mostly allocated as a general increase.
Taper the earnings-related unemployment benefit with duration of the unemployment spell to intensify job search.	The activation reform for long-term unemployed specify that intensified activation is required after 500 days and at the same time unemployment benefits are made contingent on participation in ALMPs.
Pensions	
	A wide-reaching reform was introduced from the beginning of 2005.
Abolish the accrual of pension rights during non-work periods as well as the higher accrual rates that can be earned by a worker in the early fifties, neither has a strong economic rationale, and removing them would halve the required increase in future contribution rates.	
Aggregate fiscal policy	
Central government and municipal fiscal deficits which cannot be explained by the economic cycle should be avoided. Further structural reform or spending restraint is required if additional tax cuts are to be implemented.	The combined central government and municipal deficits decreased from –0.3% of GDP in 2004 to 0.1% in 2005 due to improved central government finances (preliminary statistics).
Raise public sector efficiency	
In health care more activity-based funding could help reduce the exceptionally long waiting times. Involve a wider range of private sector providers via contracting out and voucher arrangements which would promote innovation.	A national health programme covering the period 2004-07 has been launched with the aim of improving productivity primarily through improved information management. A care guarantee system was introduced in March 2005 to address the problem of long waiting times for non-emergency care. The set maximum waiting times are the following: • Doctor appointment in primary health care 3 working days, treatment 3 months. • Specialised health care treatment: assessment of needs 3 weeks, treatment 6 months. • Dental care 6 months. If the care is not available in the public sector, the care must be organised by contracting out. As part of the productivity programme, the government has set the goal of filling only every second new vacancy within on-budget entities by 2011.

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Recommendations	Action taken since the previous *Survey* (December 2004)
Municipal finances	
The menu of taxes which municipalities control should be changed. The municipal share of corporate tax revenues should be decreased or eliminated in order to reduce the effect of cyclical fluctuations. The upper limit on real estate and land taxes should be removed.	A government task force is due to submit proposals by mid-2006 on the future structure for financing, organisation and production of municipal services, including possible changes in local authority boundaries.
The automatic upward adjustment of state grants in response to municipal cost increases should be abolished, and conditions for *ad hoc* support to individual municipalities should be tightened considerably.	The automatic adjustment of state grants has been abolished.
Benchmarking of municipal service efficiency should be developed much further.	
Charging for ageing-related services should be re-organised to better allow users to pay for care and practical help, beyond what is regarded as necessary.	

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Chapter 2

Ensuring fiscal sustainability in the face of imminent ageing

Past tax cuts, expenditure slippage and imminent fiscal pressures from ageing have exhausted the scope for further income tax cuts, even though the latter would help to improve labour market performance. The key to long-run fiscal sustainability and reducing future tax pressures is containment of public spending pressures. This will require improved productivity in public services, re-organising municipal finances and allowing private funding for some of the growth in non-core welfare services. It will also require some elements of the recently implemented pension reform to be revisited.

Recent fiscal performance

The government financial surplus has declined

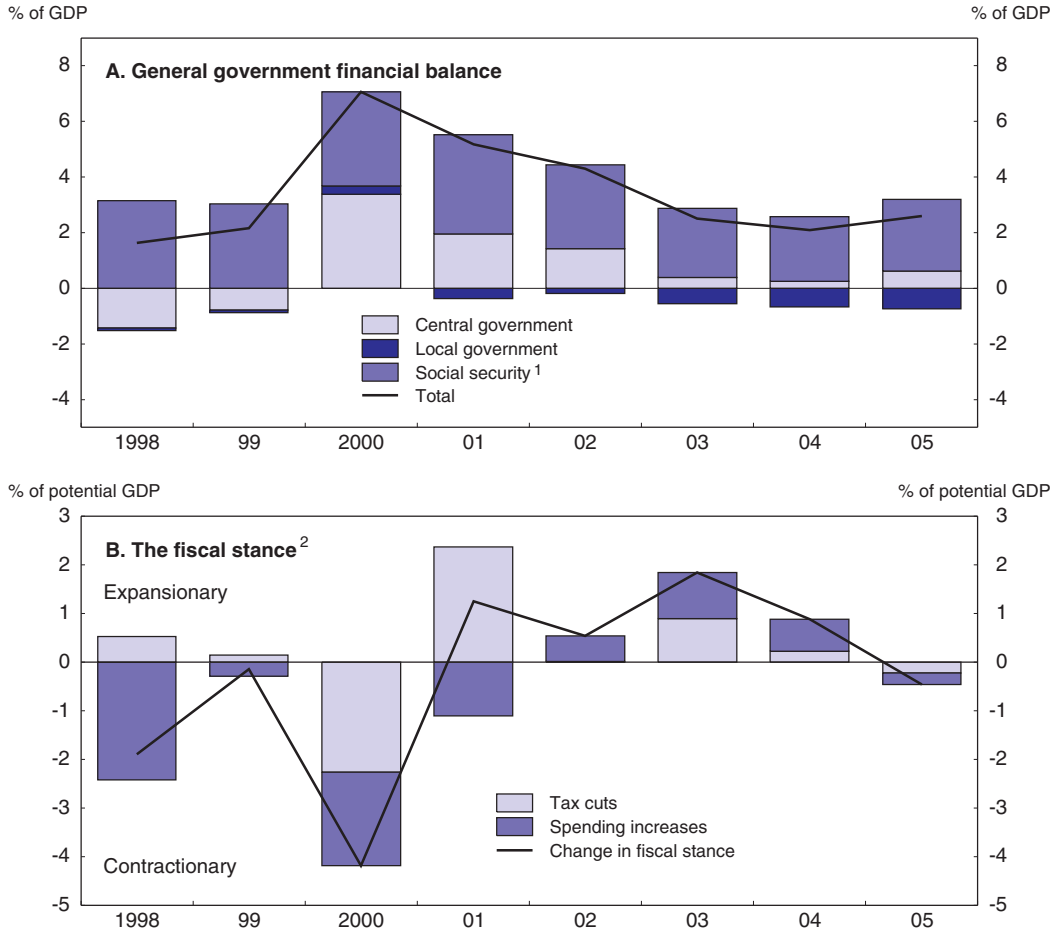
The general government financial surplus and net asset position (as a percentage of gross domestic product (GDP)) are easily the largest in the euro area. However, such comparisons are flattering because of the inclusion of pension funds within general government (Box 2.1). Conversely the combined financial balances of central and local government are now in slight deficit and the deterioration in their financial position accounts for virtually all of the fall in the general government surplus from a peak of 7% of GDP in 2000 to about 2.3% of GDP in 2005 (Figure 2.1, panel A). The reduction has been mostly structural (Figure 2.1, panel B), with the structural surplus falling in each year, except 2005. In 2001 much of the expansionary fiscal stance can be explained by a loss in asset-related revenues (direct taxes on household and corporate income from capital gains as well as direct taxes on household income from stock options) as equity prices slumped, which is not easily classified as discretionary.[1] However, expenditure increases have contributed towards an expansionary fiscal stance in each of the years 2002-04 with the ratio of public consumption to GDP rising by around 2 percentage points since 2000, while tax cuts further boosted the fiscal stance in 2003.

Spending pressures are considerable

The current government's fiscal policy objectives originally set in June 2003 include a gradual increase in *central government* spending of 1¾ per cent in real terms between 2004 and 2007 (Box 2.2). An encouraging development is that spending has indeed remained within these limits in both 2004 and 2005, in stark contrast to the spending rules under the previous government, which, while more stringent, were repeatedly over-shot by a wide margin (OECD, 2004). This was reflected in an upward drift in the share of central government consumption in GDP, which rose by ½ percentage point of GDP between 2000 and 2003 but has remained stable in 2004.

However, developments in the *municipal sector*, which accounts for three-quarters of public employment, risk undermining fiscal discipline. Employment in the municipal sector grew at a faster rate than total employment between 2000 and 2004, although private sector employment has picked up more rapidly in 2005 (Figure 2.3, panel B). Cost developments have also tended to push up the share of government spending in GDP. The price of government services, because they are predominantly labour-intensive, typically rise more quickly than the overall GDP deflator. However, the magnitude of this difference has been larger in Finland than for most other OECD countries, averaging 2% per year since 2000, the largest in the euro area with the exception of Ireland, and compared to a difference for the entire euro area of only ¼ percentage point. This is partly because the trend decline in the terms of trade has tended to depress the GDP deflator and partly because price inflation has turned out lower than expected at the time of the last centralised wage agreement when nominal wage increases were set. These combined

Figure 2.1. **Recent fiscal developments**



1. Including employment pension funds.
2. The fiscal stance is measured by the change in the cyclically-adjusted government balance, positive values indicate an expansionary fiscal stance. The components – tax cuts and spending increases – are all measured on a cyclically-adjusted basis.

Source: Statistics Finland; OECD, Economic Outlook database.

Box 2.1. **The inclusion of pensions funds in general government**

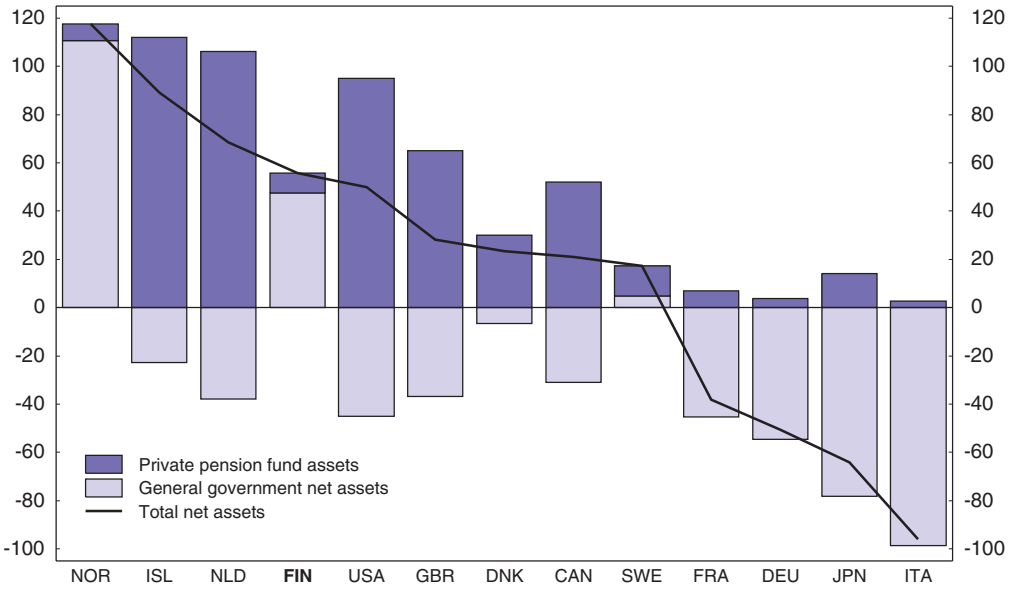
The pension schemes for private sector employees are run by a large number of private pension institutions (insurance companies, company pension funds and industry-wide pension funds). The market value of private sector pension fund assets is currently close to half of GDP and if pension funds for municipal and central government employees are also included then the share is about two-thirds of GDP. Because pension contributions are mandatory and pensions essentially follow defined benefit rules these assets are booked as general government assets, even though the institutions that manage them are mutuals and thus "owned" by the employers, who are the customers. As a counterpart, the contributions are also recorded as government receipts.

Box 2.1. **The inclusion of pensions funds in general government** *(cont.)*

Comparisons of the general government's surplus (at 2½ per cent of GDP in 2005) and net asset position (47% of GDP) with other OECD countries can therefore be misleading because of the inclusion of these pension funds within general government. While, of course, the assets held by pension funds should be taken into account when assessing fiscal sustainability, other countries accumulate pension assets in schemes that are recorded outside general government, some of which appear to have a similar set up to that in Finland. For example, a comparison with the Netherlands is striking, because their occupational pension schemes have almost complete coverage and are quasi-compulsory, but because pension rules and contributions are determined by collective agreements (with administrative extension to all jobs) rather than being specified in law, the pension assets are recorded in the private sector. If the assets of private pension schemes are included with the net asset position of general government, the combined asset position is significantly stronger than for Finland. More generally, adding private sector pension assets (whether voluntary or mandatory) to general government net assets changes Finland's comparative position considerably (Figure 2.2). Nevertheless, compared to the large continental European countries, Finland is better prepared for ageing by having partly pre-funded the future pension liabilities for the earnings-related pension.

Figure 2.2. **Government and private pension net financial assets**

In per cent of GDP, 2004



Source: OECD, Global Pension Statistics and Economic Outlook database.

It is also worth noting that the institutional separation between government and pension funds appears to have worked well in practice. There is some evidence across OECD countries that attempts to pre-fund public pension liabilities by fund accumulation in national social security systems are often largely offset within the government sector by larger deficits in other budgetary accounts. However, in a recent study of OECD countries, the extent of such "leakage" was found to be smallest for Finland (Bosworth and Burtless, 2004).

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Box 2.2. **The fiscal policy objectives for central government**

The government's fiscal policy objectives were set out in the June 2003 government programme and stipulate:

- The central government debt-to-GDP ratio must be reduced (excluding cyclical factors).
- The government aims to secure balanced central government finances under normal conditions of economic growth (*i.e.* in cyclically-adjusted terms) at the end of the electoral period in 2007, measured in terms of national accounting.
- Taxes will be cut over the electoral period, especially those on labour.
- Real spending limits for central government were originally specified in the 2004 budget for each of the four years of the government's office increasing from € 28.1 billion in 2004 to € 28.6 billion in 2006, where the sums are specified in 2004 prices (implying a total volume increase of 1¾ per cent).

Each year the spending limits are updated, reflecting price and cost developments and structural changes in the budget, but the government has emphasised that apart from these technical adjustments, the limits should not be changed. The formula used to update price and cost developments is quite elaborate, including adjustments for changes in wages costs, consumer price index (CPI) and building costs. In the two years between 2004 and 2006 the implied increase was 3¼ per cent.

The spending limits apply to about 75% of the central government budget and account for about 20% of GDP. This includes all central government outlays (including transfers to municipalities) except variations in social security spending reflecting business cycle movements, interest payments on public debt and a few other spending items such as government spending covered by revenues received from the European Union. Municipalities, on the other hand, are *not* constrained by these spending limits and can determine spending and tax rates autonomously.

To avoid an excessive deficit, the fiscal framework includes an "emergency brake" stating that "the government's underlying premise is that the central government deficit, in national account terms, should not exceed 2¾ per cent of GDP *even* in conditions of weak economic development. If, *in the light of forecasts*, the deficit *threatens* to grow larger than this, the government will, *without delay*, propose the necessary measures for reducing expenditure as well as other measures to avoid an overrun."

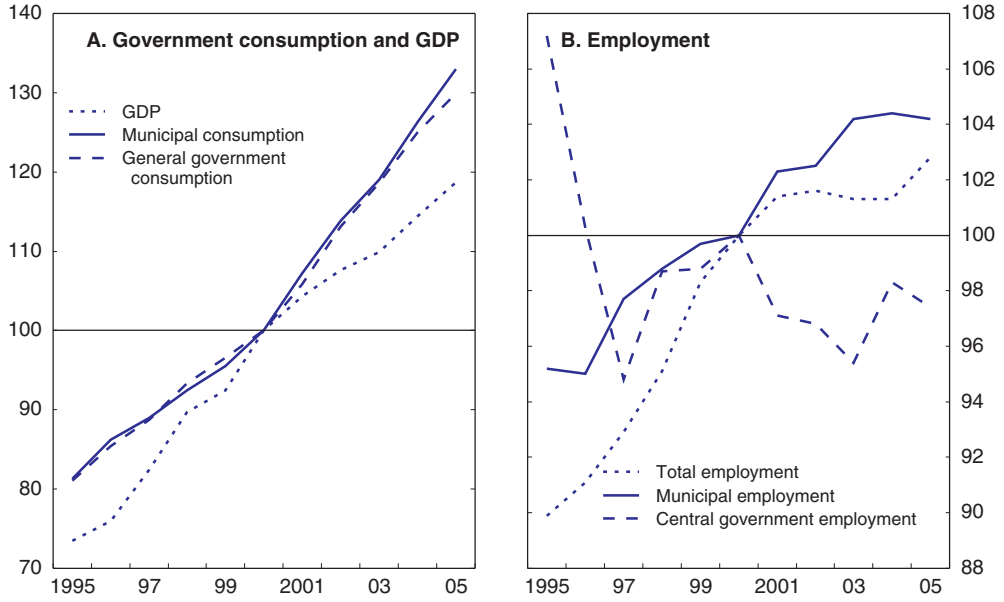
Source: Ministry of Finance (2003).

pressures, coupled with a slowdown in potential growth, have meant that total municipal nominal spending has increased by over 6% *per annum* since 2000 compared with average growth in nominal GDP of only 3½ per cent, with the share of local government consumption in GDP rising in every single year (Figure 2.3, panel A). Overall these developments have led to the share of general government consumption in GDP rising by 2 percentage points since 2000.

The government's objective is to cut taxes

An additional objective of the present government is to continue to reduce taxes over the course of 2004-07, especially those on labour. The government has already reduced taxes on labour by a total of € 1.4 billion (0.9% of GDP) in 2004 and 2005, and has pledged, in the context of the central wage agreement reached in November 2004, to reduce them by a similar amount in 2006 (Box 2.3) and 2007.

Figure 2.3. **Trends in government consumption and employment**
Index 2000 = 100



Source: Statistics Finland.

Box 2.3. **The 2006 budget proposal**

The budget proposals endorse the original spending limits originally announced in May 2003 up-rated for cost developments, which imply a total increase in the two years between 2004 and 2006 of 3¼ per cent. Other major proposals included:

- Taxation of earned income to be reduced by € 840 million (½ per cent of GDP).
- The wealth tax to be abolished, although at a cost of only € 70 million (0.05% of GDP).
- The maximum tax credit for domestic household and care work will be doubled to € 2 300.
- Temporary low-wage support for employers will be adopted for the period 2006-09, targeted at employers who recruit employees aged 54 or more to full-time jobs with a monthly pay between € 900 and € 2 000 (35% to 78% of the average production worker (APW) wage), with a maximum support of € 220.

Source: Ministry of Finance (2006).

Although tax cuts since 2000 have led to a larger fall in the tax-to-GDP ratio than for most OECD countries, the overall tax burden is still relatively high (Figure 2.4). Moreover taxes remain more heavily skewed towards those on labour than for most other OECD countries; in 2004 taxes on personal income plus employee and employer social security contributions accounted for 56% of total tax revenue, about 10 percentage points above the OECD average. The average and marginal tax rate on labour income is among the highest in the OECD. In 2004 the average tax wedge for a single person earning the average production wage was 44% and the corresponding marginal rate was 55% (Figure 2.5). Empirical evidence suggests that a high tax wedge on labour reduces employment more when minimum wages are high in relation to average wages (OECD, 2006a), as is the case

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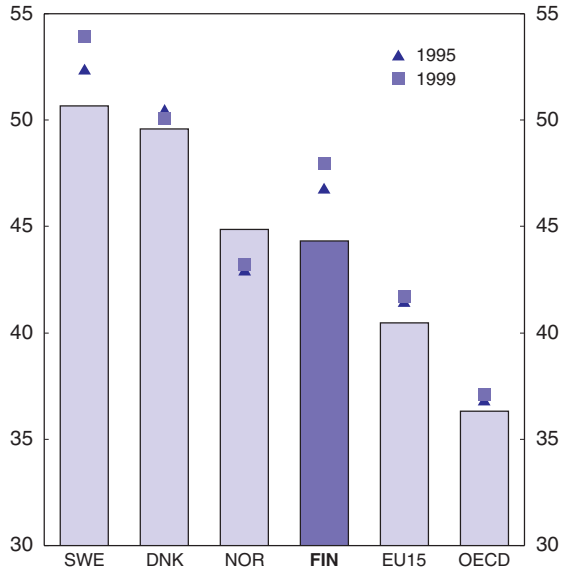
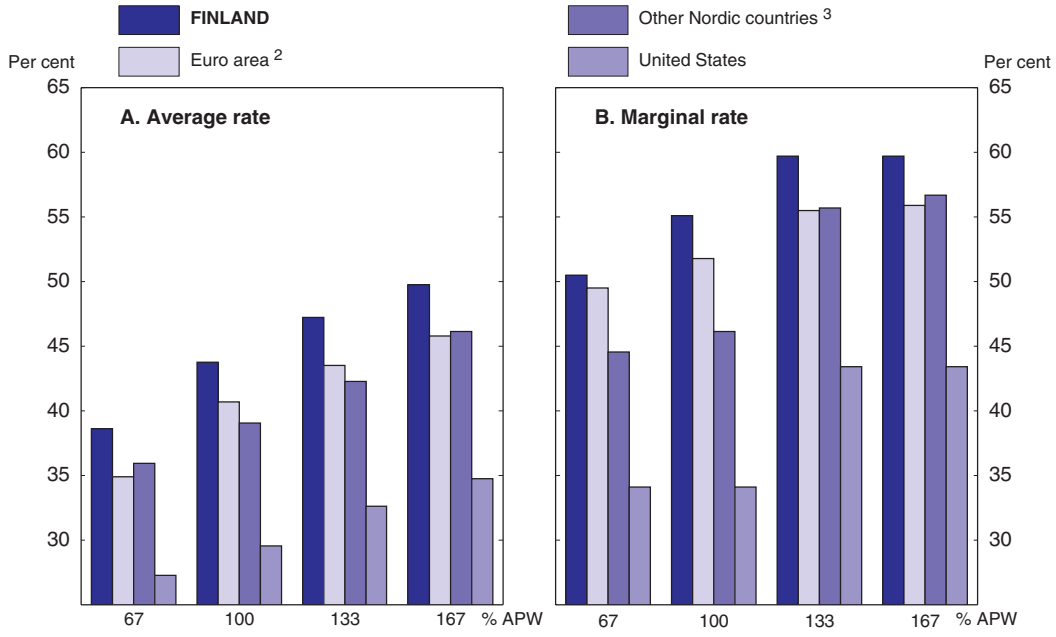
Figure 2.4. **Aggregate tax-to-GDP ratio**
2004[1]



1. 2003 for EU-15 and OECD.

Source: OECD, *Revenue Statistics – 1965-2004*, 2005 ed.

Figure 2.5. **Tax wedges for a single person**[1]
2004



1. Total tax wedge measures the combined central and sub-central government income tax plus employee's and employer's social security contributions, as a percentage of labour costs defined as gross wage earnings plus employer's social security contributions.
2. Excluding Finland.
3. Unweighted average of Denmark, Iceland, Norway and Sweden.

Source: OECD, Tax database.

in Finland (Chapter 4), because it lowers the possibility for employers to shift all or part of the payroll taxes onto lower wages. A high tax on labour also encourages a do-it-yourself attitude to many domestic chores (cleaning, gardening etc) because paying for each hour of even an unskilled worker's time is likely to require working a multiple of extra hours. An innovative attempt to try to overcome this has been through the introduction and expansion of a tax credit on domestic work (Box 2.4).

Box 2.4. **The tax credit on domestic work**

An income tax credit on household work, defined as care, service, maintenance and improvement work, was introduced in its present form in 2001. The purpose of the deduction is to increase the demand for and supply of household services and stimulate employment in this sector. The household credit against the state tax is available for 60% of the wages/costs incurred when buying services from an enterprise, an entrepreneur or a non-profit organisation. If the deduction exceeds the amount of payable state tax, the exceeding amount may be deducted from the municipal tax, health insurance payment and church tax. The maximum deduction is € 1 150 per year per spouse living in a household and adult children living at home are eligible for the deduction as well, but this maximum deduction will be doubled to € 2 230 per year (for personal care) under the 2006 Budget proposals.

During 2003 the total amount of domestic tax credit in state taxation was € 91.2 million and 5.2% of all households used the tax credit (Niilola *et al.*, 2004). The number of households using the tax credit has nearly doubled since 2001 and the amount of tax credit almost tripled. Estimates for future years suggest that approximately 400 000 households will use the tax credit for household work. During 2003 about 70% of households used the credit for maintenance work, 25-30% bought cleaning services, 5-10% gardening services and 5-10% nursing or childcare services. In monetary terms more than 85% of the tax credit was used on renovation/maintenance work and more than 8% on cleaning services.

While this is a positive initiative to stimulate employment of the low-skilled it is estimated that only around 8 000 jobs were created in 2003. Furthermore, it is estimated that half of these jobs would have existed even without the tax credit. Thus, the overall effect on employment is small and the cost per job is fairly high, although it may have a more significant effect on reducing the black economy.

On the other hand, as discussed further below, there is likely to be a conflict between the government's objectives for further tax cuts and the objective to keep the central government finances balanced. Moreover, most estimates of the effect of taxation on labour supply suggest that while they would be significant, they would need to be very large to achieve the employment target. For instance, Nickell (2004) found that a 10 percentage point rise in the tax wedge reduces labour supply by somewhere between 1 and 3% of the working-age population. Similarly, recent OECD estimates find that a 10 percentage point reduction in the tax wedge in an average OECD country would increase employment by 3.7 percentage points (OECD, 2006a). Thus, tax cuts would almost certainly need to be combined with other labour market reforms (as discussed in Chapter 3, 4 and 5) to get close to the government's more ambitious employment target. In addition, with the output gap positive according to OECD measures and GDP growth clearly above the potential rate in 2006 there are no grounds for tax cuts as a demand stimulus.

Fiscal pressures from ageing suggest public finances are not sustainable in the long run

There are two components to the ageing shock which warrant distinct policy responses. The first is the transition of the "baby-boom" generation which will lead to a bulge in the proportion of the population entering retirement after 2010. If subsequent cohorts are left to bear the financial burden of increased health and pension costs, the financial burden is likely to be excessive. Hence a natural policy response is to build up savings in advance which can then be drawn down to pay for future ageing costs, effectively smoothing the tax profile. Finland differs from most other OECD countries in that the baby boom generation retires earlier than in most other countries (Chapter 1), so that the need for pre-saving is correspondingly more urgent. The second component of the ageing shock is the general trend towards increased longevity which produces a steady rise in the share of older age groups. The key to adapting to this shock is to ensure that the economy adjusts, most obviously by increasing the length of working lives as well as by considering whether there is scope to contain ageing outlays (for example by reducing the generosity of retirement benefits) or reducing other public spending to limit the increase in the future tax burden.

Long-term projections imply a fiscal sustainability gap

The most recent outturn data for the general government financial balance in 2005 (2.3% of GDP) are somewhat stronger than the 1.8% of GDP anticipated at the time of the November 2005 Stability Programme. The medium-term Stability Programme projections imply a slight deterioration of about ¼ per cent of GDP in the financial balance in coming years as tax cuts of more than 1% of GDP are partially offset by lower interest expenditure and a reduction in government investment (Table 2.1). The projections imply that the general government surplus towards the end of the decade will be about 1½ per cent of GDP (or about 2% of GDP if the stronger than expected outturn for 2005 is carried over).

The accompanying long-term sustainability projections to 2050 in the Stability Programme suggest that there is a strong case both to boost pre-saving and take further measures to constrain public expenditure growth, even allowing for the stronger-than-expected outturn in 2005. This scenario is based on assumptions of "no policy change", which means that pension contribution rates to finance increasing pension outlays will increase, but that other tax rates remain unchanged. In this scenario additional ageing costs of 6% of GDP are incurred by 2030 (Box 2.5). This implies that the general government surplus declines to 1½ per cent of GDP over the remainder of this decade, consistent with central and local government (combined) remaining in deficit. Other key assumptions, with a brief assessment based on OECD work where relevant, are described in Box 2.5.

The scenario suggests that current fiscal policy is not sustainable in the sense that the generosity of pension and transfer incomes and spending on public services cannot be maintained at current levels without raising taxes in the future. In particular, the general government financial balance steadily deteriorates as the fiscal costs of ageing materialise with the deficit exceeding 3% of GDP in the 2030s (Figure 2.6, panel A). There are, however, striking differences across the different sectors of general government.

The pension funds remain in surplus throughout the projection and their net asset position as a share of GDP rises, although the ratio of pension assets to pension expenditure, which is a more appropriate measure of funding, declines over the projection.

Table 2.1. **The 2005 stability programme fiscal projections**

Per cent of GDP

	2004	2005[1]	2006[2]	2007[2]	2008[2]	2009[2]	Change 2005-09
Financial balance							
General government	2.1	1.8	1.6	1.6	1.5	1.5	–0.3
Central government	0.5	–0.5	–0.5	–0.5	–0.7	–0.5	0.0
Local government	–0.7	–0.5	–0.4	–0.2	–0.1	–0.1	0.4
Social security funds	2.3	2.8	2.5	2.4	2.3	2.2	–0.6
General government							
Total revenues	53.0	53.2	52.4	52.0	52.0	52.0	–1.2
Total expenditure	50.8	51.4	50.8	50.5	50.5	50.5	–0.9
Financial surplus	2.1	1.8	1.6	1.6	1.5	1.5	–0.3
Net interest payments	1.6	1.7	1.6	1.3	1.3	1.2	–0.5
Primary balance	3.7	3.4	3.1	2.9	2.8	2.8	–0.6
Components of revenue							
Taxes	32.4	32.2	31.6	31.3	31.2	31.1	–1.1
Social security contributions	12.1	12.6	12.5	12.5	12.6	12.7	0.1
Other revenues	5.1	5.1	5.0	5.1	5.1	5.1	0.0
Total revenues	53.0	53.2	52.4	52.0	52.0	52.0	–1.2
Components of expenditures							
Consumption expenditure	7.8	8.0	7.9	7.9	7.9	7.9	–0.1
Social income transfers	31.7	32.1	31.9	31.9	32.0	32.2	0.1
Interest payments	1.6	1.7	1.6	1.3	1.3	1.2	–0.5
Subsidies	1.3	1.3	1.3	1.3	1.3	1.2	–0.1
Gross fixed capital formation	3.0	2.9	2.7	2.7	2.7	2.7	–0.2
Other expenditure	5.5	5.5	5.4	5.3	5.3	5.2	–0.3
Total expenditure	50.8	51.4	50.8	50.5	50.5	50.5	–0.9
Gross debt level, % of GDP	**44.9**	**42.7**	**41.7**	**41.1**	**40.6**	**40.1**	**–2.6**
Cyclical developments							
GDP output gap	–0.3	–1.2	–0.9	–0.6	–0.3	0.0	1.2
Cyclically-adjusted balance	2.3	2.4	2.0	1.9	1.6	1.5	–0.9
Cyclically-adjusted primary balance	3.8	4.0	3.6	3.2	2.9	2.8	–1.2

1. Estimated.
2. Forecast.

Source: Ministry of Finance (2005), *Stability Programme for Finland*, November 2005 update.

Given the pre-funding, pension contributions rise by less than pension expenditure. Nevertheless, this rise in pension contributions is larger in the private sector than in the public sector and, when expressed as a share of the wage sum (rather than GDP), implies an increase of about 6 percentage points to 2030, representing a considerable addition to labour taxes. The deficit for the central and local government sector (combined) progressively worsens with general government gross debt exceeding 60% of GDP by the early 2030s (Figure 2.6, panel B) implying also a progressive worsening in the net asset position of general government (including pension funds) (Figure 2.6, panel C).

A variant scenario provides an indication of the extent of the "fiscal sustainability gap" (Figure 2.6). Additional fiscal consolidation measures (an unspecified combination of tax increases and spending cuts) from 2008, after the current electoral term, that would raise the financial surplus by about 1½ per cent of GDP would be sufficient to curb a sharp deterioration in debt in future decades with gross government debt stabilising at about 50% of GDP and general government net assets stabilising at between 30% and 50% of GDP. By 2050 total spending is projected to be lower by 5½ per cent of GDP (relative to the central scenario), 4% of which is accounted for by lower net interest expenditure and 1½ per cent

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Box 2.5. **Key assumptions underlying the long-term sustainability scenario**

- By 2030 age-related expenditure (pensions, health care, long-term care and education) are projected to increase by 6% of GDP (Table 2.2). Recent OECD work (OECD, 2006b) suggests that the projected increase in public health expenditure could be much higher than implied by these projections (by an additional 1½ percentage point of GDP) if, on top of demographic developments, expenditure grows in line with observed trends over the last 2 decades. On the other hand, the OECD projections of the increase in long-term care expenditure are in line with those of the Stability Programme.

Table 2.2. **Projections of ageing-related expenditure**

Per cent of GDP

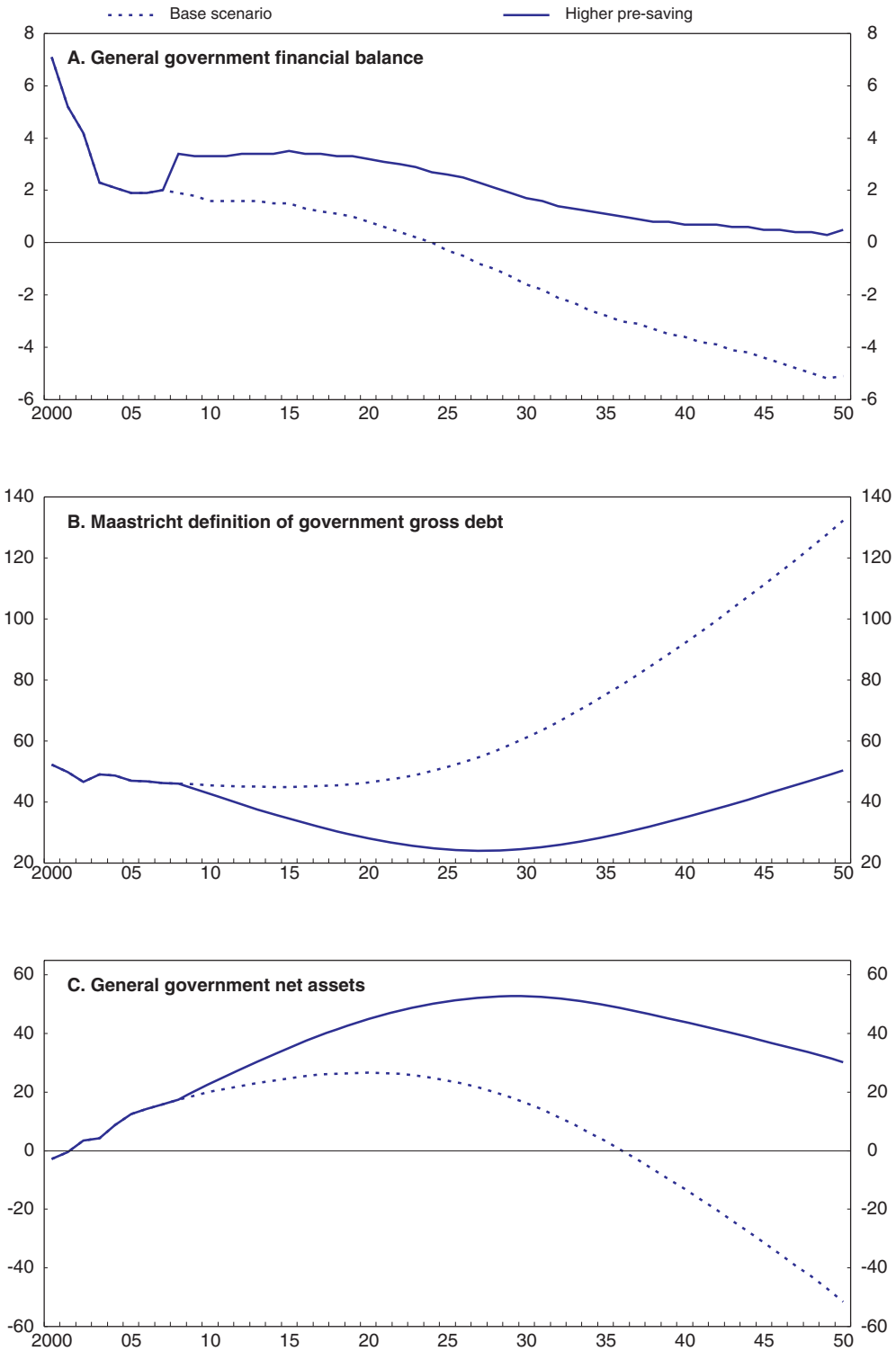
	2005	2010	2020	2030	2050	Change 2005-50
Old-age and early pensions	8.0	8.8	10.7	12.0	12.1	4.1
Other pensions	2.4	2.4	2.2	2.0	1.7	–0.7
Health care	5.5	5.6	6.2	7.0	7.4	1.9
Long-term care	1.8	1.9	2.5	3.3	4.3	2.5
Education	5.9	5.4	5.2	5.2	5.1	–0.8
Total	**23.6**	**24.2**	**26.7**	**29.6**	**30.6**	**7.0**

Source: Ministry of Finance (2005), *Stability Programme for Finland*, November 2005 Update.

- Labour productivity is expected to increase on average by 2% per annum to 2030 and by 1.7% annually thereafter. While this is below the long-run trend of recent decades, it is in line with developments since 2000 and may be a more realistic basis for medium-term projections (Chapter 1).
- The real interest rate is assumed at 3%, both for public debt and for the return on pension fund assets.
- The employment rate is expected to rise to over 74% by 2030 from 68% currently, with a particularly sharp rise in the employment rate of older workers. This contrasts with OECD projections (OECD, 2004) which assume that, in the absence of further pension reforms, in particular without additional restrictions on early retirement schemes, there will be little further improvement in the aggregate participation rate of older workers.

is attributed to the pre-saving at the beginning of the period. This would suggest that an appropriate target for the general government surplus to the end of the current decade is around 3% of GDP, which, if the pension funds maintain their current surplus, translates into roughly a combined financial balance for central and local government of about ½ per cent of GDP. A scenario described in the last *Survey* came to a similar conclusion regarding the size of the target surplus. The remainder of this chapter considers the options for both pensions and government expenditure for improving fiscal sustainability.

Figure 2.6. **Fiscal sustainability requires increased pre-saving**
In per cent of GDP



Source: Ministry of Finance, *Stability Programme 2005*.

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The pension reform improves sustainability, but not by enough

A major reform of the pension system (Box 2.6) has been implemented from the beginning of 2005 and in the context of coping with the fiscal implications of imminent ageing the reformed system can be considered under three distinct, although inter-related, criteria: the effect on the length of working lives; the effect on fiscal sustainability; and the robustness of the system to future changes in longevity.

Incentives to prolong working lives may be blunted by the availability of early retirement schemes

The pension reform does provide financial incentives to extend working life, particularly through a higher rate of pension accrual from the age of 63 and the abolition of the ceiling on the maximum pension. However, as discussed in Chapter 3, these incentives may be blunted by the continued availability of early retirement options, particularly through unemployment and disability.

Pension contributions still rise by too much

As a result of the reform the required increase in the pension contribution rate has been reduced, but, as mentioned above, is still projected to rise by 6% of private sector wages by 2030. Given the government's objectives to reduce labour taxes and the fact that contribution rates are already high by international standards, this still appears excessive. This projected future increase in the contribution rate occurs despite significant pre-funding which was further increased by the reform. The projected increase in the contribution rate highlights some elements of the reform package that appear unduly generous. In particular, increasing the accrual rate from the age of 53 and extending the accumulation period to non-paid periods (such as periods of study) will probably have little effect on work incentives, but will have a substantial cost.[2] Eliminating these two elements of the reform could reduce contribution rates by nearly 4 percentage points by 2050 (OECD, 2003; Finnish Centre for Pensions, 2002).

The introduction of a life-expectancy adjustment reduces longevity risk

The introduction of a life-expectancy coefficient will automatically adjust pension generosity to longevity. From 2010 onwards benefits will be indexed on life expectancy so that benefit levels will be adjusted to ensure that the present value of benefits does not increase as life expectancy increases. Given repeated under-estimation of increases in life expectancy in the past (Lindell, 2003) as well as continued uncertainty about future trends, this represents a valuable innovation in managing one of the main risks relating to future pension costs.[3]

Raising the rate of return on pension assets

Currently the portfolio holdings of the pension funds entail a relatively low level of risk with bonds representing about half of the portfolio and equities around 30% (Ilmakunnas and Vanne, 2004). However, the share of both equities and foreign investments has increased substantially since 1997 and following a recent report from the Finnish Pension Alliance (TELA)[4] a further recent relaxation of portfolio constraints will be introduced which may help to raise the rate of return on pension funds.

Box 2.6. **An overview of the pension system**

The public pension system (the first pillar) comprises two statutory pension schemes: the national pension scheme guaranteeing a minimum pension to all residents and an employment-based, earnings-related pension scheme. Currently the national pension is of minor importance to most retirees. Voluntary pension schemes (the second and third pillars) also play a minor role due to the relatively high net replacement rate of public pensions and full coverage of the system.

The statutory schemes are closely linked together, with the amount of the national pension depending on the size of the earnings-related pension benefits. Increases in the earnings-related pension reduce the national pension by 50%. If the earnings-related pension is above a defined level, the national pension is not paid at all. Payments in statutory pensions amounted to 11½ per cent of GDP in 2004, of which the employment-based earnings-related pensions accounted for 84% and the basic national pensions for the rest. In the future, the role of the national pensions in the total pension coverage will diminish, as the level of earnings-related pensions will rise.

Means-tested *national pensions* are administered by the Social Insurance Institution. These pensions are financed on a pay-as-you-go (PAYG) basis by contributions paid by employers (49%) and by a state share (51%). The purchasing power of national pensions is kept intact by indexation to the consumer price index (CPI).

The *earnings-related pension system* is based on a tripartite arrangement, consisting of employees, employers and the government. There are several different Acts, the Employees Pensions Act forming a framework Act. The self-employed are also covered. There are about 60 authorised pension providers of different sizes. The Finnish Centre for Pensions is the statutory central body for private sector pension schemes. The Ministry of Social Affairs and Health is in charge of the supervision of the earnings-related schemes. Employees in central and local government have their own earnings-related schemes. The schemes for central government employees are managed by the State Treasury under the general supervision of the Ministry of Finance, whereas the Local Government Pensions Institute administers the scheme for local government employees.

The financing of earnings-related pensions is a combination of a PAYG system and a funded system based on pension contributions from both employers and employees. The PAYG system covers approximately three-quarters of the earnings-related pension outlays, and the funded scheme covers the rest. Despite the partially funded pension system, the earnings-related pension scheme is entirely of a defined-benefit type. The funding is collective in the sense that it has no effect on the size of the pension. The main purpose of the funding is to smooth the future rate of pension contributions.

Following the recently introduced pension reform the retirement age is flexible (62-68) and pensions accrue from the age of 18 to 52 at the rate of 1.5% of wages a year, from 53 to 62 at 1.9% and from 63 to 68 at 4.5% a year without any cap. There are two indices in the earnings-related pension system. The first index adjusts past earnings to the present level when calculating the pension at the time of retirement. This wage coefficient puts a weighting of 80% on changes in wages and 20% on changes in prices. The other index, the earnings-related pension index aims at keeping the purchasing power of earnings-related pensions ahead of inflation. This index has a weighting of 80% on changes in prices and 20% on changes in wages. The life expectancy coefficient adjusts the pensions to be paid to the changes in longevity as of 2010.

Statutory pensions are taxed as earnings-based income (progressive tax rate) with special deductions applying for smaller pensions. The contributions to pension schemes and investment incomes of the pension providers are exempt from taxation. The taxation arrangement of earnings-related pensions is of the exempt-exempt-taxed (EET) type. Tax treatment of supplementary pensions arranged by the employer is the same as that of statutory pensions, except for certain restrictions related to the retirement age.

Ensuring fiscal sustainability will require continued efforts to contain spending pressures

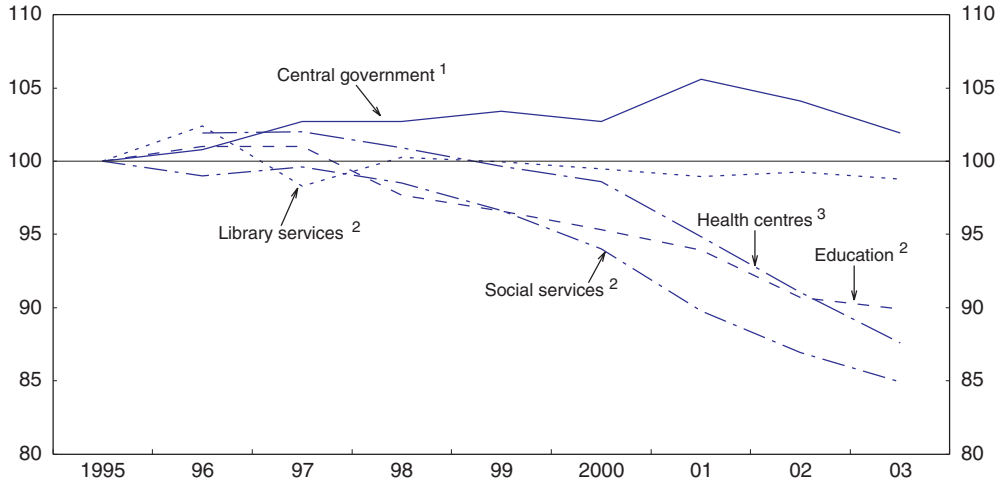
To improve future fiscal sustainability, pressures on government spending need to be relieved by taking policy actions across a broad range of areas.

Raising productivity in public services

In international comparison Finland's public services are generally very cost effective. Particularly noteworthy is the consistently top ranking in educational attainment despite relatively modest expenditure outlays (OECD, 2005a), but health outcomes are also generally good in relation to the relatively modest share of GDP devoted to health expenditure (OECD, 2005b). Nevertheless, further improvements in public sector productivity growth (especially health) would significantly improve long-term fiscal sustainability, and possibly by more than the pension reform (Kinnunen, 2002). However, there has been a persistent decline in productivity across a range of public services since the late 1990s, with pronounced declines in education, social services and, more recently, health centres (Figure 2.7). On the other hand, productivity performance in central government has been more positive, probably reflecting the greater scope to apply information technology (IT) to administrative functions which are more concentrated in central government. Thus, despite the growing share of public spending in GDP, the rise in inputs has not been matched by a corresponding rise in measured outputs. The government has already launched a wide-ranging programme to boost public sector productivity through administrative simplifications, better use of IT and increased exposure to competition (discussed in the previous *Survey*).

Figure 2.7. **Productivity in public administration and services**

Index 1995 = 100



1. Includes also administrative functions and services such as the police which are localised across the country, but are part of the central government sector. Measured figures cover about 70% of the central government sector.
2. Provided by municipalities.
3. Average levels of productivity weighted with expenditure. Different years do not necessarily include same units.

Source: Statistics Finland; Räty, T. *et al.* (2005), "Productivity and its Drivers in Finnish Primary Care 1988-2003", *VATT Research Reports*, 118.

Containing costs and improving value for money in the health system

While government spending on health as a share of GDP is relatively modest compared with many OECD countries, the share of health spending in GDP has started to trend upwards since 2000 after declining throughout the 1990s and is likely to come under increasing pressure from ageing. A recent OECD review of the health system (OECD, 2005b) suggested a number of areas where there is scope to improve financial sustainability as well as value for money:

- The share of drugs in total health expenditure has risen faster than in other Nordic or OECD countries over the last decade. To better control such expenditure consideration should be given to: transferring the responsibility for the re-imbursement of medicines from KELA (the Social Insurance institution) to the municipalities and employers; introducing physician-specific drug budgets in health centres; and developing better evaluation of the most important new drugs.
- While Finland ranks well in international comparisons of hospital efficiency, there is high variability across hospitals suggesting considerable scope for further improvements. The operational efficiency of hospitals could be improved by: reducing the number of hospital districts, separating the purchasing of specialist services from their provision; and making hospitals self-governing, subject to good performance.
- Market-testing should be made compulsory for all hospital support services.
- Free entry for retail pharmacies should be allowed and retail margins should be set competitively.
- Waiting times for elective surgery are among the longest in the OECD, although they have been falling recently. Financial incentives could be improved for surgeons and managers by making remuneration depend at least partly on a fee per-service basis rather than a fixed salary.
- To free up the time of doctors in health centres, consideration should be given to allowing nurses to prescribe for less serious cases, as well nurse-led telephone help services.

Increasing the use of contracting out

Private firms and non-profit institutions play a relatively small role in many social and welfare services, including in the provision of childcare and long-term care for the elderly and disabled. Figures relating to the late 1990s and 2001 suggest that close to 90% of places in nursing homes for the elderly as well as childcare places were in public institutions (OECD, 2004). This represents a very high share compared with most other OECD countries, especially outside the Nordic countries. And even among the Nordics, private institutions (receiving public funding) account for about 40% of childcare places in Norway (OECD, 2004). Moving towards a wider mix of providers is likely to raise efficiency by making service provision contestable and testing and spreading innovation and best-practice. A recent study found that municipal efficiency – measured with a range of volume indicators in heath, social and education services based on the combined input of providing (buying or producing) these services – was significantly higher in those municipalities where a large share of services was bought from the private sector and lower where services were bought from other municipalities (Loikkanen and Susiluoto, 2006). Given that both OECD and official long-term projections suggest that the future increase in public spending on

long-term care for the elderly is likely to be substantial, increasing the mix of service providers should be considered a particular priority in this area.

Central government productivity

Central government accounts for about one quarter of all government employment. As the average age of personnel is increasing as a result of ageing, personnel turnover is rising because of increasing retirements. The government has set the target of only filling two out of three new vacancies, consistent with productivity objectives in particular activities. While such an approach may appear crude, the experience of the early 1990s suggests that sharp reductions in inputs can lead to improved productivity growth.

Reforming the structure of municipalities

There are 432 municipalities and 231 joint municipal authorities that have the responsibility for the bulk of welfare services. The population of municipalities varies from a few hundred to more than half a million, although the average size is small at about 11 500 inhabitants, which is around one-third that in Sweden and one-half that in Denmark. A natural question is whether increasing the size of municipalities through merger would raise efficiency through greater scale economies. However, mergers have not always resulted in improved cost-effectiveness in the past (Moisio and Uusitalo, 2003). Moreover, recent research suggests that, other things being equal, larger populations tend to *reduce* efficiency in the municipal service provision, although the most prominent factor reducing efficiency was peripheral location (the weakest 10 municipalities were all found to be in Northern Finland, most of them in Lapland) (Loikkanen and Susiluoto, 2006).[5] Intriguingly, the three capital region cities also ranked relatively poorly, although this was not true of all cities. Other factors tending to reduce efficiency included diverse service structure (more common in larger municipalities), high unemployment, a high income level (implying higher wage costs) and a large share of services bought from other municipalities. A task force is due to report in mid-2006 at which time the government will decide on future structures for the financing, organisation and production of services with a view to legislating in 2007.

As wide differences in the efficiency in service provision exist across municipalities it is important that standardised information is made widely available so that the local population and politicians play an enhanced monitoring role. Considerable progress has been made in some countries, notably Norway, Sweden and the United Kingdom – in devising measures and ensuring that they are made publicly available (Sutherland *et al.*, 2005). Such benchmarking can have an important effect in spurring local government to follow best practice in service delivery.

Reforming the financing of municipalities

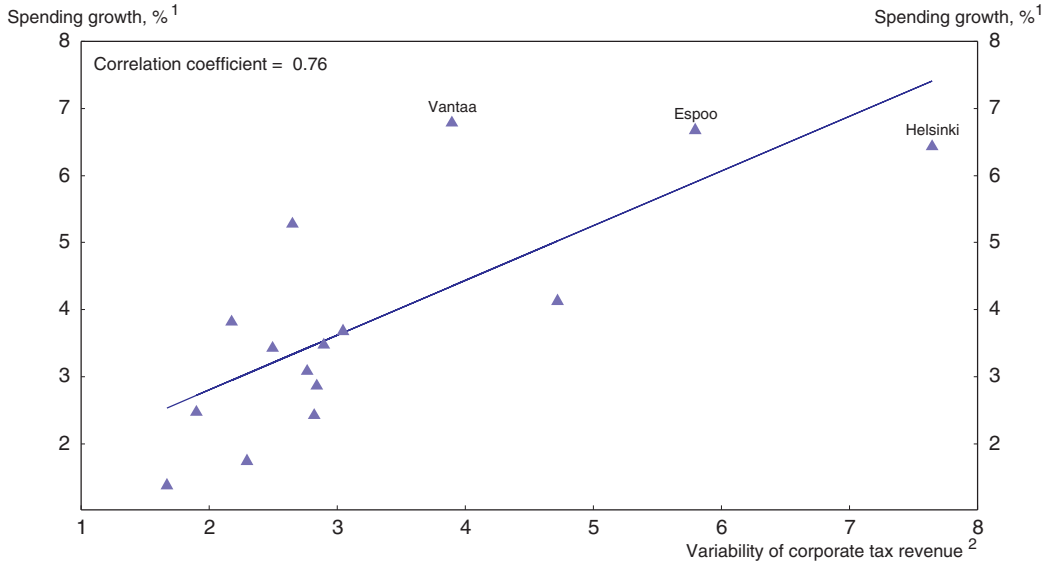
In the past legislation has required that state grants to municipalities are adjusted at four-year intervals if municipal spending on statutory tasks has increased faster than the state grant. The implementation of this rule would have implied an adjustment of about ¼ per cent of GDP in 2005 in the central government grant, which was more than the entire increase in the central government spending limit for that year. Consequently this adjustment is only being paid gradually over a four-year period and is then being abolished. This adjustment means that central government has been (inadvertently) under-writing much of the municipal expenditure increases, so its abolition is welcome. On the other

hand, one reason for the adjustment was to compensate municipalities for additional service obligations imposed on them by central government, implying central government will need to be more careful in future about expanding such service obligations where there are significant cost implications.

The continued increases in municipal spending and deficits raise concerns that they will lead to further increases in municipal income tax rates, which will frustrate the objective of reducing the overall tax burden on labour. Although each municipality is obliged to balance its budget over a three-year horizon, it has complete discretion to raise the income tax rate. One way to limit future pressures on labour taxes, while maintaining local autonomy to determine spending levels, would be to impose limits on the maximum municipal income tax rate while at the same time removing the existing maximum limit on the local property tax and widening the tax base to which it is applied (Chapter 6). Given different starting positions for different municipalities, such limits could be supplemented with a rule that any increase in the income tax rate must be accompanied by equivalent increases in the property tax rate.

Further reducing the reliance of the municipalities on corporate tax revenues might also help to contain spending pressures because there is some evidence of a ratchet effect among larger municipalities that spending increases permanently following cyclical rises in corporate tax revenue (Figure 2.8).

Figure 2.8. **Municipal corporate tax and spending growth**
15 largest municipalities, 1997-2003



1. Average annual growth from 1997 to 2003 of operation expenditure less corporate tax revenue, *i.e.* current spending which has to be financed from other revenues. Volumes based on GDP deflator.
2. Standard deviation of the ratio of corporate tax revenue to operation expenditure in the years 1997-2003.

Source: Ministry of Interior; OECD calculations.

Reconsider the priorities for public spending

To cope with future fiscal pressures from ageing there is a need to consider what the core welfare services are and whether future increases in service demand outside of this core can be met via increased private expenditure. Two areas highlighted in the previous

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Survey where there is scope for an increased role for private spending in the future are higher education and child care, where the policy objectives could be better achieved with less demands on public funding.

Tertiary education

While many countries in Europe are considering reforms to the financing of tertiary education to raise resources (OECD, 2004), Finland's total expenditure on tertiary education, at around 1¾ per cent of GDP, is already among the highest in Europe and is almost entirely publicly funded. There are, nevertheless, strong arguments on grounds of both efficiency and equity of moving in the direction of a graduate contribution system as implemented in New Zealand, Australia and the United Kingdom, where former students repay their tuition cost out of their income as graduates.

While there has been a recent proposal from a working group in the Ministry of Education to charge non-EU foreign students tuition fees from August 2007, students from other EU countries can only be charged if nationals also pay. Tuition fees would make students' demands for education attentive to the quality and subjects being offered, with subsequent effects on their supply. Similarly, higher education institutions would have clearer incentives to make their programmes more responsive to international demand if it became standard practice to charge all foreign students coming to Finland in pursuit of a partial or full degree. Despite the high global rankings of universities in Helsinki only 1¼ per cent of researchers in Finland are foreign compared to an EU15 average of over 4% (Prime Minister's Office, 2004). Tuition fees might also foster development of training for professionals based on co-operation between institutions of higher education and business firms in those industries where Finland has world leading capabilities such as paper, forestry, engineering and electronics.

Individuals with higher education benefit from a relatively high earnings premium, supporting the case for the introduction of tuition fees. Whereas the overall earnings distribution is very narrow, the differential between persons with a different level of education is fairly large. Econometric studies of the relation between education and earnings which control for other characteristics find that returns to education on average are higher in Finland than in other Nordic countries (Asplund, 2001; The Research Institute of the Finnish Economy, 2001; Uusitalo, 1999; Wössmann, 2003). This average disguises a "truncated" income distribution with little difference between those with little or no post-compulsory education, those with upper secondary and those with practically-oriented tertiary education. However, the earnings premium on tertiary education similar to an advanced university degree as compared with persons with upper secondary education only is large compared with other European countries.

Considerable support for students is provided in the form of grants for living costs, more so than in most OECD countries. In contrast, both Sweden and Norway provide most of the financial support for students' living costs in the form of loans. Changing the funding system could also reduce study times with beneficial effects on the employment rate (Chapter 5) as illustrated by a recent study finding that students take longer time to complete their studies in those European countries where the public share of higher education funding is largest (Brunello and Winter-Ebmer, 2003).

Student grants for tertiary education should be abolished while the maximum guaranteed loan amount should be raised in parallel. Going further by introducing

graduate contributions for tuition costs should also be considered as it would make it more attractive for highly-skilled foreigners to come and work in Finland.

Childcare

Childcare for children under the school age is provided either by municipalities, in which case parents pay a fee depending on their income, or by private institutions, in which case the parents receive a childcare allowance (effectively a voucher). In addition, for young children the parents can themselves care for the child at home and receive an allowance from the state. This system of childcare increases choice for parents, and generally appears to work well. However, in some municipalities an additional allowance is paid on top of the statutory childcare allowance which can create strong disincentives to work as well as making the system unnecessarily expensive (OECD, 2004). The system of childcare should be better co-ordinated across different levels of government to achieve fiscal savings and encourage increased private spending on child care. Also to contribute to the long-term financial viability of the childcare system, the role of family day-care services should be maintained where possible as such services are less costly than centre-based care services (OECD, 2005c).

Box 2.7. **Fiscal policy recommendations**

Fiscal policy

- Central government should adhere to its spending rules.
- The combined balance of central government and the municipalities should remain in surplus on a cyclically-adjusted basis for the rest of this decade. This would imply a general government surplus of 3-3½ per cent of GDP. On the current outlook and expenditure plans this is likely to rule out any further tax cuts although some change in the tax mix away from labour would be desirable.

Municipal finances

- Limit the municipal income tax rate increases at the same time as removing the existing maximum limit on the local property tax. Oblige municipalities to raise property tax rates by at least as much as any planned rise in income tax rates.
- Eliminate the municipal share of corporate tax revenues to improve the overall control of aggregate public finances by reducing cyclical fluctuations in municipal revenues which have tended to ratchet up municipal spending.

Raising productivity in public services

- Municipalities should strive to have a greater mix of providers in the provision of municipal services, particularly child care and long-term care of the elderly and disabled.
- To better control outlays on drugs within the health budget, consideration should be given to: transferring the responsibility for the re-imbursement of costs of medicines from KELA (the Social Insurance institution) to the municipalities and employers; introducing physician-specific drug budgets in health centres; and developing better evaluation of the most important new drugs.

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Box 2.7. **Fiscal policy recommendations** *(cont.)*

- While Finland ranks well in international comparisons of hospital efficiency, there is high variability across hospitals suggesting considerable scope for further improvements. The operational efficiency of hospitals could be improved by: reducing the number of hospital districts, separating the purchasing of specialist services from their provision; and making hospitals self-governing, subject to good performance.
- Reduce waiting times for elective surgery by making remuneration for surgeons and managers partly on a fee per-service rather than entirely a fixed salary basis.

Tertiary education

- Introduce tertiary education fees for all students while developing the loan system with income-contingent repayments while also maintaining public funding because of positive externalities.

Childcare

- The child care system should be better co-ordinated across different levels of government and more private spending on child care should be encouraged to achieve fiscal savings. In particular, additional childcare allowances paid by some municipalities, on top of statutory childcare allowance, should be reconsidered because they are expensive and may create strong disincentives to work. The role of family day-care services should be maintained as such services are less costly than centre-based care services.

Pensions

- Eliminate the higher pension accrual rate at age 53. Consideration should also be given to eliminating accrual rights during other non-work periods (such as periods of study) while using the social benefit system to ensure that financial support for such periods is appropriately targeted.
- Further restrict early retirement pathways.

Notes

1. Corporate tax revenues in Finland appear to be more sensitive to movements in asset prices than in most other OECD countries (Eschenbach and Schuknecht, 2002).
2. Allowing accumulation of such pension rights during periods of study also seems to work against the government's objective to reduce study times.
3. According to Alho (2003) life expectancy by the year 2050 will have increased within an 80% confidence interval of 2.3 to 9.1 years for women and 2.6 to 12.3 years for men.
4. The report chaired by Kari Puro was published in January 2006. One of its main conclusions was that the share of equity investments in employment pension insurers' investments could be increased from the current 25% to 35% over the next five years. This growth in equity investment is expected to increase the level of return and dampen the pressure to raise insurance payments by 1-2% in the long term. For further details see *www.tela.fi/*.
5. One important caveat to this study is that it excludes some services (*e.g.* transport and specialised health care) where scale economies are likely to be greatest.

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Chapter 3

Restrict early retirement to make the pension reform a success

A wide-ranging pension reform was introduced at the beginning of 2005. A central objective is to extend working lives by 2-3 years. However, success is likely to depend on further curtailment of early retirement pathways which will otherwise blunt the improved financial incentives to work longer in the reformed old-age pension system. The "unemployment pipeline" whereby the unemployed can effectively retire at age 57 should be abolished and activation measures for the older unemployed increased. There is also considerable scope to reduce the large share of the population on a disability pension, following experience of other OECD countries, particularly through better gate-keeping and greater emphasis on activation that involves early intervention combining both medical and vocational rehabilitation. Such an approach is also likely to improve the health and well-being of many of those directly concerned. Moreover, past experience suggests that early retirement pathways can amplify and perpetuate major adverse demand shocks, because the likelihood of returning to employment is low.

The introduction of a wide-ranging pension reform at the beginning of 2005 represents a major achievement. It involved a complex package of measures that achieved a wide degree of national consensus. As discussed in Chapter 2, the reform has a number of facets;[1] it improves financial sustainability and reduces risks by increased pre-funding and relating pension generosity to future changes in life expectancy; it introduces greater flexibility and fairness, by a closer link of pension benefits to lifetime earnings rather than earnings in the final years of a career; it improves financial incentives to postpone the retirement age through taking an old-age pension; and it further restricts some alternative early retirement pathways. However, the main message of this chapter is that this final element does not go far enough and without further action to restrict alternative early retirement pathways, especially through unemployment and disability, the government's target to raise the length of working lives by 2-3 years is unlikely to be realised.

Most new retirees currently do not retire on an old-age pension

In 2005 the expected number of years in employment (Box 3.1) for a 50-year old male was 9 years, well below the lower boundary of the new flexible retirement window in the old-age pension system, which runs from age 62 to 68. On the same indicator Finland was three years below the average of three other Nordic countries in 2002 (the latest year for which a comparison can be made) (Figure 3.2, panel A). The difference between the actual effective retirement age and the official retirement age is because around two-thirds of all new retirees retire early on some form of unemployment or disability benefit (Figure 3.2, panel B). Nearly one quarter of the population aged 55 to 64 receives a disability-related

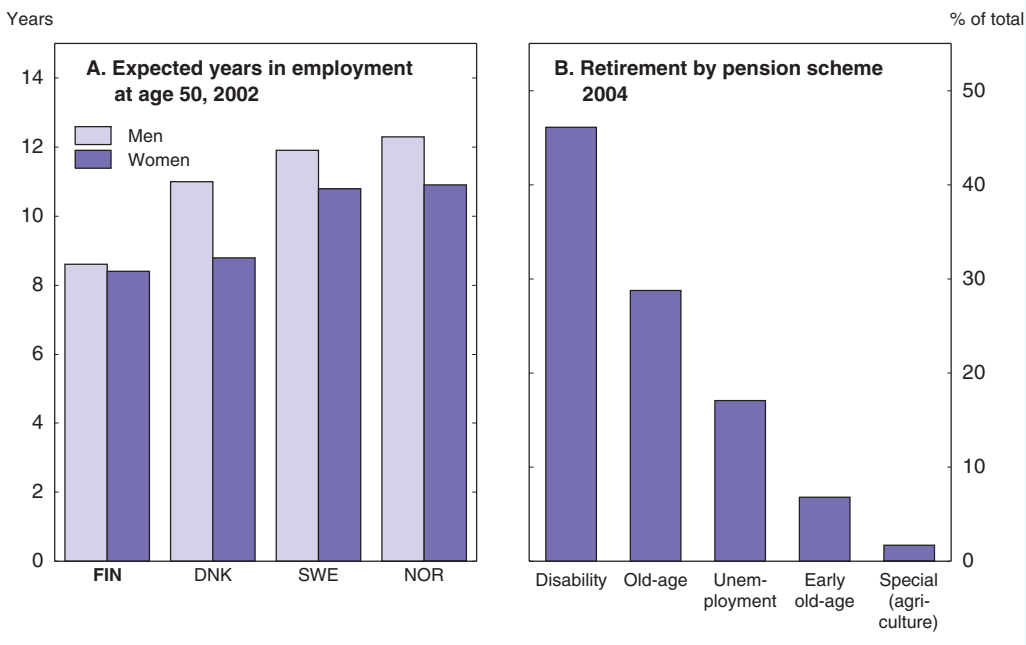
Box 3.1. **Measuring the length of a working life**

Given that extending working life is an important policy goal in Finland and more widely across the European Union and OECD, it is important to have a reliable indicator with which to monitor progress. The measures reported in the main text and Figure 3.1 correspond to a measure of expected time spent in employment or the labour force in preference to the standard EU indicator of the "average exit from the labour force" for reasons which are discussed in this box.

Eurostat regularly publishes an indicator for the average exit from the labour force based on changes in the activity rate for each cohort. On this basis Finland was just below the EU15 average in 2004 and well below the other Nordic countries. Hytti and Nio (2004) (hereafter H&N) have recently proposed an alternative indicator which effectively breaks down standard measures of life expectancy into a component spent inside the labour force (or in employment) and a component outside it. Both indicators clearly show that withdrawal from the labour market has been well below the official age of retirement; according to the latest Eurostat indicator for 2004 the average exit from the labour force was 60.5, whereas H&N calculate the expected time in employment and the labour force for a 50-year old is 9.0 and 9.7 years, respectively, in 2005.

Box 3.1. **Measuring the length of a working life** *(cont.)*

Figure 3.1. **Expectation of time spent in the labour market at age 50**
1990-2005



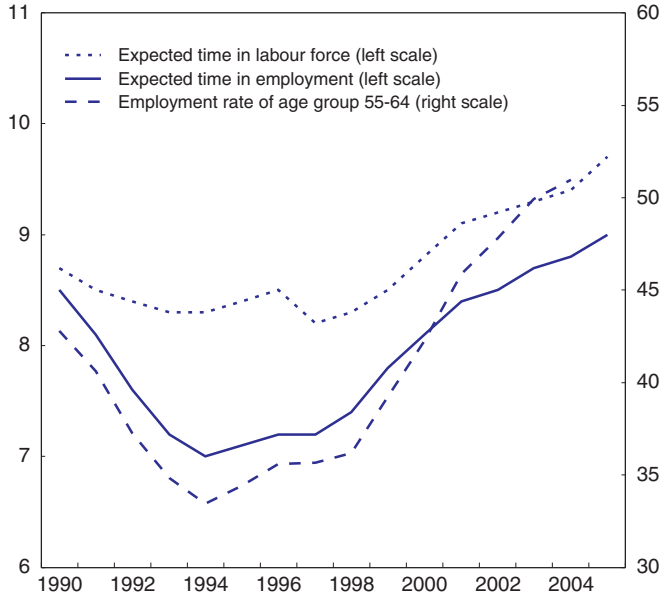
Source: Hytti, H. and I. Nio (2004), with updated figures for 2004 and 2005 direct from the authors.

There are, however, important differences in the indicators as regards their year-to-year movements. Apart from the attraction of being directly related to standard measures of life expectancy, a further advantage of H&N's indicator is that it is strongly correlated with the employment rate of older workers (Figure 3.1). Conversely the link with the employment rate is much weaker for the EU's indicator; Eurostat figures suggest that the average exit age from the labour market has *fallen* by nearly one year between 2001 and 2004 despite the employment rate for older workers (aged 55-64) having *risen* by 5 percentage points over the same period. H&N (2004) calculate a longer series for the EU indicator and show that over a longer period it exhibits implausibly large and erratic year-to-year fluctuations, with the average exit age often changing by more than one year. They point out a number of technical weaknesses which make the EU indicator unsuitable for monitoring the average exit rate for Finland: it assumes that activity rates do not rise as people grow older, whereas this occurs in 5% of the individual cohort observations for 1990-2003; it is particularly sensitive when employment trends are not progressing smoothly; it makes comparisons across countries and sexes difficult by relying on the activity rates of the 49-year olds as the basis of the calculations.

At least for Finland there appears to be a strong case for favouring an indicator of the type calculated by H&N over the current Eurostat indicator, although H&N argue that the EU indicator is likely to be more sensitive to errors for Finland than most EU countries.

Source: Hytti, H. and I. Nio (2004), "Työllisyysohjelman seuranta ja työssäoloajan pituus" (Monitoring the Employment Programme and the Length of Time at Work), *Työpoliittinen aikakauskirja*, 1/2004 and Hytti, H. and I. Nio (2006), "The Finnish Employment and Income Security Models in a Nordic Comparison", *Social Security and Health Research Working Papers*, The Social Insurance Institution, Finland (forthcoming).

Figure 3.2. **Expected years in employment and retirement by pension scheme**



Source: Hytti, H. and I. Nio (2006), "The Finnish Employment and Income Security Models in a Nordic Comparison", *Social Security and Health Research Working Papers*, The Social Insurance Institution, Finland (forthcoming); Eurostat; Finnish Centre for Pensions, *Statistical Yearbook of Pensioners in Finland – 2004*.

pension and a further 14% has effectively retired through unemployment (Table 3.1). This suggests that, if the average effective retirement age is to be raised, then use of these early retirement pathways needs to diminish. The remainder of this chapter first discusses the main early retirement pathways, as well as evidence of the linkages between them, before considering their likely interaction with the pension reform and the case for further reform of early retirement pathways.

Table 3.1. **Early retirement schemes and the effect of the 2005 reform**

	Target group	Beneficiaries aged 55-64 in 2004 (as % of age group)	Age restrictions	
			Prior to reform	After reform
Disability pathway				
Disability pension	Disabled	23.1	16-64	Relaxed medical requirements 60+
Individual early retirement	Sick and aged	0.4	60-64	Abolished
Unemployment pathway				
Unemployment pension	Long-term unemployed	7.9	60-64	Phased out from 2009
Unemployment pipeline	Long-term unemployed	5.8[1]	55-64	57-65
Conventional old-age pathway				
Early old-age pension	Older workers	0.2	60-64	62
Other pathways				
Agricultural pension	Agricultural workers	1.7	55-64	Unchanged
Part-time pension	Part-time workers	5.4	56-64	58-68

1. OECD estimate based on differences between the number of registered unemployed and the labour force survey measure of unemployment (which requires active job search).

Source: Finnish Centre for Pensions, *Statistical Yearbook of Pensioners in Finland – 2004;* Ministry of Labour, *Finnish Labour Review*; OECD calculations.

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Early retirement through unemployment

Prior to the recent reform early exit from the labour market was facilitated by the so-called "unemployment pipeline", whereby from the age of 57 the standard unemployment insurance period was followed by an extension to age 60, at which age an unemployment pension could be drawn. An unemployment pension is paid to those aged 60 to 65 who have been long-term unemployed and received unemployment benefits for the maximum period, which is 500 days. This means that the "pipeline" leading to an unemployment pension already started at the age of 55. A person aged 55 receiving an average wage who stops working benefits from a quite high initial replacement rate of about 60%. The unemployment pipeline is likely to lead to reduced employment of elderly workers. Firstly, employers target dismissals at elderly workers in the knowledge that a reasonable income level is secured for them; secondly without a risk of further benefit cut the elderly unemployed may be more passive in job search. There is strong evidence of the distortionary effect that this early retirement pathway had on incentives. The incidence of unemployment is calculated to be about twice as high for those who are old enough to qualify for the "pipeline", compared to those who are immediately below the age of qualifying for it (Ilmakunnas and Rantala, 2002). There is also a pronounced difference between the higher numbers unemployed according to the registration-based count and the labour force survey count for the relevant age group (Figure 3.3), because whereas registration is required in order to receive a benefit, a condition for inclusion in the labour force survey count is active job search. There would also seem to be tacit recognition of unemployment as an early retirement pathway; despite those aged over 55 representing

Figure 3.3. **Differences in the labour force survey and registration-based unemployment by age**[1]

2005

1. Unemployment expressed in percentage of the total population in the same age group.

Source: Ministry of Labour, *Finnish Labour Review*.

nearly half of the long-term unemployed in 2004, the same age group received only 9% of the wage-based subsidies under active measures and just 4% of the training-based active measures.

Following the reform the minimum age for qualifying for the "unemployment pipeline" rises to 57, and the unemployment pension will be abolished, but after the reform unemployment benefits can be drawn from the age of 57 up to 65 when certain conditions are met. The main effect of the reform should be to lower the incentive to stop working and claim unemployment benefit for those aged 55 and 56. However, the effect of the reform on those aged 57 and older is likely to be marginal.

Early retirement through disability

A main disability pension can be awarded to any person aged 16 to 64 who has lost at least two fifths of their work ability through illness, defect or injury, but also takes into account other characteristics such as education, age and previous work experience. An "individual early retirement pension" that was available to those aged 60 to 64, for which the medical eligibility conditions were less strict, will be phased out as a result of the 2005 reform. Despite the abolition of the individual early retirement pension the overall effect of the reform may, however, be negligible or even further encourage early retirement through disability. Firstly, the individual early retirement pension accounted for less than 5% of all new retirees taking a disability pension in 2004. Secondly, "social factors" rather than strictly medical conditions will be emphasised more in granting a disability pension for those aged over 60.

The proportion of the population on disability-related benefits is high, although less than in Sweden and Norway, and it has fallen, at least over the 1990s. The share of disability pensioners among the working-age population has fallen from just over 9% at the beginning of the 1990s to about 7½ per cent in 2000, although it has since stabilised at this level. On the other hand, much of this fall coincided with the progressive tightening in eligibility criteria as well as the exceptionally strong economic growth that took place over the 1990s, so it would be inappropriate to extrapolate this trend in the absence of further measures. In particular, between 1994 and 2000 the minimum age for the individual early retirement pension (which had less strict medical criteria) was progressively increased from 55 to 60 with a noticeable impact on the share of total disability pensions in the age group 55-59, although there was also a pronounced fall in the age group 60-64 (Figure 3.4).

As in most OECD countries a large share of the disabled suffers from diseases of the musculoskeletal system but the share with mental health conditions is growing (OECD, 2003); in 2004 one-third of disability pensioners had mental health conditions with growth over the last decade overwhelmingly accounted for by cases of depression.

Experience from other OECD countries suggests that there are at least two areas where reform should be considered, namely stricter gate-keeping and greater efforts at activation. Currently, an application for a disability pension can be made during the 300 weekday period of sickness with a medical report drawn up by any qualified medical practitioner of the applicant's choosing. Although the paperwork is then reviewed by medical staff appointed by the pension provider, the rate of rejection is low for older applicants: for those aged up to 44 the rejection rate is currently around one-third and has been steadily rising since 2000; for those aged between 55 and 59 the rejection rate has been stable at about 20% over the last decade. For those aged 60-64 it has fallen from about 10% in 2003 to only 7% in 2005,

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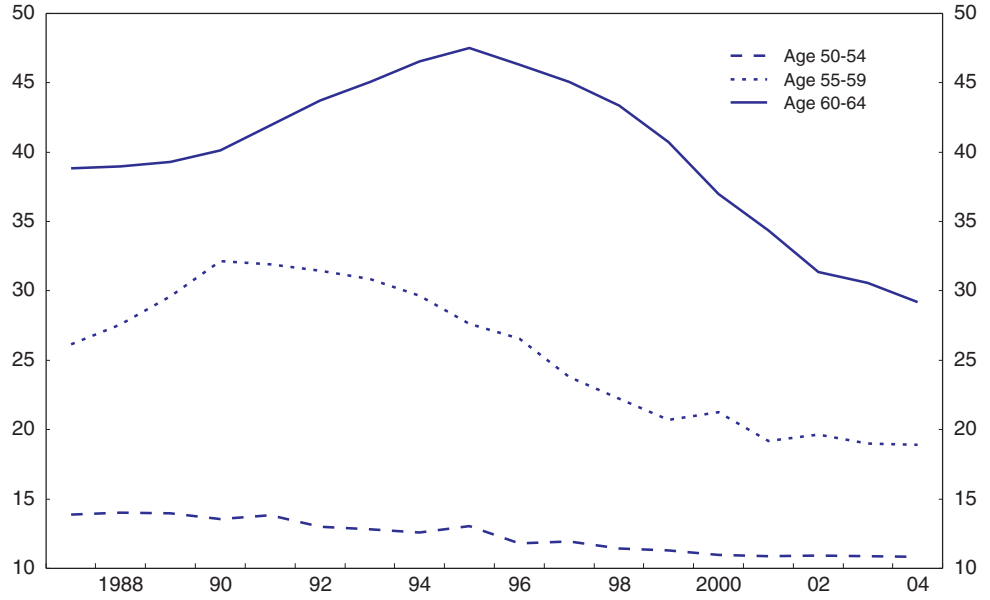
Figure 3.4. **Disability pensioners by age group**
Per cent of respective population groups



Source: Finnish Centre for Pensions.

reflecting the easier medical criteria under the individual early retirement scheme prior to 2005 as well as the greater weight which is given to social factors for this age group currently. However, experience from other OECD countries indicates that leaving the initial decision to an "anonymous" team results in more rational decisions, with less people found eligible than if the decision is left to the person's own doctor.

The activation rate for disabled "jobseekers" who are registered as unemployed is close to that for all unemployed jobseekers on active labour market measures (22% in 2003), and employment subsidies for the employment of people with disabilities can be granted for a maximum of 24 months at a time, rather than the usual maximum of 10 months. Nevertheless, the numbers of disabled on active measures is only 4% of the total stock of those on a disability pension, which is about half the average activation rate (on a similar definition) for an average of 17 OECD countries surveyed in 1999 and well below the leading countries, France and Sweden, where the activation rate is about 20% (OECD, 2003). The earnings pension scheme does provide for the possibility of rehabilitation, but although the use of rehabilitation grants has steadily grown over the last decade, the number of such grants covers only a small fraction (1½ per cent in 2005) of the total stock of disability pensioners. This is despite the fact that the rehabilitation schemes appear to be quite successful; in 2004 about 45% of those previously claiming a disability pension and two-thirds of those previously in employment were in employment after finishing vocational rehabilitation.

Recent experience from the United Kingdom suggests that placing greater obligations on those with less serious conditions to attend a series of work-focused interviews soon after they apply for a disability-related benefit can help the disabled back into work (Box 3.2). A further important difference between the recent successful pilot schemes in

Box 3.2. **A new approach helping the disabled to work: the UK's *Pathways to Work***

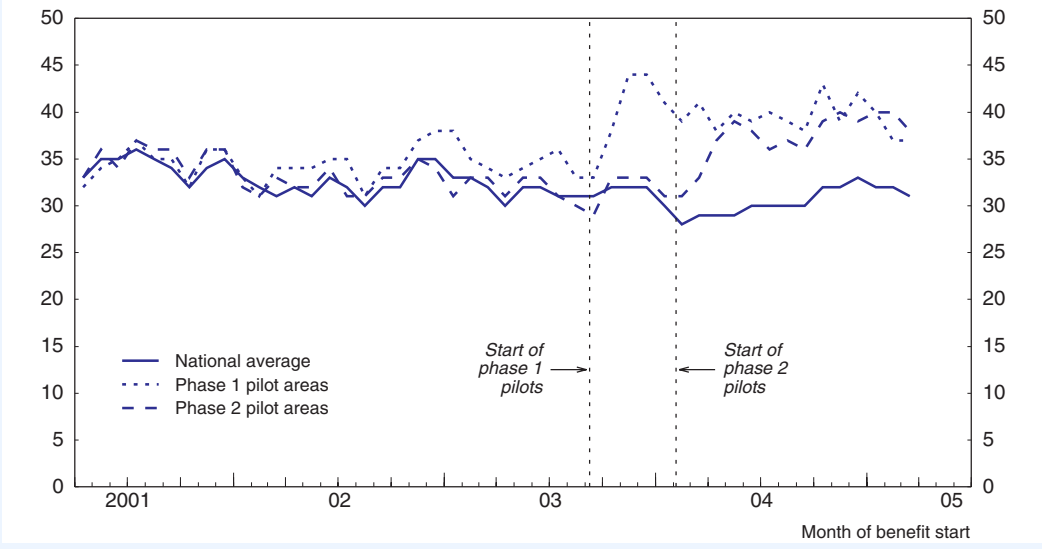
In the United Kingdom, like Finland, the share of the population claiming disability-related benefit is among the highest in the OECD. A new approach, *Pathways to Work*, targeting these benefit recipients, has recently been piloted in the United Kingdom with considerable success. The key features of this new approach are:

- most new incapacity benefit claimants are required to attend six, monthly, work-focused interviews soon after their move to incapacity benefit;
- specialist employment advice is offered in the form of new programmes run by the local health services to help manage their conditions and access to a range of tailored support;
- a supplement of £40 per week (about € 60) is paid as a return to work credit.

Covering 9% of the country at the beginning of 2005, the results of the pilots have been very promising, showing a several-fold increase in the number of claimants attending reintegration programmes and an increase in the likelihood for someone claiming incapacity benefit to leave benefits (Figure 3.5). Moreover, 10% of those taking part are existing incapacity benefit claimants who do so on an entirely voluntary basis – a sign that the approach is found to be helpful by the persons concerned (Blyth, 2006). Initial evaluation results have also been very encouraging, with both claimants and personal advisers welcoming the new approach. The Pathways to Work programme has been extended from October 2005 and by October 2006 will cover around a third of the country. The work-focused interviews have also been extended on a mandatory basis, from February 2005, to some existing claimants.

Figure 3.5. **"Pathways to Work" increases the off-flow from incapacity benefit**[1]

Six-month off-flow rate, per cent



1. The off-flow rates presented are produced from the Working Age Statistical Database (WASD). WASD does not include a proportion of short-term incapacity benefit claims, therefore the off-flows presented will be lower than the actual rates; however trends over time will be consistent.

Source: Department for Work and Pensions, January 2006.

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the United Kingdom and rehabilitation schemes currently operating in Finland, is that the former consider medical and vocational rehabilitation possibilities jointly. Arguably a combined focus might not only help the disabled back into work, but may also improve the health and well-being of those concerned. This may be particularly true for the growing numbers suffering from depression, given some evidence that the level of treatment prior to receipt of a disability pension for depression has in many cases been minimal with inadequate monitoring of subsequent treatment (Isometsä *et al*., 2000; Rytsälä *et al*., 2001), perhaps reflecting the reluctance of patients to seek continued treatment. Using a combination of medication and cognitive behavioural therapy, most people suffering from depression can be helped to a point where they can work most of the time; having something meaningful to do is also likely to benefit their health.

The early retirement pathway through a part-time pension

The part-time pension scheme was one of the most rapidly growing early retirement schemes – in the four years to 2002, it accounted for nearly 60% of the growth in all part-time jobs – although an increase in the minimum age limit from 56 to 58 has led to the number of part-time pensions falling slightly since 2002. The financial terms of the part-time pension were overly-generous; not only were beneficiaries compensated for half of their income loss due to the reduction in working time, but old-age pension rights continued to accrue at the same rate as if the person was working full-time at their previous level of earnings. Survey evidence suggests that a large proportion of part-time pensioners would have continued full-time work in the absence of a part-time pension, implying that the scheme was reducing effective labour supply. Following the 2005 reform the accumulation of pension rights from part-time retirement will be halved to make it more consistent with the rate of accumulation of a full-time pension, although a substantial subsidy element remains in terms of the compensation element paid for lower income.

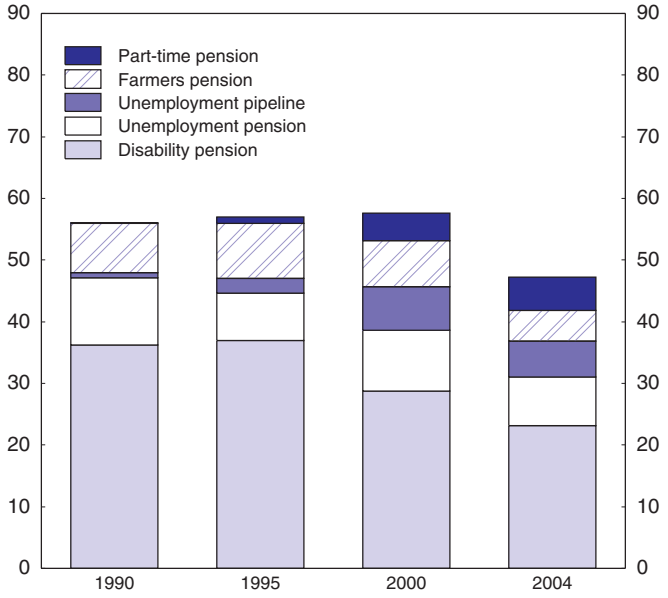
Linkages between the different early retirement pathways

The proportion of the age group 55-64 on all forms of early retirement schemes combined (including an OECD estimate of the numbers in the "unemployment pipeline") fell only slightly over the 1990s despite substantial changes to individual schemes (Figure 3.6). Although this overall proportion has fallen since 2000, it does raise the issue as to how far there is substitution between the various schemes. Of particular concern is that new restrictions on some early retirement pathways, but not others, may lead to switching.

Evidence for such switching would seem to be clearest between the unemployment and disability pathways over the 1990s:

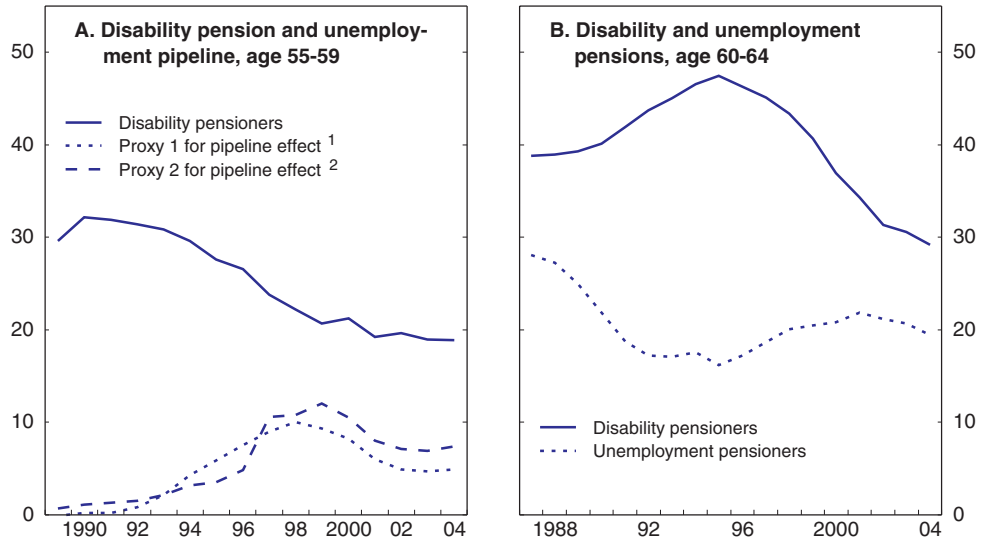
- There was a progressive fall in the proportion of the age group 55 to 59 on disability pensions following the gradual increase in the minimum age for the individual early retirement pension (which had less strict medical criteria) between 1994 and 2000. This fall corresponds quite closely with increased usage of the unemployment pipeline, where a proxy measure for the unemployment pipeline is based either on the difference between the registration-based and labour force survey unemployment counts or the difference in (registration-based) unemployment rates between successive age-groups (Figure 3.7, panel A). Further evidence of this link was found by Gould and Nyman (2002).

Figure 3.6. **Early-retirement beneficiaries**
As a percentage of the population aged 55-64



Source: Finnish Centre for Pensions, *Statistical Yearbook of Pensioners in Finland – 2004*.

Figure 3.7. **Linkages between early retirement pathways**
Per cent of respective population groups



1. Difference between the jobseeker unemployment rate of those aged 55-59 and those aged 50-54.
2. Difference between the jobseeker and Labour Force Survey unemployment rates for those aged 55-59.

Source: Finnish Centre for Pensions and Ministry of Labour, *Finnish Labour Review 4/2005*.

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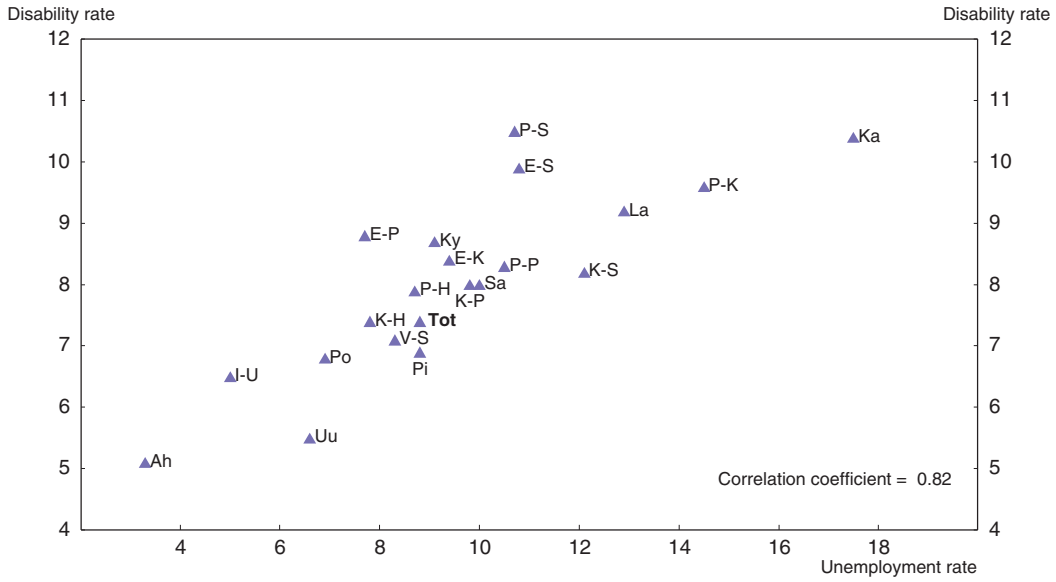
- It is also striking that the share of disability pensioners among 60 to 64 year olds mirrors the share of unemployment pensioners which is restricted to the same age group (Figure 3.7, panel B).

A further factor suggesting strong links between the unemployment and disability pathways is that there is a strong positive correlation across regions between regional unemployment rates and disability pensioners as a proportion of the working-age population (Figure 3.8). Although both may be linked to the industrial structure of a region, for example both being high where heavy manual work has been predominant, the growth in the incidence of mental health disorders among disability pensioners suggest that this can only be partial explanation.

Figure 3.8. **Regional correlation between unemployment and disability rates**[1]

2004



1. Disability rates are calculated as the number of recipients of a disabilty pension in a region divided by the population of working-age.

Source: Ministry of Labour; KELA, *Suomen Sosiaaliturva*.

The reform of the old-age pension system increases incentives to work longer

The reform which has begun to be implemented from the beginning of 2005, increases financial incentives to retire later on an old-age pension, mainly through:

- the introduction of a flexible retirement age between 63 and 68, including an early retirement option at age 62, but with a sharp rise in the accrual rate of pension rights after reaching the age of 63 to 4.5% (compared to 2.5% for those aged over 60 under the previous system);[2]
- the abolition of the ceiling on the maximum pension (which was equal to 60% of the highest pensionable wage earned during the career), which for someone with a typical work history was likely to mean that the pension did not increase by working beyond the early 60s.

Given the extent of the reform, not just to the parameters but also to the overall system, it is difficult to predict the overall effects of the change on retirement behaviour,

particularly since many of the changes will only be phased in gradually. One area for concern is that by presenting workers with a flexible window for retirement, there is no clear way of signalling that working lives should be extended in response to increasing life expectancy (Börsch-Supan, 2005). Indeed the lower age, 63, of this window (or 62 if the early retirement option is exercised) is lower than the previous official retirement age of 65 and experience from other OECD countries suggests that most retirements tend to cluster around the lowest age of any flexible retirement window.

Nevertheless, from the little experience of the new pension system that is available it is possible to glean some signs of encouragement. With the introduction of the new system in 2005 those aged 63 and 64 became eligible to retire under a full old-age pension, whereas under the previous system they would have had to work to 65 to get a full old-age pension. The number of potential new retirees in this age group was 45 000 in 2005 (about 28% of the total population in this age group, the remainder having already retired) of which 16 000 were new retirees in 2005, which is more than the 11 000 new retirees that would have been predicted under the previous system, but represents less of an increase than might have been expected. It is, however, too early to be confident about the effects of the new system on incentives of older workers to postpone retirement, especially because labour demand was particularly buoyant throughout 2005.

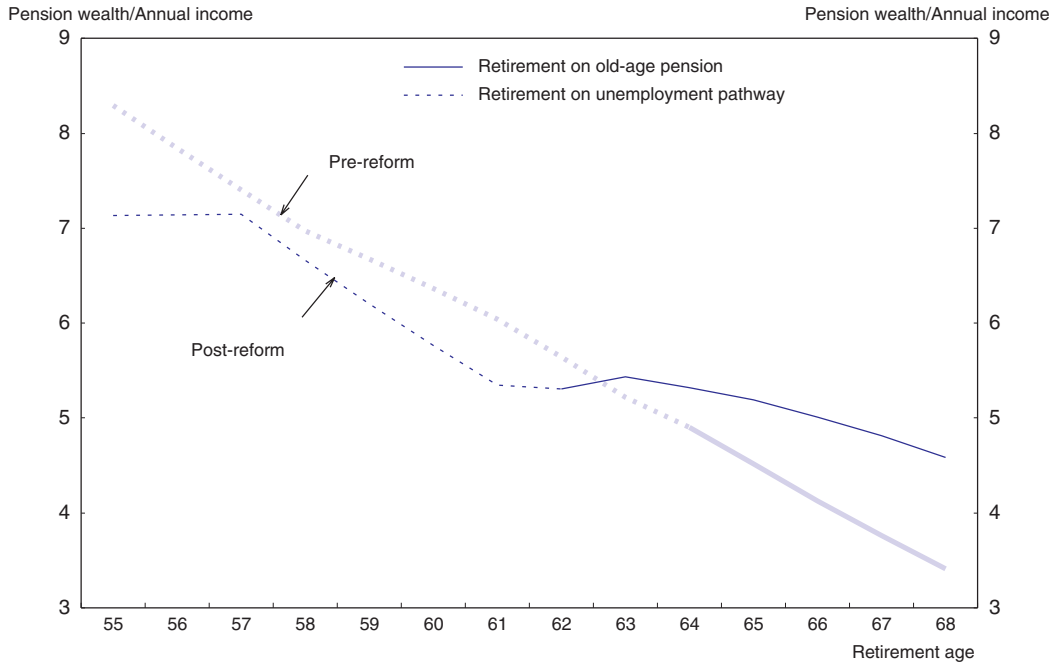
But these will be blunted by continued access to other early retirement pathways

While this evidence might suggest that someone still working in the early 60s may be encouraged to continue to work into the mid-60s or beyond, a more crucial issue remains whether many workers will continue to effectively retire before they reach the 60s using alternative early retirement pathways. Certainly the financial incentives, considered in terms of the replacement rate or the accumulation of pension wealth, to use either the unemployment or disability early retirement pathway appear strong.

The attraction to an older worker of delaying unemployment until the qualifying age for the unemployment pipeline is demonstrated by replacement rate calculations. Currently the unemployed at aged 57 (formerly 55, prior to the 2005 reform) will be eligible for an earnings-related unemployment insurance benefit until they retire on an old-age pension, typically implying a replacement ratio of around 55%; whereas a worker retiring at any earlier age will get the same earnings-related unemployment insurance benefit for 500 days, but then followed by the much less generous labour market support with a replacement rate of about 20% to 25%. However, a more complete evaluation of the attractiveness of unemployment as a pathway to early retirement should also account for the other means-tested benefits which are available, which tends to raise the replacement rate (Chapter 5),[3] as well as how this affects the accumulation of pension wealth for eventual retirement on an old-age pension.

The optimal timing for retirement can be examined from the perspective of how the accumulated value of pension wealth and benefits evolve for a representative worker for a range of retirement ages from age 55 onwards (Figure 3.9).[4] For the sake of simplicity two alternatives are considered: the early retirement unemployment pathway up to the age at which an old-age pension can be drawn (considered to be 62 under the new system and 64 under the previous system[5]) and the old-age pension subsequently. All future pension wealth is discounted from the perspective of an individual aged 55 assuming a discount rate of 3% and current survival rates. If the discounted value of pension wealth is rising

Figure 3.9. **Net present value of benefits by retirement age**



Source: OECD calculations.

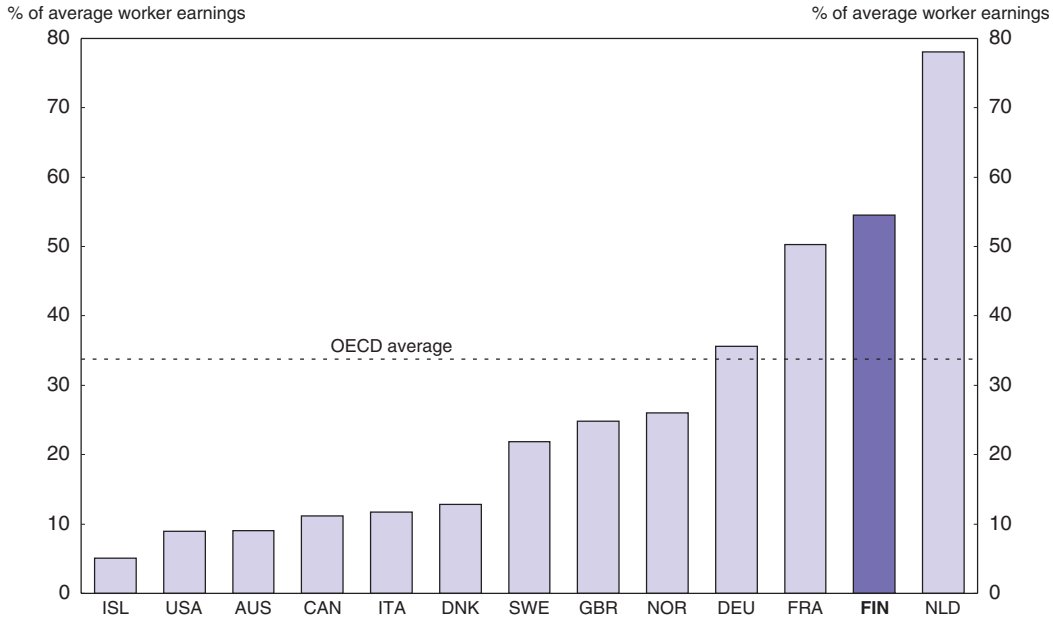
then the worker will have a financial incentive to postpone retirement. Notwithstanding the stylised nature of these calculations a number of features of the pension reform stand out:

- Under the previous pension system there was a strong incentive to retire early using the unemployment pipeline from age 55, since from all subsequent ages pension wealth decreases. The old-age pension failed to generate a superior pension wealth partly because of the ceiling on the maximum pension.
- Under the new pension system there remains a strong incentive to retire early using the unemployment pipeline from age 57, with pension wealth falling if retirement is postponed to age 61. Thereafter, as the individual is considered to retire on an old-age pension from age 62 the present value of pension wealth does not decline, and there is an incentive to retire at age 63 or 64. On the other hand, pension wealth does not rise sharply by continuing to work beyond age 62 – the sharp rise in the pension accumulation rates is barely sufficient to compensate for the assumed discount rate of 3% and the survival probability. Indeed, for this stylised case, the value of pension wealth from retiring at age 57 using the unemployment pipeline exceeds that of retiring on an old-age pension at any age, suggesting that the former will remain an attractive option.
- Comparing pre- and post-reform systems, the incentives to work longer for a worker in the early 60s are clearly improved by the reform. On the other hand, for a worker in the late 50s the incentives to continue working into the early 60s remain weak, except that the shortening of the unemployment pipeline from age 55 to 57 should postpone retirement by this route.

The incentive to retire early using the unemployment pipeline can be summarised in terms of an "implicit tax on continuing work". If the change in net pension wealth from

working an additional year, and so forgoing an extra year of pension and paying a further year of contributions remains unchanged, then the system is neutral, but if it falls then the system imposes an implicit tax on continuing work.[6] The implicit tax on continuing to work into the early 60s rather than taking the unemployment early retirement pathway at age 55 exceeds 50%, which is still high compared with most OECD countries (Figure 3.10). There is strong cross-country empirical evidence to suggest that the higher this implicit tax rate the steeper the decline in the participation rate of older workers (OECD, 2005). Judged simply by the slope of scatter plots relating this implicit tax to changes in the participation rate, each 10 percentage point decline in the implicit tax reduces the fall in the participation rate by 3 to 4 percentage points between consecutive five-year age groups.[7] Moreover, if the participation rate of workers in their late 50s was boosted then there is more likely to be a positive effect on the participation rate of workers in their mid-60s who are encouraged to continue working by the higher accrual rates from age 62.

Figure 3.10. **Implicit tax on continued work at age 55**
2003



Source: OECD, *Economic Policy Reforms: Going for Growth, 2006*, Figure A.4.

Reforming early retirement pathways to improve resilience

A further important reason for restricting access to early retirement pathways is that it may perpetuate an adverse demand shock to the labour market. This is most apparent in the usage of the unemployment pathway following the deep recession in the early 1990s. While the previous analysis has focused on the incentives for early retirement from a labour supply perspective, these incentives were also in existence before the recession and yet the unemployment rate for the age group 55 to 59 was close to those for younger age groups. However, during and following the recession the unemployment rate for the 55 to 59 age group increased more than for other groups and by the mid-1990s having increased to well over 20%, about double the rate of the 50 to 54 age group. Job loss after the eligibility

age for the pipeline often leads to permanent withdrawal from the labour market. This can be illustrated by the contrasting histories of employees in two age groups 54-64 and 40-45 who became unemployed in 1992 (Hakola and Uusitalo, 2001): of the older group, which was immediately eligible for the pipeline, only 8% where re-employed with this share further decreasing over time; whereas 32% of the younger group were re-employed within a year, with the share re-employed steadily rising over time.

Summary and recommendations

There may be understandably little appetite to revisit the issue of pensions so soon after a major reform package has begun to be implemented. However, there is clearly an important distinction to be drawn between early retirement pathways and the old-age pension system, with a further overhaul of the former urgently needed to give the recently introduced reforms the best chance of success in increasing the length of working lives. Experience across OECD countries amply demonstrates that easy access to generous early retirement pathways will lead to lower labour force participation and reduced employment of older workers. Furthermore, Finnish experience over the last decade demonstrates that tightening access can have powerful effects on the employment rate of older workers. A further argument for reform is that in their current form the early retirement pathways risk perpetuating the effects of adverse shocks. Finally increased efforts to activate a larger share of the population on disability benefits where rehabilitation emphasises both vocational and medical aspects may improve the health and well-being of those most directly concerned. Detailed recommendations are provided in Box 3.3.

Box 3.3. **Recommendations for the reform of early retirement pathways**

The general approach to reform should be to return unemployment- and disability–related benefits to the purpose they were originally designed for, rather than allow them to be used as alternative pathways for early retirement.

- Phase out the unemployment pension more quickly rather than waiting until 2009. Also phase out the unemployment pipeline.
- Raise the activation rate for older unemployed job-seekers much closer to that for other age groups.
- The disability pension should be awarded purely on medical grounds rather than giving greater emphasis to “social criteria” as under the pension reform.
- The decision to award a disability pension should be made entirely by an “anonymous” team rather than the initial medical report being drawn up by a medical practitioner of the patient’s own choosing.
- For those with more manageable medical conditions regular participation in work-focused interviews and training or activities to help the person better manage their health condition should be mandatory. In any case rehabilitation programmes should include both a medical and vocational aspects. Consider also introducing financial incentives for the disabled to take up work again.
- The compensation for reduced earnings available under the part-time pension should be abolished. Instead greater flexibility to combine a part-time pension with work might be considered, but without a subsidy.

Notes

1. See Börsch-Supan (2005) and OECD (2004a) for an overview and further details of the entire pension reform.
2. From the age of 63 pensions are calculated according to the accrued rights. Between 62 and 63 the pension will be reduced by 0.6% for each month of early retirement prior to 63. The accumulation rate remains at 1.5% a year between age of 18 and 52, increases to 1.9% between 53 and 62 and then rises to 4.5% between 63 and 67 (this compares to the previous rates of 1.5% between age 53 and 59 and 2.5% for those aged over 60).
3. Considering the availability of other means-tested benefits also tends to reduce the difference between the average replacement rate at ages before and after the qualifying age for the unemployment pipeline.
4. This approach follows Börsch-Supan (2005), although an important difference is that pension contributions here are not deducted from pension wealth, although this adjustment is made in subsequently calculating the implicit tax on continued work.
5. Under the previous pension system, retirement on a reduced old-age pension was available to a worker from the age of 60, but for this stylised example retirement on an unemployment pension up to the age of 64 is clearly a superior alternative in maximising pension wealth.
6. The implicit tax between any two ages is the decline in pension wealth between these two ages shown in Figure 3.9 plus the accumulated pension contributions up to the age of retirement.
7. More comprehensive empirical analysis based on panel data regressions points to a lower effect about one-third as big, the difference partly reflecting an independent effect from eligibility ages on the labour force participation of the over 60 age group. However, Duval (2003) argues that there may be reasons that the more elaborate empirical analysis underlying such calculations underestimates the true effects of changes in retirement incentives.

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Chapter 4

Increasing flexibility in centralised wage agreements

The centralised wage agreements have helped to contain inflation. There is evidence that wage increases were more moderate when a central agreement was concluded than in periods when no central agreement was reached. Nevertheless, there is also evidence that centralised wage setting has had some drawbacks in terms of reducing employment among low-skilled and younger workers because of high minimum wage floors. In the current wage setting system there are components that allow for greater relative wage flexibility. These should be used more extensively. The role of the government in future agreements should be to encourage greater relative wage flexibility within the current bargaining framework.

Introduction

Wage setting in Finland is characterised by a high degree of centralisation and co-ordination between union and employers' federations. Together with the Finnish government, they conclude tripartite income policy agreements covering not only wages but also employment policy, pension schemes and taxation. These tripartite income policy agreements date back to 1968 and usually last from one to two years, the agreements setting out the guidelines for the collective agreements between trade unions and employers' associations. This chapter reviews first the macroeconomic benefits and then the microeconomic costs of these income policy agreements. This provides the context for considering what the government's role should be in the next agreement.

The current income policy agreement for 2005-07

At the end of 2004 the union and employers' federations together with the government signed a tripartite income policy settlement for the years 2005-07 which is in force until the autumn of 2007. The pay increases are of a mixed nature for the first year and percentage-based for the second year. The agreement provides for an increase of € 30.06 a month or at least 1.9% in the first year and an across-the-board 1.4% in the second year. A union-specific element, which allows part of the wage increase to be negotiated at the local level, is paid in each of the years, first 0.6% and then 0.4%. An equality increment of 0.3% is paid in the second year in low-pay sectors, where pre-dominantly women are employed. This mixture of flat rate and percentage increases results in proportionally higher increases for people with low pay, reflecting the "solidarity" aspect of Finnish wage-bargaining. The union-specific element varies according to the details of the collective agreement concerned.

In the current wage agreement an indexation clause is included allowing for additional nominal wage increases contingent on consumer price index (CPI) inflation. This clause states that if between October 2004 and October 2005 consumer price inflation exceeds 2.6%, then wages should be raised by an amount corresponding to the percentage exceeding this threshold at the next general increase, though only if inflation was more than 0.4% above the threshold (*i.e.* at 3%). This clause was not invoked because CPI inflation remained well below the threshold and was expected not to exceed it. A rationale for this type of clause is risk sharing between firms and employees; contingent on workers being more risk-averse than firms this type of real wage insurance could be justified in wage bargaining.

A more appropriate deflator for assessing real wage cost from the point of view of the employer is the output price, which has consistently undershot the private consumption deflator and also to some extent CPI inflation. Thus supplementary nominal wage increases contingent on consumer prices widen the wedge between the consumer real wage and the real wage cost of employers and may have adverse employment effects. Furthermore, following a large adverse supply shock, such as an oil price rise, indexation of

nominal wages to consumer prices aggravates the direct negative employment effects of the shock.[1] In the current agreement there is a general escape clause stating that if the price rise is due to special external causes, the labour market partners can agree on using the indexation clause in another way. This reduces the risk that large term-of-trade shifts lead to a triggering of the indexation clause.

Macroeconomic benefits in terms of lower inflationary pressures

Empirical and theoretical research generally supports the view that countries with more centralised and/or co-ordinated wage-bargaining systems tend to have lower aggregate wage outcomes than countries where bargaining takes place at the industry level (OECD, 2006; Calmfors and Driffill, 1988; Flanagan, 1999). During the past 30 years most wage settlements were negotiated at the national level between union and employers' federations, often with government involvement. The coverage of the central agreement varies because the share of local trade unions that accept the central agreement varies from year to year, but generally the coverage has been wide. Nevertheless, in seven wage setting rounds no central agreement was reached (in 1973, 1980, 1983, 1988, 1994, 1995 and 2000). However, the absence of a central agreement does not imply that there is no co-ordination in wage-bargaining. Many industry-level wage bargaining rounds result in similar wage increase across industries (Uusitalo, 2004). The reason is that typically one of the larger unions reaches an agreement first and then the subsequent agreements do not differ much from the first agreement (so-called "pattern-bargaining").

There is evidence that both agreed and actual nominal wage increases are lower when bargaining takes place at the national level (Uusitalo, 2004). The average wage increase was 1.8 percentage points lower during the centralised bargaining rounds and the difference is even larger, 4 percentage points, when comparing centralised settlements with wide coverage and decentralised settlements, even after allowing for differences in inflation and unemployment (Uusitalo, 2004).[2]

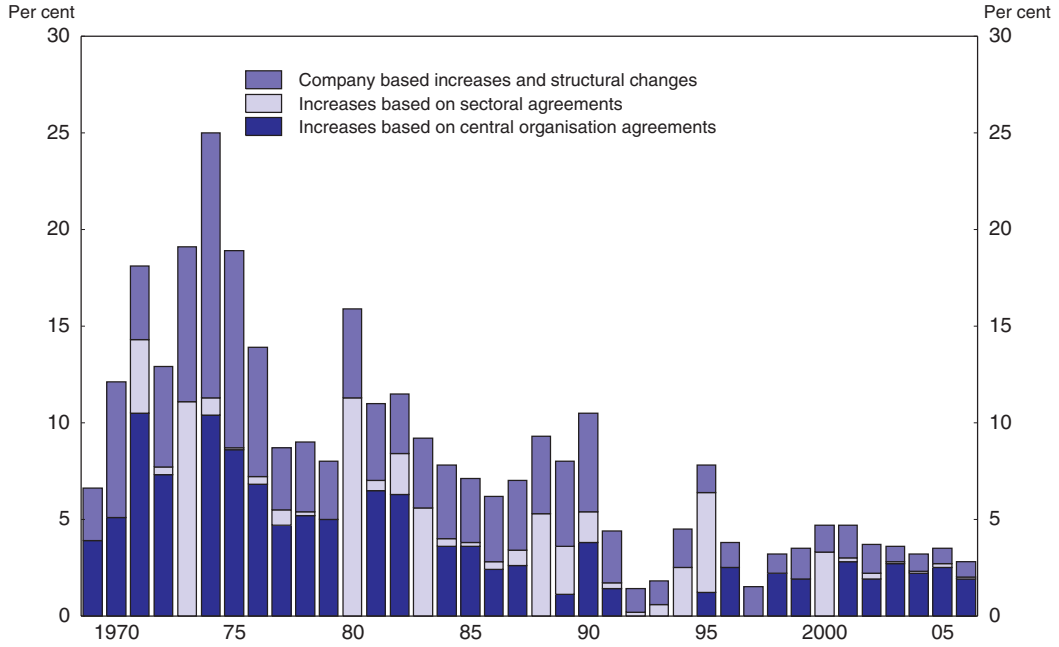
Figure 4.1 shows industrial sector wages and is a representative illustration of how the income policy has worked over three decades. The wage increases have varied substantially but since the mid- 1990s they have stabilised around 4%. Around half of the wage increases are due to centrally bargained wage increases and the other half due to locally (sectoral and company agreements including structural change) bargained wage increases. The wage increases agreed at the sectoral level have been quite small, apart from the years where no central agreement was reached. In addition to the agreed wage increase at the central and industry level the employers can pay a voluntary wage drift.[3] The decline in inflation during the 1990s was accompanied by a fall in wage drift, which in recent years has stabilised at around 1%. Non-participation in the central agreement seems to be associated with higher average wage increases than participation but higher wage drift in participating industries has compensated employees for lower bargained wages (Snellmann, 2004).

Microeconomic costs in terms of reduced flexibility

Centralised agreements contribute to real wage rigidities

Recent empirical work suggests that real rigidities rather than nominal rigidities are present in Finland because of the centralised agreements (Böckerman *et al.*, 2006 and Dickens *et al.*, 2006). For instance, there tends to be a peak in the distribution of wage

Figure 4.1. **Changes in wages of industrial workers**



Source: Ministry of Labour.

changes for manual manufacturing workers near the level of the agreed wage increase in the contemporaneous collective agreement suggesting that the final wage outcome in collective agreements largely depends on the general wage increase stipulated in the agreement.[4] Moreover, there is a peak in the distribution of nominal wage changes around the current rate of inflation which is an indication of real wage rigidity.[5] The presence of real wage rigidities is consistent with unions striving to preserve the level of real wages of their members. This is a feature of so-called "insider-outsider" models: insiders who are employed workers are highly insulated from competition from outsiders who are unemployed workers and thus aim for preserving real wages rather than increasing employment.[6]

Wage floors result in a high minimum labour cost, thereby reducing employment

A too high statutory or contractual minimum wage reduces employment for younger and less-productive workers and is a barrier to raising employment for this group. Employment losses due to minimum wages have been difficult to prove empirically (OECD, 2006; Dolado *et al.*, 1996). However, some studies find a significant negative effect, particularly for young adults (Neumark and Wascher, 1999; OECD, 1998).

Although no statutory minimum wage exists in Finland, the collective agreements specify wage floors for different types of jobs and experience levels. Sometimes the collective agreements also grade the minimum tariffs by age and some agreements make exceptions for apprentices and trainees. Labour law stipulates that the minimum provisions of the collective agreements in a sector are extended to all non-signatory firms within the same sector, provided that the collective agreement is regarded as being adequately representative. Consequently the high unionisation rate in combination with

the administrative extension suggests that in practice the minimum wages cover a major share of the labour market.

Using collective agreements for a number of traditional low-wage sectors which cover a large number of workers (hotels and restaurants, wholesale and retail trade and social services), a proxy quasi "minimum wage" can be calculated.[7] Only the hotel and restaurant agreement makes a distinction in the wage minima for younger workers, providing a lower minimum wage equal to 80% of the specified tariff wage below the age of 18 years. However, all three agreements specify a lower wage, between 80-90% of the specified tariff for trainees and apprentices during a limited period of time, often one year. The implied minimum labour cost, which is calculated by adding employers' social contributions to the quasi minimum wage, is high in international comparison. The cost of hiring a worker at the quasi minimum wage is 57% of the cost of hiring a worker at the median wage. The exception for trainees and apprentices lowers the minimum labour cost to 49% of the median cost. Many other OECD countries also make a distinction for younger workers and/or apprenticeship contracts (Box 4.1). Considering these exceptions, the minimum labour cost is still higher in Finland than the corresponding cost in these countries.

Box 4.1. **Minimum wages: exceptions for younger workers**

National or statutory minimum wages exist in 21 OECD countries, but there are substantial differences in the way they are set and operate. The main differences concern the level of the minimum relative to the median wage and the extent of differentiation by age, experience or region. The ratio of the minimum wage to the median wage varies from around 60% in Australia and France to less than 20% in Mexico. Many countries have exceptions for younger workers and/or apprentices and trainees.

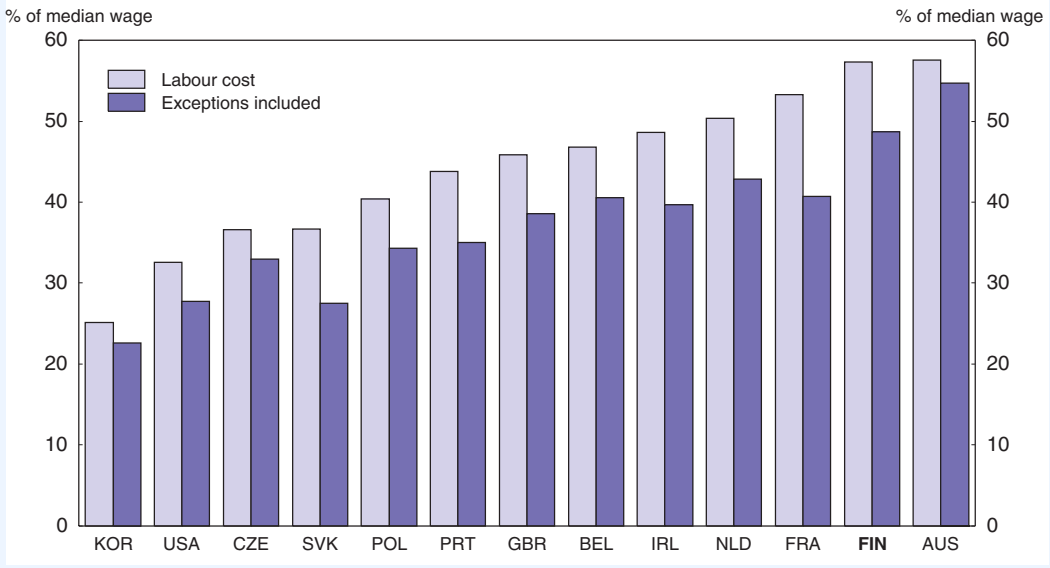
In 13 countries, exceptions from the statutory minimum wage are made for either younger workers or for apprentices and trainees (International Labour Organisation (ILO), Minimum wage database). In about half of these countries the differentiation is by age and in the other half by the type of work contract and in some cases it is a combination of the two types. For instance, in France apprentices aged 21 to 25 years old hired under a "contrat de qualification" (training contract) are paid 78% of the minima of adult workers and for apprentices aged 16-17 years the wage rate is 30% of the adult minima. Likewise in Ireland a worker who undertakes training is paid between 75 to 90% of the adult minimum wage and exceptions are also made for youths below 18 years who are paid only 70% of the adult minima. An age distinction is also made in the United Kingdom where younger workers aged 18 to 22 years are paid 85% of the adult minima and youth below 18 years only around 60% of the minimum wage.

In Sweden and Iceland, as in Finland, there is no statutory minimum wage, but the collective agreements specify the minimum wages. In many of these agreements a separate minimum is specified for younger workers. For instance, the collective agreement for construction workers in Sweden specifies lower tariff wages for workers below the age of 18 and 19 years, and similarly in Iceland the Commercial Workers' Union of Reykjavik specifies lower tariff wages for workers below 18 years (Sveriges Byggindustrier *et al.*, 2004; ILO, Minimum wage database). This is something that should be encouraged to a larger extent in the Finnish collective agreements as well.

Box 4.1. **Minimum wages: exceptions for younger workers** *(cont.)*

Using the exceptions from the statutory minimum wage specified in each country, a fictive minimum wage and labour cost, which is calculated by adding employers' social contributions to the minimum wage, for younger workers and apprentices can be calculated (Figure 4.2).* The labour cost of hiring a younger worker among the included countries is the second highest in Finland at 49% of the cost of hiring a worker at the median wage and lowest in Korea at 23% of the cost of a median worker.

Figure 4.2. **Minimum labour cost of younger workers and apprentices**[1]
2004



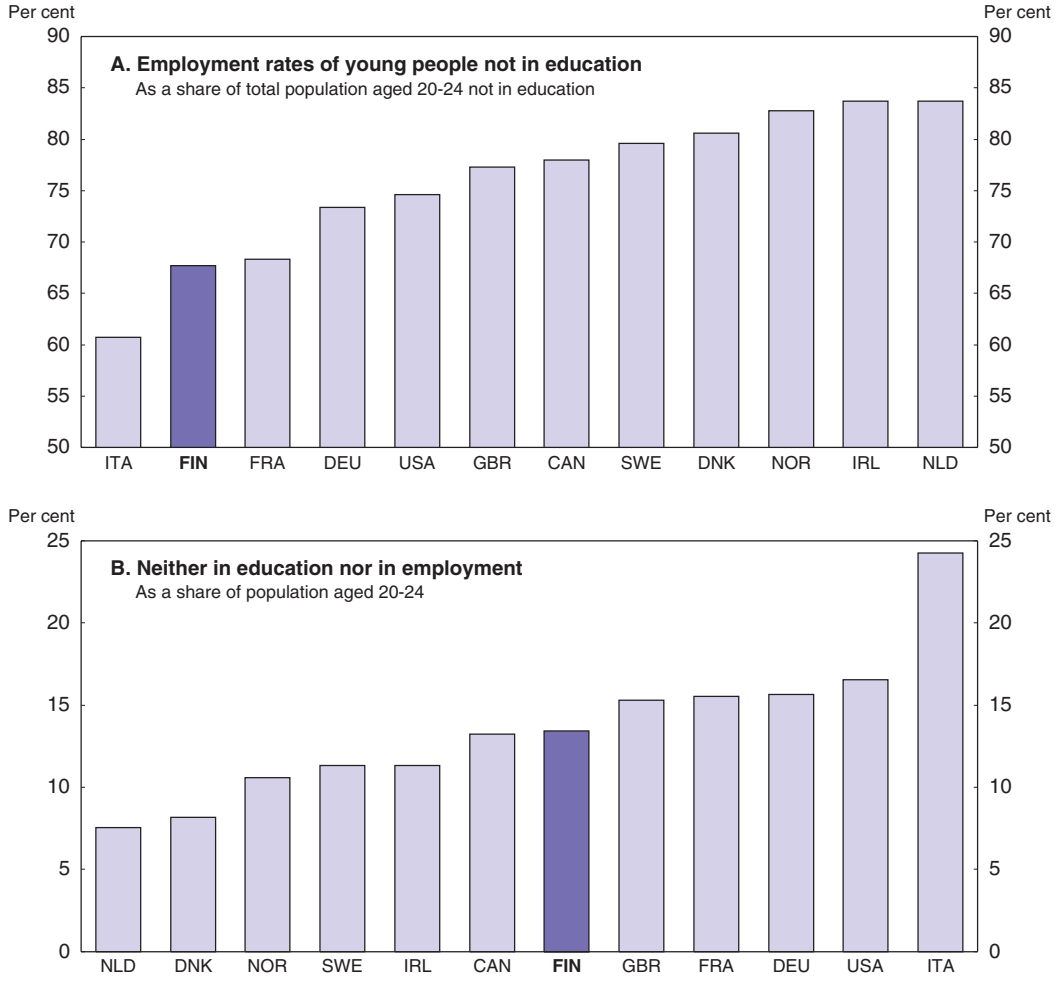
1. The cost of labour is the sum of the wage level and the corresponding social security contribution paid by employers for a single worker. The minimum cost for younger workers includes exceptions by age or by contract.

Source: OECD, Minimum Wage and Taxing Wages databases.

* The calculation excludes the exceptions for workers below the age of 17.

International comparisons of the employment rate of young people are complicated by the fact that a large number are students, some of whom work part-time to finance their studies. In Finland a relatively large number of students are included in the employment statistics; almost 40% of the students aged 20-24 years old work while they are studying. Arguably, the part-time employment of students is less of a policy concern than the employment of other young people, particularly where there is a concern about the possible effect of high wage minima. The employment rate for the age group 20-24 excluding students entirely (*i.e.* excluding them from both employment in the numerator and population in the denominator), but including military conscripts (who are counted as employed) is only 68%,[8] which is among the lowest in the OECD (Figure 4.3, panel A).[9] While the size of this group relative to the total age cohort is reduced by the relatively high share (around 60%) that are in education, the share of all 20-24 year olds that are *neither* in education *nor* in employment, at 13.4% in 2004, is still significantly higher than in other Nordic countries (Figure 4.3, panel B).[10] The labour market performance of this group is important since there is evidence of a scarring effect of the incidence of current

Figure 4.3. **Labour market performance of young people**
Aged 20-24, 2003[1]



1. Data for Finland refer to 2004.
Source: OECD, Education database.

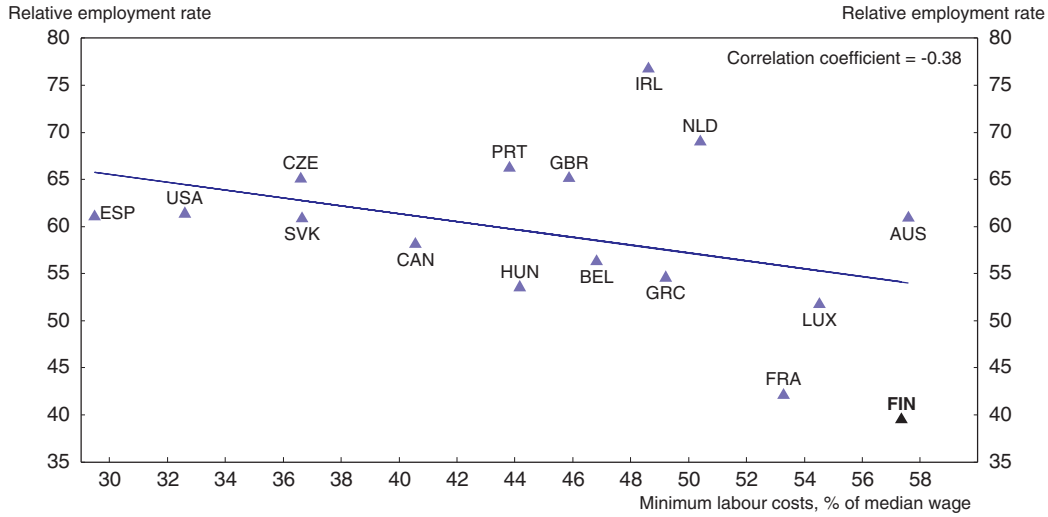
unemployment on the future employability of younger workers (Hämäläinen, 2003). It might also be the case that poor employment prospects for new entrants to the labour market encourage increased participation in education and longer study times.

For Finland there is some evidence that the high minimum labour cost may have reduced employment of younger workers (Figure 4.4). The other country, where employment among younger adults is particularly low is France, where there is a fairly high statutory national minimum wage.[11] The relation between high minimum wages and employment may be non-linear *i.e.* at very high minimum wages such as in Finland and France, the minimum wage covers many employees thereby reducing employment while at lower levels the minima are not binding and therefore do not have a negative employment effect.[12]

There is also some evidence that the high wage floors result in high relative wages in typical low-skilled and low-productivity service sectors such as hotels and restaurants and wholesale and retail trade in comparison with countries characterised by more

Figure 4.4. **Minimum labour cost[1] and employment of younger workers[2]**

2004 or latest available year



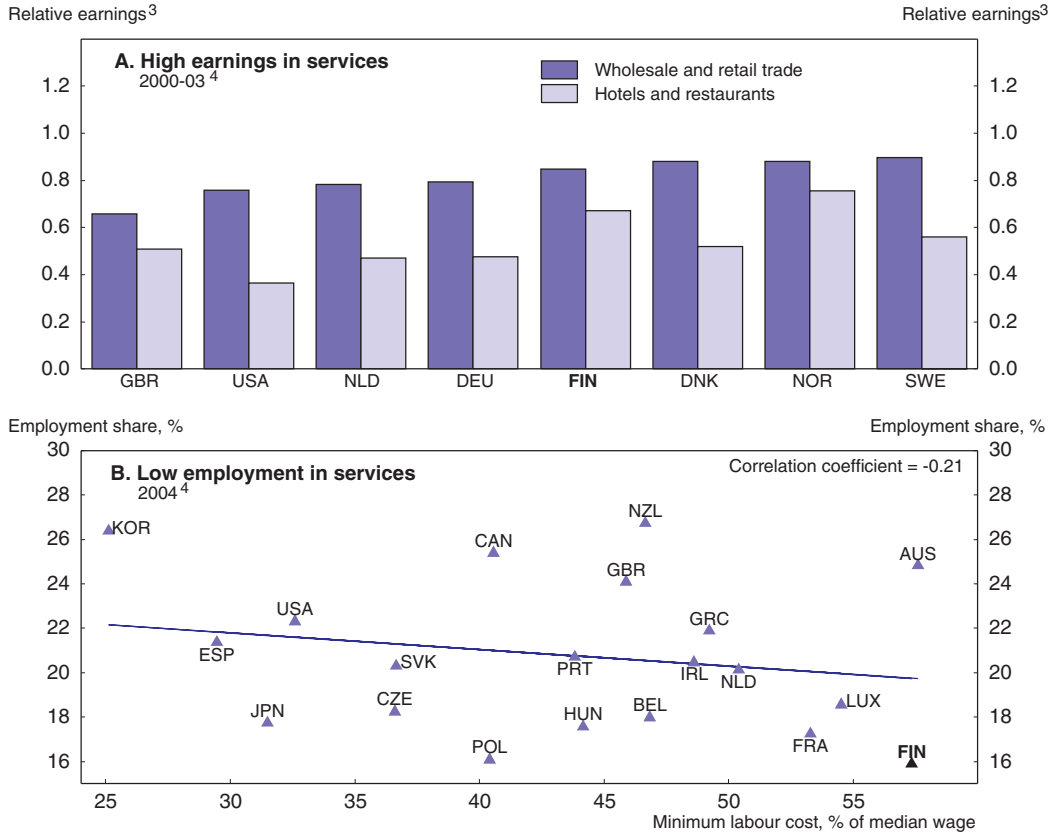
1. The cost of labour is the sum of the minimum wage level and the corresponding social security contribution paid by the employers.
2. Ratio of the employment rate of the 20-24 year olds not in education over the employment rate of the 25-54 year olds.

Source: OECD, *Education at a Glance – OECD Indicators*, 2005 ed.; Minimum Wage and Taxing Wages databases; Finnish labour cost computed from data provided by national authorities.

decentralised wage-bargaining (Figure 4.5, panel A). At the same time, employment in these low-skilled sectors is low in Finland suggesting that the minimum wages implied by the wage floors may have contributed to a shortage of low-skilled service jobs (Figure 4.5, panel B). The high minimum tariff wages may also deter investment of foreign firms in Finland and cause Finnish firms to increasingly outsource production to take advantage of low-cost labour thereby reducing job opportunities at home (Box 4.2).[13]

In Sweden minimum wages are also subject to bargaining between employers and unions and are part of the collective agreement. A study based on six collective agreements in Sweden found that sectoral minimum wages are high in international comparison at between 60-70% of the median wage (Skedinger, 2005).[14] However, there would appear to be greater flexibility in the way in which these minima are applied. In general, the minimum wages are industry-specific and are differentiated by occupation, experience and age. The minimum wage is not administratively extended by law to firms that are not members in an employer association, as in Finland, but can be extended by separate agreements. Most of these agreements specify different minimum wages for workers below 18-20 years and there is a tendency towards more differentiation of the minimum wage by age in all contracts. For instance, in the hotel and restaurant sector the minimum wage of an 18 year-old worker was lowered by almost 20% compared to a 20 year-old worker in the mid-1990s and in the construction sector the minimum wage of an 18 year-old worker is 40% less than for a 20 year-old worker. Thus, even though the level of minimum wages is high in Sweden, greater differentiation in the rate for younger workers may have contributed to a higher employment among them.

Figure 4.5. **Minimum labour cost[1] and low-skilled service sector employment[2]**



1. The cost of labour is the sum of the minimum wage level and the corresponding social security contribution paid by the employers.
2. Low-skill services are defined as the wholesale and retail trade, hotels and restaurants sector (ISIC 50-55) and are expressed as a percentage of total employment (ISIC 01-99).
3. The earnings were proxied by total compensation per employee. Relative earnings are defined as the ratio of earnings in each industry over the sum of the weighted average of earnings in all industries. The frequency of part-time employment differs across countries which affects this proxy. However, among the countries included in the figure the frequency of part-time employment is lowest in Finland, which if considered would work in the direction of understating the total (full-time equivalent) compensation per employee in Finland relative to the other countries.
4. Or nearest available year.

Source: OECD, Minimum Wage, Taxing Wages and STAN databases; Finnish labour cost computed from data provided by national authorities.

Centralised wage setting compresses the wage distribution

High unionisation, high coverage of collective agreements and highly co-ordinated collective bargaining tend to reduce wage dispersion and mainly so at the bottom of the wage scale because unions pursue a policy of compressing wage differentials for equity reasons (OECD, 2006; Blau and Kahn, 1999). If wage compression is strong enough, significant numbers of low-skilled workers and workers living in low-productivity regions may be excluded from employment. In Finland there is some evidence that wage dispersion is greater in periods when agreements have been concluded at the union level while in the periods of centralised agreements wage dispersion is more compressed (Uusitalo, 2002).

A histogram of the earnings distribution of the employed population shows a clustering in the Finnish distribution around the level of median earnings while in

Box 4.2. **Integration of the European labour market: a challenge for the Finnish labour market relations**

At the moment transitional arrangements restrict immigration of workers from the new EU member countries except for subcontractors which is particularly important in the construction sector (Chapter 6). The subcontracted workers are covered by the Posted Workers Directive and are therefore subject to the same working conditions as domestic workers specified in the collective agreements. In 2006 an act (1198/2005) to strengthen the supervision of working conditions for posted workers was implemented. The transitional restrictions on immigration will be relaxed in May 2006. In the future the free movements of persons may alleviate problems due to the shrinking working-age population and also have beneficial effects through enhanced competition. But at the same time the future free movements of persons could potentially imply that local workers would have to compete for jobs with foreign workers with lower wage claims which may put stress on the institutional framework of collective agreements. This raises the issue of how the Finnish labour and industrial relations should adapt to take advantage of the potential benefits of an integrated labour market in Europe.

The increasing pressure of globalisation and integration of the European labour market on labour market regulations has recently been seen in Sweden, which did not impose transitional restrictions on immigration from the new EU members. During the first year an estimated inflow of 22 000 workers from the new EU countries entered Sweden, which is double the previous year's inflow, yet it is only 0.5% of the labour force (Pettersson *et al.*, 2004). The current debate is whether it is sufficient that foreign workers are covered by their own national collective agreements or whether they have to sign a Swedish collective agreement, and if so what wage should be paid, the average wage or the minima in the agreements. In the event that foreign workers can work in Sweden under national (home country) collective agreements, then an increased inflow of workers may be expected in the future as Swedish firms increasingly take advantage of low-cost labour. If the Swedish collective agreement overrules the foreign agreement, then increased outsourcing of jobs to low-cost countries may occur, thus reducing the work opportunities at home. Court proceedings are currently ongoing in the European Court of Justice to decide if any breach of community obligations has been made in the case of a foreign construction company that was locked-out by the Swedish construction trade union as they had not signed a Swedish collective agreement. The ruling will have implications for the pay of foreign firms and workers in the Swedish labour market.

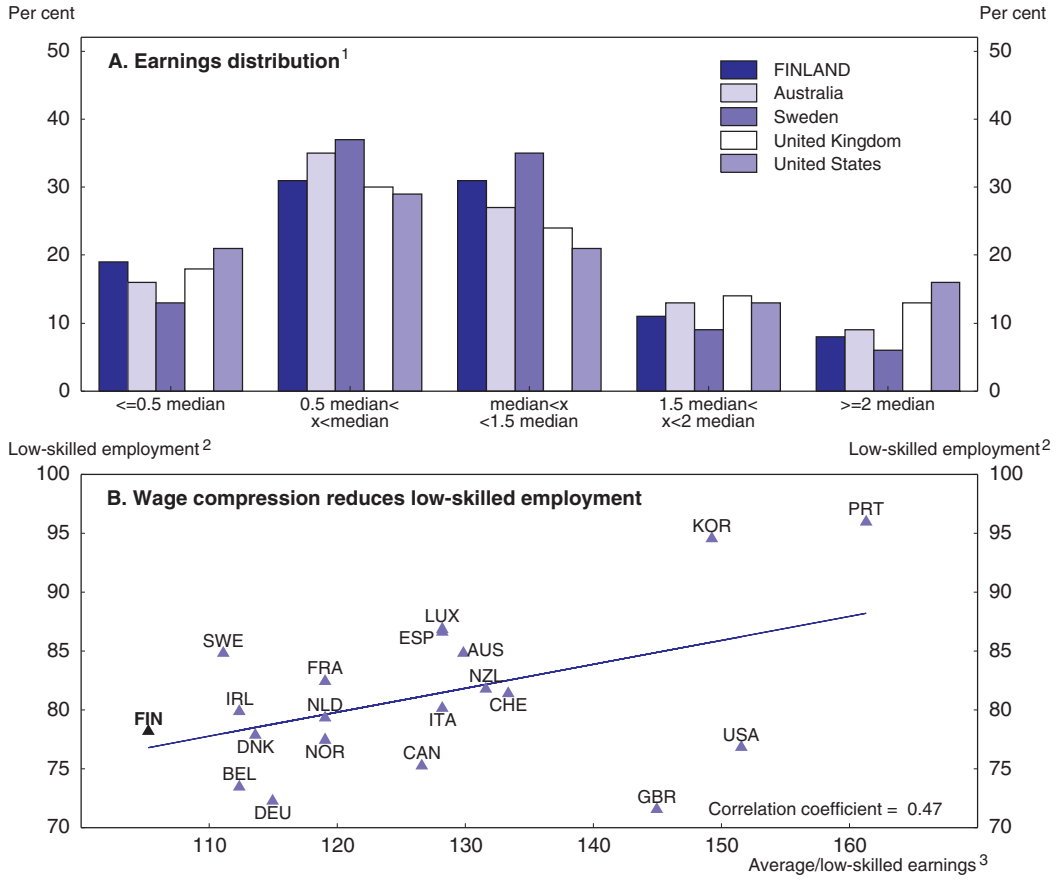
The United Kingdom and Ireland, the other two countries that also opened their borders, have different labour and industrial relations compared with the Nordics and wage setting mostly takes place at the firm level. Labour regulations in these countries are less stringent and both countries have a statutory minimum wage which regulates the lowest wage a worker, foreign or national, needs to be paid. The advantage is that it is easier for firms to hire low-cost workers and compete with foreign firms on a more equal basis, reducing the threat of outsourcing, but there is always a risk that firms take advantage of low-cost workers, pushing domestic workers into unemployment. However, the re-flagging of Irish Ferries to Cyprus with the purpose of bringing in Latvian workers to crew the ferries on wage rates less than half of the national wage shows that even statutory minimum wages may not be enough. The following agreement by the Labour Relations Commission allowed Irish Ferries to outsource its crew to an agency and introduce a two-tier pay and work condition system with current staff remaining on the same conditions and wages but all new staff being paid only slightly above the minimum wage and having different working conditions. This transitional arrangement will be in place for three years.

The issue for Finland is how to combine the current framework of centralised bargaining that specifies high minimum wage floors that are extended by law to all workers and open borders with the new low-cost EU members without risking job opportunities at home. The collective agreements protect local workers against competition from foreign workers with lower wage claims but at the same time they deter foreign investment in Finland and may also induce Finnish firms to move abroad. One possible solution is to impose a low statutory minimum wage where the level is set such that it does not price less-skilled workers out of the market but at the same time safeguards the earnings of workers.

countries with a more decentralised wage setting, for instance in the United States and the United Kingdom, the tails of the distribution are more pronounced (Figure 4.6, panel A). Likewise, the ratio of the earnings of employed with upper-secondary education relative to earnings of employed with less than upper-secondary education is 1.05, which is among the lowest in the OECD and lower than in all other Nordic countries. Thus it seems that the wage floors in the collective agreements result in high relative earnings of low-skilled workers thereby compressing the wage distribution. At the same time in countries with a compressed wage distribution, the employment of low-skilled workers is lower than in countries with a limited importance of collective bargaining and decentralised bargaining at the firm level, which results in higher earnings inequality (Figure 4.6, panel B).

Figure 4.6. **Wage compression**

2003 or nearest available year



1. Gross earnings distribution of full-time dependent employment aged 25-64.
2. Employment rate of the 25-64 year olds with below upper secondary education (average) relative to the total employment rate of the 25-64.
3. Earnings of upper secondary and post-secondary non-tertiary education relative to below upper secondary.

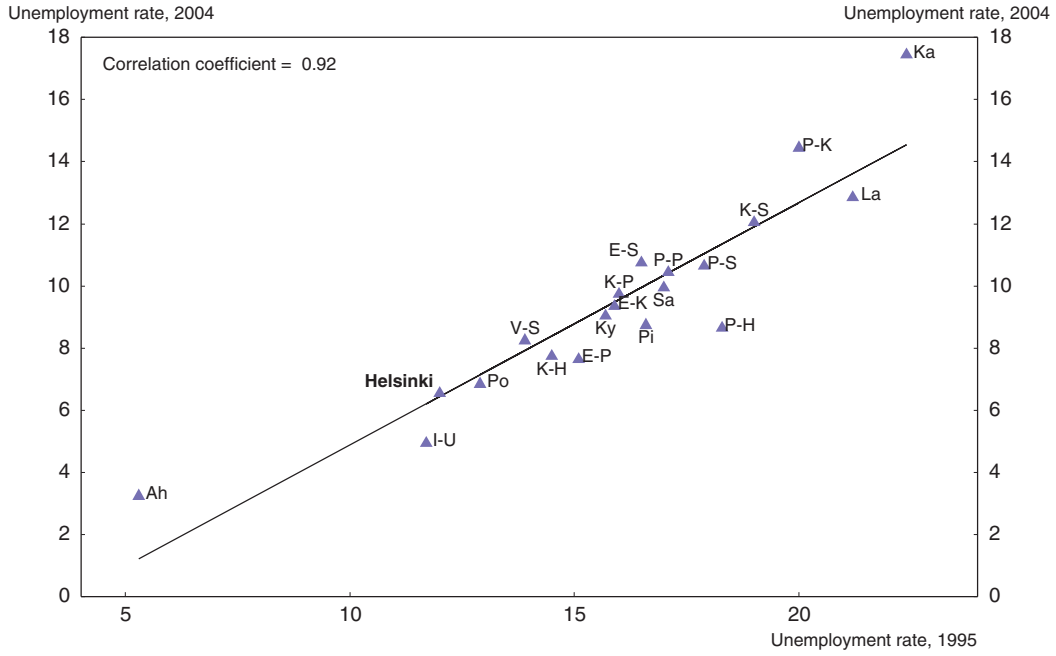
Source: OECD, *Education at a Glance – OECD Indicators*, 2005 ed., Tables A8.3a, A9.2a and A9.4a; Labour Force Statistics database.

Regional wage flexibility is also low

There are signs of increasing mismatch in the Finnish labour market with the same number of unfilled vacancies being associated with a higher unemployment rate in recent

years compared with the 1980s and 1990s. The differences in unemployment rates across regions are persistent and the differences have even increased over the last decade (Figure 4.7). The relative unemployment rate measures the ratio of unemployment in one region to the corresponding national rate and the variance in this measure has increased since the mid-1990s, which suggests that regional imbalances have worsened (Table 4.1). Regional differences in unemployment may persist because wages are not in line with local labour market conditions. In regions with low productivity, labour cost cannot adjust due to national wage floors and returns to investments in these regions may be too low, thus reducing investment inflows and job creation. Furthermore, social transfers and increasing house prices in growth areas may create disincentives to move from regions with high unemployment. National wage floors in combination with low labour mobility imply that some regions may end up growing more slowly than others.

Figure 4.7. **Persistent differences in unemployment across regions**



Source: Ministry of Labour.

Table 4.1. **Variance in the relative unemployment and employment rates**

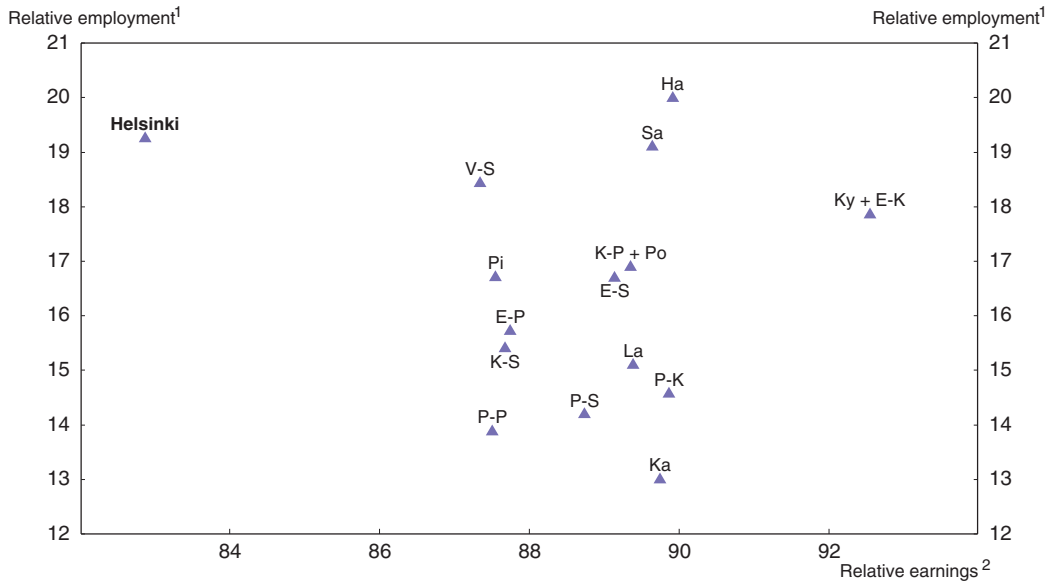
	Unemployment	Employment
1990-94	0.0993	0.0048
1995-99	0.1053	0.0068
2000-04	0.155	0.0074

Source: OECD calculations based on data from Statistics Finland.

Despite fairly large differences in relative employment of low-skilled workers across regions, corresponding relative wages across regions are similar with the exception of the Helsinki region and south-eastern Finland (Figure 4.8). Centralised wage agreements with

Figure 4.8. **Regional wage flexibility is low**

2003



1. Employment of persons with lower secondary education relative to all employed.
2. Mean earnings of persons with lower secondary education relative to mean earnings of all workers.

Source: Ministry of Labour; Statistics Finland, *Wage and Salary Statistics*.

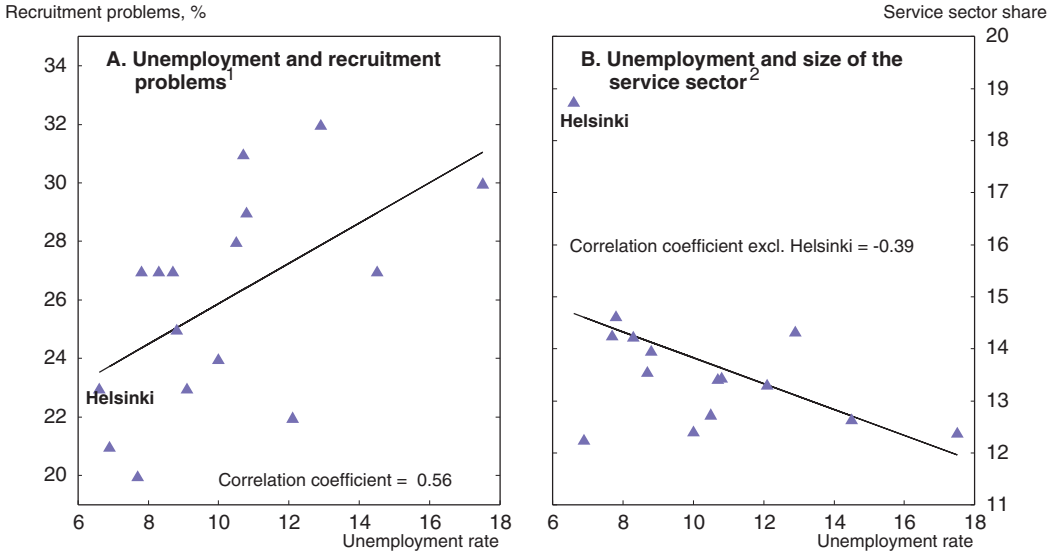
specified minimum tariff wages imply that there is little room for downward relative wage flexibility at the regional level, which can be problematic as relative wage differentials are one way of attracting investment thereby creating new work opportunities. Wage differentials between regions may also help to induce labour mobility to more dynamic regions.

Few low-skilled service jobs may contribute to perpetuate regional differences

In recent years the number of workplaces that experience recruitment problems has increased, notably in certain occupational groups such as construction, transport, agriculture and forestry and public services. There is a marked difference between regions. Hiring difficulties are more pronounced in the north and in some eastern regions (Lappi, Pohjois-Savo, Kainuu) and less pronounced in the Helsinki area and central Finland (Uusimaa, Kaakkois-Suomi, Keski-Suomi, Pohjanmaa). Recruitment problems tend to be more severe in regions that suffer from high unemployment indicating that even though there is a large pool of unemployed workers the supply of workers does not match demand (Figure 4.9, panel A). At the same time the unemployment rate is higher in regions with a smaller low-skilled service sector (Figure 4.9, panel B) suggesting that the recruitment problem is more pronounced in regions with a small service sector. Thus regional disparities may partly be explained by a large supply of low-skilled workers in regions with relatively few low-skilled jobs. One possible explanation for the shortage of the supply of low-skilled jobs is that the nation-wide wage floors deter investment and reduce job-creation in low productivity regions.

Figure 4.9. **Low-skilled service jobs and regional differences**

2004



1. Recruitment problems measure the percentage of firms having problems of hiring workers.
2. The size of low-skilled services is measured by employment in trade, hotels and restaurants as a share of total employment in each region.

Source: Ministry of Labour.

Increasing wage flexibility in the current system

The Finnish model of centralised wage setting has yielded macroeconomic benefits but at the cost of reduced relative wage flexibility. Nevertheless, in the current framework there are ways of achieving flexibility through that part of wage changes that can be decided at the local level and through various bonus schemes. The union allowance in the income agreement allows part of the general wage increase to be negotiated at the firm, municipal or industry level and enhances wage flexibility. If no agreement on the use of the union allowance is made, then the amount is paid as a percentage-based general increase. In 2005, 69% of the private sector's union allowance was paid as a general increase while only 14% was used at the local level (Confederation of Finnish Industries). In the 2003-04 income policy agreement, the share negotiated at either firm or industry level accounted for 31% and 23%, respectively, of the actual total wage increase (Heikkilä and Piekkola, 2004). Estimates for industrial workers based on the current income policy agreement for 2005-07 suggest that the share negotiated at either the firm or industry level accounts for around 30% in 2005 and 2006.[15]

A recent survey among Finnish employees and employers found that there exists a trade-off between wage flexibility and income safety. Employers would like to see greater freedom in wage setting and employees, particularly workers, emphasise the role of an earnings guarantee provided by the minimum wage tariffs specified in the collective agreement (Pekkarinen and Alho, 2004). Another study based on the same survey suggests that Finnish employers want the locally-bargained wage share to be approximately half of the total wage increase, which is significantly more than the locally-bargained share in the current centralised agreements (Heikkilä and Piekkola, 2004).

One obvious option to enhance wage flexibility would be to decentralise wage bargaining to firms, as in many English-speaking countries and in most other Nordic countries, especially Denmark, where wage-setting is far more decentralised than in Finland. But also in the current wage setting arrangements there are some possibilities to raise wage flexibility. Introducing more profit and performance-related pay schemes at the firm level allow for a higher degree of relative wage flexibility by permitting wages to reflect local conditions and skill levels. This is consistent with an increase in the share of the overall wage increase that is decided at the industry or firm level. In Finland various "bonus" systems are used fairly frequently as there has been some decentralisation of wage setting in recent years. For example, performance-related pay and profit sharing schemes have become more common (Snellman, Vartianien and Uusitalo, 2003) and this has been accompanied by an increased dispersion in the wage drift across industries (Piekkola and Marjanen, 2003). In 2003 payment by results was common, especially in the private sector where 43% of firms or workplaces used some form of payment by result. Some workplaces paid bonuses to individuals, others to groups of workers or to all employees and around 95% of those who were covered by the bonus system received a bonus. Generally the bonuses were larger in the private sector compared with the state and municipalities, but overall the amount of the bonuses was small (Table 4.2). Another possibility is to promote the use of "opt-out" clauses allowing for local wage agreements at lower wages than the centralised agreement if employers and employees agree on it. This has recently been used frequently in Germany.

Table 4.2. **Bonuses in 2003**

In per cent

	Under € 500	€ 500-1 000	Over € 1 000
Private sector	30	26	44
State	52	27	21
Municipalities	49	33	18
All sectors	33	26	41

Source: Ministry of Labour.

The government's role in the next wage agreement

The government's role in the income policy agreements has most often been the role of a broker or mediator in the wage negotiations. The government has encouraged moderate wage settlements by offering tax cuts and social policy enhancements. Moreover, the state and local governments are also important employers but they have not in general assumed a leading role in the wage bargaining rounds (Vartianien, 1998). If the government is involved in wage setting then it is legitimate that it is concerned with improving certain features of the current agreements, especially those that limit flexibility and may reduce employment (Box 4.3).

Box 4.3. **Recommendations concerning the next wage round**

The wage setting system with centralised income policies concluded by the social partners with the support of the government has moderated wage increases but at the cost of reduced wage flexibility. In future wage bargaining the social partners should pay attention to the following considerations:

- Encourage the increased use of the part of the overall wage increase (union allowance) that can be negotiated at the industry or local level.
- Promote the differentiation of minimum tariff wages by age and experience in the collective agreements, in particular for younger workers.
- Promote the use of individual performance and profit-based pay systems by trading off overall wage increases against profit- and performance-related pay at the firm level.
- Promote the use of opt-out clauses allowing for local wage agreements with lower wages than the centralised agreement if employers and employees agree on it.
- Restrict the use of indexation clauses on consumer prices given the potential negative employment effects of such a clause in cases of large supply shocks and in times when output price inflation is below consumer price inflation.
- With the opening of the labour market to immigration from the new EU countries, the introduction of a low statutory minimum wage should be considered.

Notes

1. Theory suggests that in cases of nominal demand shocks, wage setters prefer full indexation to the price level as this stabilises the real wage and thus employment. In the case of real supply shocks, wage setters want lower indexation because this leads to real wage changes that offset the direct employment effect of the shocks. When both types of shocks occur partial indexation is optimal.
2. This does not conclusively prove that centralised wage agreements have had a beneficial effect on inflation. If for example they led to strains, either because the aggregate increase in wages was too low or because relativities were squeezed, they may have made it difficult to reach a subsequent central agreement and hence ultimately have been the root cause of a (more) inflationary period of subsequent catch-up when there was no agreement. Moreover, during the 1990s unemployment was high which also should have restrained wage increases irrespective of what level wages were bargained at.
3. In future wage agreements the concept of "wage drift" is problematic because in the current tripartite agreement a part of the wage increase is reserved for local negotiations.
4. The distribution of wage changes for manual manufacturing workers also seems to be more concentrated around the modal in the years when an income policy agreement was reached, particularly in the second year of the income agreement.
5. There is some evidence that this pattern broke down at the beginning of the 1990s during the recession suggesting that wage rigidities were less prevalent under extreme circumstances (Böckerman *et al.*, 2006).
6. The insider-outsider theory dispenses the traditional assumption that union members' employment probabilities are a random draw. If the turnover cost is taken into account, which mostly falls on the firm, the probability that an unemployed person will be hired tends to be significantly less that the probability that an employed person will be retained. Thus, the interest of employed union members is substantially different from the ones of the unemployed union members (Lindbeck and Snower, 2002). In practice, the unions are primarily concerned with the employed since they tend to be far more numerous than the unemployed.
7. The minimum wage is a weighted average of the lowest monthly tariff wages in the Helsinki area weighted by the employment share of each sector in total employment of the sectors concerned. The tariff wages in wholesale and retail sale, hotels and restaurants and social services are € 1 335, 1 311 and 1 322 per month, respectively. Using tariff wages for other regions in Finland only

changes the minimum wage marginally. The minimum labour cost is calculated by adding the employers' social contributions at the minimum wage to the wage cost based on OECD's Taxing Wages models.

8. A further complication in international comparisons of activity rates of young people is accounting for those conscripted to do military service. In the calculations reported here such military conscripts are excluded both from the employment and population data.
9. The numbers are also affected by people on parental leave, where persons stay home and are thus not included in the labour force, but have a job to which they can return.
10. A part of this difference may be explained by young people taking time out to prepare for specialised university entrance exams (which often differ between universities) after completing secondary education, although many of these people might be expected to be at least part-time employed. This would further argue for streamlining and speeding up an overly bureaucratic university selection process.
11. France has recently reduced the employers' social contribution on low-wage earners implying that the labour cost of hiring a worker at the minimum wage is only 53% of the cost of hiring a worker at the median wage, while the minimum wage is 61% of the median wage.
12. Excluding Finland the correlation coefficient in Figure 4.4 drops from –0.38 to –0.22.
13. A Finnish study found that industrial activity of Finnish firms in the new EU member states tends to be labour intensive in its nature; the cumulative share of industrial investment between 1998 and 2002 was 3.6% of total overseas investment while the share of employment was nearly 10% of total overseas employment (Teollisuuden ulkomaantoiminta, Kilpailukykyä EU:n laajentumisesta, 2004).
14. The sectors included in this study are the metal industry, construction, butchery, bakery, wholesale and retail trade and hotels and restaurants.
15. The estimates are calculations by the Ministry of Labour based on the current collective agreement.

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Chapter 5

Active and passive labour market measures and the employment target

The government is planning a substantial expansion of active labour market policies (ALMPs) as an important component of its strategy to meet the employment target. However, it is not clear on the basis of current evaluations that such an expansion will have a significant effect on regular employment. More important is to change the mix of existing measures towards those that are most effective, in particular to cut back on wage subsidies for public sector employment and expand private sector wage subsidies. It is also important to bring the activation rate for the older unemployed and workers on disability schemes, which is low, in line with that for other workers. The financial incentives to take up work also need to be strengthened by tapering unemployment benefits at longer durations.

Introduction

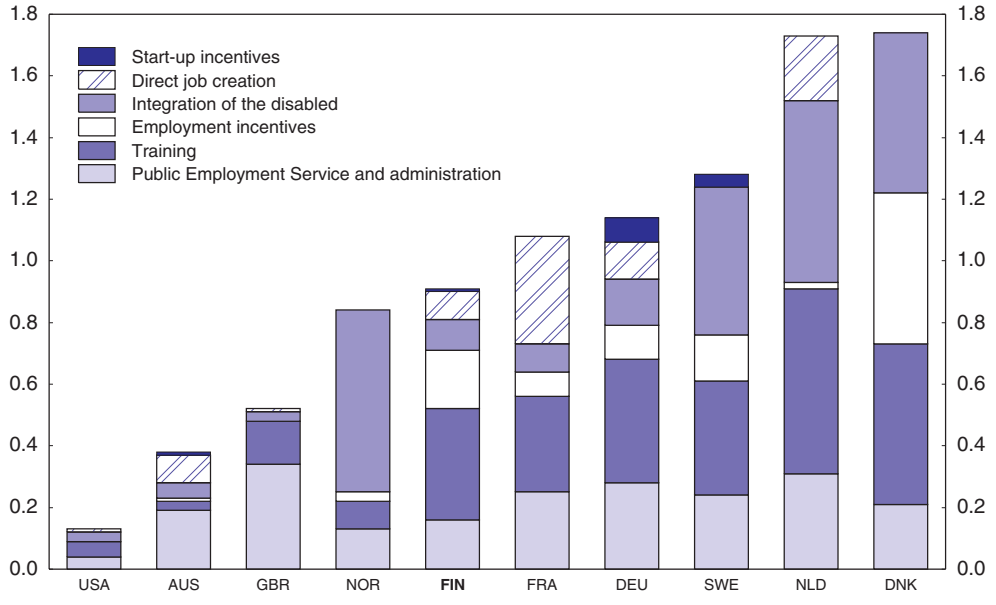
Finland, together with other Nordic countries, stands out in international comparison because of the scale of active labour market measures and the generosity of passive labour market support. The government is planning an expansion in the scale of, as well as other reforms to, active measures as one part of its strategy to achieve the employment target. This chapter reviews active and passive labour market measures, before considering how far policy changes in these areas could contribute to achieving the government's employment objectives.

Active labour market programmes

The extent of current measures

Total public expenditure on labour market measures is high at around 3% of GDP, but only about a third of this is spent on active measures. While the latter is above the OECD average, it is lower than in most other Nordic countries (OECD, 2005). Spending on training and employment incentives account for a large share of total spending on ALMPs (Figure 5.1). Spending on the integration of the disabled is particularly low, even though inactivity because of illness or disability, especially among older males, is among the highest in the OECD (OECD, 2004).

Figure 5.1. **Public expenditure on ALMPs**
Per cent of GDP, 2003/2004



Source: OECD, *Employment Outlook*, 2005, Table H, p. 264.

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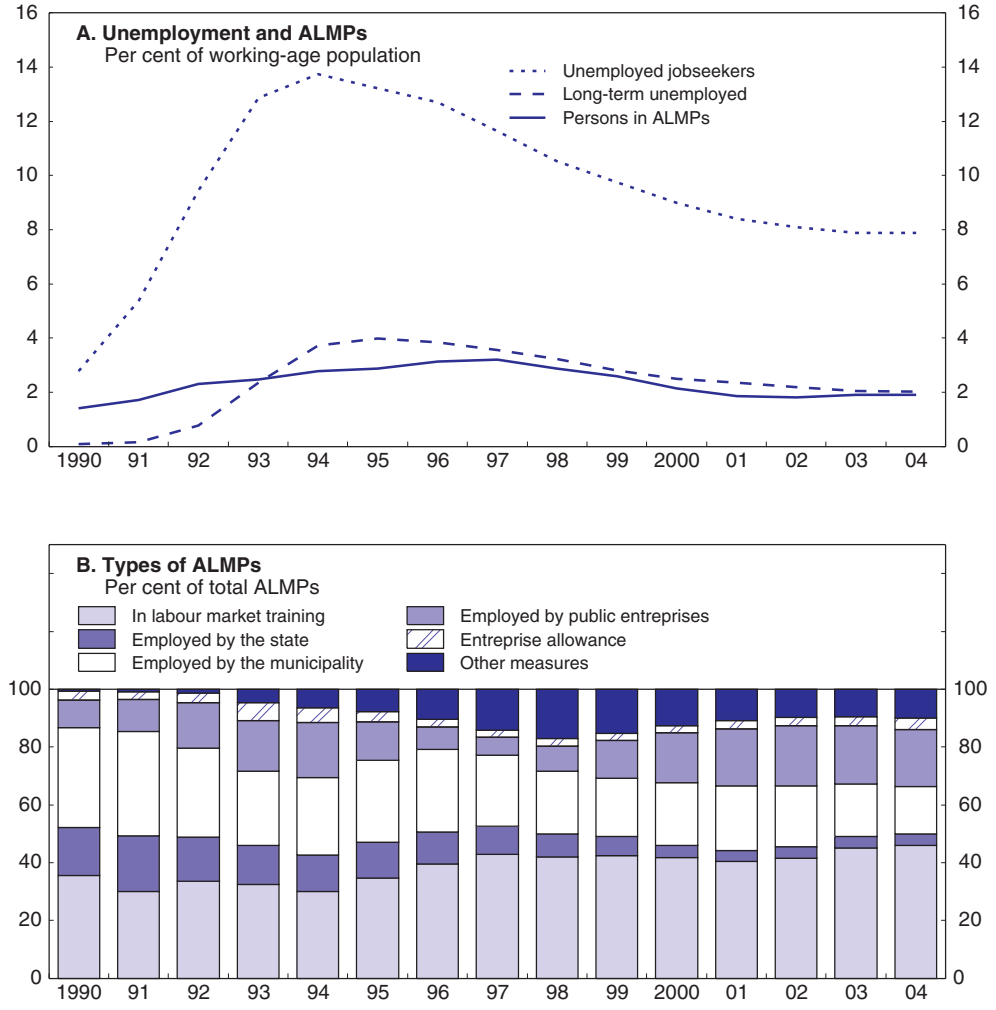
Unemployment and long-term unemployment has been declining since the mid-1990s and currently unemployment is around 8½ per cent and long-term unemployment some 2% of the working-age population. The average number of people placed in active labour market measures peaked at 3¼ per cent of the working-age population in 1997, but declined thereafter until 2001 as unemployment fell (Figure 5.2, panel A). However, in recent years there has been a modest expansion in the scale of ALMPs with the "activation rate" – the number of persons on active measures as a share of unemployment – rising from 21% in 2001 to 23% in 2004.

Figure 5.2. **Labour market performance**



Source: Ministry of Labour, *Finnish Labour Review*, 4/2005; Statistics Finland, *Statistical Yearbook of Finland 2005*.

ALMPs can be split into two types of measures: wage-based and training measures. Wage-based measures are subsidies to the employer and to the unemployed job seeker and accounted for 54% of those on active measures in 2004, whereas labour market training involves on the job training and accounted for the remainder (Figure 5.2, panel B). In the past active measures have favoured wage subsidies over training programmes. The

emphasis has recently shifted slightly towards more training programmes as the share of wage-based measures has fallen from a high of 70% at the beginning of the 1990s. Since the beginning of the 1990s a shift to more subsidised private sector jobs and less wage-based subsidies in the public sector has also taken place; currently the private sector employs nearly 62% of the total number of persons benefiting from wage subsidies compared with 20% in 1990 (Ministry of Labour, 2004).

Many younger workers are employed in wage-based subsidy schemes instead of regular employment

As part of the Government's Employment Programme, employment services for young people were introduced in 2004 to give them the opportunity to obtain training or a working place after an unemployment spell of three months. In addition, younger workers have no right to labour market support unless they are in vocational training or participating in active labour market measures. As a result, spending on labour market measures for younger workers is among the highest in the OECD (OECD, 2004).[1] In comparison with other age groups, younger workers are to a larger extent employed in subsidised jobs rather than other active labour market measures (Table 5.1). A recent Finnish study found that job placement and labour market training are successful in promoting employment of youths and also in increasing the earnings of participants (Hämäläinen and Ollikainen, 2004).

Table 5.1. **Active labour market programmes**

December 2004

Age	Unemployed jobseekers	Employed using wage-based measures	In labour market training
	Persons	% of unemployed	
15-24	34 815	33.6	12.9
25-54	180 364	20.1	13.2
55-59	55 603	7.9	1.7
60+	13 860	3.0	0.8
Total	**284 642**	**18.6**	**10.3**

Source: Ministry of Labour, *Employment Report 2004*.

One justification for the concentration of measures on younger workers may be that offering wage subsidies for younger workers is one way for employers of getting around paying the high minimum tariff wages in the centralised agreements (Chapter 4). But ALMPs may have unintended effects on regular employment. For instance, there is always a risk that employers cut back ordinary job creation to take advantage of wage subsidies. A more direct way of promoting employment of younger adults, which avoids any potential distortionary effects of ALMPs, is to lower the minimum tariff wages for younger workers in the collective agreements.

Recent and proposed reforms to ALMPs

In the activation reform of labour market support for long-term unemployed, local authorities are required to offer intensified activation measures after an unemployment spell of 500 days for at least 12 months during the following 24 months. At the same time, passive labour market support is made conditional on participating in ALMPs after the

500 days. Taken together the activation and stricter sanctions may have preventive effects, thus reducing the inflow into long-term unemployment. The overall aim is to raise the activation rate of the long-term unemployed from the current 20% to 30%. The activation rate measures the ratio of those in measures to the sum of the total number of long-term unemployed and those in measures. Older workers account for a large share of the long-term unemployed but, judging by past experience, this reform is not likely to have a major impact on their participation in ALMPs since most of these workers obtain an extension of the passive unemployment allowance rather than placement in an active measure after the 500 days.

The reform of the public employment service continued in 2005. The number of labour force service centres which provide services to long-term unemployed workers with social and health problems are to be further increased. These centres are joint service points by local authorities and other service providers and offer rehabilitation and activation services. In 2006 there will be 38 service centres established. There is some empirical evidence that job search assistance is more effective than other forms of active measures in getting the unemployed back to work (OECD, 2006; Martin and Grubb, 2001). Thus creating special service centres which provide co-ordinated and intensive services for the long-term unemployed is a positive initiative towards lowering long-term unemployment, but it is too early to draw any conclusions of the effects of this reform.

A temporary low-pay subsidy scheme for employees aged 54 and older was introduced at the beginning of 2006 and will continue until 2010. Under this scheme employers will be eligible to receive a subsidy for all employees aged 54 and older who are earning between € 900-2 000 a month for a full-time job (between 37 to 81% of the average production worker (APW) wage). It is estimated that around 5% of all wage earners will fall within this category (Ministry of Finance, 2005).

Stronger incentives for municipalities to activate the long-term unemployed

As part of the activation reform concerning the long-term unemployed, the funding of active labour market support and social assistance was reformed in early 2006. Until then, labour market support to the long-term unemployed was funded by central government and the municipalities were responsible for the funding of social assistance for which the municipalities are compensated for about one-third of the cost by the central government. Following the reform, the funding of labour market support and social assistance will be determined by the duration of the unemployment spell. For unemployment spells of more than 500 days, central government and the municipalities share the funding equally, while central government is still responsible for the funding of other labour market support such as short-term unemployment and active measures. The social assistance is also divided into a basic allowance and a means-tested allowance. The municipalities and the central government share the cost of the basic allowance while the means-tested assistance is paid by the municipality and the central government will contribute as before by providing on average a third through the state subsidy scheme. This means that the municipalities have a greater incentive to activate the long-term unemployed since the cost for active measures are paid by the central government, while the cost of those on passive labour market support is shared equally by the municipalities and the central government. The aim is to create a funding scheme where activation is beneficial for all parties.

The compensation of the municipalities by the central government is based on the cost of labour market support to the long-term unemployed in 2003.[2] This way,

municipalities have an incentive to reduce long-term unemployment below the 2003 level. The number of long-term unemployed did decline towards the end of 2005.

The evaluation evidence relating to ALMPs

The effect of ALMPs is difficult to assess empirically. In general relatively low-cost job search assistance often does well, whereas public job creation and employment subsidies are typically disappointing in getting the unemployed back into work (OECD, 2006; Martin and Grubb, 2001). In several OECD countries, evaluations of employment subsidies have found that these measures have a greater impact on employment than public training programmes or direct job-creation measures. But at the same time, most studies focusing on firm behaviour find that subsidies to private-sector employment have both large dead-weight and substitution effects so that the net employment gains are small (Martin and Grubb, 2001). A recent study found that wage subsidies in Finland stimulated employment and did not merely substitute for non-subsidised jobs (Kangasharju, 2005). Other studies seem to indicate that training has more favourable effects than employment subsidies. For instance, one robust finding in the *OECD Job Strategy* report is that higher spending on labour market training is associated with lower unemployment, whereas no such relationship emerges for other types of ALMPs (see also Boone and van Ours, 2004) and a recent Swedish study found that the direct displacement effects from subsidised employment are quite large while no such effects emerge from training (Dahlberg and Forslund, 2005). Overall, there is no clear evidence of the effects of ALMPs on regular employment and it is difficult to draw any general conclusions on what measures work best and for whom.

An important cautionary finding in a recent evaluation is that periods of unemployment are often followed by periods in ALMPs which do not lead to permanent employment and are instead followed by further periods of unemployment or another spell in ALMPs (the so-called "carousel effect"). The study found that three months after the measure had ended in 2004, approximately one-third of those who completed subsidised work and occupation-oriented training were employed, approximately half were unemployed, and 15-20% were again placed in a labour market measure (Ministry of Labour, 2004). Of those who completed practical training, an estimated 10-15% were subsequently employed, approximately one-third were unemployed and less than one-third again in ALMPs. Preliminary results from another Finnish study suggest that private-sector wage subsidies seem to be the best basis for employment. Three months after the measure has ended, approximately half continue in the job, whereas the corresponding proportion of those placed in the municipal and state sectors is approximately one-fourth.[3]

Geographic mobility may be hampered by social benefits and labour market policies targeted to certain areas. Generous social benefits reduce the incentives to look for a job in other regions and lessen mobility. If participation in ALMPs reduces the time available for job search or if ALMPs decrease the incentives to change occupation or region compared to being openly unemployed, locking-in effects are present. Studies have found that search activity and the probability of finding a job are lower among programme participants compared to the unemployed (van Ours, 2002; Fredriksson and Johansson, 2003). In Finland, ALMPs tend to be more extensively used in regions with high unemployment and this may lower the incentives to move to regions with more job openings.

Altering the mix of ALMPs rather than expanding their scale may be more effective

The rapid expansion of ALMPs implied by the government's target to raise the activation rate from 23½ per cent at the beginning of 2005 to 30% by 2007, implying an additional 35 000 places at unchanged unemployment, will be difficult without compromising quality. The implications for regular employment are difficult to assess but recent evaluations of ALMPs in Finland suggest that about one-third of those who completed subsidised work or training were employed after ending the programme (Ministry of Labour, 2004). This would imply only a modest increase in the employment rate of around 0.3 percentage point. However, this estimate does not take into account potential displacement effects on employment which would further lower the overall employment effect.

Moreover, the marginal effects of a rapid expansion in schemes may be lower than suggested by current evaluations. Evidence from the wide use of ALMPs in Sweden during the 1990s when the activation rate was around 30% suggests that there is a problem of expanding training programmes rapidly when the supporting infrastructure is inadequate (Calmfors *et al.*, 2001). There is also some international evidence that large scale youth programmes seem to have large displacement effects. For instance, a study of the expansion of youth programmes in Sweden during the recession in the 1990s shows that those programmes are associated with large displacement effects and thus crowd out regular employment (Edin *et al.*, 1999). At the same time it is unclear whether there are any positive employment effects for the participants (Calmfors *et al.*, 2001). This may suggest that there is a risk that large scale labour market programmes have decreasing marginal returns and thus caution needs to be exercised when considering an expansion of existing programmes. While there is scope for improving the mix of the current ALMPs towards more effective measures, such as more private sector and less public sector wage subsidies, it is doubtful on the basis of current evaluations of ALMPs that an expansion in their scale will have a significant effect on aggregate labour market outcomes.

Targeting ALMPs on older workers and long-term unemployed

One of the weaknesses of the current active labour market programmes is the low coverage of older workers despite the government's goal that 55-59 year old persons who became unemployed in or after 2000 should be back in regular employment *via* training and rehabilitation measures. At the end of 2004, the age group 55 and older accounted for around 25% of the unemployed and almost 50% of the long-term unemployed. At the same time they accounted for only 9% of the employed in wage-subsidy programmes and 4% in labour market training (Table 5.2).

The emphasis on labour force service centres which provide services to long-term unemployed workers with social and health problems is a good idea. However, one problem is that many disabled persons are not included in this client group. Today only about 4% of the total stock of those on a disability pension are on active measures, which is about half the average activation rate. Some recent evidence from the United Kingdom suggests that placing greater obligations on those with less severe health conditions to attend a series of work-focused interviews soon after they apply for a disability-related benefit can help the disabled back into work (Chapter 3). This suggests that the client group of long-term unemployed should be extended to include many of those workers with less severe conditions on disability pensions since this may have beneficial effects on employment for this group.

Table 5.2. **Age distribution of the unemployed and of those in active labour market measures**

December 2004, percentage of total

Age	All unemployed	Long-term unemployed	Employed using wage-based measures	In labour market training
15-24	12.2	1.5	22.1	15.3
25-54	63.4	50.8	68.8	81.2
55-59	19.5	36.9	8.3	3.2
60+	4.9	10.8	0.8	0.4
Total	**100.0**	**100.0**	**100.0**	**100.0**
Total (thousands)	284.6	72.3	52.8	29.3

Source: Ministry of Labour, *Employment Report 2004*.

Unemployment benefits

The majority of the unemployed receive one of three types of payment: an earnings-related unemployment allowance; a basic allowance paid by the unemployment insurance funds; or a flat-rate means-tested labour market support paid by the state. The earnings-related allowance is more generous, but is only payable for 500 days, whereas the labour market support is payable indefinitely (Table 5.3). One notable exception is the unemployment pipeline where persons aged 59 (effectively the "unemployment pipeline" starts at the age 57) are entitled to an extension of the unemployment allowance after the end of the 500 days until the age of 65 contingent on the person having been employed for at least five years during the past 20 years.[4]

Table 5.3. **Unemployment benefits**

2004

Benefit	Percentage of all registered job seekers	Qualifying conditions	Amount	Maximum duration	Gross replacement rate at APW wage
Earnings-related allowance	42	Employed for 43 weeks at least 18 hours a week during the last 28-month review period. Member of unemployment insurance fund for 10 months.	Basic allowance + 45% of difference between previous earnings and basic allowance with an upper limit of € 2 090. After that the earnings-related part declines to 20%.	500 days plus extension for 180 days for older workers.	55%
Basic allowance	7	Employed for 43 weeks at least 18 hours a week during the last 28-month review period.	€ 23/day + allowance for dependent children.	500 days.	18%
Labour market support	49	Subject to means test, need to register at an unemployment office for 5 days.	€ 23/day + allowance for dependent children.	Unlimited conditional on activation.	18%

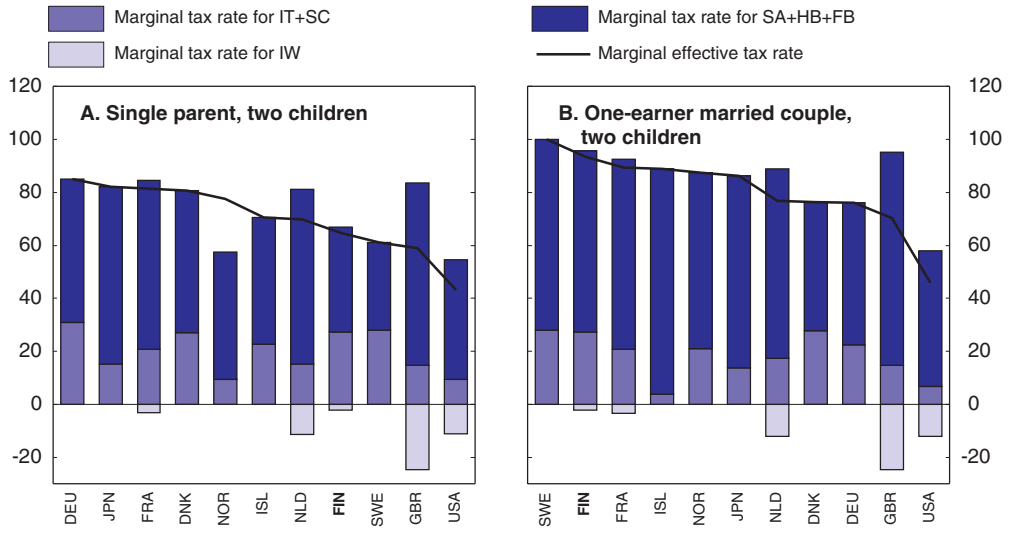
Source: Ministry of Labour, *Finnish Labour Review,* Vol. 48, 1/2005.

The gross replacement rate associated with the earnings-related unemployment allowance is 55% while the rate for the basic allowance is about 20%, calculated at the earnings level of an APW. However, taking into account taxes and benefits such as the housing allowance that accrues to an unemployed person the net replacement rate is higher. The interaction between taxes and benefits distorts the incentives for persons when deciding whether to work. Overall the financial incentives to move back into work for long-term unemployed or inactive persons are weak because the combined impact of

increased income tax payments and social security contributions and withdrawal of income-tested benefits (social assistance, housing benefits, in-work benefits and family benefits) offset most of the gain in disposable income from taking up work, especially for a low-skilled worker with a family. The marginal effective tax rate (METR) when moving out of unemployment into full time work is high, particularly for one-earner couples where it is over 90% where the largest contribution is from social assistance, housing allowance and family benefits. This may cause "inactivity traps" (Figure 5.3).[5] Measures that raise the financial incentives to work for low-wage earners are an important part of increasing overall labour supply. Empirical evidence tends to suggest that high levels of unemployment benefits and a long duration tend to raise equilibrium unemployment. Overall these studies find that long duration is more detrimental to employment than high replacement rates (OECD, 2006) suggesting that there is scope for reducing the duration, or at least tapering the generosity of labour market support.

Figure 5.3. **Marginal effective tax rates for long-term unemployed and inactive**[1]

2002



1. Decomposition of the marginal effective tax rate (METR) when moving from long-term unemployment or inactivity to full-time work at wage level equals to 67% of APW. These METRs indicate how much of the wages earned following a move to work from unemployment is taken away in the form of taxes and lower welfare benefits.
   IT refers to income tax, SC to social security contributions, IW to in-work benefits, SA to social assistance, HB to housing benefits and FB to family benefits.

Source: OECD (2006), *OECD Employment Outlook*, OECD, Paris (forthcoming).

Labour supply disincentives from generous unemployment benefits can be mitigated to some degree by benefit administration practices that use financial sanctions to enforce the obligation to search for work and accept reasonable job offers (OECD 2006; Boone *et al.*, 2004; Hasselpflug, 2005). In Finland entitlement to the unemployment allowance or labour market support can be suspended for a period of 2 months if a person without a good reason stops looking for work for more than 6 months or refuses to accept a suitable job or training offer.[6] A summary indicator of the overall strictness of sanctions provided by the Danish Finance Ministry ranks Finland in the middle of a group of 25 countries, with Netherlands and Austria having the strongest requirements of the countries considered

(Hasselpflug, 2005). In comparison with other Nordic countries, Finland seems to have weaker requirements regarding geographic and occupational mobility when searching and accepting work. This may contribute to the low level of regional mobility.

More is needed to reach the employment target

It is doubtful that the planned expansion of active measures will have large employment effects. More important is that the ongoing reforms to activate the long-term unemployed, which are a good initiative, are followed through, and applied equally to older workers. The expansion of labour force service centres providing services to long-term unemployed workers with social and health problems is also a useful initiative, but as argued in Chapter 3, the client group should be extended to many of those with less severe conditions on disability pensions. Furthermore, the composition of active measures should be directed towards those that are most effective rather than expanding the scale of all measures. Recommendations concerning active and passive labour market measures are detailed in Box 5.1.

Box 5.1. **Recommendations concerning active and passive labour market support**

To reach the government's employment target of an employment rate of 75% the following measures should be considered:

- Change the mix and targeting of active labour market measures in favour of those that are most effective. In particular, further reduce wage subsidies for public sector jobs and provide more private sector wage subsidies, but do not expand their overall scale.
- Increase the activation of older workers and persons on disability schemes.
- Increase the financial incentives to work by tapering unemployment benefits at longer durations to reduce the marginal effective tax rate (METR) from taking up work.

Notes

1. In 2002 spending on youth measures was 0.17% of GDP which is above the OECD average of 0.12%.
2. This is specified in the government proposal "Hallituksen esitys eduskunnalle" (HE 164/2005). The estimated cost of this reform is € 180 million in 2006 and after a transition period of three years the cost will fall to € 150 million. This implicitly means that the benchmarking for the reimbursement scheme for municipalities will be altered.
3. The Ministry of Labour has contracted to the Tampere University Work Research Centre a follow-up study on the labour market performance of participants in ALMPs.
4. This was recently changed and the old rules apply to persons born prior to 1950 who reach the age of 57 before the end of the 500 day period. These persons receive an extension of the unemployment allowance until the age of 60, thereafter they can apply for the unemployment pension.
5. A METR of 100 indicates that moving from long-term unemployment or inactivity to work leads to no additional net income.
6. If a person repeatedly refuses to accept a job or training offer, the entitlement is suspended until the person has been employed or is in training for 3 months.

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Chapter 6

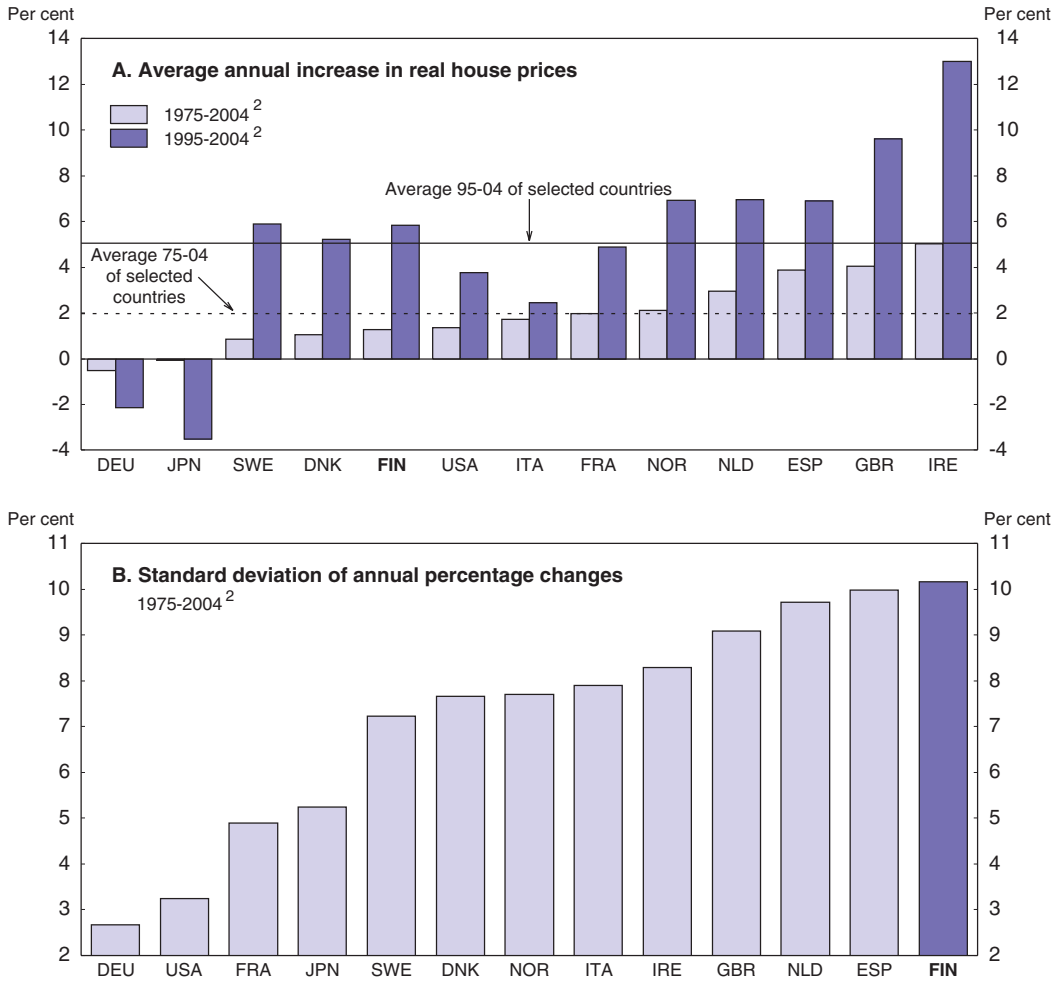
Housing: reducing risks and improving policies

While pronounced cycles in house prices have been a major cause of macroeconomic instability in the past, current house price developments do not yet suggest an overheating of the housing market. However, several important concerns are related to both direct effects of housing markets on overall activity and to more structural and regional issues. A factor making housing markets and the macroeconomy vulnerable to interest-rate shocks is the high share of mortgage loans linked to variable interest rates. Tax subsidies to housing may largely be capitalised in higher land prices rather than increasing housing availability to the extent that slow planning procedures and municipalities' unwillingness to provide building land have limited the growth of the housing stock in growth regions. This would argue for improving municipalities' incentives to provide building land, speeding up planning procedures and a phased removal of the tax advantage associated with housing. Furthermore, the provision of social housing and the housing allowance system should be better targeted on those most in need of affordable housing.

Introduction

House prices in Finland have been amongst the most volatile in the OECD over the last three decades (Figure 6.1) although their trend growth has been close to the OECD average. Much of this volatility is accounted for by the housing bubble that emerged in the late 1980s and its dramatic collapse in the early 1990s (Box 6.1). Generally, price changes have been strongly correlated with both the business cycle and consumption (Figure 6.2). In recent years annual house price increases have, however, remained in single digits,

Figure 6.1. **Real house prices:[1] average annual increase and variability**



1. House prices are deflated using the private consumption deflator.
2. 2003 for Denmark.

Source: Table III.4 in OECD, *OECD Economic Outlook*, No. 78, December 2005.

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Box 6.1. **The house price bubble and banking crisis of the early 1990s**

The collapse of the house price bubble in the early 1990s ushered in one of the most severe recessions experienced by any OECD country.* The housing bubble and the following banking crisis were preceded by a housing and financial market boom and overheating of the economy. During the boom period in the late 1980s, real house prices increased more than 60%, but plummeted by almost 50% between 1990 and 1993, while housing completions in 1996 were only one-third of the peak in the early 1990s.

The boom can be partly explained by the liberalisation of financial markets and inadequacies in prudential supervision of the banking sector. In addition to the deregulation of interest rates, competition between banks was raised by foreign banks entering the domestic financial market and the freeing up of foreign capital movements. The increase in asset prices made it easier to apply for a loan as the value of collateral also increased. The boom peaked in late 1988 when credit expanded by almost 30%. However, bank lending continued to grow until 1991. After that the domestic credit stock declined for four years and it took until 1996 for bank lending to recover.

During the crisis, the share of non-performing bank loans grew rapidly, with the proportion of non-performing loans rising to 9% when the banking crisis was at its worst (IMF, 1998). This caused huge credit losses to banks, and it has been argued that they were an essential factor contributing to the severity of the crisis. Most of the credit losses, however, came from corporate loans. While credit losses from housing loans were minimal, households reacted to excess indebtedness and declining collateral values by accelerating the pay-back of loans. The resulting increase in the saving ratio made the situation even worse by reducing domestic demand, increasing the number of bankruptcies in the non-tradable sector and thereby the credit losses of banks.

The total costs of the banking crisis are calculated to have been 8-10% of GDP. The crisis was also costly for the government which provided the banks with around € 16 billion of support. All in all, the net cost to the government was half of this amount.

The crisis did, however, trigger a vast improvement in the productivity of the banking sector. The improvement is partly explained by a considerable reduction in the number of bank offices and personnel. The rapid adoption of new technologies and increased international competition have also contributed to the increase in productivity.

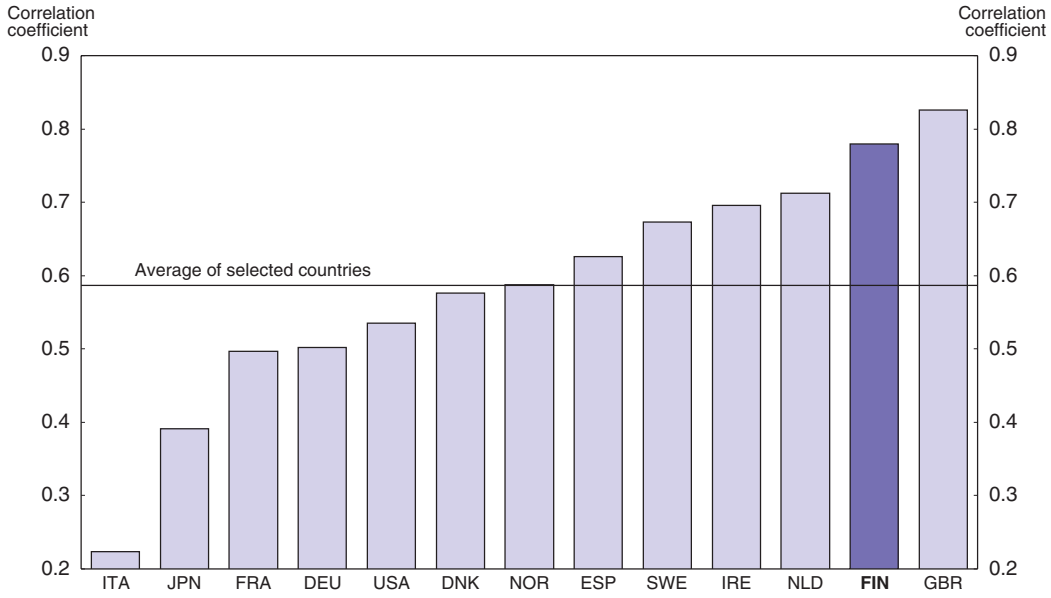
* See Honkapohja and Koskela (1999) and Kiander and Vartia (1998) for a review of the recession.

though they have accelerated recently, especially in the Helsinki region. Overall, there is no strong evidence that houses are currently overvalued. This suggests that now is an opportune time to consider the reasons for the strong links between economic activity and the housing market and whether there is a case for policy action to reduce the risk of macroeconomic instability in the future.

In 2002 an international panel of experts (Ministry of Environment, 2002a) concluded that, despite the volatility of the housing market, housing policy and well-functioning financial markets have underpinned the provision of an adequate supply of affordable housing: the stock of dwellings *per capita* is high in international comparison and has been growing faster than in the other Nordic countries (Figure 6.3). Housing standards, in terms of basic amenities, have increased considerably; around 50% of apartments have their own sauna, and homelessness has halved since the late 1980s.

Figure 6.2. **Correlation of private consumption growth with real house price changes**

1975-2004[1]

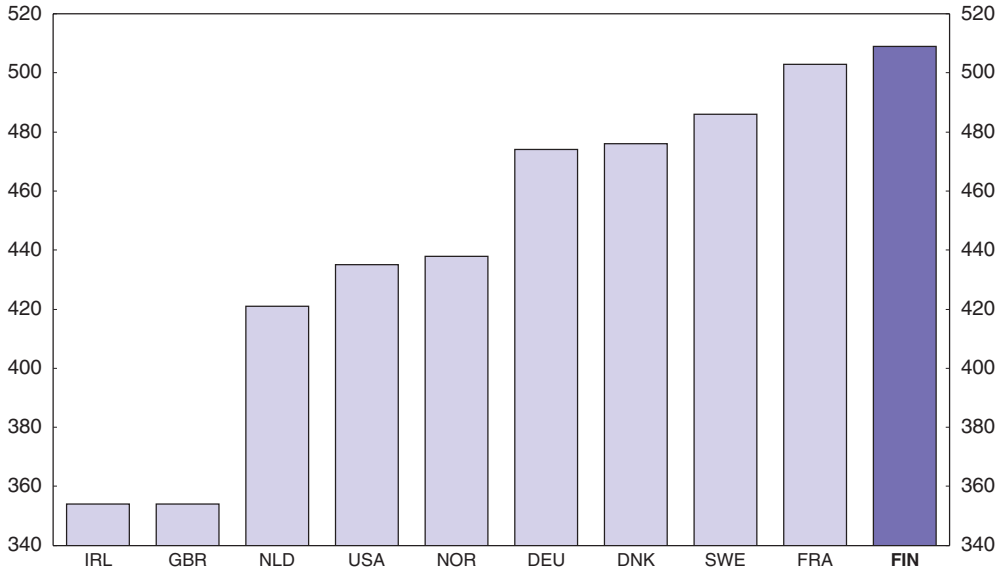


1. 2003 for Denmark.

Source: Table III.4 in OECD, *OECD Economic Outlook*, No. 78, December 2005.

Figure 6.3. **Dwelling stock**

Per 1 000 inhabitants, 2003[1]



1. Or latest year.

Source: Statistics Finland, *Construction and Housing Yearbook*, 2005 ed., Chapter 19, Table 1.

Nevertheless, there are signs of shortages in some of the main metropolitan areas and the housing stock falls short of the population's aspirations in some respects, notably the

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average dwelling size is smaller than in other Nordic countries. The remainder of this chapter reviews the functioning of the housing market and considers a wide range of related policy issues including: the links between the housing market and economic activity; whether there are more efficient ways of achieving the government's objectives, while making the housing market more responsive to people's aspirations; and whether the mix and overall burden of taxation and subsidies on housing is optimal.

The current housing system and dwelling stock: an overview

Housing policy has focused on providing housing with decent standards for all Finns. The housing situation was very difficult after the Second World War as housing standards were low in international comparison, internal migration extensive and financial markets underdeveloped. In view of the difficult starting point, housing policy has thus been fairly successful in reaching its objectives (Box 6.2).

Box 6.2. **Housing policy objectives**

The central objective of housing policy is to enhance the affordability of decent homes for everyone. Based on the indicators discussed above, housing policy has been successful in promoting this objective. However, housing policy is facing a number of challenges that emerge from regional imbalances, the ageing of the population, volatility in housing markets and environmental and quality issues. The government has issued a 2004-06 housing policy programme (Ministry of Environment, 2004a) and a programme for construction policy (Ministry of Environment, 2002b).

The main objectives of the programme for housing policy are the following:

- Enhance housing production in growth centres by improving planning and land policies, increasing social housing in these regions and promoting the supply of private rental housing.
- Encourage maintenance and repair of the housing stock, taking into account the needs of the elderly for living at home.
- Smooth the problems related to housing in regions where out-migration is large, for example by reducing the sale restrictions on dwellings built with government subsidies.

The programme for construction policy includes the following major goals:

- Further improve the quality of housing and the living environment by developing the training and education system and R&D in the construction sector as well as by specifying required qualifications of professionals and by agreeing on common standards.
- Enhance ecological and life-cycle aspects in the construction sector.
- Promote competition and productivity in the construction sector by using more calls for tender in public building, facilitating co-operation between public and private parties in the sector and improving conditions for international activities of the construction sector.
- Improve the resilience of the construction sector to business cycle fluctuations.
- Develop planning and building permit systems to shorten the process between planning and the start of building projects.
- Develop co-operation between the state and municipalities in providing urban infrastructure.

The national and local authorities affect housing supply as they are responsible for the zoning of land, whereas private companies and co-operatives build houses, including the construction of social housing. Most of the financing is provided by banks. However, as in many other OECD countries the state provides considerable support to housing, in total about 1% of GDP in 2004. The state subsidises the financing of housing production and renovations through preferential loan schemes. Furthermore, it provides tax deductions for interest payments for owner-occupied housing and a housing allowance for low-income households.

Owner-occupied housing is predominant even though the share of owner-occupation fell from 67% in 1990 to 58% in 2004 following the bursting of the housing bubble and the liberalisation of the private rental market in 1995.[1] Moreover, social rental housing production was promoted through government programmes. More than half of the rental dwellings are owned by non-profit institutions providing social housing (17% of the housing stock).

The average age of the housing stock is relatively low, with more than 60% of the dwellings built after 1970 and less than 4% built before 1920. Housing standards, in terms of average floor area per person, have risen significantly from 15 square meters in 1970 to 37 square meters in 2003. However, the average size per person is still relatively low in international comparison and the lowest in the Nordic countries (Lujanen and Palmgren, 2004). The housing stock does not seem to meet households' aspirations: according to a survey by the Ministry of Environment, 76% of households would prefer living in detached or semi-detached houses but less than half of the households participating in the survey actually lived in such dwellings (Ministry of Environment, 2004b).

The housing market and overall activity

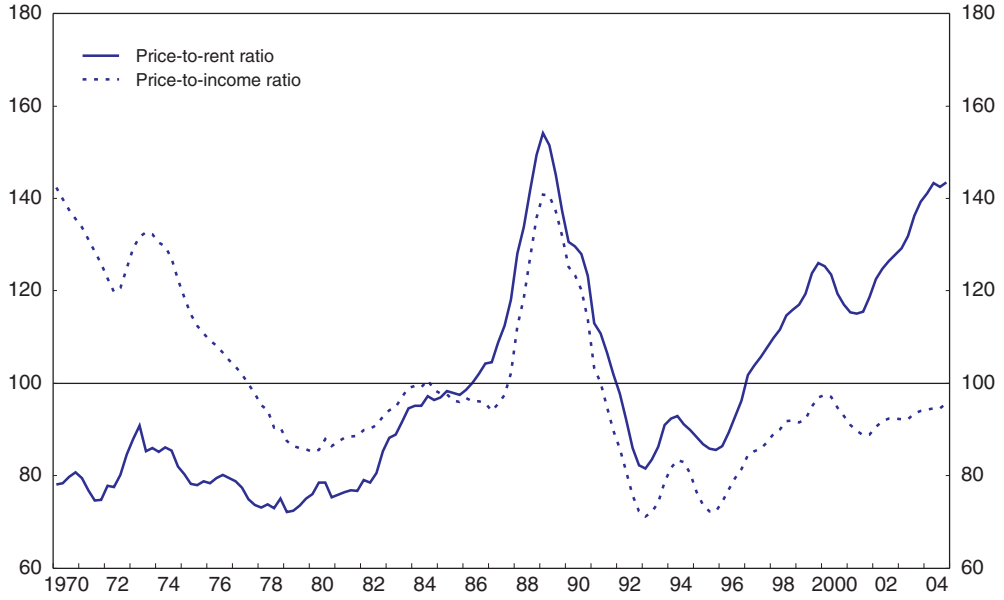
The current state of the housing market

As in most other OECD countries, house prices have increased over the last decade. Real house prices have risen by more than 80% in general and by 100% in the Helsinki metropolitan area since the first quarter of 1995. However, the price increases have been less pronounced than in some other OECD countries, such as Ireland, Spain or the United Kingdom. As strong house price increases are not necessarily evidence of an overvaluation, it is important to relate the house price increases to their underlying fundamentals in order to assess whether markets are overvalued.

Recent research (Girouard *et al.*, 2006; Herrala, 2005; Oikarinen, 2005) suggests that the current house price level is largely in line with the fundamental drivers. For instance, the price-to-income ratio, which is an indicator of the affordability of housing, is below its historical average (Figure 6.4). In many other OECD countries this ratio is above its long-term average (Girouard *et al.*, 2006). However, the ratio of prices to households' disposable income alone may be an insufficient measure to evaluate housing affordability as it does not capture the sustainability of households' mortgage debt service payments. The study by Herrala (2005) shows that, although the size of mortgage loans has risen, lower interest rates and longer loan periods have compensated for the increase in house prices and mortgage indebtedness.

One way to assess the over or undervaluation of houses is to compare the price of owner occupation and rental accommodation using price-to-rent ratios (the nominal house price index divided by the rent component of the consumer price index). The price

Figure 6.4. **Price-to-rent and price-to-income ratios**
Long-term average = 100



Source: OECD, *OECD Economic Outlook*, No. 78, December 2005, Figure III.4.

of owner-occupied housing has risen more rapidly than rents in recent years and is currently higher than the long-run average, as in many OECD countries (Figure 6.4).[2] This development can, however, be justified by the low level of interest rates since a decline in interest rates reduces the relative cost of owner-occupation as compared to renting.

Based on econometric work that links house price changes to fundamentals, Oikarinen (2005) shows that the current house price level is roughly in line with the long-run drivers of house prices. In particular, the growth in real disposable income and the decline in the real mortgage rate have justified a substantial part of the increase in house prices in the Helsinki metropolitan area over the last ten years. Even though house prices do not currently seem to be overvalued, a sudden change in fundamentals could have a severe effect on the ability of households to meet their mortgage payments. Van den Noord (2006) shows, for instance, that although the probability of a downturn in the housing market is currently small, the probability would rise rapidly if real house prices were to continue to rise and there were an increase in interest rates from their current low level. Indeed, the most recent figures on house prices confirm that this may become a concern, in particular in the Helsinki area where the annual increase in house prices was close to 10% in the last quarter of 2005.

The link between the housing market and consumption appears to be strong

The housing market acts as an important transmission mechanism between monetary policy and consumption. A rise in mortgage interest rates affects consumption through their direct effects on disposable income as the burden of interest payments increases. The housing market may also have an indirect impact on consumption through wealth effects.

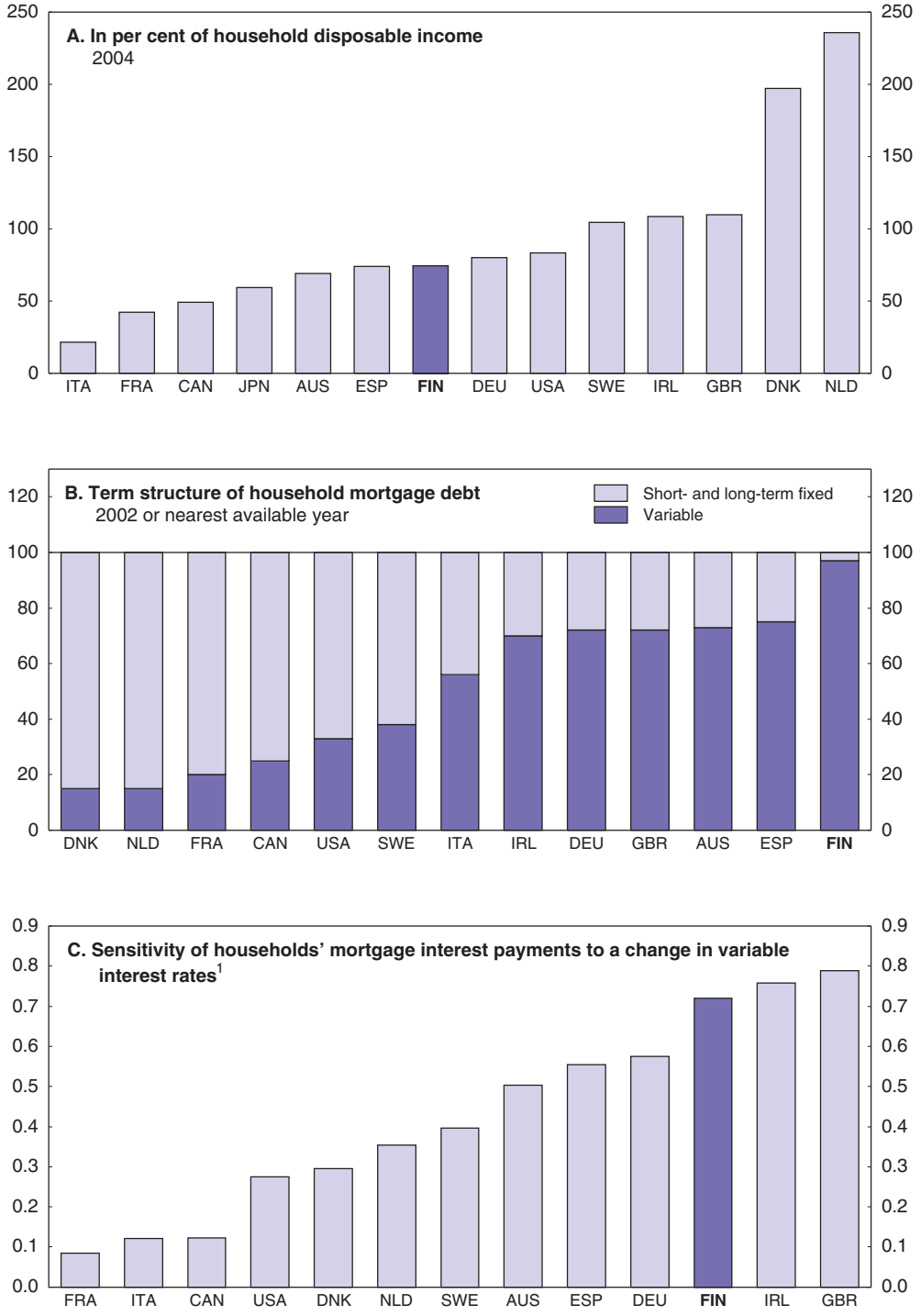
Mortgage debt and wealth effects

The level of mortgage debt is important in determining the magnitude of the direct impact of interest rate changes on mortgage debt service and hence consumption. In international comparison mortgage debt as a share of disposable income is relatively low (Figure 6.5, panel A). However, debt has been increasing rapidly in recent years, even though it is still below the 1989 peak when it reached 90% of households' disposable income. If indebtedness continues to rise rapidly, the debt ratio will exceed the previous peak in a few years. The effect of an interest rate change on mortgage debt service depends not only on the level of debt but also on the term structure of mortgage interest rates: the more short-term variable rates are used, the greater the sensitivity. As reported by Miles (2003) fixed and variable-rate mortgage products have very different risk and cost characteristics. Fixed-rate mortgages are not without risk, but they give a certainty over the profile of households' monthly debt service payments. Variable-rate mortgages do not provide such a certainty. However, due to the term premium fixed-rate mortgages may often *ex post* turn out to be more expensive. How attractive these products are from the view point of households depends to a significant extent on the costs of the option to repay the mortgage early and re-mortgage. The attractiveness of fixed-rate mortgages depends also on the risk aversion of households. While variable-rate mortgage products may be a good alternative for some households, fixed-rate mortgages are clearly a less risky alternative for some households, in particular first-time house buyers, households with long maturity or large mortgages. In this respect Finland is an extreme case with a surprisingly high share (95%) of the mortgage loans based on variable interest rates (Figure 6.5, panel B), which are usually tied closely to the 12-month Euribor rate.

A crude measure of the effects of interest rates on the mortgage debt service (Figure 6.5, panel C) suggests that the sensitivity of Finnish households to interest rate changes is high compared with most other OECD countries due to the large proportion of variable rate mortgages. A 1 percentage point increase in short-term interest rates could lead to a 0.7 percentage point rise in the interest payment-to-disposable income ratio. Increasing the length of the maturity of mortgage loans would be one way to smooth the effects of interest rate increases on households' debt servicing payments. Indeed, banks have started to offer loan contracts where an increase in interest rates automatically leads to a lengthening of the maturity so that debt servicing remains constant. While the average maturity of mortgages has traditionally been relatively short and is currently around 17 years, in recent years the maturity of new mortgages has risen[3] so that there may be less room now to increase the length of the maturity further.

Housing is a major wealth component and house prices may influence consumption. Housing wealth in relation to financial wealth is relatively large compared with other countries. Changes in housing wealth may also affect borrowing constraints as it can be used as collateral for loans with more favourable conditions than other forms of household borrowing (mortgage equity withdrawal). Econometric analysis (Annex 6.A1) suggests that the short-run effect of a change in housing wealth on households' consumption is relatively large as compared with most other OECD countries and is larger than the short-run effect of financial wealth. The short-run effect of housing wealth is also considerably larger (as well as being statistically better determined) than the long-run effect (Table 6.1).

Figure 6.5. **Household mortgage debt**



1. Estimated effect of a 1 percentage point increase in short-term interest rates on gross mortgage interest payments (as a per cent of households' disposable income). The effect is calculated as the product of the share of mortgages subject to variable rates and houseoulds' outstanding mortgage debt.

Source: European Mortgage Federation, *HypoStat 2004*; OECD, *OECD Economic Outlook*, No. 78, December 2005, Table III.1.

Table 6.1. **Housing wealth effect on consumption**

Estimated short-term marginal propensities to consume out of real housing wealth

Australia	0.02
Canada	0.03
Japan	0.01
Netherlands	0.02
Spain	0.01
United Kingdom	0.08
Finland	**0.05**

Source: Catte, P., N. Girouard, R. Price, and C. André (2004), "Housing Markets, Wealth and the Business Cycle", *OECD Economics Department Working Papers*, No. 394 and OECD calculations.

How should policy respond?

The heavy use of variable-rate mortgages largely reflects the preferences of households as banks are not much constrained in the products they can offer. Hence, there is no clear sign of failures in the Finnish mortgage market. However, the sensitivity to the interest rate changes should be a matter of policy concern. Finland no longer has an independent monetary policy and wealth effects appear to be much stronger than for the major euro area countries. Furthermore, variations in house prices are not strongly correlated with that of most other euro area countries (Table 6.2). The government currently operates a mortgage guarantee scheme available to all borrowers. While this scheme is intended as an insurance against default risk arising from possible discontinuity of income and is not likely to be the cause of the high share of variable-rate mortgages, it may be one factor diminishing the risk awareness of households and banks and thus inhibiting the development of fixed-rate mortgages. Such mortgage guarantee schemes are relatively rare in OECD countries and so it is unclear what particular rationale there is for one in Finland. Furthermore, they are usually targeted on low-income households in the countries where there exist similar schemes, *e.g.* in the Netherlands (Waarborgsfonds Eigen Woningen, WEW). The government should, therefore, consider phasing out or better targeting this scheme. While this would leave households and banks at an increased risk from a rise in interest rates, it might strengthen their incentives to insure against the risk by using fixed-rate mortgages (Box 6.3).

Table 6.2. **Correlation between house price cycles**

Correlation of house price changes, 1975-2004

	DNK	FIN	FRA	DEU	IRL	ITA	NLD	ESP	SWE	GBR
DNK	1	0.06	–0.25	–0.32	0.27	–0.65[1]	0.4[1]	–0.04	0.21	0.13
FIN		1	0.23	–0.36[1]	0.23	0.04	–0.1	0.35	0.41[1]	0.73[1]
FRA			1	0.1	0.31	0.6[1]	0.25	0.64[1]	0.63[1]	0.53[1]
DEU				1	0.17	0.39[1]	–0.03	–0.07	–0.09	–0.06
IRL					1	0.17	0.34	0.19	0.49[1]	0.36[1]
ITA						1	–0.06	0.36[1]	0.33	0.21
NLD							1	0.38[1]	0.49[1]	0.02
ESP								1	0.64[1]	0.59[1]
SWE									1	0.53[1]
GBR										1

1. Statistically significant at 5% level.
Source: OECD calculations.

Box 6.3. **The government guarantee for mortgages**

A government guarantee scheme is available to all borrowers buying a home or building a house since 1996. It was designed to facilitate the guarantee and collateral arrangements of borrowers and to replace the personal guarantees that led to large losses during the recession. Many households lost their homes as they were used as a collateral or as a basis for personal guarantees during the debt-defaults in the early 1990s.

The banks grant government guarantees as part of their housing loan decisions, and borrowers do not need to apply for a guarantee separately. The Housing Fund of Finland (ARA) supervises the banks' guarantee operations. A government guaranteed loan cannot exceed 85% of the purchase price of the house. The state guarantee provides a secondary collateral. If the prospective homeowner receives an interest subsidy, the loan guarantee is not subject to a charge. Otherwise the loan applicant may obtain the guarantee against a 2.5% premium. In the case of default, losses are covered after the primary collateral is liquidated by the lender and if the lender has not been able to recover the full amount of the receivables due from the collateral. The guarantee covers a maximum of 20% or € 25 250 of the outstanding loan balance and additionally, a maximum of 20% of the interest and penalty interest on the principal.

Statistical facts:

- In 2004 banks granted 35 000 mortgage loans with government guarantees.
- Currently, more than 150 000 government guarantees exist.
- About € 10 billion of the households' mortgage loan stock (€ 42 billion) is partly covered by the government guarantee.
- The total value of the government guarantees is currently € 750 million.
- Losses covered by the guarantees have been relatively small at € 175 000.

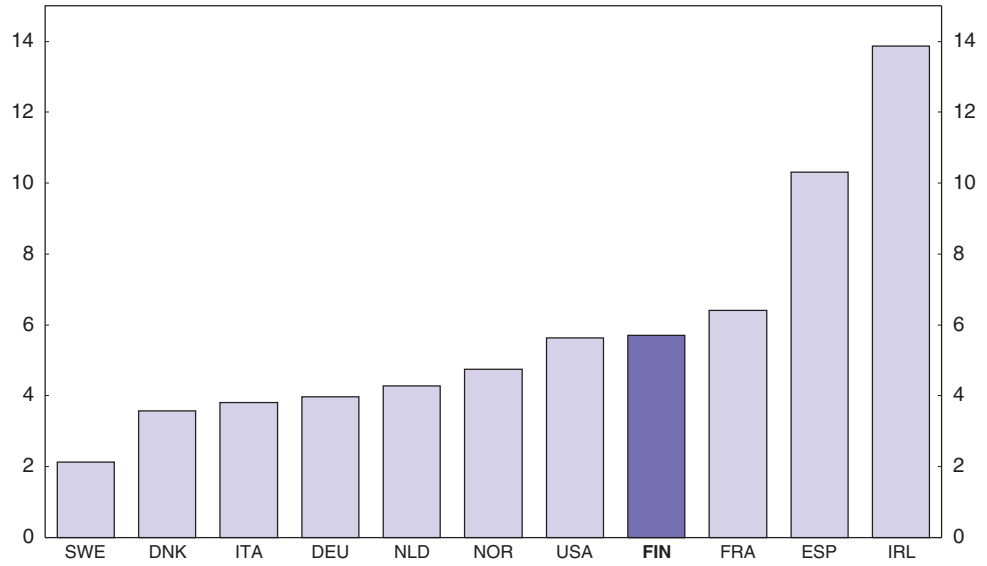
Housing investment and the construction sector

The impact of house price developments on the construction sector forms an important additional channel through which housing markets affect macroeconomic stability. For instance, OECD (2006a) suggests that construction booms and busts may have large macroeconomic consequences. The Finnish construction sector accounts for nearly 10% of the total value added in the non-agricultural business sector. In international comparison the construction sector is relatively large, even though dwelling completions per inhabitant are considerably smaller than in countries where housing is booming, such as Spain and Ireland (Figure 6.6).

Compared with house and land prices, construction costs have increased only moderately over the last decade. However, there may be future pressures on construction costs if the sector continues to grow rapidly. In particular, labour costs could rise more sharply. Unemployment in the construction sector has fallen below the national average and the number of unfilled vacancies exceeds the level found in the boom period of the late 1980s.

One explanation of why there has not been more pressure on construction costs may be the increased share of foreigners working in residential construction, particularly in southern Finland. Their share of total hours worked in housing construction is estimated to have been around 5-8% in 2004 (Lith, 2005). Foreign workers (mainly Estonians) have been able to work in Finland despite the restriction on the free movement of labour from the new EU member countries, mainly because they have not been hired directly by Finnish

Figure 6.6. **Dwelling completions**
Per 1 000 inhabitants, annual average 2000-03[1]



1. Or latest year.

Source: Statistics Finland, *Construction and Housing Yearbook*, 2005 ed., Chapter 19, Table 5.

firms but by foreign-based contractors or subcontractors. Under the freedom to provide services, the employees of such companies are not required to have a work permit if they are working temporarily in Finland whereas foreigners directly hired to work in Finland need a work permit. The requirements on work permits were originally set for a transition period of two years until the beginning of May 2006 in most "old" EU countries. These restrictions will be removed in Finland in May 2006 which should help in overcoming labour shortages in the future.

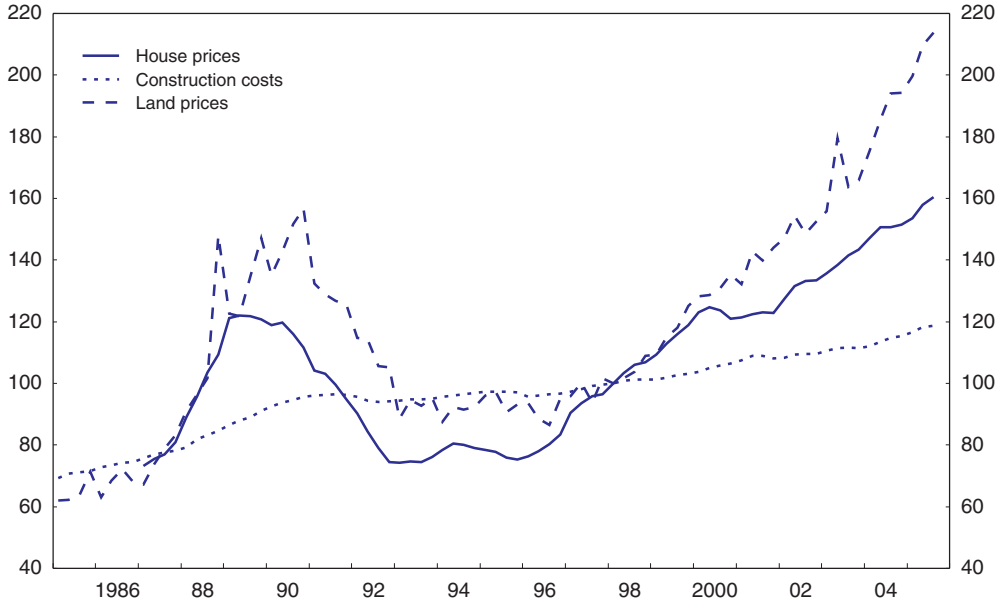
Raising the effectiveness of housing policies

While housing policy has been fairly successful in achieving its goals, there is scope for improvement. Housing support should be better targeted and housing supply in growth areas should become more elastic. Furthermore, there is a good case for reconsidering the role of property taxes in municipal finances. This section first assesses the problems related to planning and shortages of building land. It then considers different tax policy aspects related to housing, in particular property taxes and tax advantages associated with housing and home ownership. This is followed by an assessment of the housing finance and support system. Finally, the regional dimension of housing and labour mobility are discussed.

The planning system and supply of building land

The main factor driving up house prices has been the price of land. From the beginning of 1998 to the later part of 2005, land prices rose by 114%, while house prices increased by 54% (Figure 6.7). This feature is astonishing as Finland is a sparsely populated country and there is land available even around the metropolitan areas. The sharp rise in land prices signals a mismatch between the availability of and demand for building land. In a survey by the Finnish Local and Regional Authority (Laine, 2004) the shortage of

Figure 6.7. **Trends in housing related price indices**
Index 1998 Q1 = 100



Source: Statistics Finland.

building land is listed as one of the major bottlenecks limiting housing construction, particularly in the rapidly growing areas. According to the survey, this problem has worsened since the early 2000s. The survey lists the diversity of interests groups related to planning, lack of resources, problems in financing local infrastructure and the slowness of appeals on planning decisions as the most problematic issues.

The new *Planning and Building Act* was enacted in 2000. All government levels are involved in land use planning. The government sets general national planning guidelines and a regional plan is prepared and approved by a regional council where the municipalities are represented. This plan is ratified by the Ministry of Environment. The municipalities are responsible for the local master plan and the local detailed plan. They thus have a strong role in planning and no ratification of their planning decisions is required by other government levels.

The sluggish response of house building to the increase in prices in rapidly growing regions is partly due to the slow planning process. There are, for instance, multiple possibilities to appeal over decisions on building permits and local plans. The applicants and third parties have the right to challenge the decisions in both the regional and supreme administrative court. In 2004 the average length of proceedings in regional courts was 12.6 months, special permits took 9.7 months and building permits 7.9 months. If the parties appeal to the Supreme Court the length increases on average by an additional 11.9 months. 12% of planning and building decisions were appealed to regional courts and 26% were appealed to the Supreme Administrative Court (Korkeinhallinto-oikeus, 2004).

Since municipalities are responsible for providing the costly infrastructure in urban areas, such as roads and sewage, they may also have a disincentive to allocate sufficient building land for housing construction. In addition, they are responsible for providing

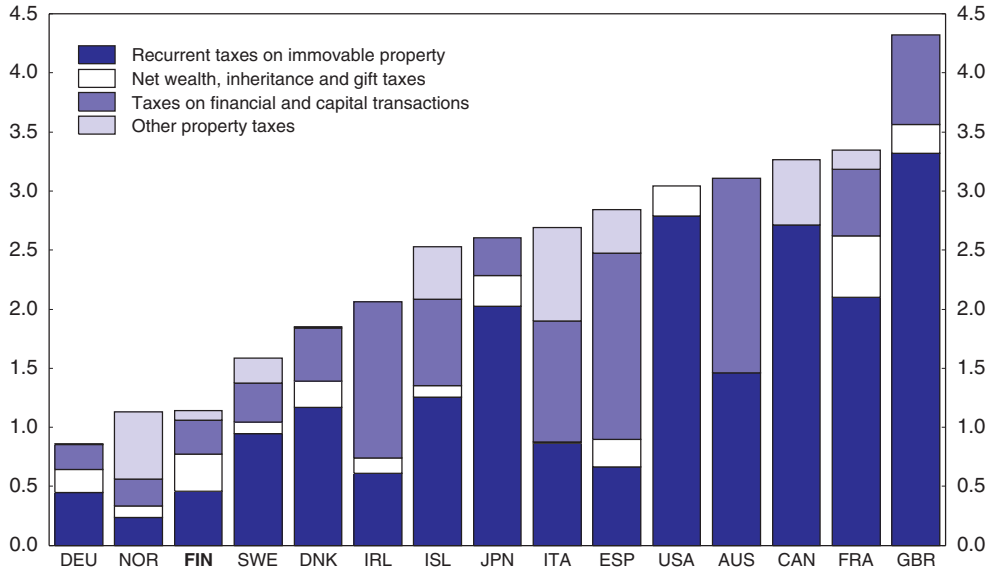
schools and children day care, health care and other services for the new residents. The government has recently decided to provide earmarked grants (maximum 35% of total expenses) to municipalities to support the provision of infrastructure in the growing regions.

The issues related to planning and municipalities' incentives to provide building land have been cited as major problems in discussions and reports.[4] The government is tackling these issues in the national construction and housing policy programmes by proposing to improve planning procedures and co-operation between the state and municipalities in providing infrastructure and services to new urban areas. Recently, a working group appointed by the government released its report on whether the *Planning and Building Act* should be revised so that municipalities' duties laid down in the Act to provide housing plots could be better enforced.[5] The working group also considered how the planning process could be speeded up. One of the conclusions of the report is that forcing municipalities to provide housing plots in all circumstances is not appropriate in the current system. Several recommendations concerning improving planning procedures are, however, proposed in the report. In particular, the report considers limiting the multiple possibilities to appeal over planning decisions.

Taxation of property

Tax policy is often used to alter housing market developments. In particular, the tax treatment of housing in Finland has played an important role in favouring home ownership. Mortgage interest payments are tax deductible, capital gains and imputed rental income are not taxed and property taxation is very low compared with many OECD countries (Figure 6.8).[6]

Figure 6.8. **Property tax revenue**
As a percentage of GDP, 2004[1]



1. 2003 for Australia.

Source: OECD, *Revenue Statistics, 1965-2004*, 2005 ed.

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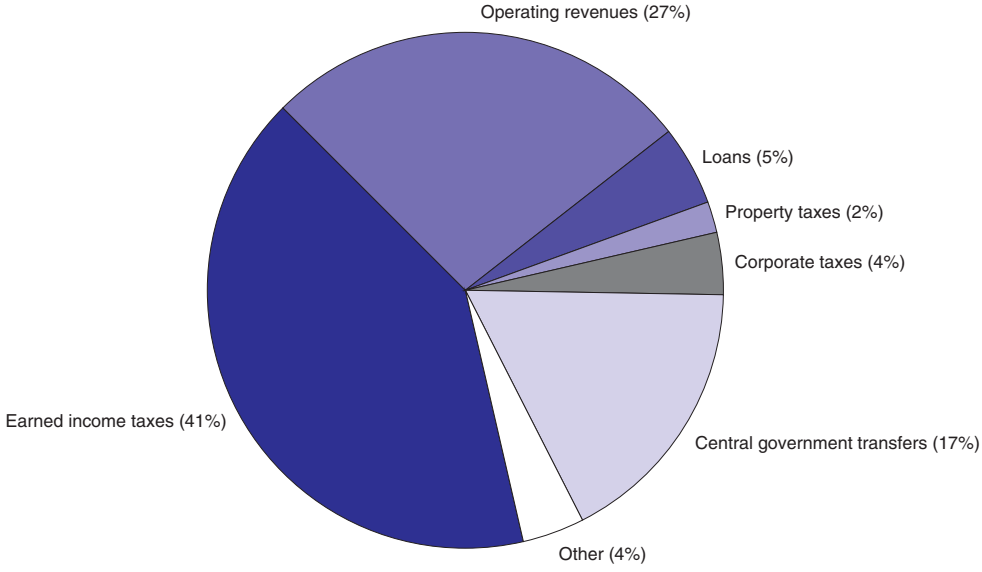
Municipal level property tax

One way to encourage municipalities to provide more building land and speed up planning processes would be to widen their possibilities to levy property taxes and to extend the tax base to undeveloped land, particularly in urban areas, which is currently not taxed. The property tax was introduced in 1993 when a major tax reform of the income tax system was implemented.[7] However, the role of property taxation as a revenue source has remained limited. While municipalities are free to decide on their own income tax rate without any upper threshold, the property tax rate is only allowed to vary within narrow limits. Currently, the general property tax rate can vary between 0.5 and 1.0%, but residential buildings are taxed at a lower rate (0.22-0.5%). The share of property tax revenues in total municipal revenues was around 2% in 2004, whereas the revenues from earned income and corporate tax accounted for 45% of total revenues (Figure 6.9).

Figure 6.9. **Municipal finances**
2004, in per cent of total revenues



Source: Ministry of Interior.

Some changes towards a wider use of property taxation are underway: land that is earmarked for house building but remains without construction activity will be taxed above the normal property tax rate. However, there is clearly room for further changes, most notably raising the lowest threshold and removing the upper threshold on the property tax rate. The major advantage of the use of property taxes at the local government level is that the tax base is more stable than the personal income and especially the corporate income tax. Property tax revenues are also relatively predictable (Joumard and Kongsrud, 2003). Moreover, higher property taxation would mitigate the upward pressure on labour income taxation that several municipalities are currently facing.

In order to further enhance the incentives of municipalities, property tax revenues could be exempted from the fiscal equalisation system. Currently all municipal tax revenues are taken into account in the equalisation of central government transfers. The

system basically implies that municipalities with a smaller tax base relative to the average receive compensation whereas municipalities with a large tax base will receive less central government transfers (Box 6.4). The incentives could also be promoted by allowing municipalities to tax the increase in the value of building land provided for housing or by encouraging them to use their preferential right to buy land and to charge building developers for the costs of new infrastructure.

Box 6.4. **The fiscal equalisation system**

Since municipalities are responsible for many functions that involve redistribution (from the rich to the poor and from the working-age population to the young and the old), some equalisation of resources is necessary. The tax equalisation scheme aims to reduce disparities among municipalities in their capacity to raise revenues while the state grant scheme contributes to the funding of the local provision of statutory services.

The tax equalisation system is based on a comparison between a municipality's potential tax revenues per inhabitant and the country average (potential tax revenues are defined as those that the municipality would get if it adopted the average tax rate). If the potential tax revenue of a municipality falls below 90% of the country's average, then the tax equalisation scheme raises this municipality's financial resources by redistributing tax revenues collected from wealthier municipalities (in 2004, more than three fourths of the municipalities were below this threshold). If it exceeds the 90% threshold, the municipality contributes to the tax redistribution scheme (40% of its tax revenues, starting from the 90% threshold). In 2006 the 90% threshold was raised to almost 92% and the 40% share was reduced to 37%. These changes are related to reimbursing municipalities the additional costs due to the labour market support reform and loss of revenues due to some other reforms.

Municipalities also receive block grants, based on notional expenditure needs, from the state. Notional spending on social welfare and health care is based on the age structure of the municipalities' population and some geographic criteria. Social welfare grants also take into account the level of unemployment, and health grants take into account a morbidity factor. State transfers for education are based on the number of students. Every year, state transfers are adjusted to reflect price and public sector wage developments. State grants were cut significantly in the mid-1990s. However, in recent years the share of state grants has been increasing, representing 5.2% of GDP in 2004.

No formal relationship exists between grants and taxes, creating uncertainties over the availability of municipal financial resources. In the second half of the 1990s, booming corporate income tax revenues led to cuts in state grants, *de facto* preventing excessive spending. However, there is no automatic mechanism leading to higher grants in periods of falling tax revenues. Furthermore, despite the recent reduction to two years, the delay in redistributing tax revenues through the tax equalisation scheme creates additional uncertainty on the resources that will accrue to them.

The exclusion of property tax from the equalisation system has been discussed (Ministry of Interior, 2004), but was not adopted, in part because such a reform would benefit most those municipalities that have a large industrial tax base. As an intermediate alternative, the reform could relate only to residential property. This would also strengthen the link between municipalities' incentives to supply building land for housing and property taxation, as efforts to improve the local infrastructure are likely to be reflected in property values, increasing the tax yield for municipalities. This link between property

taxation and municipal incentives does not exist, however, if the property values in the tax assessment are not market based.

Currently, the assessment value of property is not closely linked to recent price developments (Box 6.5). The assessment value of buildings is based on the repurchase value set annually by the Ministry of Finance. The rise in the repurchase value has been much slower than that of house prices. For example, house prices increased by about 30% in Finland from 2000 to 2005 whereas the repurchase value increased by less than 10%.[8] Similarly, assessment values of land lag behind the development in land prices. For example, the assessment values of land in the Helsinki city centre have not been changed since 1997.

Box 6.5. **The determination of assessment values for property taxation**

The amount of property tax is determined by the tax rate and the assessment value of land and buildings. The assessment value of land is based on wealth tax law and annual decisions by the tax authority. The government has proposed to abolish the wealth tax from 2006. The assessment value will be determined by a new law on the valuation of assets. Until now, the calculation of this value was determined by municipal maps including information about site prices in a region and assessment guidelines. The site prices in the maps reflect the price of raw land sold in the region as well as the planning situation and land policy of the municipalities.* Region-specific current values are determined for sites with residential buildings, offices, shopping malls and industrial buildings. The target of the tax authorities is to have the assessment value of land at 73.5% of the value indicated by the site price maps and assessment guidelines.

The property tax assessment value of buildings is determined by the repurchasing value of the buildings and by deductions related to their age. The repurchasing value of a building is based on the assessment of the construction costs of a similar new building. This assessment does not take into account differences in construction costs by region. The Ministry of Finance sets annually the repurchase values of different types of buildings. These values are 70% of average construction costs and reflect the changes in the construction cost index. The tax assessment value is obtained by subtracting annual age deductions from the repurchase value. Thus, the tax assessment value often does not reflect the market value of buildings. The total assessment value of a property is obtained by summing the assessment value of the building component with that of the site.

* The difficulty in updating the assessment values of land, *e.g.* in the Helsinki area, is that there are few land transactions which could be used as a basis for updating the assessment values of land in the area.

If the assessment value of property were linked directly to recent house prices, property taxes would affect house price developments. Muellbauer (2005) argues that it is crucial to link the property tax to current or recent house prices throughout the house price cycle, so that property tax would be a constant proportion of capital values. This would tend to dampen house price cycles since higher house prices have an immediate effect on tax payments and thus on households' income. Furthermore, if households extrapolate house price rises into the future they will also anticipate the greater tax burden. This will lead to more cautious spending and portfolio decisions.

Other tax policies

As in many other countries, taxation is geared towards facilitating households' access to home ownership *via* the deductibility of mortgage interest payments from income tax, while

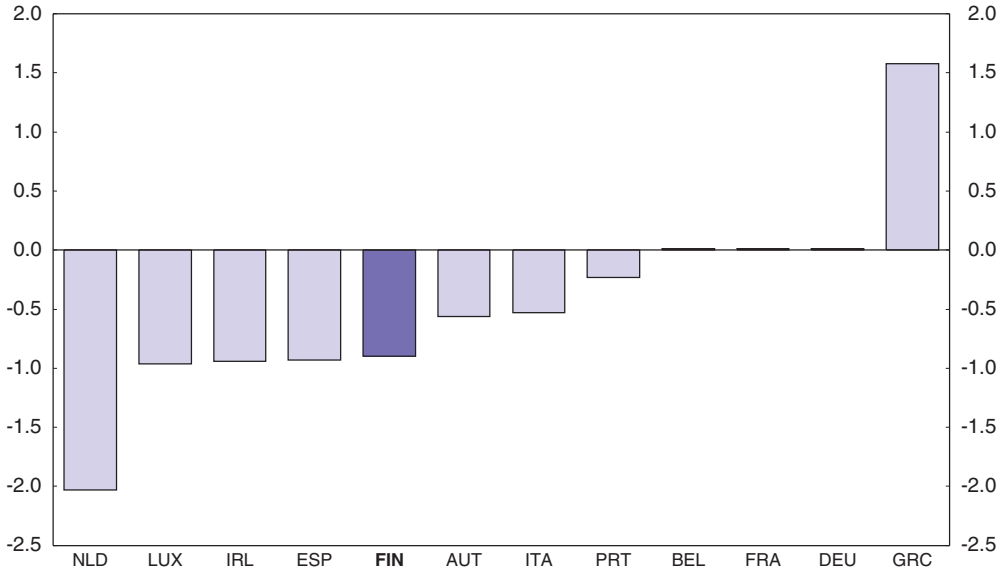
the imputed rental income and capital gains from home ownership are not taxed. Taken together these tax advantages form a complex taxation structure which departs from the principle of tax neutrality and strongly favours home ownership instead of renting.

Finland has a dual tax system where capital and labour income are taxed at different rates (van den Noord and Heady, 2001). The deductibility of interest payments is determined by the intended use of the debt. The right to deduct interest payments concerns interest on mortgages, government-secured student loans and interest expenses accrued from producing taxable income. The interest payments are primarily deductible from capital income. If interest payments exceed capital income, it is possible to deduct the rest from the labour income tax liability in the form of a tax credit (Saarimaa, 2005)[9] in which case they can be deducted at the capital income tax rate.[10]

The favourable tax treatment of owner occupation is often justified by the specific nature of housing and the positive externalities for society associated with its consumption (OECD, 2005). However, the deductibility of mortgage interest expenses may be an inefficient policy instrument to promote home ownership since it also affects house prices. This is the case, in particular, when housing supply does not respond swiftly to increasing demand. In addition, the tax relief leads to higher demand for mortgage loans at any given interest rate which may amplify the housing cycle. Although the deduction was shifted from the progressive income tax to the flat capital income tax rate in 1993, it still plays an important role, accounting for 0.25% of GDP. In international comparison, the tax treatment of mortgage interest payments in Finland is more favourable than in many other OECD counties (Figure 6.10). Tax deductibility should be scaled back, possibly in the context of a more comprehensive reform of housing policies. However, to the extent that a more general reform would involve a substansial increase in property taxes the urgency of

Figure 6.10. **Impact of tax deductibility of interest payments**[1]

1999, per cent



1. Difference between after-tax and pre-tax real interest rate on mortgage loans.

Source: Van den Noord, P. (2005), "Tax Incentives and House Price Volatility in the Euro Area: Theory and Evidence", *Économie internationale*, No. 101.

phasing out the mortgage deductibility would be reduced. In the current environment of low interest rates, the decision to phase out the tax relief would be more acceptable to the public and easier to carry out since the subsidy is smaller in such circumstances.

Another type of tax incentive, present in many OECD countries, is that gains from sales of owner-occupied housing are exempt from capital gains tax (Catte *et al.*, 2004). In Finland these gains are exempt from taxation if the owner has lived in the dwelling for more than two years. Taking all tax elements together, policy in Finland gives an especially favourable status to home ownership (Table 6.3).

Table 6.3. **Taxation of residential property**

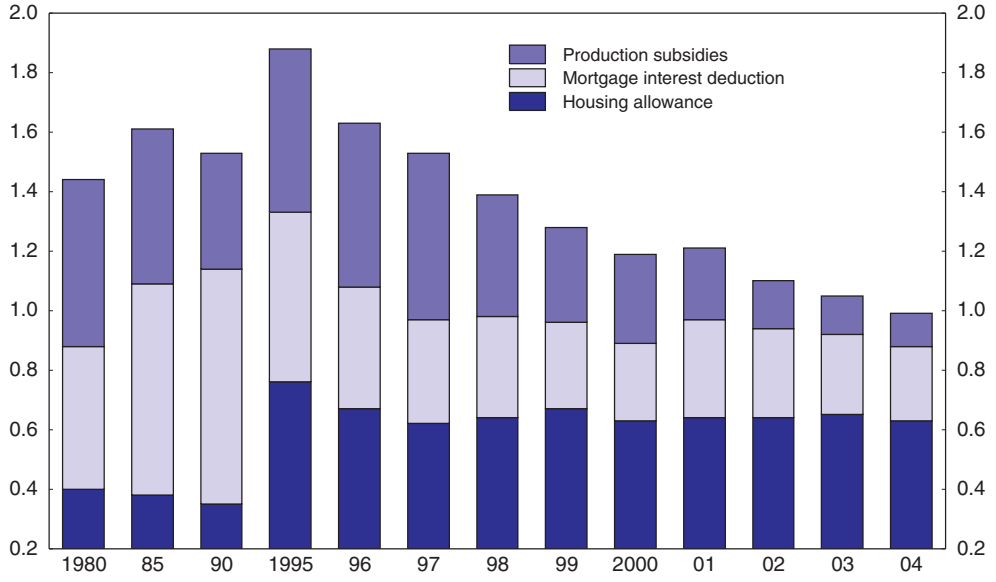
	Imputed rental income taxed	Tax relief on mortgages		Capital gains on housing assets taxable	Inheritance tax
		Interest	Principal repayments		
Austria	N	Y (up to ceiling)	N	Y	Y
Belgium	Y (with fixed deduction)	Y (up to imputed rental income)	Y (within limit)	Y (if sold < 5 years) POOD are exempt	Y
Canada	N	N	N	Y (on 50% of gains) POOD are exempt	N (but subject to capital gains tax)
Denmark	N	Y	n.a.	Y POOD are exempt	Y
Germany	N	N	N	Y (if sold < 10 years) POOD are exempt	Y (lower than for financial assets)
Finland	N	Y (up to a ceiling)	n.a.	Y POOD exempt if sold > 2 years	Y
France	N	N	N	Y POOD are exempt	Y
Ireland	N	Y	N	Y POOD are exempt	Y
Italy	N (for POOD)	Y (for POOD)	N	Y (50% for POOD)	Y (until 2001)
Netherlands	Y	Y	N	N	Y (above tax free threshold)
Norway	Y	Partly (as other interest expenses)	N	Y	Y
Spain	N (for POOD)	Y	Y	Y (exempt if reinvested)	Y
Sweden	Y	Y	N	Y (exempt if reinvested)	N
United Kingdom	N	N	N	Y POOD are exempt	Y
United States	N	Y (up to ceiling)	N	Y (until 2002) (deduction for POOD if held > 2 years)	Y (to be phased out)

Note: POOD = principal owner-occupied dwellings.
Source: Catte, P., N. Girouard, R. Price, and C. André (2004), "Housing Markets, Wealth and the Business Cycle", *OECD Economics Department Working Papers*, No. 394; Baunkjoer, C.F. (2004), "Housing Taxation", *Housing and Housing Policy in Nordic Countries*, M. Lujanen (ed.), Nordic Council of Ministers.

Housing finance and support systems

In addition to tax policy, government housing finance and subsidies play an important role in shaping the housing market. These subsidies can be divided into different programmes depending on whether they are intended to support housing supply or to subsidise housing demand. In total such subsidies amounted to 1% of GDP in 2004 (Figure 6.11).

Figure 6.11. **Housing subsidies**
As a percentage of GDP



Source: Ministry of Environment.

Housing allowances

The housing allowance accounted for two-thirds of these subsidies in 2004. A general allowance is granted to low-income households irrespective of the type of housing tenure (social rental, private rental, "right of occupancy"[11] and home ownership). 159 000 households received this assistance in 2004. In addition, more than 300 000 people were included in separate housing allowance programmes for pensioners and students. Overall, around 20% of all households receive a housing allowance.

The amount of the general housing allowance is linked to households' income through a so-called "deductible amount". The size of the "deductible amount" (the amount of rent paid by the household) is determined by family type, number of children, and geographic location and it increases in small steps as the gross income of the household increases. The amount of housing allowance that households receive covers 80% of the difference between the actual housing costs and the "deductible amount". The actual housing cost includes expenses such as rent, water and heating payments for tenants and water, heating and maintenance costs as well as 55% of personal or 80% of a household's total mortgage interest payments for home-owners. Although the majority of claimants for

housing allowance are tenants, the possibility to obtain the allowance to cover mortgage interest payments favours housing investment over other types of investment.

The housing allowance system allows the eligible households to raise the magnitude of the allowance by moving to higher quality housing. Thus, the system not only reduces living expenses but also increases the quality of housing of low-income households. The system thus promotes the principal housing policy objective of providing good quality housing at an affordable price. However, the fact that the housing allowance depends on the actual rent paid may increase incentives to move to a more expensive accommodation, at least within the limits of the housing cost ceilings[12] covered by the housing allowance. Indeed, Kangasharju (2003) argues that the system over-compensates low-income households for their low rent-paying ability since an average household receiving housing allowance typically lives in more expensive and higher quality housing than an average household without housing allowance after controlling for many household and dwelling-specific factors.

If instead of depending on the actual rent, the housing allowance were a lump sum determined by the average rent in a region, households' income and size, the household would choose the quality and price of the accommodation. For example, households could choose between paying more than the allowance and living in more expensive accommodation or living in less expensive housing and keeping the difference. Such a reform in the housing allowance system would increase the choice of households and be less costly for the government. A reform along these lines was undertaken in a pilot programme in the United Kingdom in 2004.[13]

While housing allowances can form an important source of revenue for low-income households, when taken together with other features of the tax-benefit system they may create unemployment and poverty traps. Such traps arise when individuals have little incentive to move from unemployment to full-time work or to increase their hours worked as the increase in net income is relatively small due to the combined effect of increased tax payments and the withdrawal of income-tested benefits. The extent to which additional gains from work are "taxed away" can be measured by the marginal effective tax rate (METR). In international comparison the housing allowance component plays an important role in Finland, in particular discouraging low-income individuals who have a job from working longer hours. In 2002, Finland had the sixth highest housing allowance component in the OECD.[14] The government has taken some action to alleviate the negative effects of the housing allowance on unemployment traps: in the 2006 budget proposal, the government suggested that when long-term unemployed return to work their higher income will not reduce their housing allowance in the first three months.

Loan subsidies

The tax deductibility of mortgage interest payments is one important subsidy promoting housing demand. An additional form is the ASP scheme (saving system for young people) intended for first-time homebuyers. This scheme subsidises interest payments. However, in the current environment of low interest rates this form of subsidy is negligible as there is a minimum threshold for the interest rate below which there is no subsidy. As with mortgage interest deductibility this scheme should be abolished, and with interest rates low this is a good time to do so.

The main forms of support for housing supply are government provided, subsidised loans (ARAVA loans) and privately provided loans with a government interest subsidy (interest subsidy loans). These subsidies are granted by a governmental agency (ARA) and are intended mainly for municipalities or non-profit corporations. While ARAVA loans can only be used to finance social rental and "right of occupancy" dwellings, interest subsidy loans are also available for financing the construction and acquisition of owner-occupied dwellings.

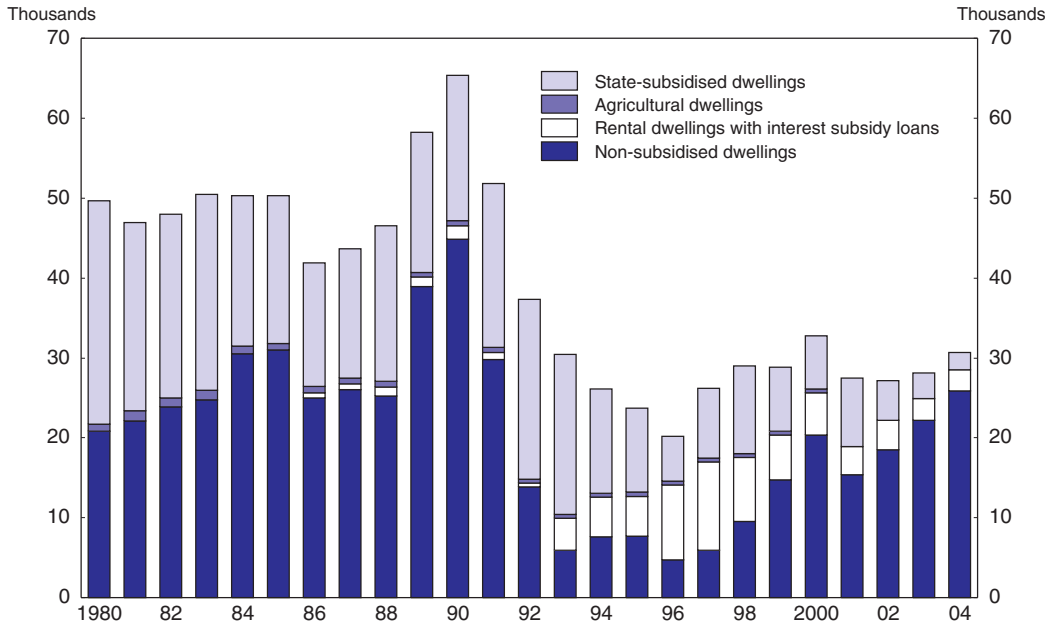
Government subsidised loans for social housing are subject to regulations concerning tenant selection and providers of social housing:

- The selection of tenants is based on social criteria and financial need. Specific criteria are set annually by the government, including the urgency of housing needs, level of income and wealth. Tenant selection procedures are controlled by the local authorities. Tenants for social housing are means-tested at the time of taking up a tenancy and local authorities are obliged to carry out random checks to ensure the selection criteria have been respected.
- Only certain borrowers are allowed to obtain ARAVA and interest subsidy loans: *i)* local authorities or public corporations; *ii)* non-profit corporations that fulfil certain preconditions and are accepted by ARA; and *iii)* limited liability companies in which one or more of the organisations mentioned are dominant.
- Social rental housing is subject to cost and quality control. ARA approves buildings to ensure standards of architectural design and quality as well as geographic and social integration criteria. It also monitors cost and quality and ensures the use of competitive tendering.
- Social rental dwellings are to be used as rental dwellings for 40 years. The rent is based on capital and maintenance expenditure (cost recovery principle). The dwellings intended for social housing can only be sold to a buyer who is accepted in the regulations, *i.e.* some of the organisations mentioned above, and the price should not exceed the maximum amount determined in the regulations.

A typical characteristic of highly volatile housing markets is that housing construction also has strong variations. Indeed, the government housing policy, through ARAVA and interest subsidy loans, has played an important counter-cyclical role in supporting construction and dampening fluctuations in housing production, in particular, maintaining a minimum level of production during the crisis period in the early 1990s. Since then, subsidised loans have lost in importance. In 2004 the number of dwelling starts subsidised by these loans declined to one third of those in the mid 1990s (Figure 6.12) and the share of such subsidies relative to total government subsidies for housing has diminished from around 30% to only 11%.

While the share of government-subsidised housing production has decreased, more than 50% of rental housing is provided through social housing and almost 100% of new rental production is government-subsidised implying that the role of private rental activities and especially production is rather small. This is surprising since Finland has a relatively liberal rental market. For example, since 1995 no rent controls have been in operation, when entering a rental contract, though there are some limits to raising the rent afterwards. One explanation could be that the high level of social housing provision and the wide possibilities to apply for social housing programmes has crowded out private providers of rental housing. It is striking that 73% of Finland's population is eligible for the social housing programme. In addition, private providers may find it difficult to profitably invest and compete with high quality social housing. This high level of eligibility for social

Figure 6.12. **Dwelling completions by type of financing**



Source: Statistics Finland.

housing reflects the government's objective of social cohesion, in particular that there should be a mix of households from a range of income backgrounds using social housing. On the other hand, this objective could alternatively be pursued by building social housing in the same region with private housing. At the same time limiting eligibility to social housing would reduce the cost for the government and encourage the private rental market with probably little implication for this objective.

Regional dimensions of housing markets

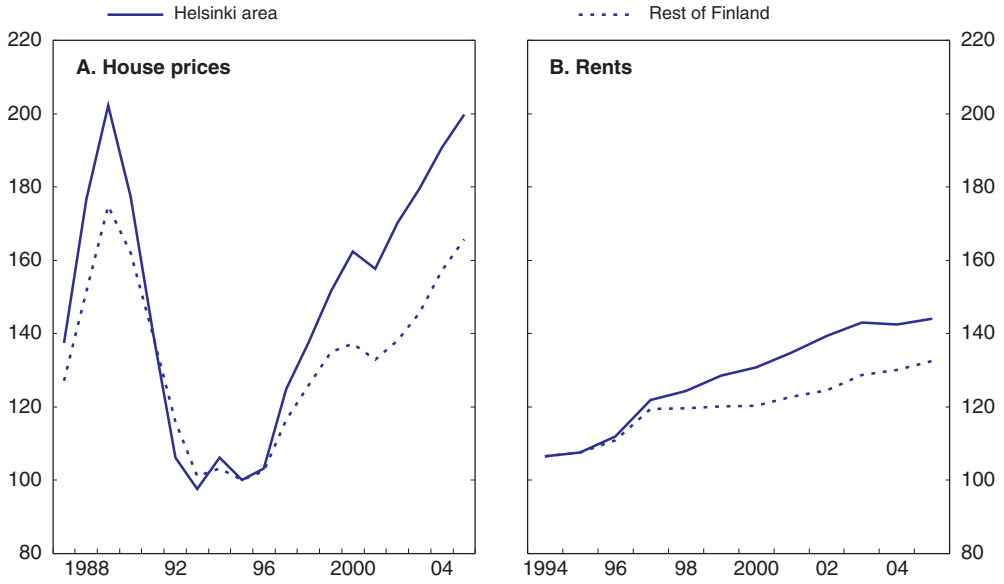
Regional developments in housing supply

There are wide regional disparities in house prices (Figure 6.13). For example, the average real house price in the Helsinki metropolitan area was almost double the price in the rest of Finland in 2005, while the average rent in the Helsinki metropolitan area was 33% higher. Moreover, the divergence is increasing as house prices and rents rise faster in the growth centres relative to other regions. During the past decade real house prices in the Helsinki metropolitan area grew annually by more than 7% whereas in the rest of Finland the annual price increase was around 5%.

In a well-functioning system house building should respond to increases in house prices. However, in some regions building activity has decreased recently, while house prices have increased. For example, in the Uusimaa region (including the Helsinki area) the annual growth of real house prices has been on average 5% in 2000-04, whereas the number of building permits has *fallen* by around 3%. As discussed above, this may partly reflect the slow planning procedures and municipalities' disincentives to provide building land.

The regional dimension is also an important factor in the planning and supply of social housing. The demand for housing has been concentrated in a few growth areas, such

Figure 6.13. **Trends in housing prices and rents**
In real terms,[1] index 1995 = 100



1. Deflated by the CPI.

Source: Statistics Finland and OECD, Economic Outlook database.

as metropolitan Helsinki and the surrounding area, and the Turku, Tampere, Jyväskylä and Oulu areas. This creates pressures on supply of social rental housing in these areas, whereas in other regions social housing faces opposite challenges with empty social rental dwellings. There were 87 000 applicants queuing for social rental housing in 2004 of which 70% were in the growth centres. Over one fourth of these applicants were in urgent need of housing, whereas in other regions less than 10% of applicants were in urgent need of housing. The housing market situation has been most difficult in the Helsinki area, where less than one fifth of the applicants have obtained a dwelling.

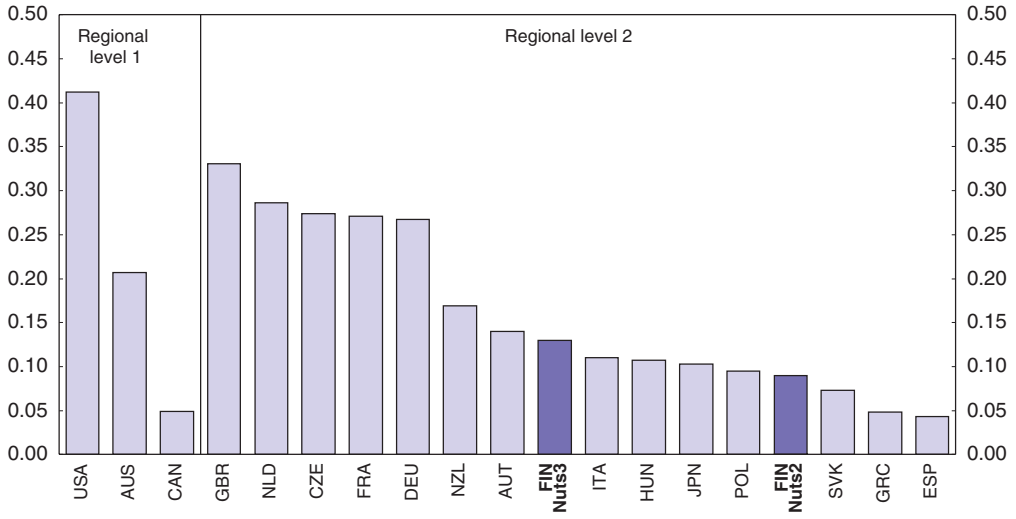
Mobility and housing markets

As highlighted in Chapter 4, there are large disparities in regional labour market performance and these disparities have increased over time. A low level of geographic labour mobility may be one explanation. Local factors, in particular housing market conditions and policies, are likely to influence decisions to change residence to take up a new job. For example, considerable regional disparities in house prices may hinder migration and internal migration in Finland is low in international comparison (Figure 6.14).

Home ownership is often seen as a barrier to labour mobility. Home owners are less likely than others to move to a new location, due to transaction costs and potential capital losses. Similarly, social housing may form a barrier to mobility, if there are queues for social housing in the new location. Both probably undermine mobility in Finland: home ownership is the dominant tenure type and social housing accounts for around 50% of rental housing (Figure 6.15). Furthermore, social housing may create obstacles for moving to growth areas as there are bottlenecks in the supply of social housing in these areas.

Figure 6.14. **Regional mobility rates**

Net flows as a percentage of the population aged 15-64,[1] 2003[2]

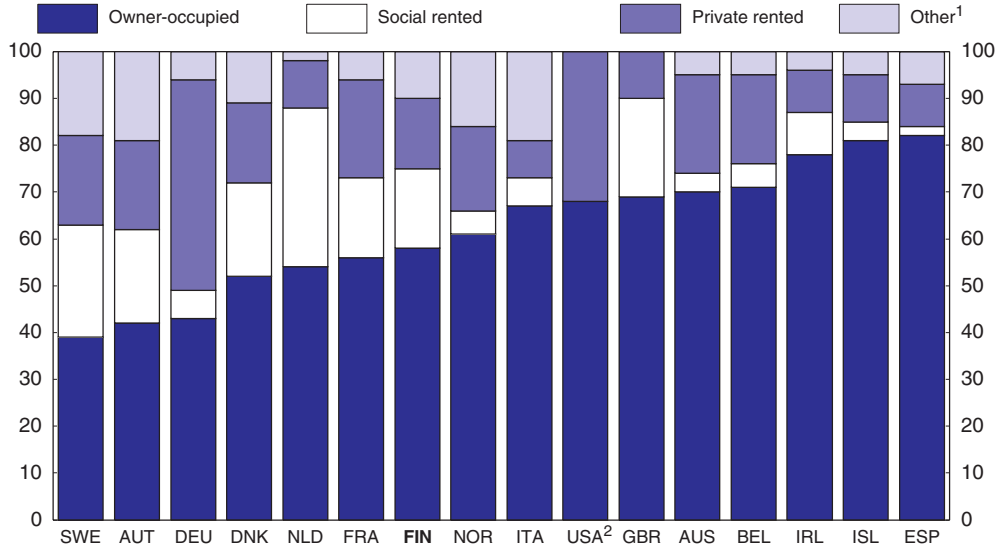


1. For Australia and Italy, the population of reference is the total population; for Japan, it is the population aged more than five years and for Finland, it is the population aged more than 15 years old. The net migration rate is calculated as the ratio of the sum of the absolute values of regional in and out flows divided by two, to the total population aged 15-64.
2. 1999 for the Netherlands; 2001 for Japan; 2002 for France and Italy.

Source: Statistics Finland; OECD (2005), *OECD Employment Outlook*, OECD, Paris, Chart 2.7, panel B.

Figure 6.15. **Dwellings by tenure**

2004 or latest available year



1. For Finland, it is the unknown type which is included here while for most of the other countries, it includes the co-operative housing, employer-provided housing, etc. On the other hand, for Finland, these categories are included in the private rentals.
2. For the United States, it was not possible to split rented housing into private rentals and social housing.

Source: Department of Housing of the Direction General of Planning, Housing and Heritage (2002), *Housing statistics in the European Union*, *http://international.vrom.nl/Docs/internationaal/housingStats2002.pdf*; Karlberg, B. and A. Victorin (2004), "Housing Tenures in the Nordic Countries", Chapter 4, *Housing and Housing Policy in the Nordic Countries*, M. Lujanen (ed.), Norden 2004:7, Nordic Council of Ministers, Helsinki; Ball, M. (2005), "European Housing Review 2005", RICS; Economic Council (2001), *Danish Economy, Spring 2001*, Copenhagen; OECD (2005), *OECD Economic Surveys: Spain*, OECD, Paris.

Indeed, econometric analysis by Hämäläinen and Böckerman (2002) confirms that both the high dispersion of regional house prices and the high level of home ownership reduce net migration between regions, particularly by discouraging in-migration. International comparisons (OECD, 2005) suggest that home ownership significantly reduces the probability of regional migration, while social housing also reduces the probability, but to a lesser extent. This in turn suggests that policies strongly favouring home ownership and social housing over other types of tenure should be reconsidered.

Summing up

To sum up, housing policy and the financing system have succeeded in their primary objective of providing affordable and high quality housing for all Finns. There is, however, scope for improving the functioning of the housing market and the efficiency of housing policies (Box 6.6).

Box 6.6. **Recommendations concerning the housing market**

- Consideration should be given to phase out or better target the state loan guarantee scheme in such a way that it will not undermine the risk awareness of home buyers.
- Begin scaling back mortgage interest deductibility, possibly in the context of a more comprehensive reform of housing policies and taxation.
- Shift taxation away from labour towards property by further easing the limits on municipal property tax rates and extending the tax base to undeveloped land, which is currently not taxed. The property tax on housing should be excluded from the equalisation system so as to encourage housing development and the tax assessment of residential properties should be more closely aligned with market values.
- Speed up the planning process by reducing the possibilities to appeal over the decisions concerning building permits and local plans.
- Limit eligibility to social housing to reduce the cost for the government and encourage the private rental market.
- Reform the housing allowance system to improve efficiency and to allow households to exercise choice by linking the magnitude of the allowance to the average rent in the region and by allowing households to choose the quality and price of the housing.

Notes

1. Some of the decline in home ownership may be due to statistical reasons since almost 10% of the dwelling tenure is listed as other and unknown.
2. It should be noted that the long-run average of price-to-rent ratio may be affected by the abolishing of the rental control in 1995. However, the effect is probably relatively small since rents have been increasing only at a relatively moderate pace since 1995.
3. Currently, banks are offering loans with 30 or even 60 years maturity.
4. See, for example, the report written by a group of experts appointed by the Ministry of Environment.
5. This working group was headed by Mr. Tarasti and more details about the report can be found in the Web page of the Ministry of Environment (in Finnish): *www.ymparisto.fi/default.asp?contentid=174640&lan=FI*(accessed 10 April 2006).

6. The revenues from taxing immovable property (buildings and land) accrue to municipalities, but that of other property taxes, such as taxes on financial and capital transactions and net wealth, inheritance and gift taxes, accrue to the central government.
7. At the same time the tax on imputed rents was abolished.
8. The repurchasing values are set down in the annual statutory regulation by the Ministry of Finance (1155/2000 & 1126/2004). These values concern the whole country and do not differ between regions.
9. There is a ceiling for the deductible amount (€ 1 400 for an individual and € 3 600 for a two-adult family with two children) in the case where interest expenses are deducted from labour income. In contrast, the interest expenses are fully deductible from capital income.
10. The tax rate on capital gains is currently 28%, but first home buyers are allowed to deduct interest payments at the rate of 30%.
11. The right of occupancy is a form of housing tenure that falls between owner-occupancy and renting. Residents buy into the scheme by paying a percentage (15%) of the value of their home. Residents also pay a monthly charge which is based on the cost recovery principle. The right of occupancy dwellings cannot be transformed to owner-occupancy.
12. The maximum ceiling for housing costs is determined by geographic location, size of housing, building year and heating system.
13. See *www.dwp.gov.uk/housingbenefit/lha/*.
14. The comparison of the marginal effective tax rates (METR) was carried out by decomposing the METR and by examining the housing allowance component of the METR for individuals moving from unemployment to full-time work and for individuals deciding to work longer hours or moving to jobs offering higher wages. Two types of family situation were considered: a single parent with two children and a one earner married-couple with two children. For further details see OECD (2006b).

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ANNEX 6.A1

Housing wealth and consumption

This annex reports the results of the analysis of housing wealth effects on consumption. The analysis is based on the life cycle and permanent income hypotheses suggesting that households smooth their consumption over time so that in the long-run their consumption depends on their life-time income and wealth. However, in the short-run, consumption may diverge from the long-run trend. Building on earlier OECD work the short-run dynamics is estimated using an error correction approach that estimates the long-run relationship between consumption, income and wealth and that at the same time allows for a temporary deviation from the long-run trend.

The long-run relationship between consumption, income and wealth is estimated using disaggregated components of households' net wealth, *i.e.* housing and financial wealth, using annual data spanning 1979-2004.

$$\ln C = \alpha_0 + \alpha_1 \ln FW + \alpha_2 \ln HW + \alpha_3 \ln Y + ect \qquad (6.A.1)$$

where *C* is real consumption, *Y* is households' real disposable income, *FW* and *HW* denote real net housing and financial wealth, respectively. Net financial wealth is determined as financial assets minus financial liabilities except mortgages whereas net housing wealth is determined as housing assets minus households' mortgages. The coefficients related to households' income, financial and housing wealth in equation (6.A.1) are the long-term elasticities with respect to these variables. Finally, *ect* represents the residual from the regression capturing the difference between actual and long-term values of consumption.

The short-run dynamics are estimated using the following equation:

$$\Delta \ln C = \beta_0 + \beta_1 \Delta UN + \beta_2 \Delta \ln FW + \beta_3 \Delta \ln HW + \beta_4 \Delta \ln Y + \tau ect_{-1} \qquad (6.A.2)$$

where Δ indicates first-order differences and ect_{-1} is the error-correction term capturing deviations from the long-run trend. The larger this coefficient is, the faster the adjustment to the equilibrium. In addition to households' income and wealth, the short-run dynamics are explained by the unemployment rate (*UN*). It was also tested whether the short-run specification should take into account additional explanatory variables, such as interest rates and inflation. However, these variables did not have a statistically significant effect on consumption.

Table 6.A1.1 presents the estimation results for both the long-run relationship (panel A) and the short-run dynamics (panel B). The estimates were first conducted without any restrictions on the long-run relationship and then the long-run elasticities with respect to income, financial and housing wealth were restricted to sum to one. This

Table 6.A1.1. **Detailed estimation results**

	Panel A	
	Long-run relationship	
	Unrestricted specification	Restricted specification
Constant	5.186	0.041
	(5.14)	(1.46)
Real financial wealth	0.164	0.096
	(8.25)	(4.51)
Real housing wealth	0.071	0.004
	(2.80)	(0.14)
Real income	0.555	0.899
	(7.90)	(32.00)
R^2	0.99	0.98
	Panel B	
	Short-run dynamics	
	Long-run unrestricted specification	Long-run restricted specification
Constant	0.013	0.013
	(3.75)	(3.91)
Δ real financial wealth	0.059	0.033
	(2.69)	(1.82)
Δ real housing wealth	0.104	0.107
	(3.88)	(3.84)
Δ real income	0.219	0.239
	(2.41)	(2.11)
Δ unemployment rate	–0.006	–0.008
	(–0.55)	(–4.10)
ect(–1)	–0.366	–0.258
	(–2.00)	(–1.57)
R^2	0.91	0.90

restriction is, however, rejected at the 1% significance level. In the specification without the restriction, the sum of elasticities is close to 0.8. This implies that the long-run relationship between consumption, income and wealth is not homogeneous or that it is not well determined which may be due to the boom and bust in the late 1980s and early 1990s. It is worth noting that the results of the short-run dynamics are relatively robust to the inclusion of the restriction on the sum of elasticities.

The magnitude of short and long-run effects of housing wealth on consumption is of special interest when assessing the effects of housing markets on consumption. The short-run consumption elasticity is clearly higher than the long-run elasticity. Furthermore, the short-run elasticity with respect to housing wealth is larger than that with respect to financial wealth, whereas in the long-run the elasticity with respect to financial wealth is higher.

Instead of examining the elasticities with respect to housing wealth, it is also interesting to analyse the marginal propensity to consume out of housing wealth, *i.e.* the amount that consumption changes in response to incremental changes in housing wealth. A convenient way to approximate the marginal propensity (*MPC*) is to use the expression for the elasticity of consumption with respect to housing wealth: $\varepsilon(C/HW) = \frac{\Delta C/C}{\Delta HW/HW} = \Delta C/\Delta HW * HW/C = MPC * (HW/C)$. In international comparison the short-run marginal propensity is relatively high in Finland, while the long-run propensity is around the OECD average (0.03). This result is also consistent with the findings of Clapham *et al.* (2002).

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Glossary

ALMP	Active labour market programmes
APW	Average production worker
CAP	Common Agricultural Policy
CPI	Consumer price index
EU	European Union
EU15	European Union, first 15 member states
EET	Exempt-exempt-taxed
GDP	Gross domestic product
ICT	Information and communication technology
ILO	International Labour Organisation
IT	Information technology
METR	Marginal effective tax rate
PAYG	Pay-as-you-go
PES	Public employment service
PPP	Purchasing power parity
R&D	Research and development
UK	United Kingdom
US	United States
WASD	Working Age Statistical Database

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