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**FINLAND**





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*The Secretariat’s draft report was prepared for the Committee by Anne-Marie Brook, Petar Vujanovic, Marketta Henriksson and Marte Sollie under the supervision of Peter Hoeller. Research assistance was provided by Isabelle Duong.*

*The previous Survey of Finland was issued in May 2006.*

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## BASIC STATISTICS OF FINLAND, 2007

### THE LAND

Area (1 000 km <sup>2</sup> )	338.1	Major cities (thousand inhabitants, end 2006)	
of which:		Helsinki	564.5
Agricultural	22.6	Espoo	235.0
Forests	263.1	Tampere	206.4
Lakes	34.3	Vantaa	189.7

### THE PEOPLE

Population (thousand, end 2006)	5 277	Labour force (thousand)	2 675
Number of inhabitants per km <sup>2</sup> of land area	17.4	Employment (thousand)	2 493
Net natural increase (thousand, 2006)	10.8	Employment (% of total)	
Net migration (thousand, 2006)	10.3	Agriculture, forestry and fishing	4.8
		Industry and construction	25.9
		Services	69.3

### PARLIAMENT AND GOVERNMENT

Composition of Parliament (number of seats):		Government, number of ministers from:	
Centre Party	51	Centre Party	10
Social Democratic Party	45	National Coalition Party	6
National Coalition Party (conservatives)	50	Green League	2
Left Alliance	17	Swedish People's Party	2
Green League	15	Total	20
Swedish People's Party	9		
Christian League	7		
Other	6		
Total	200	Last general elections: 18 March 2007	

### PRODUCTION AND PUBLIC SECTOR

Gross domestic product (billion EUR)	178.5	Public consumption (% of GDP)	21.2
GDP per head (EUR)	33 746		
Gross fixed capital investment:		General government (% of GDP):	
% of GDP	20.3	Current and capital expenditure	47.5
Per head (EUR)	6 864	Current revenue	52.5

### FOREIGN TRADE

Exports of goods and services (% of GDP)	44.8	Imports of goods and services (% of GDP)	40.1
Main exports (% of total)		Main imports (% of total)	
Metals, machinery and transport equipment	36.1	Intermediate goods	38.7
Electrical and optical equipment	23.0	Consumer goods	24.0
Wood, pulp and paper	19.8	Capital goods	23.5
Other goods	21.1	Energy	13.8

### THE CURRENCY

Monetary unit: Euro		Currency unit per USD, average of daily figures	
		Year 2007	0.7305
		April 2008	0.6351

## Executive summary

**T**he Finnish economy has performed very well in recent years, with strong GDP growth in a low-inflation environment, rising employment and a sound fiscal position. Strong social safety nets and high education standards put the country in a good position to benefit from the opportunities of globalisation. However, unemployment remains high compared with the best performing countries, despite rising labour shortages, pointing to significant rigidities in the labour market. In addition, the challenges of population ageing and rising health costs pose risks. It will be vital to keep a large government surplus in the coming years and to ensure that labour force participation, especially among older workers, continues to rise. Municipalities, in particular, will face increasingly greater demands in the field of health and old-age care. The industrial structure of the economy also poses risks, since the forestry sector is under intense pressure, and even in the successful telecommunications industry, international competition is strong. Structural policies do not always facilitate a rapid reallocation of resources. Moreover, taxation of labour is high, undermining work incentives, encouraging highly skilled tasks to be offshored, and making it more difficult to attract and retain highly skilled workers in Finland.

Against this background, the challenge for Finland is to find ways to modify the tax and welfare systems so that they better encourage efficiency and improve labour market incentives, without losing the benefits of redistribution and social support. Key challenges include:

- **Ensuring long-term fiscal sustainability:** Further adjustments to the pension system are needed, and the government should ensure that its intention to achieve a general government structural surplus of 3½ per cent of GDP is met.
- **Raising tax revenues more efficiently:** The taxation of labour should be lowered, particularly on high income earners, to help attract and retain highly skilled jobs and workers, and to limit the incentive to reclassify labour income as capital. Taxes on property are currently very low and should be raised, both because property is an immobile tax base and because it falls more heavily on the wealthy. Both the corporate tax and VAT bases could be broadened, and the corporate tax rate cut.
- **Making public spending more cost effective:** More competition should be promoted between public and private providers of services and a level playing field ensured.
- **Raising employment and promoting labour mobility:** A number of challenging reforms are needed to promote wage flexibility, raise labour market participation and encourage unemployed people to accept jobs in other regions.
- **Reforming the tertiary education system:** The system for allocating study places is in urgent need of reform to speed the transition of young people into tertiary education. Other reforms are needed to shorten study times.
- **Making Finland more attractive to foreign workers:** More could be done to fill job vacancies with skilled foreigners, while immigrants need more language and training assistance.

## Assessment and recommendations

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### *The Finnish economy is generally well placed to benefit from the opportunities of globalisation*

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A number of features of the Finnish economy place the country in a good position to benefit from the opportunities of globalisation; these include openness to international trade and foreign direct investment, a high education level of the population, and a strong innovation record. Indeed, top Finnish firms, such as Nokia, have been flexible and innovative in taking advantage of these opportunities through outsourcing and specialisation. Moreover, the government plays a key role in easing the pain that economic restructuring can involve; the tax and benefit system facilitates a significant redistribution of the benefits of globalisation and social safety nets provide support for those who lose their job.

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### *But wage inflexibility, poor labour mobility, and other policies impede the efficient allocation of resources*

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The low-tech segment of industry, however, remains sizeable. Intensifying international competition, offshoring, excess capacity due to weakening demand in Europe and high input costs have contributed to a number of plant closures in the pulp and paper industry, and even in the successful telecommunications industry the composition of output has changed. Rapid reallocation of resources is a consequence of globalisation and technical change, emphasising the importance of economic policies that make it easy for firms to adopt new production techniques and that facilitate the movement of production factors from declining sectors to vibrant ones. Unfortunately, labour market institutions do not provide sufficient flexibility. Job demarcation in traditional industries remains too rigid and there is little wage flexibility, while unemployed workers have only weak incentives to move to a different part of the country for work. As a result, labour shortages are rising, despite a still high level of unemployment compared with the best performing countries. In addition, the turnover of firms is quite low, suggesting that business conditions may not be conducive to entrepreneurialism and the diversification of output into new activities. These problems are exacerbated by some regional development policies which support employment in low-density regions at the expense of agglomeration. *National support to agriculture is very high, for example, and should be reduced, to assist the reallocation of resources to other sectors with better growth potential. A more transparent and better-targeted approach should be used to address regional development needs.* Any conflicts between labour market policies – such as those intended to encourage the unemployed to move to

more dynamic regions – and the government's regional development goals, should be openly articulated and steps should be taken to address any contradictions.

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*Sustaining the welfare system will require higher employment, a better tax mix and more cost-effective public spending*

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The use of collective mechanisms for risk sharing – a key feature of the Nordic model – has made it easier for Finnish citizens to embrace both globalisation and competition. The tax burden is above the OECD average, although within the group of Nordic countries, Finland has a relatively low overall tax burden and social expenditure, and public spending is lower than in many other European countries. Even so, the tax and welfare systems have generally ensured that the winners from structural transformation have shared their gains to some extent with the losers. Moreover, the composition of public spending has tended to support high employment levels, such as through the provision of affordable child care and early education. Nevertheless, income inequalities have been rising, and unemployed households remain vulnerable. Unemployment remains high and therefore the tax and welfare systems should be reviewed in order to see whether the trade-off between the incentives to work and income support is appropriate. The challenge for Finland is to modify the existing system so that it better encourages efficiency and sharpens labour market incentives, without losing the benefits of redistribution and social support. Given the ageing population and the need to lift employment rates, it is also worrying that many graduates do not enter the labour market until their late 20s. Taxation of labour is currently too high, particularly given the increased mobility of jobs and people that globalisation implies. In this context, the sustainability of the welfare system will require significantly higher employment, more efficient taxation and more cost-effective public spending.

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*Recent economic performance has been good although large wage increases pose risks to competitiveness*

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Economic growth was above 4% in 2006 and 2007, contributing to a further catching up in GDP per capita towards the slightly higher average level of the other Nordic countries and the significantly higher level of the United States. The unemployment rate has fallen significantly in recent years to below 6½ per cent, but it still remains above that of the other Nordic countries. It is clear that bringing about an improvement in the functioning of the labour market continues to be one of Finland's biggest policy challenges. Against the background of rising labour shortages, the 2007-08 wage negotiations – which took place at the industry and firm level – resulted in much higher wage increases than in previous years. Since most agreements were for a two- to three-year period, this will push up wage inflation not only in 2008 but also over the following two years, undermining competitiveness. In combination with slowing global demand, exports are likely to become considerably less dynamic and GDP growth could slow to 2½ per cent in 2009, with unemployment stabilising at around 6%.

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*Medium-term fiscal policy challenges should be addressed with further pension reform and tighter fiscal policy in the short term*

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Recent fiscal policy outcomes have been positive with general government surpluses generally exceeding their targets. However, demographic change will significantly alter this picture from 2010 onward. Despite significant pre-funding and a wide-ranging pension reform in 2005 that is being gradually phased in, the government acknowledges that pension contribution rates will increase by 4 percentage points by 2030 to keep the pension system on an even keel. The central government surplus leaves room for offsetting a major part of this increase by reducing income taxes. However, there would remain a sustainability gap of approximately 1% of GDP. At the same time, a key challenge for Finland is to continue to cut labour taxes, while still preserving the essential elements of social support offered by the Nordic model. To permit this, further adjustments to the pension system will be needed. *The main priority should be to increase the effective retirement age and fully close the unemployment pipeline, which effectively provides access to early retirement from the age of 57. In addition, study periods should be made ineligible for pension credit accumulation and the merits of higher accrual rates for workers from the age of 53 to 62 years should be re-examined.* The combined financial balance for central and local government is currently in surplus, but maintaining a surplus over the coming years will require *a more efficient tax mix and significant further steps to raise productivity in the public sector – particularly in the delivery of municipal social services.*

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*The dual income tax system has been a positive response to globalisation, although it has some drawbacks*

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Globalisation creates a tension between the need to spend on social safety nets and the need to maintain tax revenue from mobile factors. In response to the increasing mobility of capital, there has been a trend decline in corporate tax rates across the OECD along with a broadening of the tax base. In Finland, the dual income tax (DIT) system has also permitted a much lower tax rate on capital income, while labour income is still taxed more heavily. The DIT system has increased the efficiency of capital investments. Nevertheless, the DIT system creates incentives for individuals to reclassify labour as capital income, and the procedures put in place to limit this have increased the complexity of the tax system, while still permitting some groups of workers to reclassify their income relatively easily. Reclassification incentives could be reduced by lowering the average tax rate on upper income earners. Finland should also *monitor the success of the Norwegian shareholder equity system with a view to adopting a similar scheme – if it is judged to be successful – to reduce income-shifting incentives.* The 2005 tax reform cut the corporate tax rate slightly to 26%. This brought the Finnish rate below the EU15 average. However, the average statutory tax rate in the new member states was about 19% in 2006 and planned changes will bring it down another percentage point. The latest cut in the corporate rate was not accompanied by any base broadening measures. *There is probably still room to broaden the corporate tax base and lower the rate.*

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*Taxes on labour are too high and those on property too low*

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Although labour remains less mobile than capital, globalisation has facilitated the mobility of jobs and labour. The tax burden on labour is relatively high, particularly for upper-income earners, and there are concerns that by pushing up labour costs, the high tax wedge may be an important factor in production-location and offshoring decisions. *The tax burden on labour should be lowered with priority being given to lowering the top marginal tax rate on labour to keep and attract highly skilled jobs and to reduce incentives for income reclassification.* On the other hand, immobile factors such as immovable property are taxed lightly and *there is considerable scope for increasing the taxation of property and land.* This makes sense not only from a globalisation perspective (given that immovable property is an immobile tax base) but also because property taxes tend to weigh more heavily on the wealthy, and hence may help to compensate for a reduction in labour taxation of the top income earners. *To increase efficiency, the value added tax (VAT) base should be broadened and the additional revenues used to lower either the standard VAT rate or labour taxes more generally.* Unfortunately the government's plan to cut the reduced VAT rate on food in 2009 goes in the wrong direction. If the policy goal is to assist low income families, targeted support is much more efficient.

---

*Greater competition in the delivery of social services would spur productivity growth and facilitate economic diversification*

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Social services, which are mainly delivered by the municipalities, account for almost 20% of total economy value added, making it the second most important sector after manufacturing. But productivity has declined, posing fiscal sustainability concerns and the risk of labour shortages in key social services as the population ages. A significant number of municipal mergers are under way which may improve efficiency in the long term, although the number of municipalities (about 350 even after the mergers) will remain far too high. *To raise productivity a sharper distinction should be drawn between core and non-core services with municipal resources being increasingly focussed on the former.* The private sector should be encouraged to play a larger role in the provision of social services – particularly support services that are not considered core outputs. This will require more active encouragement of competition between public and private providers of services. *The central government should ensure that the framework conditions in which municipalities operate guarantee a level playing field between private and public providers.* This may require changes to public procurement legislation and the introduction of policies to encourage the incorporation of all municipally-owned activities that constitute economic activities. There is also considerable scope for the central and municipal governments to *promote municipal-level productivity gains, such as by developing more sophisticated benchmarking exercises and other measures to facilitate the sharing of best practice municipal management.*

---

*Greater labour market flexibility would allow the economy to respond better to the pressures stemming from globalisation*

---

Finland has enjoyed a period of strong labour market performance in recent years, with robust employment growth and steadily declining unemployment. However, further progress in dealing with the ongoing restructuring associated with globalisation requires decisive reforms in the labour market. Raising wage flexibility should be a priority. Finland's wage negotiation framework still needs reform to ensure that outcomes more closely reflect labour market conditions for each skill level and occupation. Future rounds should continue to be negotiated at a decentralised level and the process of determining a greater proportion of wage increases at the firm level should continue. At the same time, some degree of co-ordination might be required to ensure that wage developments as a whole are compatible with overall productivity growth and the ECB's inflation target. Opting out of collective agreements should be made easier, and the government should canvass the costs and benefits of eliminating the current practice of extending by legislation virtually all collective agreements to all firms. Finland is increasingly facing skill shortages and the time to fill job vacancies is lengthening, particularly in buoyant regions of the country. This is coupled with high unemployment rates in other regions, suggesting a need for higher inter-regional labour mobility. The legal requirements for geographic (and occupational) mobility of the unemployed should be more strictly enforced and real sanctions applied. In addition, subsidies directed at assisting inter-regional mobility should be rebalanced. Those that are found to be the most effective should be increased while others (such as the second residence subsidy) should be abolished.

---

*More needs to be done to raise employment, particularly among older workers, those with disabilities, and young people*

---

Finland's population is one of the most rapidly ageing in the OECD and the labour force is expected to start declining by 2010. The resulting fall in employment and growing dependency ratios threaten the sustainability of the welfare system. A number of policy changes are needed to raise labour market participation:

- *The unemployment pipeline that facilitates older workers' early withdrawal from the workforce should be abolished.*
- *Access to sickness and disability pensions should be tightened and greater efforts should be made to assist the current stock of sick and disabled to rejoin the workforce.*
- *Unemployment benefits should be tapered over time to better motivate job search and activation.*
- *While the full-time working culture should be generally maintained, the part-time options and their effectiveness should be reviewed. For example, different ways of encouraging retired people to take up part-time work should be explored, disability pension rules should be made more accommodating of part-time work, and inflexibilities in child care arrangements addressed.*
- *The interaction between the tax and benefit system should be fine-tuned to raise incentives to find work, participate more intensively in work, and encourage career progression. This might require a reduction in some benefit levels.*

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*Higher employment also requires changes to tertiary education so as to speed up the transition from secondary school to tertiary education*

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While Finland is excellent at providing the population with basic skills, there are problems in the later stages of the education system. The transition from secondary to tertiary education is a particular problem, as it can take many years. Due to this “matriculation backlog”, only a minority of students is admitted to their preferred field of study immediately after completing secondary studies. Most require several attempts before gaining a study place. This is a considerable source of inefficiency and contributes to the high age of tertiary graduates. To reduce inefficiencies in the allocation of study places, tertiary institutions should be encouraged to assess applications by relying more on the matriculation exam results. To eliminate the matriculation backlog, additional starting places could be temporarily allocated to areas of greatest demand, although not to the full extent of the backlog. In the long term, the centrally-planned system of starting places should be relaxed by allowing the educational institutions to determine the number of starting places, with financing following the student. Allowing demand to play a larger role in the determination of starting places would also support a more regionally balanced division of starting places, taking better into account the preferences of the students and needs of the labour market. To ensure that prospective students are making informed choices, students should be provided with more information on employment prospects and the wages of graduates.

To support the other measures, the introduction of tuition fees should be considered. Although tuition fees are never popular, there is little evidence that they would conflict with equity considerations, provided that a well-designed income-contingent loans system, which covers both tuition fees and living expenses, ensures study opportunities for students from all family backgrounds. Tuition fees would offer considerable benefits including: greater financial resources for educational institutions; improved incentives for students to graduate quickly; improved incentives for them to select their courses of study based on labour market potential; higher expectations by students and greater responsiveness of institutions to students’ preferences.

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*And more needs to be done to shorten study times and ensure that the degrees are flexible enough*

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Besides the delays in starting tertiary education, Finnish students graduate late because of long study times. One contributing factor is the Finnish system of study support. Study support should be reformed by tightening the annual minimum study credit requirement. Achieving this standard should also be a condition for continued eligibility for student benefits, such as cheap housing. The system of grants should, at the same time, be changed into a system of income-contingent loans. Long study times are also explained by the dominant position of the Master's degree as the first university degree. Finnish degree requirements may also not be flexible enough to adjust to changing labour market demands, as subject specialisation begins early and continues straight on to a Master's degree. To shorten study times and to increase degree flexibility by encouraging students to graduate with a Bachelor's degree first, university admittance rules should be changed, so that students would be automatically enrolled in a Bachelor's instead of a Master's degree. Bachelor's degrees should also be given a



stronger weight in the financing of universities. Admission to a Master's degree should be contingent on completion of a Bachelor's degree to a sufficiently high standard.

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*Immigration numbers are low but more could be done to target migrants for some areas of skill shortages*

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While immigration has traditionally been low – particularly work-related immigration – a growing number of Finnish firms are facing skill shortages and are looking to recruit labour abroad. However, there remain a number of obstacles to attracting skilled migrants to Finland, particularly now that many other countries are competing to attract workers from the same sources, notably Central and Eastern Europe. *The government should do more to identify those sectors that could most benefit from migrant labour and provide assistance to firms (especially smaller firms) that are competing to attract these workers, such as by co-sponsoring employment fairs in source countries. The government should also provide more resources for educating and training migrant workers to smooth their transition into the Finnish workforce. Finally, more could be done to attract foreign students and to encourage them to stay on to work after graduation.*



## Chapter 1

# Getting the most out of globalisation

*Openness to international trade and foreign direct investment, a high education level, a strong innovation record, and social safety nets that support those adversely affected, put Finland in a good position to benefit from the opportunities offered by globalisation. However, the fiscal challenges posed by ageing suggest that the Nordic model of social support will not be sustainable without significantly higher employment together with more efficient public spending and taxation. In addition, labour market institutions and some other policies do not permit sufficient flexibility to promote the rapid reallocation of resources that globalisation and technical change demand, while the tax and welfare systems distort economic choices in a number of areas. As a result, labour shortages are rising, despite a still high level of unemployment, and some industries are facing severe competitive pressures. By considering these problems through the lens of globalisation, this chapter identifies the key challenges facing the economy – challenges that are taken up in more detail in the following chapters.*

The Finnish economy consistently ranks as one of the world's most competitive economies in a range of surveys.<sup>1</sup> Moreover, the post-crisis transformation from a country that specialised in traditional industries into a leading producer of high-tech goods shows that Finland can adapt quickly to changes in the economic environment when required. Macroeconomic performance over recent years has been strong as the economy has recovered from the severe downturn in the early 1990s; gross domestic product (GDP) per capita has grown rapidly, continuing to catch up towards that of the best performing OECD countries, fiscal outcomes have been generally good, and solid employment growth has permitted a fall in the unemployment rate. An important factor underpinning this good performance is the education system, which contributes to high levels of productivity and permits a relatively high wage level by global standards. Besides providing young people with a good education that equips them for well-paid jobs in the future, the government also plays a key role in easing the pain that economic restructuring can inflict. While the tax burden is not as high as in some other Nordic countries, it remains high compared with other OECD countries, permitting a significant redistribution of the benefits of globalisation, while social safety nets support those who lose their jobs.

From this starting point, Finland is in a good position to benefit from the opportunities of globalisation. Nokia continues to be the most well known of the many Finnish firms that have profited from globalisation. Yet not all sectors of the economy are as flexible and innovative as Nokia, and given the still large industrial sector that includes a sizeable low-tech segment, Finland faces head-to-head competition in several industries, pointing to considerable future adjustment pressures. This is particularly true in the forestry industry, where high input costs have contributed to a number of recent plant closures. In a number of areas, economic policies may impede firms' ability to adapt to new production techniques and make it more difficult for factors of production to move into new sectors from declining ones. Labour mobility in particular needs to increase, as does relative wage flexibility. Wage setting remains excessively rigid, despite the fact that the most recent wage bargaining took place at the industry level, rather than at the central level as in most previous rounds. Moreover, some aspects of the Nordic model appear to be under threat. As both capital and labour become increasingly mobile, globalisation puts pressure on the location of productive activities and therefore on the public finances. At the same time it pushes the incomes of the most talented upwards and puts downward pressure on the incomes of the least skilled, leading to a widening in the income distribution. While the welfare system plays a crucial role in ensuring Finland's continued economic success, some aspects of it distort economic choices, and these distortions may be more costly in a globalised world. The challenge for Finland is to find ways to modify the existing system so that it better encourages efficiency and improves labour market incentives, without losing the benefits of redistribution and social support. The importance of policies that will further raise employment and promote labour market flexibility are also highlighted in *Going for Growth* (OECD, 2008a), which identifies the four main priorities as: a lower tax

wedge on labour income; policies to encourage more older people to work; reforms to the unemployment benefit system; and more flexible wage setting.<sup>2</sup>

The majority of this chapter is devoted to a consideration of these challenges through the lens of globalisation. It highlights the channels through which Finland has benefited the most from globalisation and those where the full benefits are yet to be reaped. Given the structural change that globalisation stimulates, one of the most critical requirements for success is flexibility and there are a number of respects in which the Finnish economy is insufficiently flexible. This discussion then leads directly to the introduction of the key challenges facing the economy. The first of these, as discussed in previous *Surveys*, is to ensure fiscal sustainability. Related to fiscal sustainability, but also with the goal of supporting the Nordic model, the second challenge is to lower taxes on labour and to make the tax system more efficient. This will require higher tax rates on property, together with reforms in the municipal sector to raise productivity growth and facilitate economic diversification. Third, is the ongoing challenge of making the labour market function better – both by making wage setting more flexible and by introducing policy changes to further raise employment. Fourth, reforms to the tertiary education sector are needed to bring forward the availability of tertiary graduates to the labour market. Finally, the role that immigration policy can play in addressing skill shortages is gaining attention, but more could be done to facilitate the matching of potential migrants to jobs.

## The benefits and challenges of globalisation

Globalisation spurs productivity through several channels: i) openness to trade, which promotes competition and encourages resources to be directed towards the most productive activities; ii) openness to foreign direct investment (FDI) and the presence of foreign multinational enterprises, which can facilitate technological transfers and spillovers of best practice to domestic firms; and iii) advances in information and communication technologies, which have led to the geographical fragmentation of production chains, permitting firms to cut costs in low value-added areas through offshoring and redirecting resources to what they do best and where it can be done best (see Baldwin [2006] for an overview).

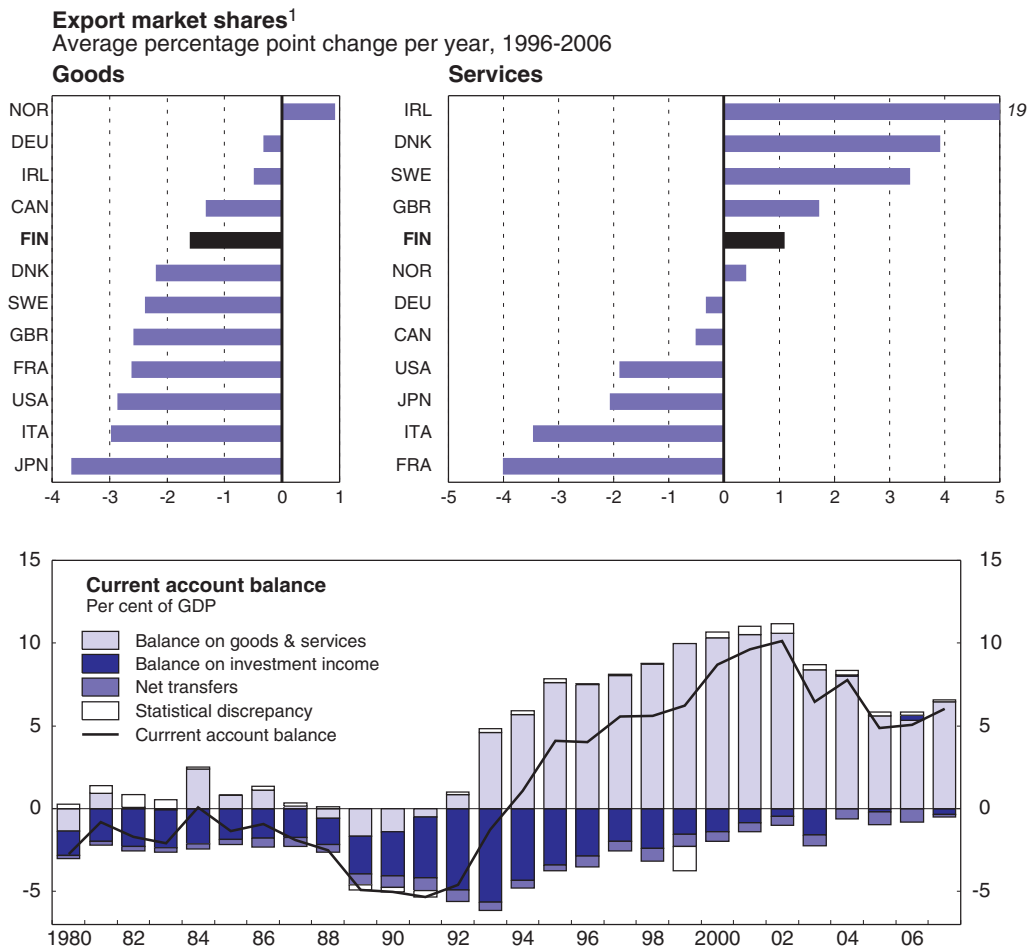
There is significant evidence that Finnish companies have benefited from all three of these channels. As a small open economy, trade plays an important role in the economy, with trade in goods making up more than a third of GDP in 2006.<sup>3</sup> At about 8% of GDP, services trade is less important but growing in importance. As is also the case in most other Nordic countries, Finland has been losing export market share in goods since 1996 but gaining market share in exporting services (Figure 1.1, top right panel).

### **Industrial restructuring has been significant but low-tech sectors remain important**

Compared with other advanced OECD economies, Finland performs well in the production of high- and medium-technology manufactures, and these sectors have expanded their share of value added over the past decade. The Nokia effect is particularly evident in the large increase in the value-added share of the information, communication and technology (ICT) manufacturing over the past decade (Figure 1.2).

Nevertheless, these high-tech sectors remain a relatively small proportion of total value added, and low-growth sectors, although shrinking in importance, continue to make up a higher share of total value added in Finland than in most other advanced economies

Figure 1.1. Trade indicators



StatLink <http://dx.doi.org/10.1787/336875400080>

1. In current prices.

Source: IMF (2008), Balance of Payments Statistics database, April; OECD (2007), Economic Outlook 82 database.

(Figure 1.3). This partly reflects Finland’s long-standing comparative advantage in these sectors (especially forestry-related manufactures), but it also reflects the fact that the agricultural sector continues to make up a larger share of value added than in many other comparative countries. Finnish national support to agriculture is the second highest in the European Union (as a percentage of GDP) and winding it back would assist the reallocation of resources to sectors with better growth potential (Box 1.1).

In order to facilitate structural adjustment, care also needs to be taken with regional policy. While regional development policy contributes positively in many ways, it may also sometimes work against other government policies, impeding structural adjustment. Box 1.2 highlights some of the problems and concludes that the government should adopt a more transparent approach to addressing regional development needs.

**Export share analysis suggests few clear areas of comparative advantage**

An analysis of Finland’s export performance by technology level also suggests that Finland’s export basket is not particularly high-tech. The only EU15 countries with a higher

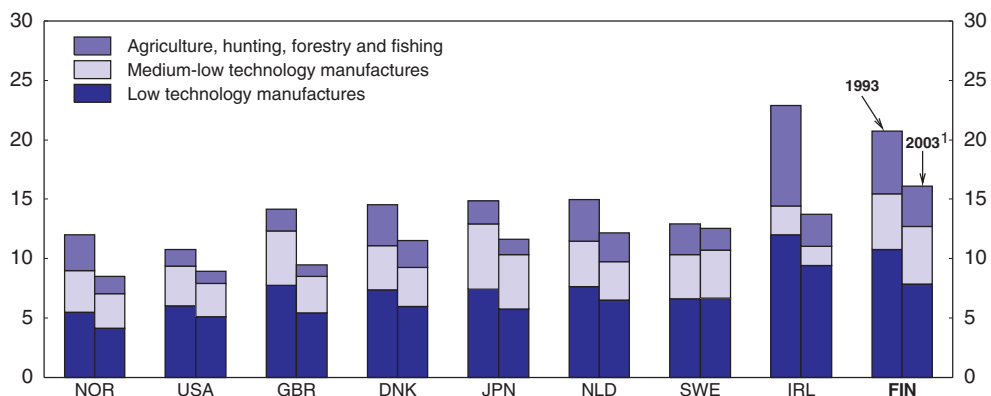
Figure 1.2. **High and medium-high technology manufactures are important**  
Value-added shares by industry and change between 1990-93 and 2000-03



StatLink <http://dx.doi.org/10.1787/336877311366>

Source: OECD (2006), STAN indicators database, [www.oecd.org/sti/stan/indicators](http://www.oecd.org/sti/stan/indicators).

Figure 1.3. **Finland still specialises in many low-growth sectors**  
Per cent of total value added



StatLink <http://dx.doi.org/10.1787/337011540812>

1. 2002 for medium-low and low technology manufactures in Sweden and for all three sectors in Ireland.

Source: OECD (2006), STAN Indicators database, [www.oecd.org/sti/stan/indicators](http://www.oecd.org/sti/stan/indicators).

share of low-tech exports are Denmark, Italy, Greece and Portugal. About half of Finland's total goods exports are classified as high or medium-high tech, less even than China's (Figure 1.4).<sup>4</sup> While in part this reflects the continued importance of low-tech exports, it also reflects the increasing extent to which high-tech production is now outsourced to lower-cost countries.

### Box 1.1. **Agricultural support is expensive and increases the tax burden**

When Finland joined the EU in 1995, transitional arrangements were made that permit it to continue to provide significant national financial support to the agricultural sector. Subsequent negotiations have resulted in some reductions in the level of support. Nevertheless, when measured relative to GDP, in 2006 Finland had the second highest level of national agricultural sector support in the EU25, after Latvia (OECD, PSE/CSE database). In 2007, total agricultural support was € 1.9 billion (around 1% of GDP), of which roughly 60% was funded by the national budget, and 40% by EU funds.<sup>1</sup> Productivity growth in agriculture has been just 1% per annum over the past decade – largely reflecting farm consolidation. Indeed, the number of farms has fallen by a third since 1995 and the agriculture and fisheries share of the labour force has almost halved. However, due to the cold climate, productivity levels remain low and support payments form a very significant proportion of farm revenues. In 2006, for example, agricultural support payments accounted for almost half of the total income in agriculture and horticulture (Niemi and Ahlstedt, 2008). Finland has no timetable for phasing out the high levels of national support to agriculture.

The rationale for continued national agricultural support is related to regional development policy, and underpinned by the goal of supporting population dispersion. However, the cost of this policy is high. Since Finland does not have a comparative advantage in this sector, support payments prevent the reallocation of resources to more productive uses. These payments also add to the tax burden. It would be better to use regional policy and rural development policies as a way to develop alternatives to agriculture. For example, compared with most other EU members Finland uses less of the so-called “second pillar” of the Common Agricultural Policy (CAP) for diversification, using instead the great bulk of these resources for agri-environmental support (OECD, 2008b).

Other concerns are about security of supply, food quality and animal welfare. Given previous war-time experiences, concerns about emergency supply of food are understandable, even if the risks are very small nowadays. Moreover, a recent literature survey (Mann, 2007) highlights empirical evidence that food security and production self-sufficiency are different issues. In particular, there is no indication that a level of close to or complete self-sufficiency during normal times is of much help to a country which faces an effective trade embargo, unless the country is also self-sufficient in agricultural production technology and energy. Moreover, for a country without a comparative advantage in agricultural production, the welfare and opportunity costs of any policy of self-sufficiency are very high. Finally, trends in agricultural trade liberalisation are likely to work against self-sufficiency in all products (as is already the case for sugar). These factors suggest that alternatives to food self-sufficiency should be considered. One alternative approach would involve envisaging a broader geographical area for the potential supply of food, rather than the nation state. Another option would be to rely more on food storage,<sup>2</sup> or to pay most attention to maintaining expertise in staple food production. However, a focus on staple food production would work in the opposite direction to the recent trend towards producing higher-quality foodstuffs. Concerns about food quality and animal welfare should be dealt with by appropriate labelling, permitting consumers to pay more for higher-quality (including domestically produced) products.

The following decades will see a continuation of structural change in the agricultural sector. The CAP is evolving in a way so that farm incomes will increasingly depend on market returns. For the dairy industry in particular – the largest and most important agricultural sector in Finland, located mainly in the northern regions – the expected abolition of the milk quota system in 2015 is likely to make many dairy farms unprofitable. Rather than seeking to secure the survival of this sector, which would be very costly, Finnish



### Box 1.1. **Agricultural support is expensive and increases the tax burden** (cont.)

policy makers should consider the alternatives. The key questions are: i) How important is agriculture to population dispersion goals, and are there other better ways of achieving these? ii) How much are Finnish consumers and taxpayers willing to pay to maintain a costly and relatively inefficient sector? Compared with the past decade, the time is increasingly right for Finland to undergo an acceleration of structural change. In particular, the cost of reducing employment (agricultural employment makes up about 4% of total employment) should be much lower now that unemployment has fallen and job vacancy rates are higher.

1. EU-funded support to the Finnish agricultural sector totalled just over 0.4% of GDP in 2007. Three-quarters of this reflects CAP payments and the remainder coupled aid payments to less-favoured farming areas and environmental support. National funding support totalled around 0.6% of GDP. Half of this reflects coupled aid payments to less-favoured farming areas and environmental support. The other half represents additional national support, more than half of which is directed to the northern regions, primarily to support the dairy industry. See Niemi and Ahlstedt (2008) for further details.
2. The National Emergency Supply Agency is already responsible for emergency storage: stocks of grain adequate for one year's consumption; enough fodder grain and imported protein fodder to guarantee the sufficient breeding of domestic animals; seeds for growing crops and grass sufficient for one sowing.

### Box 1.2. **Ensuring that regional development policies are consistent with other policies**

The over-arching goal of Finnish regional development policies is not explicitly stated. However, many such policies are motivated by support for maintaining a “populated countryside” (as discussed in Prime Minister's Office, 2007). The bulk of regional policy initiatives are run through EU structural funds, while government policies, among other things, impose an obligation on municipalities to provide social services of high quality, even in remote regions.

Regional policies are recognised as contributing positively to economic development in a number of ways, such as by strengthening innovation practices, including through a “cluster-based” approach, while they also ensure an adequate provision of public and private services to all regions. This has contributed to a very small variance of educational performance across students in rural and urban communities; Finland is also one of the countries in the world with the highest coverage of broadband.<sup>1</sup>

In some cases, however, regional policies may at the same time work against the achievement of other policy goals, including environmental goals and the goal of maximising productivity by ensuring an efficient allocation of resources:

- **Energy efficiency:** Energy production from peat is currently taxed very lightly, despite the fact that it contributes more than 10% to Finland's total carbon dioxide emissions and is even more damaging to the environment than coal (Box 3.2). The reason for treating peat more leniently than other sources of greenhouse gas emissions is a desire to preserve employment in some remote regions where energy production from peat forms an important part of the economic base. However, since other fuel sources are less damaging to the environment, the current policy essentially implies regional employment support at the cost of higher emissions and therefore a higher cost of emission-reductions.
- **Education:** To ensure that residents in all regions have access to education and to safeguard the supply of educated labour outside the growth centres, the government allocates tertiary education study places across a comprehensive network of 51 higher education institutions in over 100 different locations. As documented in Chapter 6, student demand outstrips the supply of study places especially in the growth centres,

### Box 1.2. Ensuring that regional development policies are consistent with other policies (cont.)

forcing some students (typically those who do not gain a study place in Helsinki) to study in more remote regions where they have little intention of remaining. Since this policy of maintaining a dispersed network of tertiary education institutes provides few incentives for young people to move away from remote regions where unemployment is very high, it may be inconsistent with the government's goal of lowering unemployment and reducing the extent of geographical labour market mismatches (Chapter 5).

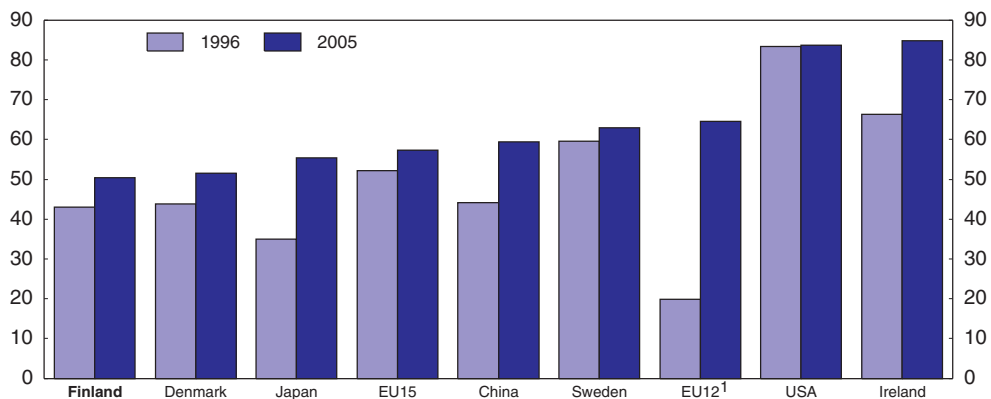
- **Agricultural support:** As discussed in Box 1.1, the very high level of EU and national support to agriculture and horticulture is preventing resources from shifting to more productive uses. In particular, the majority of national support to agriculture is directed to the northern regions, despite the fact that the most productive land is in the south.


While regional development goals may be important, there is a strong argument for a more transparent approach to addressing them. If there is a need to preserve employment in certain remote regions, then it would be better to move away from supporting emission-intensive peat production to providing financial assistance for more environmentally-friendly firms to move to or start up in the relevant regions. More generally, if it is important to maintain population in specific regions, the government could consider providing direct fiscal incentives to these regions.<sup>2</sup> A coherent approach should be developed to reconcile regional development objectives with the need for more inter-regional labour market mobility. In this respect, the January 2008 merger between regional policy and employment and other economic policies in the newly created Ministry of Employment and the Economy may help to increase the transparency of policies and increase their synergies with other policies.

1. See OECD (2005a and 2008b) for more detailed analysis of specific regional development policies.
2. Additional fiscal support could be provided to municipalities in these regions, who face fiscal pressures stemming from low tax revenues and the high cost of servicing a dispersed and often elderly population (see OECD [2008b] for discussion of the challenges facing sparsely populated regions). In the longer term, if population dispersion remains an important goal, the government may wish to consider countering natural population decline in these regions with more direct fiscal support to residents in sensitive regions. For instance, Norway has differentiated social security contributions, while in Alaska, people are encouraged to stay by the lack of any state or sales taxes and the Permanent Fund Dividend which gives all permanent residents an annual bonus.

Figure 1.4. **Share of high and medium-high tech exports**

Per cent of total goods exports



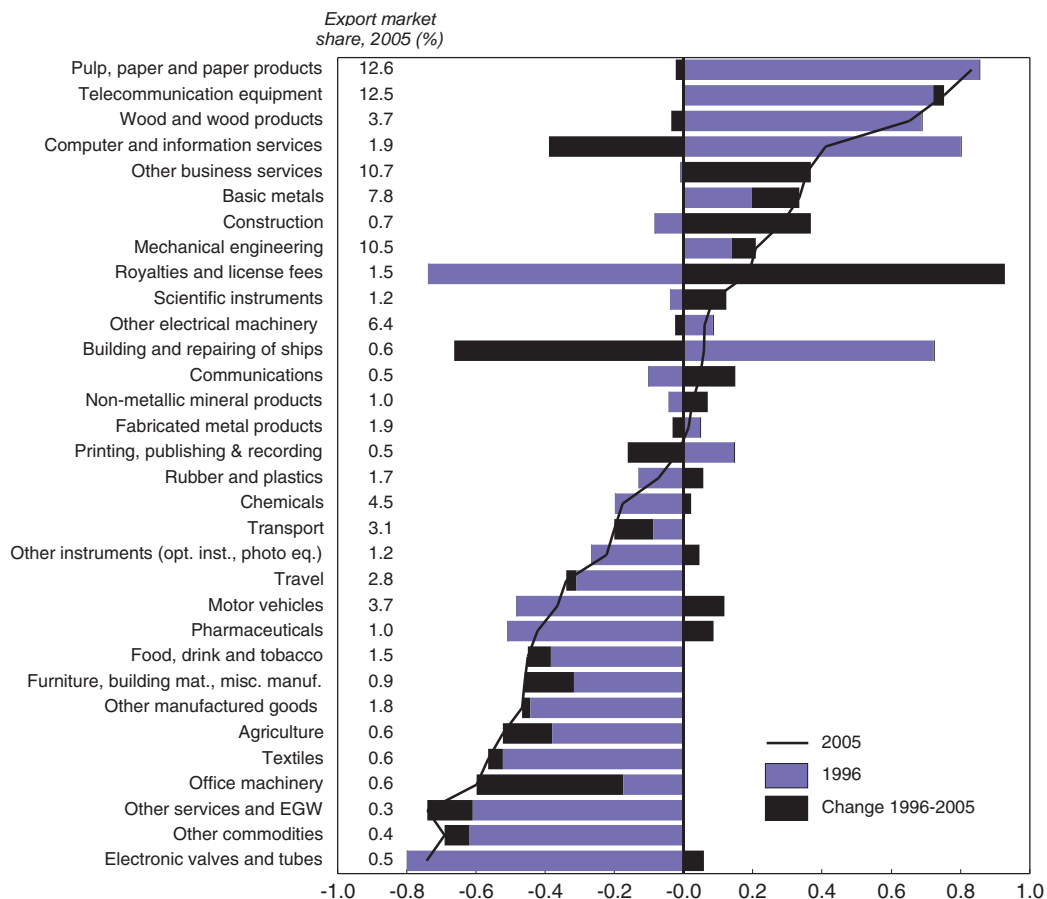
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1. EU12 includes the 12 new EU member countries since 2004.

Source: UN, COMTRADE database and OECD calculations.

Figure 1.5 uses Revealed Symmetric Comparative Advantage (RSCA) analysis to further investigate Finland's degree of specialisation in different export sectors.<sup>5</sup> This analysis shows that Finland's top three sectors in terms of comparative advantage (those which enjoy a higher than average export market share) are: pulp and paper; telecoms equipment; and wood and wood products. Since two of these are low-tech products, Finland's overall loss of export market share is perhaps not so surprising, although Finland is at the frontier of the production technology. Between 1996 and 2005 Finland's share of total world export value of the paper and wood sectors combined fell by around a third from 25% to 16% while the share contributed by manufactured telecommunications equipment doubled from 6% to 13% of total world export value. The telecommunications sector also contributed to important gains in the export share of other business services (which doubled from 5% to 11% of total export value). The share of total export value

Figure 1.5. Finland RSCA<sup>1</sup> by sector



StatLink <http://dx.doi.org/10.1787/337076785235>

1. RSCAs are shown for all commodities whose export share is more than 0.4%. Others are aggregated into three combined categories as follows: 1) Other services and EGW: government services; electricity, gas and water supply; insurance, financial services; personal, cultural and recreational services. 2) Other commodities: forestry; mineral oil refining, coke and nuclear fuel; fishing; mining and quarrying. 3) Other manufactured goods: insulated wire; radio and television receivers; railroad equipment and transport; clothing; leather and footwear; aircraft and spacecraft.

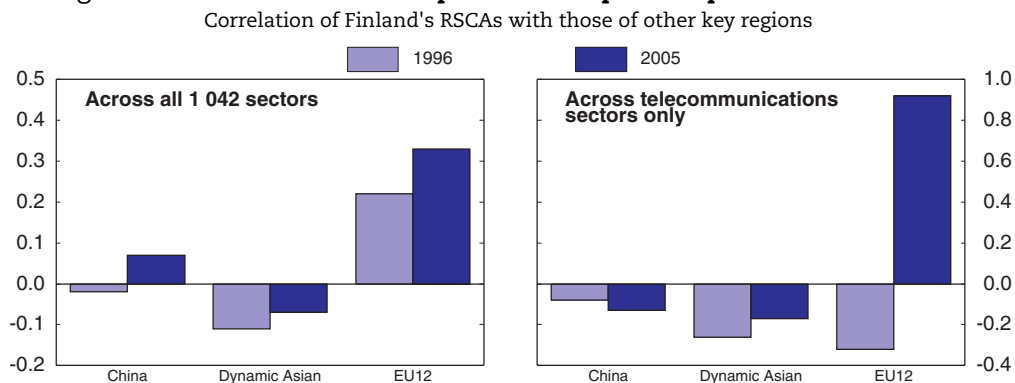
Source: OECD calculations based on the UN COMTRADE and UNCTAD databases.


contributed by other services – consisting mainly of travel and transport – remained little changed at around 10%.

There are several areas where Finland has had a comparative advantage, but where it is losing it rapidly, such as building and repairing of ships, printing and publishing, and computer and information services. Moreover the paper and pulp industry is facing increasing pressures, and suffered a 7% decline in market share between 1996 and 2005. In some industries a loss of comparative advantage may reflect inadequacies in the dataset, to the extent that it fails to capture niche-market specialisation within a broader category. For example, within the shipbuilding industry, Finland has a cruise ship specialty, which may be higher value added. Finland has also significantly increased its degree of specialisation over the past decade in some industries in which it did not boast a higher than average export market share (*e.g.* other business services and construction).

One way of quantifying the extent to which Finland faces head-on competition with different groups of countries is to calculate the correlation between Finland's RSCA index in the different export sectors and those of the key competitor countries or regions. The left hand panel of Figure 1.6 illustrates that Finland's export specialisation is becoming more similar to that of China and the Dynamic Asian region. But the strongest head-to-head competition is coming from the 12 new EU member countries (EU12). When the same analysis is conducted for the telecommunications sectors alone (right hand panel) it appears that competition from the EU12 is even more acute (note the different scale on the two charts). To some extent, however, competition from these countries reflects the foreign investments and outsourcing by Finnish multinational enterprises (MNEs). Indeed, there is significant evidence that Finnish MNEs are actively taking advantage of production possibilities abroad, including in the new EU member countries. For example, Herfindahl concentration indices suggest that the sales of Finnish MNEs' manufacturing affiliates in foreign countries are more geographically dispersed than those of the MNEs for the other OECD countries for which data is available (OECD, 2005b). Finnish MNEs have taken particular advantage of the integration of many Central and Eastern European countries into the European Union, with a large number of manufacturing affiliates located in these countries, particularly in Estonia where linguistic and cultural links are important, and in Hungary (Widgrén, 2006).

Figure 1.6. **New EU members present sharper competition than China**



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Note: The correlation is a rank correlation between Finland's RSCAs in the relevant sectors with those of China, the dynamic Asian economies and the EU12. The RSCAs for the EU12 and the dynamic Asian economies are calculated using extra-regional trade data.

Source: OECD calculations based on the UN COMTRADE and UNCTAD databases.

## Insufficient diversification?

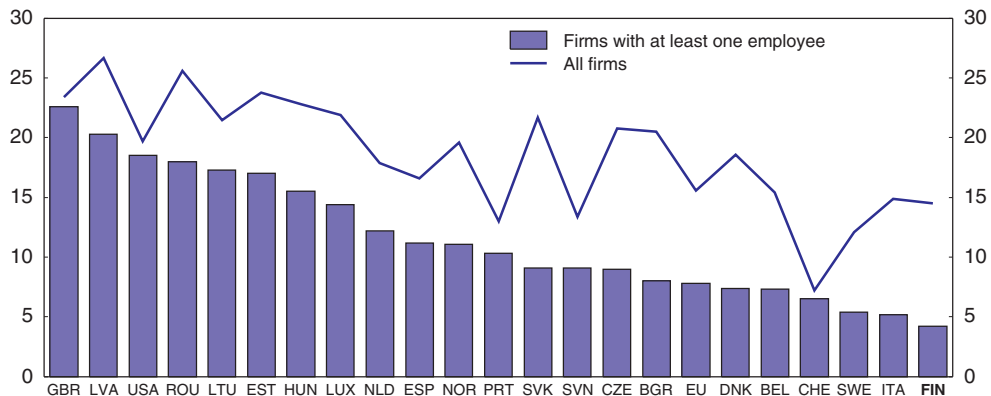
Overall, the data paint a picture of an economy in flux. Finland maintains a higher than average export market share in its traditional low-tech industries (pulp and paper; wood and wood products), although the pulp and paper industry has experienced a gradual decline in employment since the early 1990s, with some acceleration in job losses in 2007. Moreover, future prospects for the pulp and paper industry look increasingly dim. A key problem is that the price of Russian roundwood (which makes up roughly 20% of the input wood into the Finnish industry) is increasing as Russia raises export duties. The increases began in 2007 and the most significant rise is due to take place in January 2009, at which point Russian imported roundwood is expected to become prohibitively expensive. Since imported inputs are unlikely to be completely replaced by other sources, a significant output decline in the sector is expected.<sup>6</sup> Another problem is that wage levels in this industry are much higher than for comparable jobs (as noted in Box 5.1). Finally, increased competition from new pulp mills in Latin America and new paper plants in China and other parts of Asia are pushing down the relative price of end products.


Meanwhile, although Finland's comparative advantage remains strong in the telecommunications sector, a high degree of economic reliance on a single company may potentially be dangerous. Agglomeration and clustering can have large benefits and Finland should be proud of the success of the telecommunications sector, but it is also worth considering the risks. Looking forward, the competitive pressures in Finland's areas of comparative advantage are only likely to intensify (following the trend illustrated in Figure 1.6). So for globalisation to continue to benefit Finland, resources will continually need to be re-allocated towards higher value-added goods and services. Finland will probably maintain a comparative advantage in the production of or development of ICT goods, but that advantage could be eroded more quickly in the future as technologies converge, standards change and pressures continue for the international relocation of productive activities. There does seem to be scope, however, for Finland to find new ways to facilitate the use of ICT in other sectors, including in the production of both public and private sector social services (Chapter 4).

Finland's industrial structure also has important implications for living standards. Like other major ICT exporters such as Sweden and Korea, Finland has experienced a trend decline in the terms of trade since the mid-1990s. This implies that a measure of living standards that correctly reflects consumption possibilities would be lower than a conventional measure of GDP. Indeed, OECD (2006a) estimated that the downward adjustment to GDP growth would be around  $\frac{3}{4}$  percentage point per annum since 2000, considerably weakening Finland's performance relative to other OECD countries.

Finland's relatively concentrated industrial structure raises questions about whether business conditions are generally conducive to the emergence of new sectors. One indication that the Finnish economy might not be conducive for new start-ups is the fact that firm turnover is very low; among those firms with more than one employee, firm turnover in Finland in the late 1990s and early 2000s was the lowest in a sample of 24 countries (Figure 1.7).<sup>7</sup> Another indication is the fact that Finland measures poorly in terms of the contribution that resource allocation across industries and firms makes to sectoral levels of total factor productivity (Arnold *et al.*, 2008). One possible explanation could be the high top personal tax rate. Johansson *et al.* (2008) found that countries with a very high top personal tax rate had reduced entrepreneurial activity, which in turn lowered

Figure 1.7. **Firm turnover in industry and services**  
Firm births plus deaths as per cent of number of firms, average 1997-2004<sup>1</sup>



StatLink  <http://dx.doi.org/10.1787/337124447857>

1. 1996 for the United States and 1997 for Canada.

Source: Eurostat; OECD Firm-Level Data Project, [www.oecd.org/eco/firmleveldataport](http://www.oecd.org/eco/firmleveldataport).

total factor productivity growth. Other factors that may impede entrepreneurialism in Finland are labour market rigidities (Chapter 5) and the complexity of the tax system (Chapter 3). Finally, it has also been suggested that Finland's bankruptcy law increases the risks of entrepreneurialism in Finland compared with other countries (Prime Minister's Office, 2004).

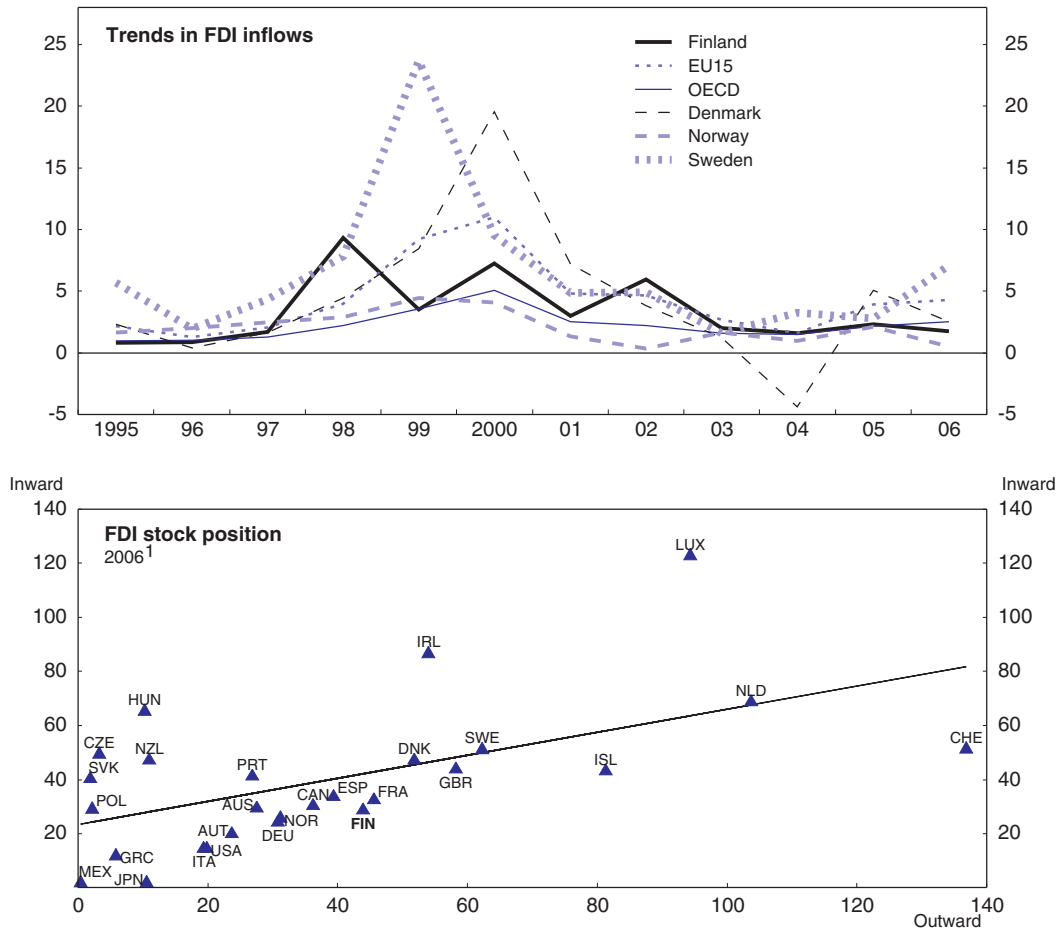
### The stock of inward FDI is below the OECD average

Given the positive technological spillovers that can stem from inward FDI, the government has been concerned that Finland is not attracting more FDI inflows. Inflows have been declining in recent years and Finland's total stock of inward FDI as a percentage of GDP is lower than in most other OECD countries (Figure 1.8). The recent deterioration of FDI inflows is partly an industry effect, as there has been a shift in the composition of output away from industries that typically have a high investment ratio (e.g. pulp and paper), towards industries where investment ratios are typically lower (e.g. electrical and optical equipment).

How much does it matter that Finnish FDI inflows are not larger? One of the main advantages of inward FDI is the opportunity to benefit from technological transfers and spillovers from best-practice foreign firms to domestic firms. But given the relatively high productivity of Finnish firms, foreign MNEs in Finland have little productivity advantage (OECD, 2005b) and are less R&D intensive (Figure 1.9). The relative dominance of the manufacturing sector by domestic firms implies that domestic firms are undertaking the bulk of manufacturing R&D expenditure. Nevertheless, although it is starting from a lower base, the growth in real terms of R&D expenditure of foreign MNEs is as high as that in Finland. To the extent that only high-tech firms conduct R&D, this may reflect positively on the quality of FDI in Finland.

Moreover, Finland's overall level of business investment as a share of GDP does not stand out as being particularly low in international comparison, particularly when it is acknowledged that these statistics do not include investment in R&D, which is among the highest in the OECD and has increased substantially since the early 1990s. OECD measures

Figure 1.8. **Foreign direct investment**  
Per cent of GDP

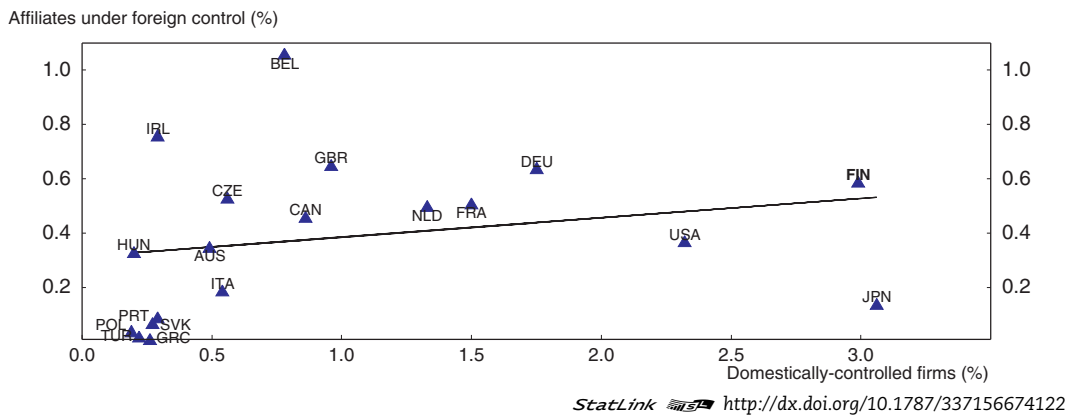


StatLink <http://dx.doi.org/10.1787/337134447076>

1. Or latest available year.

Source: OECD (2008), *International Direct Investment Statistics and National Accounts of OECD Countries* – online databases, January.

Figure 1.9. **Finnish firms have a very high R&D intensity<sup>1</sup>**  
2004<sup>2</sup>



StatLink <http://dx.doi.org/10.1787/337156674122>

1. R&D expenditure as a share of value added in the business sector.

2. Or latest available year.

Source: Update of OECD (2005), *OECD Economic Globalisation Indicators*, Figure G.4.1.

of formal discrimination against FDI show that Finland is relatively open to FDI investment (OECD, 2006b). However, policy factors that may serve to deter higher levels of inward investment include: a relatively high cost of labour (particularly unskilled labour); the inflexibility of labour markets more generally; the high level of state ownership in some sectors;<sup>8</sup> and rigid product market regulations in some sectors (particularly retail distribution). Any government efforts to attract additional FDI should focus on these priority areas.

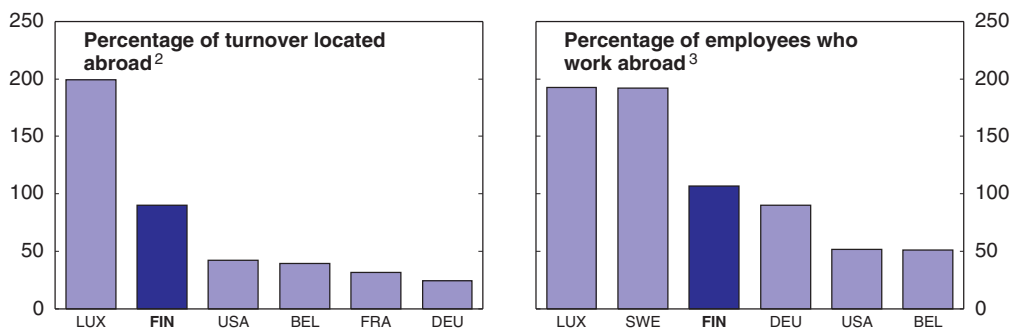
## Outward FDI is stronger


Finland's relatively high stock of outward FDI as a percentage of GDP (Figure 1.8, bottom panel) suggests that Finnish firms have been proactive in making the most of globalisation opportunities by outsourcing or offshoring<sup>9</sup> production in order to relocate various links in their supply chains so that costs can be cut in low value-added areas. This is confirmed by data showing that Finnish companies have a very high share of turnover and employees located abroad (Figure 1.10). As at the end of 2006, Finland retained only 20% of Nokia's productive capacity with most of the remainder located in Asia (44%) and other parts of Europe (24%), while a smaller share of capacity is located in Latin America (Nokia, 2007). Nine out of Nokia's ten telephone-producing manufacturing facilities are now located outside of Finland, while domestic activities are increasingly focused on R&D, design and the development of new telecommunication services.

In general, Finnish MNEs are heavily concentrated in the manufacturing sector, with only a relatively small share in the service sector – although Nokia is increasingly focussing on the development of telecommunications and internet services. Within the manufacturing sector, however, Finnish firms (particularly Nokia) have also increasingly diversified their R&D activities to other countries. The share of R&D conducted by Finnish manufacturing firms abroad more than doubled from about 17% in 1997 to about 45% in 2001, after which the share of foreign R&D seems to have stabilised at around 40% in recent years (Ali-Yrkkö and Palmberg, 2006). Not surprisingly, inventions – as measured by patent applications – have also become increasingly internationalised. For example, just

Figure 1.10. **The internationalisation of Finnish multinationals**

2002<sup>1</sup>



StatLink  <http://dx.doi.org/10.1787/337184886275>

1. Or latest available year.

2. Manufacturing sector turnover of affiliates located abroad as a percentage of domestic turnover of parent companies.

3. Number of employees working abroad as a percentage of total manufacturing sector employment of parent companies in Finland.

Source: OECD (2005), OECD Economic Globalisation Indicators.



over one quarter of Finland-owned patent applications to the European Patent Office were invented abroad between 2001 and 2004 (OECD, 2007a).

Where do the returns from outsourcing show up? The significant increase in royalty and license fee receipts related to offshored production of products that were developed in Finland (Nokia phones being the obvious example) shows up in the trade accounts – as indicated by a dramatic increase in the “Royalties and license fees” category indicated in Figure 1.5. At the same time, investment income from abroad has risen sharply.

## Globalisation and the Nordic model

Welfare provision in the Nordic countries is predominantly universal: welfare arrangements are typically considered to be a citizen’s right with receipt independent of income and wealth, while financing is collective via taxation. However, there are also some important differences between the Nordic countries (Box 1.3). In Finland, there are strong universal elements for most services, including education, hospital care, social benefits, care for the elderly and the basic pension. The earnings-related pension system is an exception, as is income-linked unemployment insurance, as entitlement is a function of contributions. Overall, there is strong support by the population for retaining the current welfare system, although there may be scope for adding an additional user-pays dimension for those services, such as tertiary education, which have a high private return (Chapter 6).

Even though Finland has quite low income inequality by OECD standards, it has increased over the past decade. In a recent study investigating the factors underpinning distributional changes, OECD (2008c) showed that the increase in income inequality in Finland was not driven by changes in the distribution of wage or self-employment income.<sup>10</sup> Rather, the increase in the dispersion of household disposable income reflects the increasing role of non-wage income – particularly capital income, the distribution of which has become significantly more concentrated. This is consistent with a shift in the remuneration of the highest income earners towards capital, following the introduction of the dual income tax system (Chapter 3).<sup>11</sup> The same study also documented a reduction in the degree of redistribution by the tax and benefit system, and this has also contributed to the increase in inequality. Nevertheless, in considering policies to address inequality, the authors emphasise the importance of preventing large income inequalities from developing in the first place – by facilitating access to paid work, by strengthening the earnings capacity of people and by ensuring that all children are equipped with the skills that they need. Given the generally good education system, the low employment rates for some groups stand out as the key policy area for improvement in Finland, with respect to the goal of minimising income inequalities and maintaining the current good level of social mobility.<sup>12</sup> A recent study investigating the incidence of poverty in Finland also confirms that unemployed households are the most vulnerable group (Riihelä *et al.*, 2007). While redistribution is also important, the question is how to do it without damaging market signals too much. Reducing unemployment is likely to require better regional mobility. However, this may be impeded by some aspects of regional development policy, such as the policy of providing a disproportionate number of study places outside the growth centres (Box 1.2).

What role is globalisation playing in the distribution of income? Unfortunately, it is difficult to disentangle the impact of globalisation from other structural changes – such as the impact of rapid technical progress. Because global integration has expanded the

### Box 1.3. Finland and the Nordic model

While the Nordic model is often characterised as consisting of the supportive welfare state, funded by relatively high taxation, openness to globalisation is the critical third leg of the model. Indeed, an important benefit of the Nordic model is that the use of collective mechanisms for sharing risks has made it easier for Finnish citizens to embrace both globalisation and competition.<sup>1</sup> Supporters of the Nordic model argue that openness to trade and competitive forces have permitted strong GDP growth, while the tax and welfare systems have ensured that the winners from structural transformation have to some extent compensated the losers, and provided them with the resources to adjust to the structural change engendered by globalisation. Relative to Denmark and Sweden, however, Finland has lower total tax revenue as a percentage of GDP. In addition, Finnish public social expenditure is not particularly high (Chapter 3).<sup>2</sup> In this sense, Finland could be described as conforming less to the Nordic model than the other Nordic countries. Table 1.1 also highlights differences in labour market regulation and outcomes, with Danish policies and labour market outcomes generally ranking more highly than those in the other countries.

Table 1.1. **Other Nordic countries lead the way in many areas**

The best country score is bolded in each case

Policy indicator	Finland	Denmark	Sweden	Norway
Structural unemployment rate (NAIRU, 2007 estimate) <sup>1</sup>	7.5	4.4	4.9	<b>3.3</b>
Regional unemployment dispersion (standard deviation, 2003)	2.3	--	0.9	<b>0.4</b>
Real wage rigidity <sup>2</sup>	0.50	<b>0.13</b>	0.52	0.22
Employment protection legislation (EPL, 2003) <sup>3</sup>	2.02	<b>1.42</b>	2.24	2.56
Product market regulation (PMR, 2003) <sup>3</sup>	1.32	<b>1.12</b>	1.23	1.48

1. The 2007 NAIRU figure for Finland is an *Economic Outlook 83* estimate.

2. On a scale of 0 (where no one is subject to the rigidity) to 1 (where all workers are potentially affected).

3. A lower score represents less restrictive regulations.

Source: OECD, *Economic Outlook 82 database* and *Economic Outlook 83 database*; OECD, *Employment Protection Legislation database*; OECD, *Product market regulation database* ([www.oecd.org/eco/pmr](http://www.oecd.org/eco/pmr)); OECD (2006) *Employment Outlook*; Dickens, W. et al. (2006), "The Interaction of Labour Markets and Inflation: Micro Evidence from the International Wage Flexibility Project", [www.brookings.edu/papers/2007/02\\_labormarket\\_dickens.aspx](http://www.brookings.edu/papers/2007/02_labormarket_dickens.aspx).

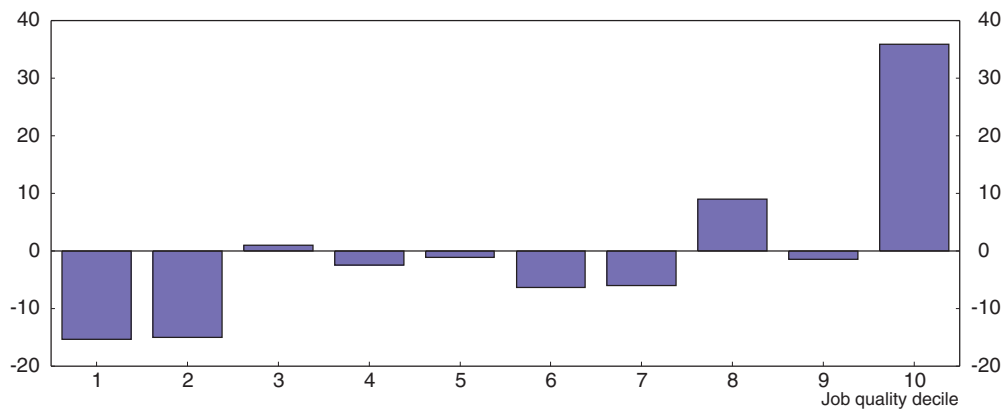
1. Sanz and Martinez i Coma (2007) show that there is a positive correlation between social expenditure and support for free trade, even after taking into account other factors that also affect people's opinion on free trade.


2. Figure 3.2 shows that out of 24 OECD countries, Finland had only the 12th highest level of public social expenditure as a percentage of GDP in 2003. All of the other Nordic countries, plus (in order of highest to lowest) Germany, France, Belgium, Italy, Portugal, Austria and the United Kingdom spent more.

relative supply of labour in the global economy – particularly low skilled labour – the relatively higher-paid low skilled workers in advanced economies have become less competitive. Globalisation could thus be expected to reduce the share of income accruing to labour through two channels: through greater offshoring of the less skill-intensive stages of production; and through increased access to cheap imports of goods and services (which may displace domestically-produced goods and services). But at the same time, skill-biased technical change is affecting the labour share in a similar way, and recent studies have found it difficult to identify which of the two drivers (technical change and trade) have had the largest impact on wage inequality.<sup>13</sup>

One factor that may have prevented a more marked widening of the income distribution in Finland is the culture of wage setting, which tends to give equal wage increases to all workers across all industries. While it is sometimes argued that this can be done in a country with a high average skill level, there is also evidence that wages and productivity have moved sufficiently far out of line that low skilled employment is suffering. Indeed, Figure 1.11 shows that job losses since 2000 have been concentrated among the least skilled, while there have been strong employment gains for the highest skilled. In some other countries there has been strong job growth not only in the top income decile but also in the lowest-paid categories, reflecting growth in service sector jobs that cannot be easily offshored or computerised.<sup>14</sup> In Finland, by contrast, the data suggest a shortcoming in the economy's ability to produce more low-paid service sector jobs.

Figure 1.11. **Employment share by job quality decile**<sup>1</sup>  
Percentage change, 2001-05



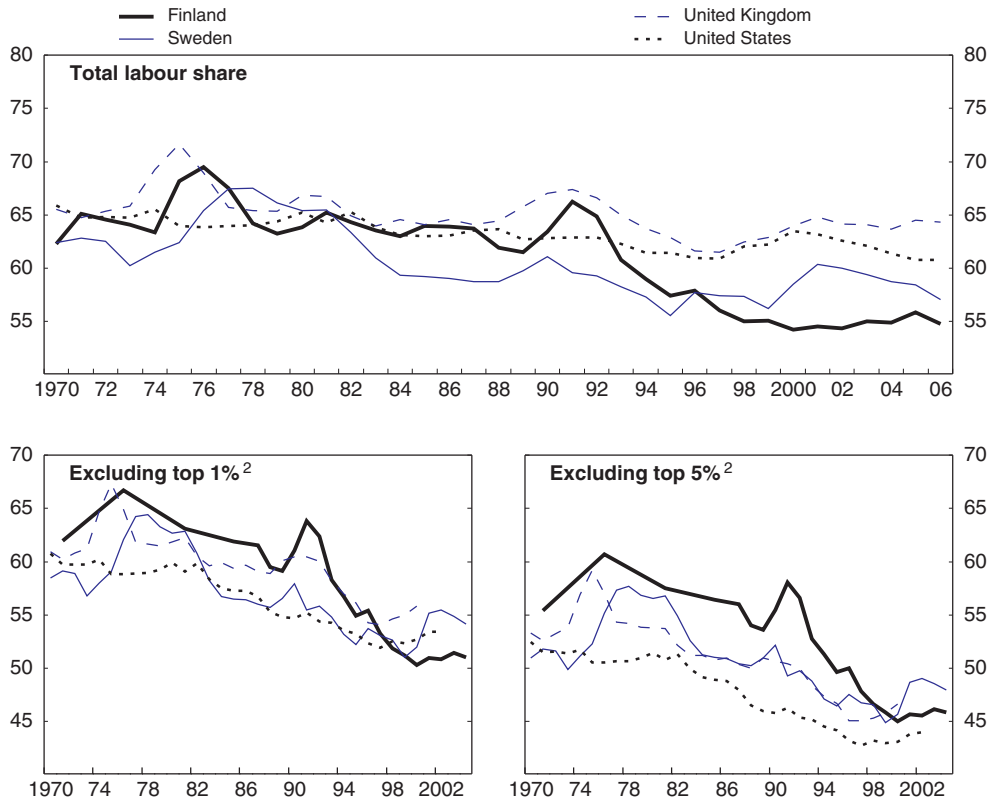
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1. Quality deciles are based on mean hourly wages in 2001.

Source: Statistics Finland, *Structure of Earnings database*, 2001 and 2005 and OECD calculations.

The labour share of income fell during the 1990s, by slightly more than in the United Kingdom and the United States, before stabilising more recently. Similar trends are observed when the incomes of the top 1% and 5% earners are excluded (Figure 1.12). Although the factors underpinning trends in the labour share are not fully understood, Jaumotte and Tytell (2007) have identified some differences in labour share patterns across countries. First, for most countries, much of the decline in the labour share can be attributed to the unskilled sectors of the economy. Second, countries with the smallest falls in the labour share tend to be those that introduced changes to labour market policies that have raised employment, such as policies that have reduced the tax wedge and the unemployment benefit replacement ratio. In order to mitigate the risk of a resumption in the previous downward trend stemming from offshoring and the loss of competitiveness in some sectors, it is important that Finland accelerate the pace of labour market reforms aimed at raising employment. This analysis also emphasises the importance of maintaining high standards in compulsory education, further increasing the quality of tertiary and vocational education, and facilitating the movement of resources from lower into higher value-added industries.

Figure 1.12. **Labour share of income**  
Total labour compensation,<sup>1</sup> in per cent of GDP



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1. Total labour compensation, including employers' social security contributions and imputed labour income for self-employed earners.
2. Data on top income shares are not necessarily consistent between countries and in some cases there may be breaks over time. See Atkinson and Piketty (2007) for details.

Source: OECD (2007), *OECD Economic Outlook: Statistics and Projections*, No. 81 – online database; Atkinson, A.B. and T. Piketty (2007), *Top Incomes over the Twentieth Century*, Oxford University Press; Riihelä, M. et al. (2005), "Trends in Top Income Shares in Finland", VATT Discussion Papers, No. 371, Government Institute for Economic Research, Helsinki; Roine, J. and D. Waldenström (2008), "The Evolution of Top Incomes in an Egalitarian Society: Sweden, 1903-2004", *Journal of Public Economics*, Vol. 92 (1-2).

Looking forward, an important question is how sustainable the Nordic model will be in the face of increasingly mobile tax bases and production, together with the fiscal challenge posed by ageing. A recent book addressing this question (Andersen et al., 2007) concludes that the model can remain viable and successful only if the challenges that it is currently facing are understood, and if this translates into economic reforms. As identified in previous *Economic Surveys* (OECD, 2003, 2006a), the majority of the priorities for reform are in the labour market, and its interaction with the tax-benefit system. While these challenges have been fully acknowledged by the government for some time, progress in addressing them has been slow, reflecting Finland's consensual decision-making process and a perceived lack of urgency. But more ambitious reforms would significantly improve the sustainability of the Nordic model in Finland. Indeed, there are important lessons to be learned from the other Nordic countries which have made considerably greater progress in some areas, particularly with respect to labour market reform (Table 1.1). The key challenges are outlined in more detail below.

## Significant challenges remain

Although Finland is making the most of globalisation in many ways, there remain a number of significant policy challenges, which – if addressed well – would permit Finland to benefit further. These key challenges, as summarised below, are to: ensure fiscal sustainability and the effectiveness and efficiency of public spending and taxation; make the labour market function better; make tertiary education as good as compulsory education; and encourage more skilled immigrants to move to Finland.

### **Ensuring good macroeconomic performance and fiscal sustainability**

The challenge of population ageing and its implications for medium- and long-term fiscal sustainability has been covered in detail in previous *Surveys* (e.g. OECD, 2003, 2006a). The 2005 pension reform was an important first step towards addressing these concerns. Nevertheless, without further pension reform, social security contribution rates will have to rise in the future. Since higher contribution rates would push up the labour tax wedge and worsen employment-creation conditions, Chapter 2 argues that additional measures should be taken to avoid this outcome. In the short term, the government should take steps to ensure that the fiscal target set out in the Government Programme – a target of 3½ per cent of GDP for the general government surplus – is met. Additional steps to improve the longer run sustainability of the fiscal accounts are also outlined.

### **Setting tax policies that support the Nordic model**

Tax policy, the role of the welfare state in providing support for those affected by restructuring, and support for globalisation are closely inter-related. This *Survey* acknowledges the risk-sharing benefits of tax-funded social support, at least if a significant part of public spending is geared towards supporting a high rate of labour force participation, such as through spending on child care and early education, and through spending to help workers cope with risks and adapt to new conditions in times of rapid change. But as both capital and labour become more mobile, there is pressure to lower the tax burden. To permit this, the key focus of tax policy should be on ensuring that taxation imposes as few distortions as possible. A more efficient tax system can maximise the revenues available for social service provision, and at the same time ensure that tax rates are not so high as to scare away the base.

In this context, it is clear that taxes in Finland are too low on immobile factors of production (land) and too high on mobile factors (labour). Chapter 3 discusses the key challenges in changing the composition of taxes. Since both property and labour taxes are levied by the municipal governments – who typically find it easier to raise taxes on labour rather than property – this will require the central government to rethink the framework conditions under which municipalities operate. At the same time, the top marginal tax rate on labour levied by the central government should be reduced, and there is a case for broadening the value-added tax (VAT) base. Although broadening the VAT base often raises distributional concerns, Chapter 3 shows that a lower VAT rate on certain items is not an efficient way to address concerns about poverty. Similarly, the chapter highlights the fact that higher property taxes can improve the distributional burden of taxation.

### **Reforming the municipal service sector**

Significant efficiency gains in the provision of health and social services are needed to prevent tax rates from going up, as ageing (and rising costs due to technical advances) puts

new pressures on services such as health and elderly care. Existing policies rely on the hope that economies of scale gained by municipal mergers will (at least in the medium to long run) be sufficient to permit productivity improvements and cost savings. While municipal mergers should be encouraged, they are unlikely to provide any significant boost to productivity. Rather, Chapter 4 argues that more competition is the key to improved performance. To bring this about, well-specified contracts to ensure a high standard of quality are required; but it should not necessarily matter whether the bidding to provide a service is won by a private firm or a public agency. As discussed in Chapter 4, encouraging greater competition, while safeguarding quality, will involve: i) drawing a sharper distinction between core and non-core services, so that government resources can be increasingly focused on the core services; ii) encouraging the private sector to play a larger role in the provision of non-core services; and iii) ensuring a level playing field between private and public providers, by improving public procurement rules and guarding against cross-subsidies to public providers.

### **Making the labour market function better**

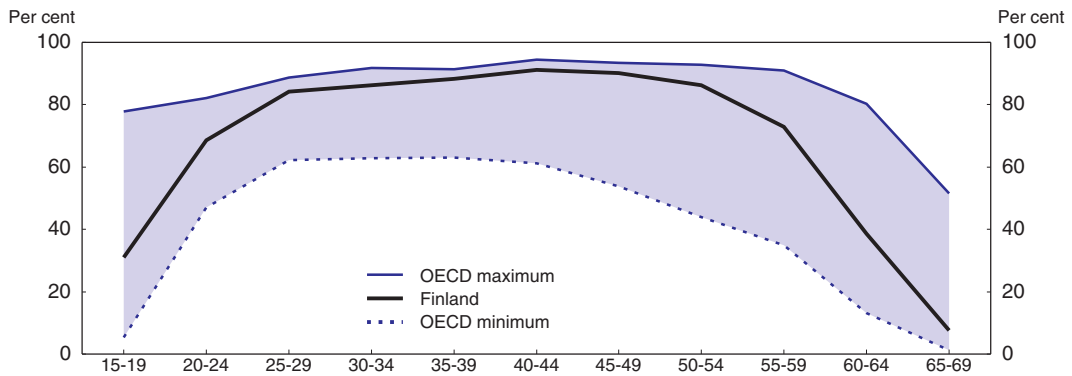

The case for labour market policies that promote higher employment and encourage greater labour market flexibility has been made in many previous OECD *Surveys*, and some progress has been achieved. For example, the employment rate of older workers has increased and unemployment has fallen. Nevertheless, Finland continues to compare poorly on these indicators relative to many other OECD countries. In addition, Chapter 5 documents worsening mismatches between labour demand and supply, and across geographical areas, despite the fact that unemployment is still high.

A key problem is insufficient wage flexibility. Considerable wage compression mutes signals about supply and demand. The recent move away from centralised wage bargaining to more sectoral- and enterprise-level negotiations held promise, but the most recent wage negotiations did little to make wage outcomes better reflect local firm and industry productivity performances. Given the increased possibilities that globalisation offers for production-shifting and outsourcing – such as through the unbundling of the production process – labour demand is becoming more sensitive to the wage rate (Andersen, 2003). While in theory a more elastic labour demand should moderate wage demands, Chapter 5 shows that there has been little evidence of this in Finland, with very high wage demands seen even in those industries facing strong competitive pressures and plant closures.

In addition, structural policies continue to distort labour-leisure decisions. For example, while labour force participation is relatively high among the prime age cohorts, it is still low among older workers (Figure 1.13). Among other things, this reflects the continued existence of the “unemployment pipeline” for unemployed people aged 57 and over, and the looseness of activation requirements for older workers on sickness and disability benefits. Similarly, exit rates from long-term unemployment are very low, reflecting access to extended periods of untapered unemployment benefits. Chapter 5 shows that the policies required to raise labour force participation are relatively clear – as shown by the success in 2005 of increasing the retirement pipeline eligibility age from 55 to 57 – but little more is being done to abolish the pipeline. For young people also, both participation rates and employment should be higher. While some other Nordic countries have made better progress with reforms in this field (most notably Denmark with its *flexicurity* system), Finland spends less on active labour market programmes and there is

Figure 1.13. **Higher labour force participation needed for the old and young**

Participation rate, 2006

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Note: The shaded area shows the area between the highest and lowest participation rate for each age group over all OECD countries.

Source: OECD (2008), *Labour Force Statistics – online database* (January).

resistance to the easier hire-and-fire rules that a coherent flexicurity framework would entail. Restrictions on part-time work also hold back participation.

### **Making tertiary education as good as compulsory education**

As in other high wage countries, there are strong incentives for Finnish companies to “hollow-out” low- and medium-skill production jobs, which are increasingly being offshored and computerised. This underscores the importance of ensuring that a large proportion of workers have a good quality education and the ability to undertake complex knowledge-based tasks. With one of the best compulsory education systems in the world, Finland has a strong base for producing a high level of human capital. Unfortunately, however, inefficiencies in the tertiary education admissions process mean that many graduates from general upper secondary school are forced to delay their entrance into tertiary education for extended periods (matriculation backlog). Study times in universities are long, largely because most students graduate with a Master’s degree rather than a Bachelor’s degree as in most other countries. These problems delay the labour force participation of tertiary graduates. In addition, the highly specialised nature of study programmes may provide insufficient breadth and cross-disciplinary expertise, while the centrally-controlled and non-competitive nature of the system may impede innovation and quality.

Chapter 6 discusses the challenges involved in reforming the tertiary education system to overcome these weaknesses. The matriculation backlog presents a significant source of inefficiency and abolishing the backlog should be made a priority. To this end, entrance into tertiary institutions should be based on the matriculation examination only, while in the meantime the number of starting places should be temporarily increased, although not to the full extent of the backlog. Significant improvements could also be made by enrolling all university students in Bachelor’s rather than Master’s degrees and by tightening the study progress conditions of the study support. In addition, more market-based mechanisms are needed to improve the incentives faced by both students and education institutions, including the possible introduction of tuition fees (which would also provide additional resources to the tertiary education system). Moreover, the

introduction of tuition fees, combined with a cut in the top marginal tax rate (as recommended in Chapter 3), would make a coherent policy package.

### **Encouraging more skilled immigrants to move to Finland**

Immigration is currently low, but there is potential for foreign labour to be used to a greater extent to alleviate specific skill shortages, as is the case in some other countries (such as the United Kingdom and Ireland). In order to ensure that migrants support economic growth, it is important to focus recruitment efforts on young skilled immigrants, who are ready to join the labour force quickly. Chapter 7 discusses the challenges inherent in attracting skilled migrants to a relatively cold country with a difficult language and concludes that more effort could be devoted to active recruitment abroad to fill specific vacancies, combined with specific integration assistance (including language training). This may require speeding up application processing times and improving cross-border qualification recognition.

### **Notes**

1. For instance, see the World Economic Forum (2006). Being ranked highly could be a mixed blessing, however, as there is a negative correlation (the coefficient is  $-0.39$ ) between the rankings and growth performance over time. Germany, Switzerland and Japan, for instance, were ranked 2nd, 3rd and 4th in the 1995 rankings (out of the 23 OECD countries assessed), but posted only the 20th, 23rd and 22nd GDP per capita growth performance over the following 5 years.
2. The fifth policy priority identified in *Going for Growth* is to continue with product market deregulation, as well as privatisation.
3. Calculated as  $([\text{exports} + \text{imports}]/2)/\text{GDP} \times 100$ .
4. While a very high share of China's exports are classified as high-tech, within this field it may be specialising in the labour intensive and lower value-added parts of the production chain.
5. See Broadbent *et al.* (2006) and Rae and Sollie (2007) for a more detailed discussion of RSCA analysis.
6. Simulations suggest that if half the roundwood currently imported from Russia can be replaced from other sources, then output in the forest industry would fall by around 10%, and the total effect of the export duties would be a reduction in GDP of around 0.5%. A worst case scenario, in which no alternative supply of roundwood is available, would cut output of the forest industries by 20%, causing a 1.4% drop in GDP and a significant fall in employment (Bank of Finland, 2007).
7. The Eurostat database of business demography contains slightly more recent data, which suggest that there has been a slight pick-up in total firm births (but not deaths) in recent years. However, this is likely to reflect an increase in sole proprietorships driven by income-shifting incentives (Chapter 3). There is little evidence to suggest that turnover of firms with more than one employee has increased.
8. State ownership remains significant in alcohol retailing, air transportation, postal services, insurance, energy, manufacturing and forestry. The government has no privatisation programme.
9. The terms outsourcing and offshoring are often used interchangeably. Both can be used to describe the process of purchasing intermediate goods and services from foreign suppliers, although outsourcing can also be done domestically, while offshoring always refers to inputs being sourced from abroad and also incorporates international insourcing (importing goods or services from foreign affiliates of domestic parent companies).
10. In fact, for full-time male workers, OECD (2008c) showed that earnings inequality was either stable or declined between 1990 and 2005.
11. Riihelä *et al.* (2005) show that the main factor that has driven up the top 1% income share in Finland since the mid-1990s is an unprecedented increase in the fraction of capital income. Between 1990 and 2004, the share of capital income in the incomes of the top 1% group rose from 14% to 63%, and the authors attribute this primarily to income shifting associated with the 1993 introduction of the dual income tax system.



12. OECD (2008c) shows that there is a close relationship between high social mobility and low income inequality. This suggests that ensuring a relatively equal distribution of resources is often a necessary precondition to ensuring equality of opportunity.
13. See Jaumotte and Tytell (2007) for a short literature review.
14. This was the case in the United Kingdom over the 1990s. For an illustration, see Figure 2.1 in OECD (2007b).

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## ANNEX 1.A1

*Progress in structural reform*

This annex reviews action taken to follow recommendations made in the 2006 *OECD Economic Survey of Finland* and earlier *Surveys*. Recommendations that are new in this *Survey* are shown in the boxes at the end of each relevant chapter.

Recommendations	Action taken since the previous <i>Survey</i> (May 2006)
<b>A. Labour markets</b>	
<b><i>Raise the employment of the old and young:</i></b>	
Dismantle demand-side barriers to the retention and hiring of older workers including by removing the age-related component of social security contributions.	Age-related social security contributions will be phased out in 2008 for small- to medium-sized companies.
Reduce the average age at which young people begin to work. Introduce tertiary education fees for all students while developing the loan system with income-contingent repayments.	Improvements in the recognition of prior learning in higher education (2007). Introduction of an electronic application system for selection processes (2008).
Introduce greater flexibility into the system of centralised wage determination and avoid specifying minimum absolute changes in wages.	The share of wage increases negotiated at the local level is larger in the new agreements, and a number of agreements include commitments to further increase this share during their validity period.
<ul style="list-style-type: none"> <li>● Encourage the increased use of the part of the overall wage increase (union allowance) that can be negotiated at the industry or local level.</li> <li>● Promote the differentiation of minimum tariff wages by age and experience in the collective agreements, in particular for younger workers.</li> <li>● 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.</li> <li>● 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.</li> <li>● Consider the introduction of a low statutory minimum wage.</li> </ul>	
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 financial incentives to work by tapering unemployment benefits at longer durations to reduce the marginal effective tax rate (METR).	The conditionality of labour market support for long-term unemployed was increased. A refusal to participate in activation measures now leads to penalties, which may include the discontinuation of the allowance or reduced allowance for a specified period (2006).

Recommendations	Action taken since the previous Survey (May 2006)
<b>B. Pensions</b>	
<p>Return unemployment- and disability-related benefits to the purpose they were originally designed for, rather than allowing them to be used as alternative pathways for early retirement.</p> <ul style="list-style-type: none"> <li>● Eliminate the higher pension accrual rate at age 53.</li> <li>● Phase out the unemployment pension more quickly rather than waiting until 2009. Also phase out the unemployment pipeline.</li> <li>● The disability pension should be awarded purely on medical grounds rather than giving greater emphasis to “social criteria” as under the pension reform.</li> <li>● 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.</li> <li>● For those with more manageable medical conditions, regular participation in work-focused interviews and training or activities to help the persons better manage their health condition should be mandatory. In any case rehabilitation programmes should include both medical and vocational aspects. Consider also introducing financial incentives for the disabled to take up work again.</li> <li>● Abolish the compensation for reduced earnings available under the part-time pension. Instead greater flexibility to combine a part-time pension with work might be considered, but without a subsidy.</li> </ul> <p>Consider eliminating accrual rights during other non-work periods (such as periods of study).</p>	
<b>C. Raise public sector efficiency</b>	
<p>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.</p>	<p>A project and a forum for best practices in local government is bringing together all those involved (2007-09) and a number of other programmes are encouraging municipal and service structure reforms (e.g. the Municipal Framework Act of the Reform to Restructure Municipalities and Services).</p>
<p>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 the 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.</p>	<p>A working group made several proposals to further strengthen the role of family day-care (2007). The social security working group is looking at child care (2007-09). The private care allowance was increased (2007, 2009).</p>
<p>To better control outlays on drugs within the health budget, consideration should be given to: transferring the responsibility for the re-imbursment 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.</p>	<p>A system of health centre-specific drug portfolios has been developed with drugs for these portfolios chosen on the basis of cost-effectiveness. There is a plan for a national system of evaluating the most important new drugs at the national level (2008).</p>
<p>Improve the operational efficiency of hospitals 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.</p>	<p>The Framework Act and a number of projects and programmes related to the municipal and service structure reforms will reduce the number of hospital districts.</p>
<p>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.</p>	<p>Municipalities are purchasing more elective surgery from the private sector where surgeons are remunerated on a fee per-service basis.</p>
<b>D. Municipal finances</b>	
<p>Delete or eliminate the municipal share of corporate tax revenues to reduce the effect of cyclical fluctuations.</p> <p>Limit 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.</p>	

Recommendations	Action taken since the previous <i>Survey</i> (May 2006)
Tighten conditions for <i>ad hoc</i> support to individual municipalities.	The Ministry of Finance can now set additional conditions for the grant (2007).
Further develop benchmarking of municipal service efficiency.	A project for promoting best practices is underway (2007-09).
Re-organise charging for ageing-related services to better allow users to pay for care and practical help, beyond what is regarded as necessary.	
<b>E. Housing</b>	
Phase out or better target the state loan guarantee scheme in such a way that it does not undermine the risk awareness of home buyers.	The maximum duration of the state loan guarantee has been shortened (2006).
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 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 decisions concerning building permits and local plans.	The Land Use and Building Act was reformed (2007). The reform process is continuing this year.
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.	



## Chapter 2

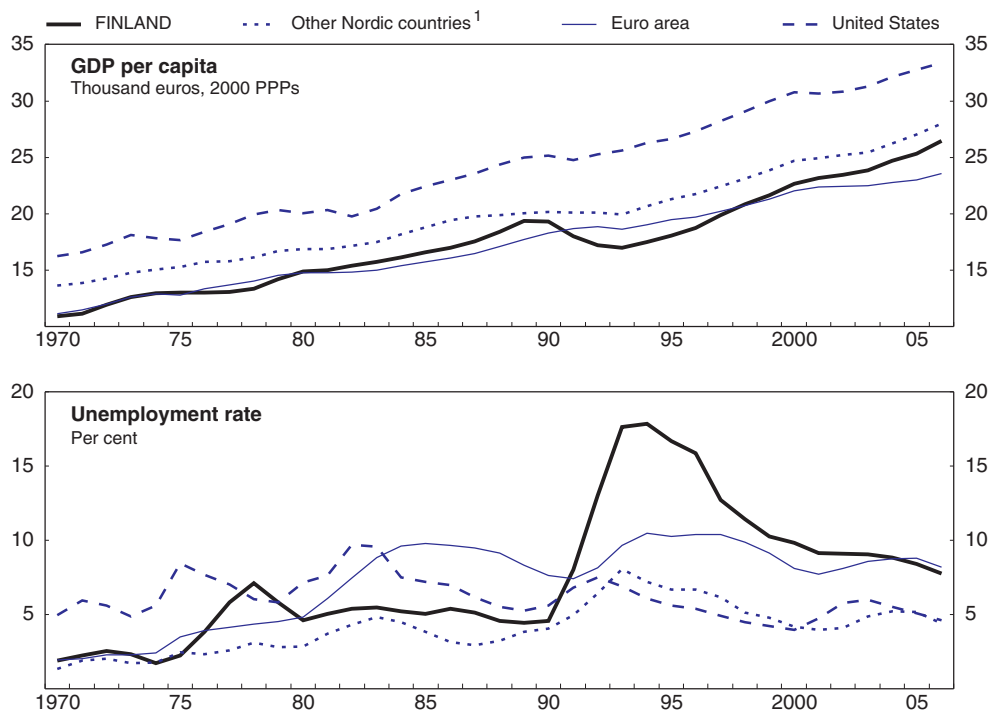
# Recent macroeconomic performance and fiscal sustainability


*This chapter briefly summarises Finland's recent economic performance and highlights the potential for cutting labour taxes in the near term, by pairing tax cuts with offsetting contractionary policies. Priorities for achieving longer term fiscal sustainability are also discussed, including further pension reform.*

## Recent macroeconomic performance has been good

Output grew by 4.3% in 2007, above its trend rate, contributing to a further catching up in GDP per capita towards the slightly higher level of the other Nordic countries and the significantly higher level of the United States. The level of GDP per capita now ranks 15th in the OECD (Figure 2.1, top panel), almost on a par with the United Kingdom and not far behind Sweden and Denmark.

Figure 2.1. **Key economic indicators**



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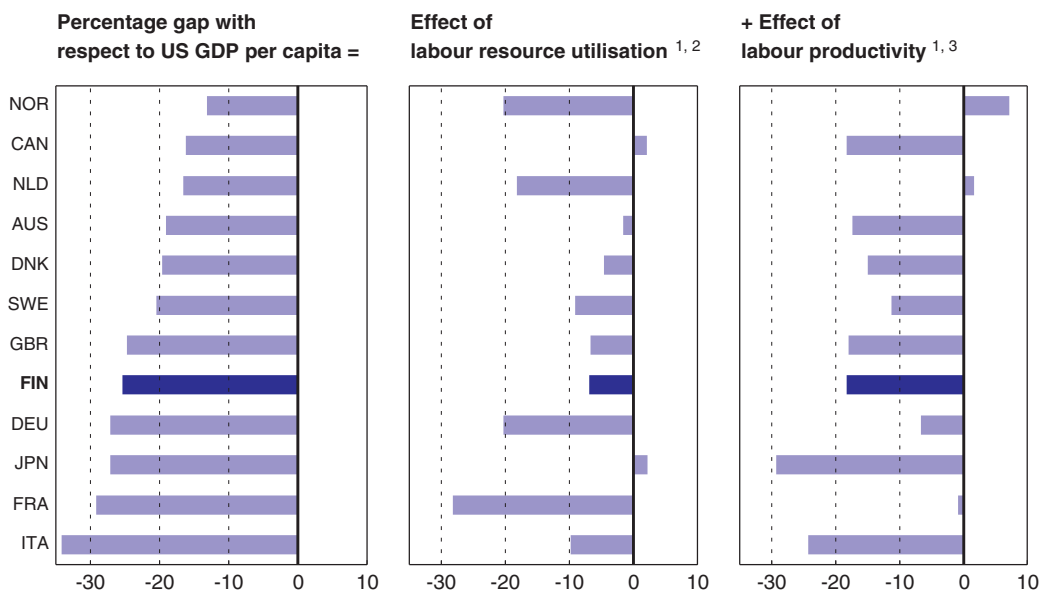
1. Weighted average of Denmark, Iceland, mainland (in case of the GDP) Norway and Sweden.

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

About two-thirds of the gap in living standards with the United States is explained by lower labour productivity, while a lower number of hours worked by the working-age population also plays an important role (Figure 2.2). Overall, productivity in the manufacturing sector has been relatively good, with most of the gap relative to the United States being explained by lower productivity levels in the services sector (Chapter 4). The unemployment rate has fallen significantly in recent years, but it still remains well above its pre-recession level and well above that of the other Nordic countries (Figure 2.1, bottom panel).



Figure 2.2. **The sources of differences in income**  
2006, in current USD at purchasing power parity exchange rates



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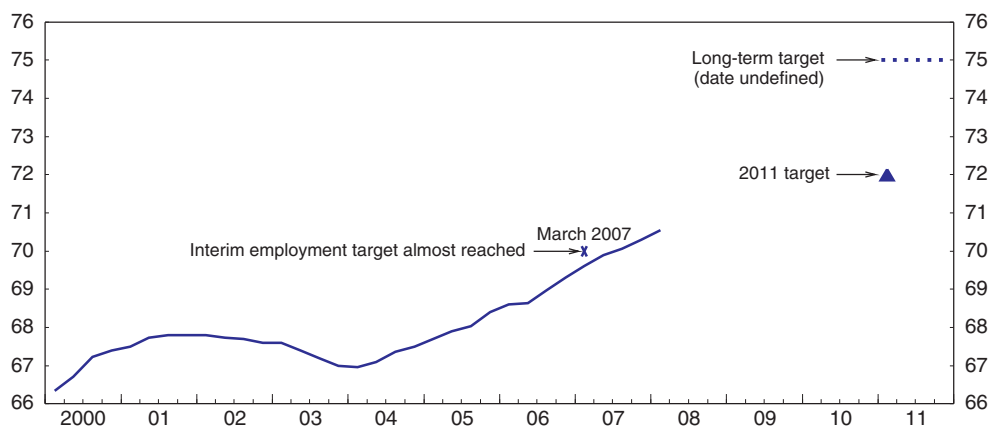
1. Percentage gap with respect to the US level.
2. Labour resource utilisation is measured as total number of hours worked divided by working-age population.
3. Labour productivity is measured as GDP per hour worked.

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

## But major challenges in the labour market remain

As highlighted in Chapter 1, the labour market continues to be one of Finland's biggest macroeconomic challenges. Although employment grew rapidly in recent years, and the unemployment rate has fallen significantly, meeting the government's long-run employment rate target of 75% will be difficult (Figure 2.3), particularly given population ageing and low participation rates among the older cohorts. Reforms are also needed to get

Figure 2.3. **Employment rate: Targets and recent performance**  
Per cent, monthly



StatLink <http://dx.doi.org/10.1787/337320586057>

Source: Statistics Finland.

more young people into employment, both by making graduates available to the labour market earlier and by further reducing youth unemployment. Higher participation is also needed to combat labour shortages which have now emerged, even though the unemployment rate remains above 6¼ per cent. These labour shortages, together with some undesirable features of the 2007 wage round, are likely to push up inflation (Box 2.1).

The government's recently initiated review of social security policies (the SATA Committee) will provide an opportunity to reform the most distortionary policies that are currently impeding labour market participation incentives for older workers (Chapter 5). The first recommendations (rush list) are expected in the autumn of 2008 with all work to be completed in 2009. The priorities should be to eliminate the unemployment pipeline, reform disability pensions, taper unemployment benefits and address incentive issues arising from the interaction of the social security and tax systems.

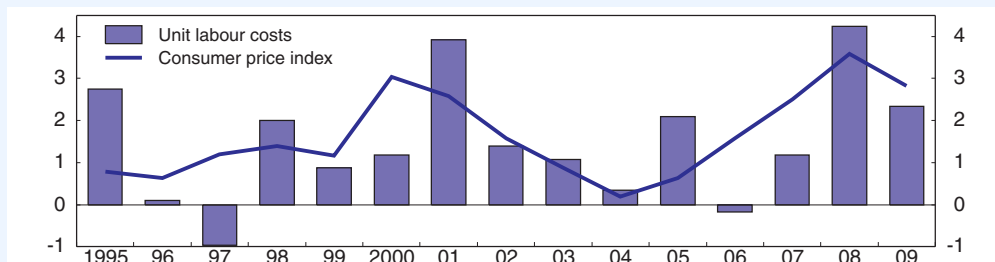
### Box 2.1. Higher wage settlements push up inflation

Finland has enjoyed a period of benign inflation over the past few years despite strong economic growth and strong import price increases. This is in part due to a series of moderate multi-annual central wage agreements, which were accompanied by tax cuts. However, the past year has seen a significant acceleration in inflation from an average of around 1.6% in 2006 to an average of over 2.5% in 2007 (Figure 2.4) and a recent spike to almost 4% in early 2008. In addition to the increases in oil and other commodity prices faced also by other countries, inflation has also been boosted by particularly strong GDP growth, while the recent industry-level wage negotiations will result in real product wage increases significantly higher than warranted by productivity growth.

Inflation is expected to remain high in 2008 and 2009. This is likely to be driven not only by GDP growth at around potential and the maintenance of a significant positive output gap, but also by an expected surge in labour costs following the completion of the recent industry-based wage negotiations (Chapter 5). Indeed, the 2007-08 wage negotiation round is expected to result in unit labour costs growing by around 4½ per cent in 2008 – well above the historical average of 1.4% over the past 10 years. This is expected to contribute to inflation rising to around 3½ per cent in 2008 before moderating somewhat in 2009 (Figure 2.4). A one-off change in the taxation of motor vehicles is expected to reduce inflation by 0.2 percentage points in 2008 and a reduction in the VAT rate for food is expected to reduce inflation by 0.5 percentage points in 2009.

Figure 2.4. **Headline CPI inflation and unit labour costs**

Percentage change<sup>1</sup>



StatLink  <http://dx.doi.org/10.1787/337321283552>

1. OECD projections for 2008 and 2009.

Source: OECD (2008), *Economic Outlook 83* database.

Table 2.1 provides a summary of recent economic performance and the near-term outlook. Growth in Finland is expected to decelerate over the next two years in line with weakening conditions globally. Growing tightness in the labour market, both in terms of skill shortages and the slowing growth in the working-age population, will also impede growth over this period, although this will be somewhat ameliorated by a rising participation rate as the recent period of strong growth continues to draw people into the labour force. However, growth is not expected to be sufficient to reduce the unemployment rate much further. The outcome of recent wage negotiations will contribute to accelerating inflation over the next few years as will the lagged effects of higher import prices (Box 2.1).

Table 2.1. **Recent macroeconomic performance and forecasts**

	Percentage changes				
	2005	2006	2007	2008 <sup>1</sup>	2009 <sup>1</sup>
GDP, volume	3.1	4.8	4.3	2.8	2.3
Harmonised consumer price index	0.8	1.3	1.6	3.5	2.5
GDP price deflator	0.2	1.6	2.3	2.4	2.0
Employment rate (level) <sup>2</sup>	68.4	69.4	70.6	71.3	71.5
Unemployment rate (level) <sup>3</sup>	8.4	7.7	6.9	6.3	6.0
Government net lending (level, % of GDP)	2.7	4.0	5.2 <sup>4</sup>	4.4	3.8
Output gap (level) <sup>5</sup>	-1.0	0.7	1.5	1.1	0.4

1. OECD Economic Outlook 83 projections.

2. As a percentage of the working-age population. 2007 figure uses an estimate of the working-age population.

3. Per cent of the labour force.

4. Ministry of Finance estimate for 2007.

5. Per cent of potential GDP.

Source: OECD (2008), *Economic Outlook 83 database*; Ministry of Finance.

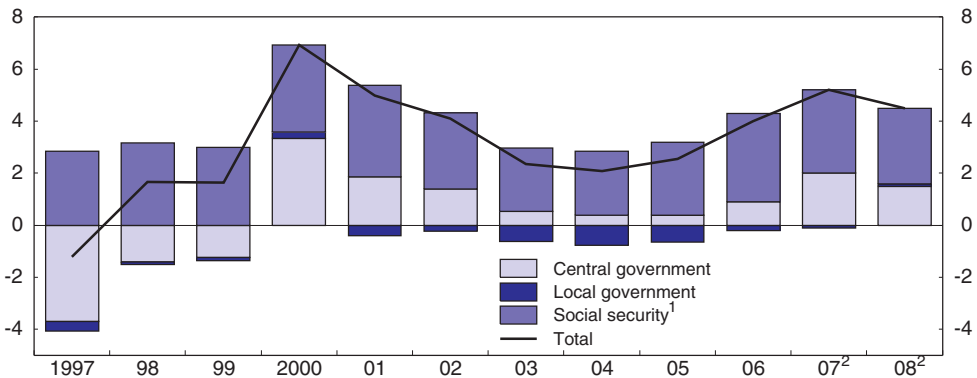
## Fiscal indicators are positive in the short term


While the general government financial surplus was the largest in the euro area in 2007 at 5.2% of GDP, such comparisons are misleading because of the inclusion of pension funds within the general government accounts. Even so, excluding social security balances, as is done in many other countries,<sup>1</sup> the government fiscal balance is likely to be positive in 2008 (Figure 2.5).

Finland is in the unusual position of having multiple targets for the fiscal balance. The government programme (Prime Minister's Office, 2007) targets a *central government* structural surplus corresponding to 1% of GDP. The 2007 Stability Programme (Ministry of Finance, 2007) states that this target is consistent with a broader intention to reach a *general government* structural surplus of 3½ per cent of GDP by 2011. Nevertheless, the formal Stability Programme target is for a *general government* structural surplus of just 2% of GDP, the same objective as in the previous programme. It is widely expected that the Stability Programme target will be easily achieved, with the surplus estimated to be above 2% in 2011 on the basis of current policies, in which case Finland will be considered to have fulfilled its EU obligations. It is also possible that the surplus will reach 3½ per cent of GDP.

Nevertheless, there are two reasons why the government should further tighten fiscal policy. First, tighter fiscal policy makes sense from a short-term cyclical perspective. With the actual fiscal surplus expected to fall this year (Figure 2.5), and the output gap expected to remain large (although narrowing), the structural surplus is likely

Figure 2.5. **Recent fiscal developments**  
General government financial balance, in per cent of GDP



StatLink  <http://dx.doi.org/10.1787/337341514317>

1. Including employment pension funds.
2. Ministry of Finance's estimate (2007) and projection (2008).

Source: Statistics Finland and Ministry of Finance (2007), "Stability Programme Update for Finland 2007", *Economic Policy Surveys*, No. 4c/2007, November.

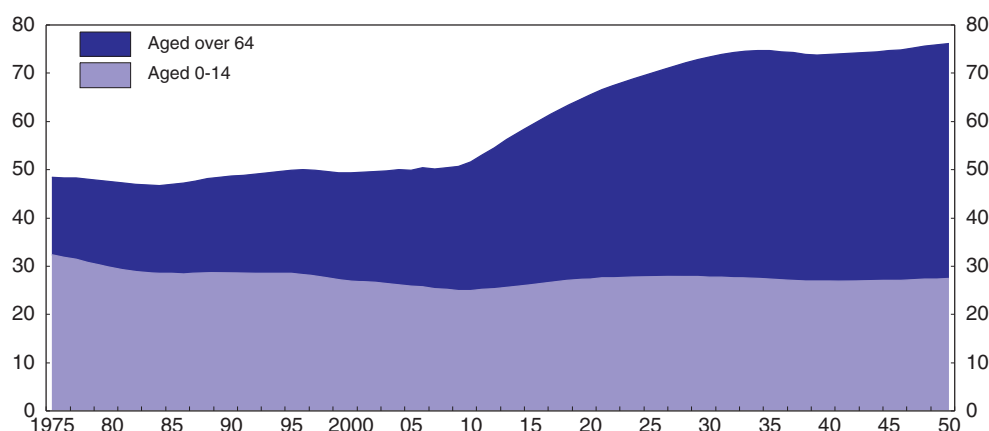
to narrow slightly in 2008, implying an expansionary fiscal stance.<sup>2</sup> Cyclical considerations in setting fiscal policy have been acknowledged by the government: it has stated that cuts to labour taxes should be postponed until such time as the cyclical position weakens. Indeed, pro-cyclical fiscal policy should be avoided. In the past, the stimulatory effects of tax cuts have been mitigated by linking them to relatively low wage increases as part of the centrally-negotiated wage agreements. However, the fact that the 2007-08 wage negotiations were conducted at the industry- and firm-level should not necessarily imply a postponement of further reductions in the taxation of labour. Tax cuts on structural grounds, even though expansionary *per se*, can still be made now as long as they are packaged together with offsetting contractionary policies. For example, the recommendation in Chapter 3 for cuts to the top labour tax rate combined with higher property taxes would not be stimulatory. Tax cuts could also be matched with other structural reforms, such as those recommended to address skill shortages. Instead the government has announced cuts to the VAT on food – a policy that is clearly moving in the wrong direction (Chapter 3).


The second reason to aim for the more ambitious fiscal target is that fiscal pressures stemming from population ageing mean that longer term fiscal sustainability will not be achieved without further effort (see below). In this respect, it is welcome that the current government is committed to the system of spending limits that proved successful with the previous government (see Box 2.2 in the previous survey).<sup>3</sup>

### But long-term fiscal sustainability remains a concern

Chapter 2 of the previous Survey discussed at length the issue of fiscal sustainability given the projected dramatic demographic ageing of the population. This topic has also been a prominent feature of recent government stability programmes (see for instance Chapter 6 of Ministry of Finance, 2007). The degree of demographic ageing expected in Finland over the coming decades is illustrated in Figure 2.6 which plots projected dependency ratios to 2050. This dramatic climb in the dependency ratio is projected to widen the already large ageing-related funding gap with growth in

Figure 2.6. **The dependency ratio is rising**  
Per cent of working-age population



StatLink  <http://dx.doi.org/10.1787/337354112841>

Source: Statistics Finland.

expenditure related to ageing outstripping ageing-related revenue (pension contributions and income earned from pension-fund investments). Indeed, the difference reaches 20% of GDP by 2050 (Table 2.2). The bulk of this 20% difference will be funded by other non-ageing related revenue and through the sale of assets accumulated for this purpose. What is particularly notable is that the impact of ageing peaks considerably earlier in Finland than in most other European countries so that by 2030 Finland's age-related public expenditure as a proportion of GDP is the highest in the EU15 (EPC, 2006).

Table 2.2. **Ageing-related spending and revenue projections**

	Per cent of GDP			
	2005	2010	2030	2050
<b>Expenditure</b>				
Pensions	10.4	11.2	14.0	13.8
Health and long-term care	7.3	7.7	9.6	10.5
Other	9.0	8.0	7.7	10.5
<b>Revenue</b>				
Property income	3.2	3.6	4.7	3.6
Pension contributions	9.1	9.0	11.2	11.2
<b>Difference</b>	<b>14.4</b>	<b>14.3</b>	<b>15.4</b>	<b>20.0</b>

Source: Ministry of Finance (2007), "Stability Programme Update for Finland 2007", *Economic Policy Surveys*, No. 4c/2007, November.

The long-term sustainability projections included in the December 2007 Stability Programme suggest that neither the 2% target in the 2007 Stability Programme nor the 3½ per cent target in the Government Programme is sufficient to guarantee the long-term sustainability of public finances. According to the calculations presented in the 2007 Stability Programme, a general government surplus of around 4½ per cent of GDP would be needed.<sup>4</sup> Previous *Surveys* have also concluded that given the ageing population, it will not be possible to maintain the current generosity of pension and transfer incomes and spending on public services (including elderly care) without

raising taxes in the future (OECD, 2006). Indeed, the 2007 Stability Programme acknowledges that social security contribution rates must still rise by 4 percentage points (of the total wage bill) to ensure sustainability, even after taking into account the 2005 pension reform and an upward revision in 2007 to the targeted return on pension assets from 3½ to 4%. Such an increase in contribution rates would represent a considerable increase in the labour tax wedge, and if implemented, could hinder employment growth. If part of this increase in contribution rates were to be offset by the central government surplus, then a sustainability gap of 1% of GDP would still remain. This highlights the need for further action to fully close the gap. Indeed, as discussed later in the following chapter, a key challenge for Finland is to continue to cut the labour tax wedge, while still preserving the essential elements of social support offered by the Nordic model.

There are several possible avenues for achieving long-term fiscal sustainability without increasing the tax wedge. Further pension reform is an obvious option.<sup>5</sup> At present, however, further pension reform is not yet on the table, and the government has instead suggested (in the 2007 Stability Programme) that the following two components taken together could bridge the sustainability gap: a 0.5% annual increase in the productivity of health and long-term care between now and 2050, and a further 1 percentage point increase in the return on pension assets. Raising the productivity of social services is indeed a priority, although bringing about a 0.5% annual productivity increase would be very challenging and involve some difficult decisions (Chapter 4). Also great care should be taken in determining the appropriate assumed return on pension assets. Further pension reform would be a much more prudent course of action to ensure sustainability and avoid the need for increases in the social security contribution rate.

Although the 2005 pension reform was a very positive initiative and it is recognised that it was a package where agreement might not have been reached without all elements, it is clear that the reform did not go far enough. The Finnish authorities should now start considering supplementary measures; especially as such a reform is likely to take time. The goal of the government should be to aim for a general government financial surplus of at least 3½ per cent of GDP in the short term, while at the same time moving to introduce further pension reform that is sufficient to prevent any increases in the social security contribution rate. Since fiscal sustainability was covered in Chapter 2 of the previous Survey, in-depth analysis is not provided here. However, it should be noted that the pension system continues to allow some workers to retire as young as 62, and the unemployment pipeline essentially permits even earlier withdrawal from the workforce in some cases (Chapter 5). Although the effective retirement age has risen in recent years, it is still below the OECD average despite life expectancy being slightly higher than the OECD average. One priority should be to fully eliminate the unemployment pipeline, and further raise the effective retirement age as quickly as possible. In addition, it has been estimated that the future required social security contribution rates could be reduced by almost 4 percentage points, without affecting work incentives much, by removing the higher accrual rate which applies from age 53 and by making non-paid periods (such as time spent studying) ineligible for pension credit accumulation (OECD, 2006). Box 2.2 provides a summary of the key fiscal recommendations.

**Box 2.2. Summary of recommendations to ensure fiscal sustainability**

- Aim for a general government financial surplus of at least 3½ per cent of GDP in the short term.
- Implement further pension reforms (see next bullet), improve the tax mix (as discussed in Chapter 3), and take significant further steps to raise productivity growth in the public sector – particularly in the delivery of municipal social services (Chapter 4).
- Further pension reform should aim to prevent increases in social security contribution rates. The priority should be to increase the effective retirement age to 65 and fully close the unemployment pipeline to retirement. In addition, study periods should be made ineligible for pension credit accumulation, and the effectiveness of the higher accrual rates for older workers should be scrutinised.

**Notes**

1. See Box 2.1 in the last survey (OECD, 2006) for further discussion.
2. On the basis of the projections outlined in the government's Stability Programme (Ministry of Finance, 2007) and those outlined by the European Commission (European Commission, 2008).
3. The system of spending limits has been useful, as it has allowed less scope for pro-cyclical fiscal policy, and the surplus generated in central government finances has been used for debt reduction and to increase the State Pension Fund (Ministry of Finance, 2007). Some minor changes have been made based on previous experience with the system. These changes included introducing a fixed annual provision for supplementary budgets, an unallocated provision for recognition of new government expenditure and the option of allocating unbudgeted funds within the spending limits to the next budget year.
4. This computation uses the most recent population projections by Statistics Finland, which indicated that because of longer life expectancy, the number of senior citizens will swell by more than forecast in the EU's 2004 population projection for Finland. Using the older figures, the required surplus would have been only 4% of GDP (Ministry of Finance, 2007).
5. Due to ageing, the surplus in the social security funds is expected to drop quite quickly over the next few years, from around 3% of GDP in 2007 to closer to 2% by 2011 (Ministry of Finance, 2007).

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## Chapter 3

# Setting tax policies that support the Nordic model

*Finland's extensive welfare arrangements require a relatively high overall level of taxation. Partly as a response to increased international integration, Finland introduced the dual income tax system at the beginning of the 1990s. Under this system companies and personal capital income are taxed at a relatively low rate on a broad base, while labour income is taxed more heavily. This has made corporate and capital taxation more competitive, without significantly lowering the total tax take. However, the dual income tax system has introduced incentives for some groups of workers to re-classify labour as capital income. In addition, there are concerns about the potential implications of high taxes on labour demand and supply. Although taxation of high-income workers has been reduced, it remains high by international standards. In the context of globalisation, there are concerns that high taxation of skilled workers may encourage more offshoring of highly skilled jobs, and potentially outward migration. In contrast, immobile factors such as property are taxed lightly.*

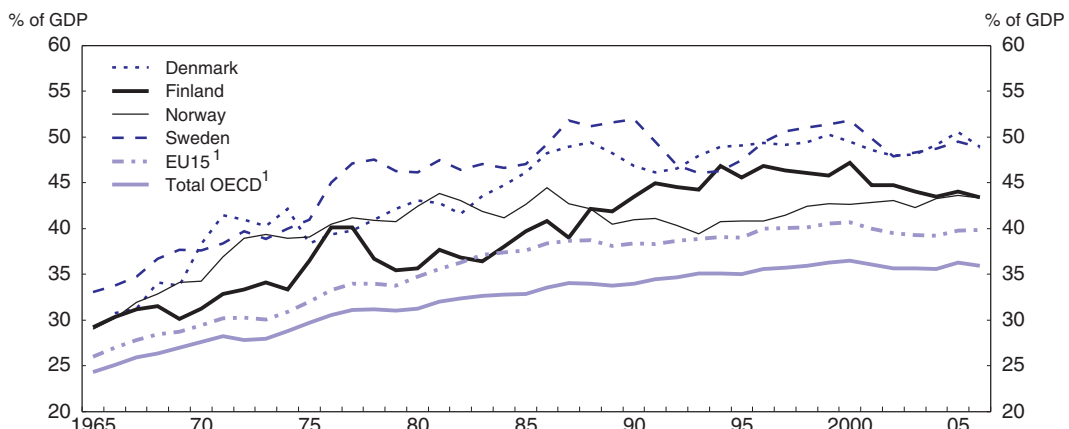
Globalisation puts pressure on the capacity of welfare states to raise tax revenue from mobile factors. The mobility of different tax bases varies substantially and the degree to which globalisation undermines the ability to tax mobile factors remains uncertain. Capital is particularly mobile as the barriers to international capital movements have been removed. This, together with transfer pricing, has made corporate profits increasingly mobile as well, and international aspects of corporate taxation have become an important policy issue. However, the location of production is determined by many factors. The corporate tax regime is not necessarily the most important, although it does clearly have some influence on corporate location and investment (Devereux, 2007 and Nicoletti et al., 2007). Increasingly, labour is also becoming more mobile, although so far its mobility is still low compared to that of capital. In return for levying relatively high taxes, countries such as Finland tend to offer a higher level of public services and the quality of these services is likely to be important in determining the population's willingness to pay.<sup>1</sup>

This chapter considers two aspects of the interaction between globalisation and tax policy. First, what are the implications of globalisation for the welfare state? Second, what does globalisation imply for the best way to raise tax revenues? There are no definitive answers. But it is clear that the policy focus should be on ensuring that taxation does not lead to large distortions, while taking equity concerns into account. In this context, the chapter concludes that taxes are too low on the most immobile factors of production (land) and too high on the more mobile factors (particularly highly skilled labour).

### Taxation and the Nordic model

One common feature of the Nordic countries is that they are small and open, and they have comprehensive welfare arrangements. Government spending in Finland as a share of

Figure 3.1. Total tax revenue



StatLink  <http://dx.doi.org/10.1787/337382264705>

1. Unweighted average.

Source: OECD (2007), Revenue Statistics 1965-2006 and Economic Outlook database.

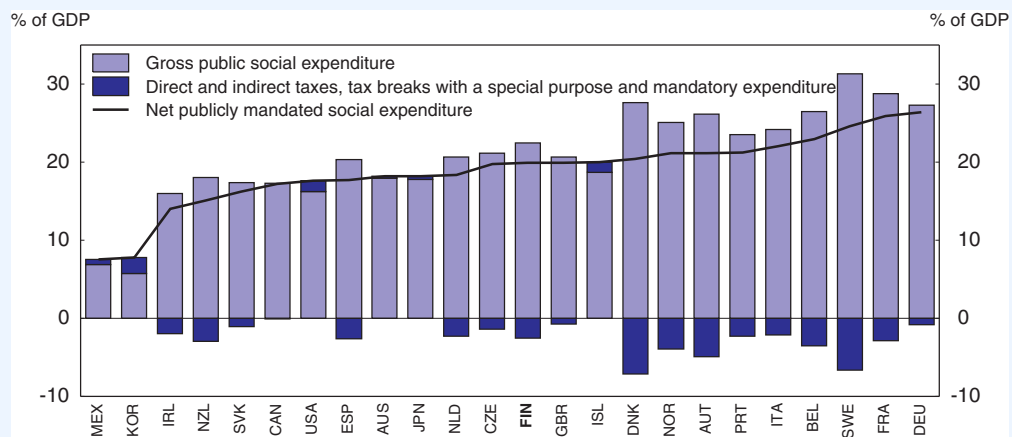
GDP is nearly 50% and, even though it has declined over the past 10 years, it is still large in international comparison. The financing of the welfare state necessitates a relatively high level of tax revenues as a percentage of GDP, which in the case of Finland is slightly below 45% of GDP (Figure 3.1). Total government revenues (*i.e.* including non-tax revenues) are somewhat above 50% of GDP. However, international comparisons of taxation and government expenditure have their pitfalls (Box 3.1).

### Box 3.1. How large is the welfare state?

International comparisons may be affected by differences in the taxation of social transfers, together with differences in the extent to which countries provide social or economic assistance via tax expenditure, rather than government spending (Adema and Ladaïque, 2005 and OECD, 2007a). Tax-to-GDP ratios exclude non-tax revenues, which for some countries can be significant. Moreover, the financing of social spending is not restricted to the government as most OECD countries require co-payments by private agents. Figure 3.2 illustrates how social expenditure changes when adjusted for differences in taxation and when mandatory private social spending is added. All the Nordic countries tax recipients of public benefits and thereby claw back part of the public transfers. Finland also imposes mandatory private social expenditure which offsets this somewhat. By contrast, in several of the English-speaking countries, some benefits are not taxed while the tax system is used for redistribution, notably through the use of tax breaks for social purposes. Finally, in several countries voluntary private schemes are extensively used (not reported in the figure), and it could be argued that these are part of the social service provision of a country, even though they are not part of the welfare state.\* Overall, Figure 3.2 shows that international differences in the size of the welfare state, while still large, are smaller than suggested by gross social expenditure data alone.

Figure 3.2. Public social expenditure

2003



StatLink  <http://dx.doi.org/10.1787/337387388133>

Source: OECD (2007), *Social Expenditure 1980-2006*, Table A.3.1.a.

\* For example, in the United States net current voluntary private social expenditure amounts to almost 9% of GDP, raising the level of total social expenditure to about 25% of GDP.

Since the Nordic countries have a long history of openness to trade, the need to make the welfare state and public sector developments compatible with international integration is not new. The economic literature does not, however, reach a consensus on the implications of globalisation for taxation and the welfare state (Andersen, 2003). On the one hand, it is often argued that sharper international competition requires lower tax rates on corporations (to prevent re-location or profit shifting) and on labour income (to prevent a brain drain). To afford lower taxes, this would require some paring back of welfare spending. On the other hand, it can be argued that because globalisation implies a rapid reallocation of resources and an associated increase in income and occupational volatility, it becomes more important to have a welfare state that adequately shares the gains of globalisation across the population and provides support for those affected by restructuring. More integration should also imply a better diversification of risks due to a broader product and geographic spread of exports and diversification of financial investments, although this benefit may be partially offset by idiosyncratic risks related to increased specialisation.

Looking across countries, there is little evidence of a convergence in the size of the welfare state across countries. For example, in an analysis of the effect of increased trade and capital mobility on social protection for 18 OECD countries, Swank (2005) concluded that the overall coverage provided by the welfare state has not changed significantly as a result of globalisation. Figure 3.1 tells a similar story; the tax take has been relatively stable over the past 15 years in both the Nordic countries and across the OECD as a whole, while at the same time trade and capital mobility have risen considerably.

While there is no evidence that tax competition due to international integration has led to a “race to the bottom” in social standards, it is probable that governments’ room for manoeuvre has become more limited (Genschel, 2005). The ageing of the population will also put increasing pressure on the welfare state. Finally, the Nordic countries, with their comprehensive welfare arrangements, might face additional challenges if the provision of generous social benefits leads to higher immigration from low income countries, while at the same time high taxes prompt the most highly skilled to emigrate. The bottom line is that continued efforts will be needed to ensure that the composition of tax revenues is optimised and to improve the efficiency of public spending (Chapter 4).

### The dual income tax system as a response to globalisation

Tax reforms aimed at lowering marginal tax rates and broadening the tax base were common across OECD countries during the 1980s and 1990s. The Nordic countries went one step further and introduced the dual income tax (DIT) system in the late 1980s or early 1990s, although this system has been partially unwound in Denmark.<sup>2</sup> In contrast to the comprehensive income tax system, which applies a single progressive tax schedule to taxpayers’ income from all sources, the DIT system applies a separate flat tax rate to all capital income and a progressive tax schedule to income from other sources. Capital is generally taxed at a rate close to or equal to the corporate income tax rate and the move to a DIT system has permitted significant cuts in the statutory rates on both capital and corporate income, accompanied by base broadening. For entrepreneurs, the DIT system requires a separation of capital and labour income, so that returns on business assets are treated the same as other forms of investment.

The introduction of the DIT system was partly a response to increased globalisation and in particular to the removal of the remaining barriers to international capital movements. The DIT system has a number of advantages (Sørensen, 1998 and van den Noord and Heady, 2001).

First, there are efficiency gains to applying a lower rate on capital than labour, as capital is more mobile internationally and its supply is more elastic. Second, a relatively narrow gap between the tax rates on corporate profits and income from capital might increase efficiency by limiting the opportunities for tax arbitrage and the potential for locking-in effects.<sup>3</sup> Third, a proportional rate, together with a broad base, promotes tax neutrality between different sources of capital income. Finally, dual income tax systems tend to simplify the system of capital taxation as they imply less need for capital tax allowances and credits.

The main drawback of the DIT system is that it generates incentives to transform labour income into capital income (dividends), because the gap between the statutory tax rates on labour and capital income is large. Attempts to counteract these incentives for closely-held corporations have involved establishing a special regime for “active” owners of closely-held corporate businesses, for which total business income is split into labour and capital components according to a complex set of rules. The splitting of income necessitates the imputation of a rate of return on the business assets of proprietorships and partnerships, as well as separating the proprietor’s business and non-business assets, both of which can be difficult. Thus the DIT system has not come without cost since administrative problems have developed, both in determining when a shareholder is “active” and in calculating the imputed return on capital. Moreover, there is evidence that income splitting has not been very successful in preventing tax planning – see Kari and Karikallio (2007) for Finland and Sørensen (2005) for Norway. Pirttilä and Selin (2006) also find evidence for income shifting among self-employed workers in Finland.

As pointed out in OECD (2006a), the implications of DIT systems for equity are less clear. In principle, such systems achieve horizontal equity in the taxation of capital income and (separately) in the taxation of labour income. Taxpayers with a different mix of capital and labour income are taxed differently under a dual income tax system, which might be seen as violating horizontal equity if current income is used as the basis for evaluation. However, under a number of assumptions and if horizontal equity is evaluated on the basis of life time income, the taxation of capital at a flat rate becomes a source of horizontal equity.<sup>4</sup> On the other hand, the introduction of a lower proportional tax rate on capital income might undermine vertical equity, especially because income from capital tends to be concentrated in the upper income brackets. Defenders of the DIT system argue that this loss of vertical equity is largely offset by gains in efficiency due to the strong reduction in tax-arbitrage opportunities and that semi-comprehensive income tax systems do not necessarily result in greater vertical equity.

Despite the benefits of the DIT system, the Finnish tax system is not free of distortions. For example, owner-occupied housing is taxed more favourably than other forms of capital income (see below). Moreover, several tax incentives to promote private pension savings are provided.<sup>5</sup> This has contributed to an increase in voluntary retirement savings, probably at the expense of other saving vehicles. The size of the tax subsidy, measured as the average net tax cost across age groups per unit of pre-tax contribution in a tax-favoured retirement saving plan, is about 20% per unit of contributions (Yoo and de Serres, 2004). This is around the OECD average.

### How to optimise the tax mix

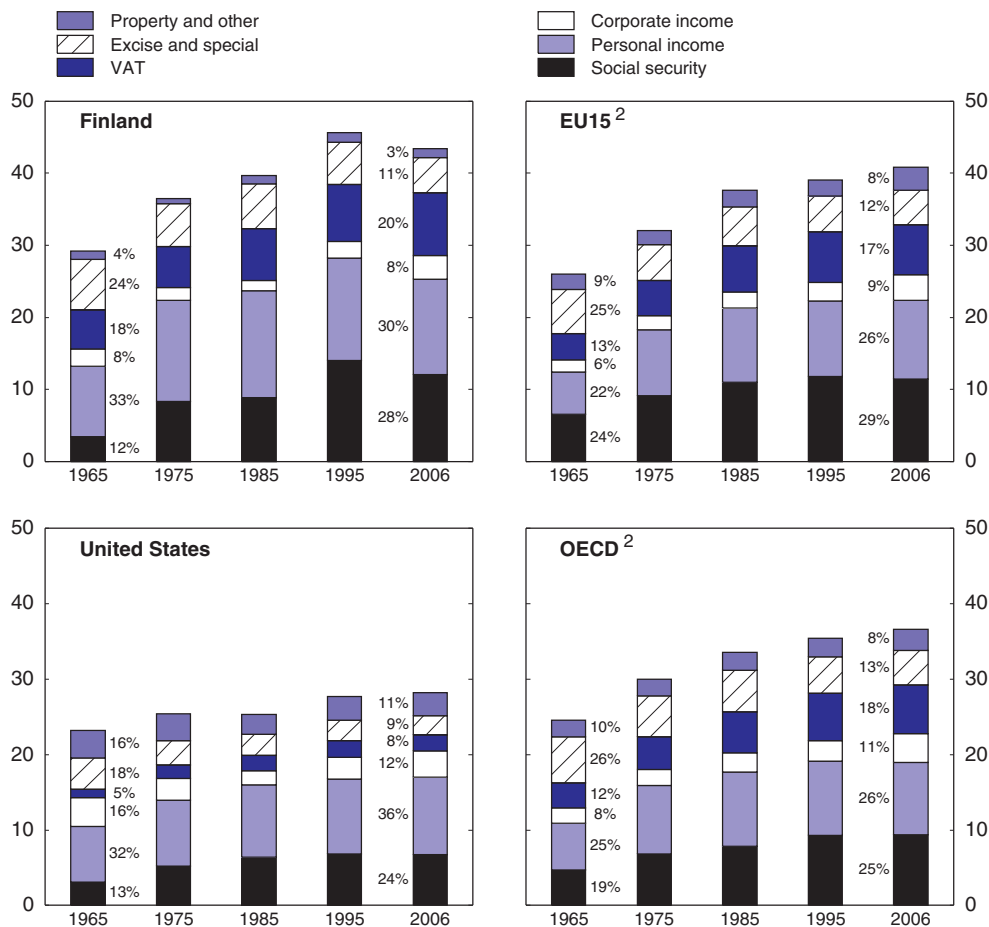
The remainder of this chapter focuses on the composition of tax revenues, and the goal of raising them as efficiently as possible against the backdrop of globalisation. Recent OECD research has found that an efficient tax mix can have positive impacts on economic

growth. Most notably, for a given overall tax level, a higher reliance on consumption and property taxes is associated with a higher level of GDP per capita, compared with a higher reliance on personal income and corporate taxes. Moreover, distinguishing between different income taxes, labour taxes appear to have a less adverse impact on GDP per capita than taxes on corporate income. Preliminary results also suggest that property taxes have a less negative effect on GDP per capita than consumption taxes (Johansson et al., 2008). The European Commission (2006) also finds that a shift from direct to indirect taxes is associated with positive effects on GDP growth and employment.

The Finnish tax system is well designed in many respects (see Annex 3.A1 for a brief overview of the tax system). Corporate profits and capital are taxed at a flat rate on a broad base. In addition, consumption taxes form an important component of tax revenues, although there is room to broaden the base. When social security contributions and personal income tax are added together, Finland raises about 60% of its taxes from labour (Figure 3.3). The mix between the two components has varied somewhat over the past 30 years, but taken together they have been stable, and slightly higher than the EU and OECD averages.

Figure 3.3. The evolution of the tax mix

Per cent of GDP (per cent of total revenue)<sup>1</sup>



StatLink <http://dx.doi.org/10.1787/337404602182>

1. The bars show data as a per cent of GDP, the percentage figures show the share in total revenues.

2. Unweighted average.

Source: OECD (2007), Revenue Statistics 1965-2006.

Finland's framework for environmental taxes is also generally well designed, although some sectors (such as the emission-intensive peat sector) continue to receive significant subsidies (Box 3.2). On the other hand, property taxes are among the lowest in the OECD and increasing them would permit cuts in other more distortive taxes (such as taxes on labour) while at the same time contributing to narrowing the wealth distribution and providing a sound funding basis for local governments.<sup>6</sup> These issues are discussed further below.

### Box 3.2. Environmental policy and energy taxation<sup>1</sup>

While it has weaknesses, Finland's overall environmental policy is quite balanced relative to that of many other OECD countries. Most environmentally-damaging substances are taxed when consumed, programmes for energy efficiency are in place in most sectors (covering 60% of total final consumption of energy) and Finland is taking its obligations under the EU burden-sharing agreement and the Kyoto Protocol seriously. Reliance on renewable energy sources is high at nearly a quarter of total primary energy supply. However, Finland has a high energy intensity compared with its neighbours, owing in part to the importance of emission-intensive industries such as pulp and paper and basic metals. As a result, CO<sub>2</sub> emissions as a share of GDP are roughly in line with the OECD average, but higher than the EU15 average. The major problem with Finland's current policies is that one important source of energy – peat, which has a particularly high emission level – receives preferential treatment due to regional policy objectives. Some other sectors (*e.g.* agriculture and energy intensive industry) also receive favourable tax treatment of energy inputs.

Under the Kyoto Protocol and the EU's burden-sharing agreement, Finland has a target to stabilise its greenhouse gas (GHG) emissions at their 1990 level over the commitment period 2008-12. The main instrument to achieve this target is participation in the EU's Emissions Trading Scheme (EU-ETS), although it will also be possible for the ETS-sectors to purchase emission credits from outside the EU under the flexibility mechanisms of the Kyoto Protocol. In addition, domestic policies and measures, such as the promotion of energy conservation and renewables are in place. In early 2008 emission allowances were allocated free of charge to energy production and industry for the 2008-12 emission trading period, with less allocated to sectors with the greatest potential to reduce emissions. The implied emission reductions vary from around 9-14% in industrial processes and peak-load power plants, to 23% in district heating and 69% from the power sector. Emissions are expected to decline somewhat in future years due to the commissioning – likely in 2011 – of Olkiluoto 3, the new nuclear power plant. However, most of the required reduction is expected to come from the EU-ETS in terms of purchases of allowances rather than abatement in Finland, as most industrial and energy facilities are already operating close to the technical energy efficiency frontier.

For sectors not covered by the ETS – such as transport – a basic tax and a surtax, along with a security of supply fee, are levied. The tax on fuels for transport and for heat production (but not for any other uses) is based on the fuel's CO<sub>2</sub> emissions, at a rate of € 20.41 per tonne of CO<sub>2</sub>. There is a 50% rebate for natural gas, to encourage increased gas use as a substitute for oil and coal. Fuels used in the production of electricity are exempt from the CO<sub>2</sub> tax. Instead, electricity is taxed at consumption, where industry enjoys a lower rate than households, as in other OECD countries. To encourage the use of renewable energy in electricity production, there are subsidies for certain energy types, such as hydro, wind and some forms of biomass. Several other initiatives to promote renewable energy also exist, such as support for R&D and subsidies for investment in renewables.

### Box 3.2. Environmental policy and energy taxation<sup>1</sup> (cont.)

The government raised energy taxes by 9.8% on average in early 2008. The biggest increases are on energy products that are used mainly by sectors not covered by the ETS. For example the tax on light fuel oil has increased by 23.2% and the tax on electricity for households by 18.8%. The average CO<sub>2</sub> emissions of the Finnish vehicle fleet is 180 g per km, above the EU average of 165 g per km and 50% above the proposed EU goal of 120 g per km by 2012. To address this, a new CO<sub>2</sub>-based tax regime on passenger car registration was introduced in January 2008 to prompt purchases of more fuel-efficient cars and facilitate a faster turnover of the existing stock of cars. The tax scheme will be further enhanced by extending the new regime to vans and by reforming the annual vehicle tax on all registered vehicles.

The overall effectiveness of Finland's energy policy is undermined by the fact that peat is tax exempt in heat production and receives a subsidy (the peat promotion scheme) in electricity production, even though the emissions from peat are estimated to be 7% higher than those from coal and 117% higher than those from natural gas (Pingoud *et al.*, 1997). Peat accounts for about 13% of total CO<sub>2</sub> emissions, and the share is likely to stay at this level until 2020. Despite this, the national climate change strategy chose to shelter peat from taxation, largely to protect peat-sector employment, much of which is located in remote regions. As discussed in Box 1.2, it would be better to move away from supporting emission-intensive peat production to providing more transparent financial assistance to lagging regions. To this end, the government should not extend the special treatment for peat when the current measures expire in 2010.<sup>2</sup> Other weaknesses of Finland's energy taxation policy are the tax refund systems for certain energy-intensive industries and the agriculture sector.<sup>3</sup>

1. This box draws on IEA (2008).

2. Whereas the Intergovernmental Panel on Climate Change and EU classify peat as a fossil fuel, Finnish scientists claim that it should be reclassified as a renewable energy source. This debate has not yet been resolved.

3. An enterprise with energy expenses exceeding 3.7% of value added can apply for 85% of the excess energy tax expenditures to be refunded up to € 50 000. Farmers receive a 30-50% refund on taxes paid for fuel oil and electricity. The 2008 revenue losses due to these two refund systems are estimated to be € 19 million and € 20 million respectively.

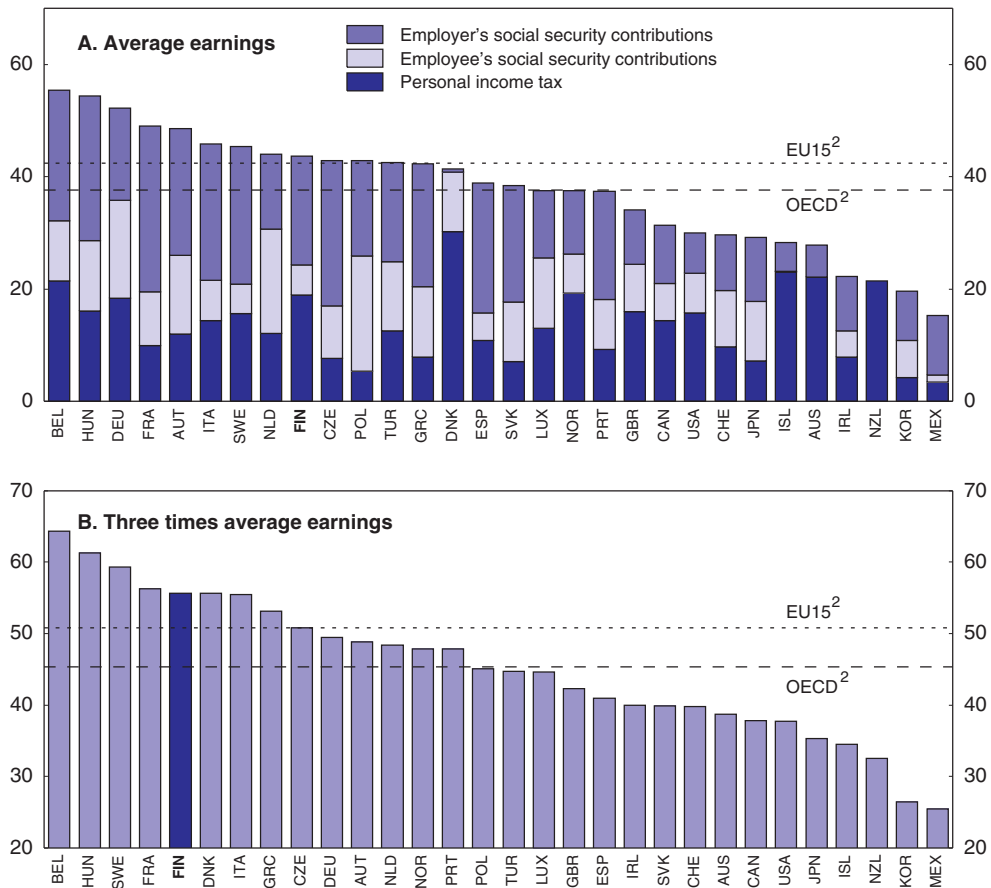
## Labour taxation is too high


The high taxation of labour raises several issues. First, high average and marginal effective tax rates distort work incentives – particularly among those with the lowest earnings potential. Second, taxation impacts on labour costs, especially where there are wage floors, and thereby on labour demand. Third, globalisation implies increased labour mobility, suggesting that the most highly educated might increasingly prefer to work in other countries should the tax burden on labour remain high. At the same time globalisation also affects labour demand through intensified competition, implying a higher potential cost of retaining high labour taxes.

The tax wedge for a single individual with no children at average earnings is about 44% in Finland (Figure 3.4).<sup>7</sup> The personal income tax and social security contributions (SSC) paid by the employee account for close to 25 percentage points, while employers' SSC account for the remaining 20 percentage points. Currently, the average tax wedge is the 9th highest in the OECD for this family type. For a married couple *with* children the average tax wedge decreases by about 6 percentage points. As most OECD countries have special



Figure 3.4. **Average tax wedges on the earnings of a single individual<sup>1</sup>**  
As a per cent of gross labour costs, 2007



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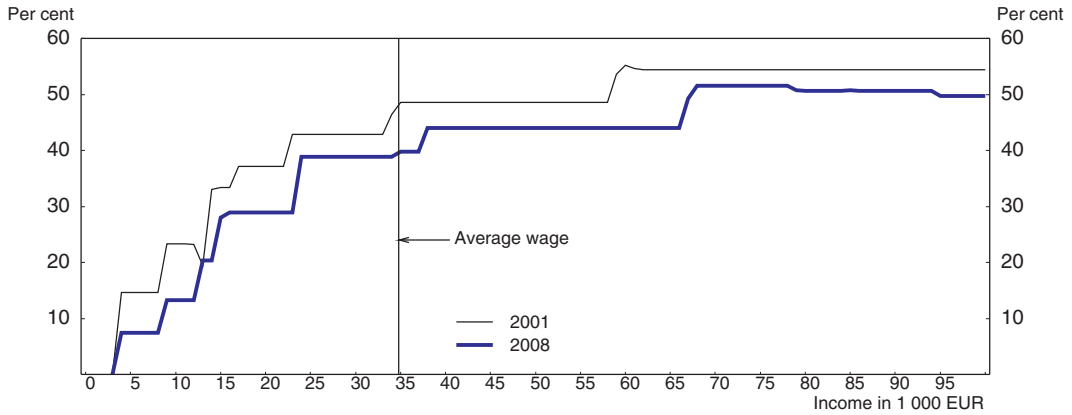
1. For a single individual without children. Tax wedges are calculated as the sum of personal income tax, employee plus employer social security contributions together with any payroll taxes as a percentage of labour costs (gross wage plus employers' contributions).
2. Unweighted average.

Source: OECD (2008), *Taxing Wages 2006-2007*.

transfer and tax arrangements for families with children, the ranking of Finland does not change much for this family type. However, the wage level of the most highly skilled persons is several times higher than the average, and tax wedges at these income levels are much higher. For example, the tax wedge for a single person earning three times the average wage is 56%, the 5th highest in the OECD (Figure 3.4, lower panel) and for someone earning five times the average wage the tax wedge is the 4th highest. While there is little empirical evidence of competition between countries on labour taxes, most studies show that highly educated workers are more mobile than other groups.

The taxation of labour peaked in 1995 and has since come down. The main focus of reform has been to improve incentives to enter the labour market (Journard and Suyker, 2002). Since 2001 the standard allowance for work-related expenses has been raised (from € 400 in 2001 to € 620 in 2007) and the statutory tax rate on labour income at the central government level has been cut by about 5 percentage points for all income brackets (Figure 3.5). Adjustments in and merging of income brackets have lowered the statutory

Figure 3.5. **Marginal tax rate on labour**<sup>1</sup>  
Central and municipal government



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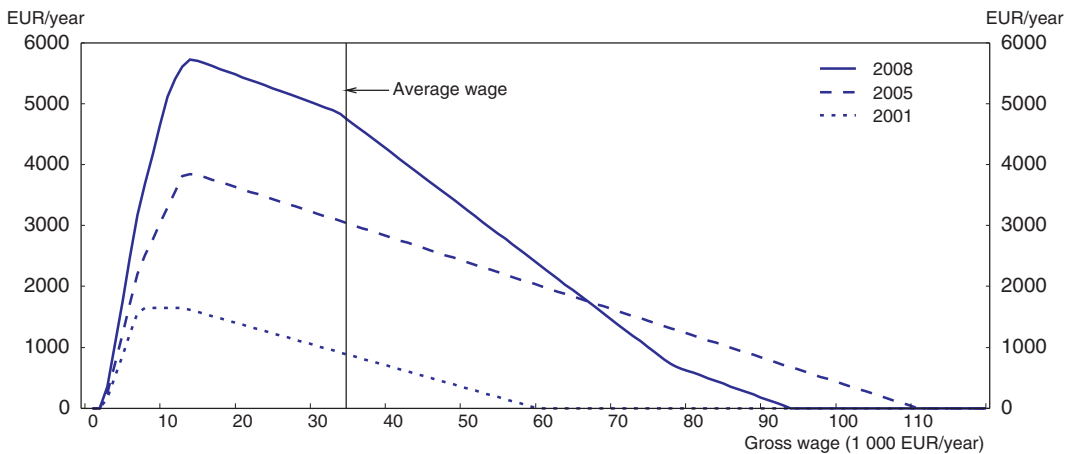
1. Excluding pension and unemployment insurance premiums.

Source: Ministry of Finance and OECD (2008), *Taxing Wages* – online database.

marginal tax rate by more for some income groups. The progressive schedule is applied at the central government level while municipalities tax labour income at a flat rate (of their choice).<sup>8</sup> Since the flat tax rate at the municipal level has been creeping up, this has offset about 1/5 of the reduction in the top statutory rate at the central government level, at least for higher income earners.

The municipal tax base is decided by the parliament, and changes are as a rule compensated at the municipal level. Since the mid-1990s work incentives for the lowest-paid have been improved by significant increases in the coverage and generosity of the municipal-level earned-income tax allowance (EITA). In addition, an earned-income tax credit (EITC) was introduced in January 2006, which can be used instead of the EITA in municipal taxation to lower the tax burden of low and medium income earners. Figure 3.6 illustrates how the generosity and coverage of the two allowances (the EITA and EITC) have increased. The impact of the allowances on marginal effective tax rates (METRs) varies

Figure 3.6. **Income tax allowances**



StatLink <http://dx.doi.org/10.1787/337538188005>

Source: Ministry of Finance.

significantly along the income ladder. At low income levels it reduces the METR by 16.5 percentage points, while in the phase out it increases the METR by between 1 and 2 percentage points. To reduce the negative impact on work incentives for different income groups, the phase out is very gradual and virtually every worker benefits from the allowance. About 55% of all taxpayers were entitled to both allowances in 2007. The average deduction has increased from about € 1 300 per person in 2002 to just above € 4 000 per person in 2007, raising the financing cost by 65%.<sup>9</sup>

One key concern regarding high taxation of labour is the potential negative impact on labour supply. A large economic literature has established that differences in taxation can account for part of the differences in hours worked between the United States and Continental Europe (Causa, 2008).<sup>10</sup> However, the Nordic countries pose more of a puzzle, since the number of hours worked is relatively high (by European standards) despite high taxes. The way in which tax proceeds are spent provides one explanation. For example if high taxes are used to subsidise child care for individuals who work, then the effect on hours worked will be less than if tax proceeds are simply returned to lower income families in the form of lump sum transfers (Rogerson, 2007). Nevertheless, high marginal tax rates faced by some groups in Finland are likely to affect labour supply significantly (Chapter 5).

Another concern about high labour taxation is that by pushing up the cost of labour it might hinder job creation by affecting companies' location decisions and by hindering entrepreneurialism. As shown in Figure 3.4 (lower panel), the average tax burden for high income earners is one of the highest in the OECD, leading to concerns about the attractiveness of Finland for highly skilled jobs and labour. Indeed, a study measuring the effective tax burden on highly qualified manpower (the IBC taxation index) found that Finland, with an estimated rate of 56.5%, had the highest burden of the 21 OECD countries in the study (BAK, 2005). This implies that the gross salary an employer has to pay to attract highly qualified workers is higher in Finland than in other OECD countries.

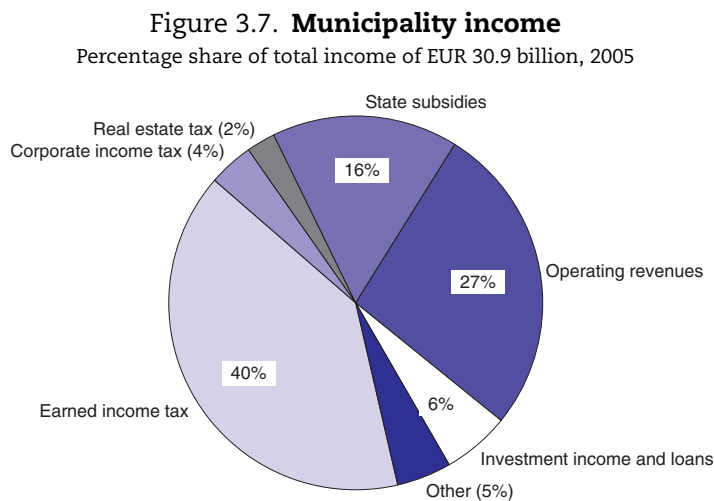
Allowances and the progressivity in the tax system play an important role in lowering the average tax rate for low and average income earners. For the highly skilled, the top statutory tax rate is a key driver of the effective average tax rate, although the tax base and social security contributions also have an important influence. While the average tax wedge is the most important tax rate for location decisions, there is some evidence that highly skilled workers can be retained (or attracted) by reducing the degree of progressivity in the tax system, even if average taxes remain high (Rasmussen, 2004). Cutting the top statutory rate at the central government level by 5 percentage points would lower the tax wedge on income three times above the average wage by 1.5 percentage points,<sup>11</sup> but only reduce revenues by around € 200 million (0.3% of revenue).<sup>12</sup> Cutting the top statutory rate is relatively cheap because only about 1% of wage earners have income above € 100 000. Such tax cuts could have an important impact on Finland's ability to attract and retain highly skilled jobs and workers.<sup>13</sup>


In recognition of concerns about the high taxation of labour, the government is committed to cutting labour taxes across all income groups by a total of EUR 1.6 billion (Prime Minister's Office, 2007). To date, no timetable for these tax cuts exists since the government wants to avoid a pro-cyclical fiscal stimulus. However, as discussed in Chapter 2, it should be possible to introduce some tax cuts in the near term, as part of a package of policies that aim to prevent excessive economic stimulus. For example, a rebalancing of taxes from labour to property, combined with a broadening of the VAT base

(see below) would not necessarily stimulate the economy, particularly if priority is given to lowering the tax wedge for high income earners by cutting the top marginal tax rate. Besides the fact that it would be less stimulatory, there are a number of more important reasons to prioritise tax cuts for high income earners. First, it has been documented that the labour tax wedge for high income earners ranks significantly worse (relative to other OECD countries) than does the tax wedge for average earners. Since offshoring of highly skilled jobs is already important, a lower tax wedge would help keep these jobs in Finland, and attract new ones. Second, it would also help to make Finland an attractive destination for internationally-mobile highly skilled workers. Third, cutting the top marginal tax rate on labour would narrow the large gap between labour and capital tax rates, thus weakening incentives for shifting income from labour to capital. A lower top marginal tax rate would also be consistent with the introduction of tuition fees on tertiary education (as recommended in Chapter 6).

### Municipal taxation needs refining

The municipalities are responsible for providing most public services, including health and education, giving them control over roughly 40% of total public expenditure. The challenges of continuing to provide high quality social services to an ageing population will require a more efficient production of these services (Chapter 4). On the revenue side, almost half the municipalities' budget is raised through their own taxes, a quarter through user charges and fees (operating revenue), while the remainder consists of state grants, investment income and borrowing (Figure 3.7).



*StatLink*  <http://dx.doi.org/10.1787/337543063542>

Source: The Association of Finnish Local and Regional Authorities.

Most municipal tax revenue is raised through the local tax on personal income. While the tax base is determined nationally, municipalities have full control over the rate. It has been trending up in recent years. In 2008, roughly one in four municipalities plan to raise income tax rates further, partly as a response to the hike in public sector wages. In contrast, municipalities have relatively little discretion over property tax rates, as maximum and minimum rates are legislated by the central government. From a globalisation perspective, this set-up is sub-optimal, since higher spending obligations

associated with rising health care costs can force municipalities to raise taxes on income, whereas higher property taxes would be less distortionary. Municipalities also receive a share of local corporate tax revenues, which creates problems due to their volatility (Journard and Kongsrud, 2003).

### **Municipalities have raised labour taxation**

While the central government tax rate on labour has declined, the average tax rate levied by the municipalities has crept up from 16.5% in 1990 to 18.4% in 2006 (Table 3.1). Municipalities have full discretion in setting the tax rate on labour income, yet the range of the municipal tax rates is relatively narrow: 16% to 21% in 2006. There are several explanations for the upward drift. Some argue that local democracy does not exert downward pressure because of ignorance about municipal tax rates and a primary focus on the quality of municipal services without fully realising the link between expenditure and taxes (Lundsgaard, 2005). Another argument is that the tax equalisation system – which is based on potential tax revenue per capita – gives municipalities little incentive to boost their “potential tax revenue” base by lowering tax rates to attract high earning citizens.<sup>14</sup> Perhaps most importantly, many municipal governments are facing increasing spending pressures, and raising taxes is often easier than making the politically difficult decisions that are required to raise productivity (Chapter 4). At the same time, the fact that the central government imposes a cap on the property tax rate but not on labour taxes makes it difficult for municipalities to raise taxes anywhere else than on labour. In order to encourage a shift in the composition of the revenue base from labour to property, and to overcome political opposition at the municipal level to higher property taxes, the central government needs to set stricter framework conditions (see below).

**Table 3.1. Composition of the marginal tax rate for a person earning the average gross wage<sup>1</sup>**

	1990	1995	2001	2008
Marginal tax rate on earned income	50.0	53.1	48.1	45.2
<i>Of which contribution from:</i>				
Central government income tax	29.0	25.4	22.8	18.9
Municipal government income tax <sup>2</sup>	16.5	16.5	17.4	18.4
Social security contributions and church tax	4.6	11.2	8.0	8.0

1. Average earnings in 2007 were EUR 34 800.

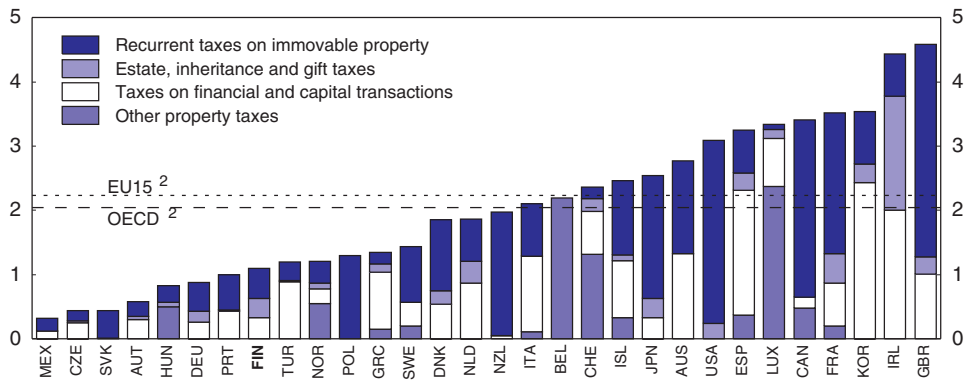

2. Ministry of Finance estimate for 2008.

Source: Ministry of Finance.

### **Property taxes should be raised instead**

Recurrent taxes on immovable property are well suited for local government financing (Journard and Kongsrud, 2003) as the tax base is immobile and the tax is difficult to evade. In addition, local government efforts to improve local infrastructure are likely to be reflected in land and housing values, thus increasing the tax yield. This link between local government service provision and revenue creates positive incentive effects for local governments. However, in Finland this link is weak, as property taxation is very low (Figure 3.8).

The recurrent tax on immovable property is currently levied on all real property with the exception of water areas, forests and agricultural land. The tax due is determined by

Figure 3.8. **Property taxation: an international perspective**Tax revenues as a per cent of GDP, 2006<sup>1</sup>StatLink  <http://dx.doi.org/10.1787/337584661512>

1. 2004 for Portugal; 2005 for Australia, Greece, Iceland, Mexico and Poland.

2. Total property taxes; unweighted average.

Source: OECD (2007), *Revenue Statistics 1965-2006*.

the property value and the tax rates set annually by each municipality. Within the range set by the central government, most municipalities levy a tax rate that is closer to the minimum than the maximum rate (Table 3.2).<sup>15</sup> Although this shows that municipalities have room to raise property taxes further, the mere presence of the maximum is likely to give the impression that higher property taxes are undesirable.

Table 3.2. **Central government prescribed ranges for municipal property tax rates**

	Minimum	Maximum	Simple average tax rate levied across all municipalities
General property <sup>1</sup>	0.50	1.0	0.67
Primary residences	0.22	0.5	0.29
Secondary residences	0.22	1.1	0.84
Vacant lots	1.00	3.0	1.07
Buildings of not-for-profit organisations	0	1.0	0.05
Agricultural and forestry land	Exempt	Exempt	0

1. This is the tax rate that applies to all other property not specified elsewhere (e.g. commercial).

Source: Ministry of Finance (2005), *Taxation in Finland*.

One problem – highlighted in the previous *Survey* – is that the assessment value of property is based on the repurchase value set annually by the Ministry of Finance, which has not kept pace with house price inflation. For example, until recently the assessment values of land in the Helsinki city centre had not been changed since 1997. Since the abolishment of the wealth tax in 2006, the tax authorities have aimed to bring the assessment value of land up to 73.5% of the market value. As a result, the average assessment values of land rose by 17% in 2007, and by as much as 20 to 30% in regions where the assessment values were significantly below target. Approximately 10% of sites still have an assessment value below target. Despite the significant increase in assessment values in 2007, tax revenue increased by only € 35 million (0.05% of total tax revenues), reflecting the very low level of current property tax rates. There is also a strong argument for extending the property tax to agricultural and forestry land (which is currently

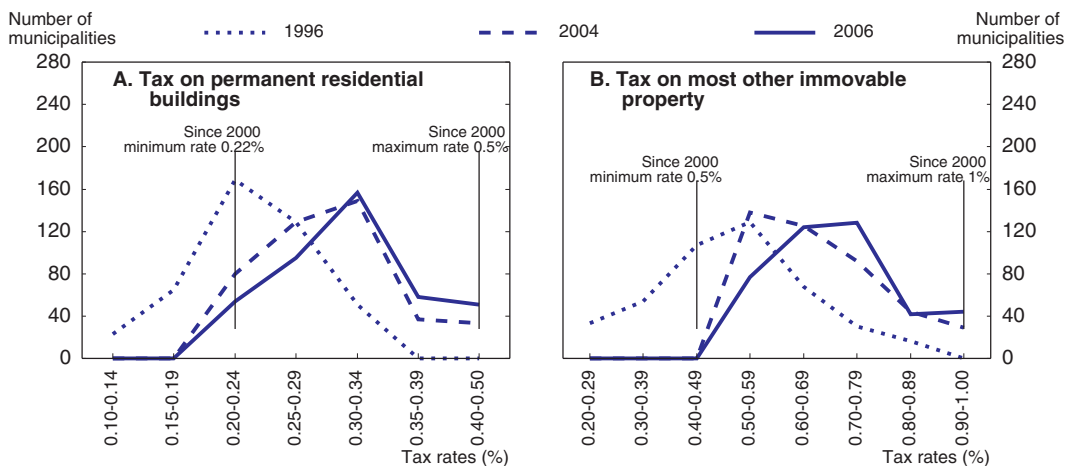
untaxed), as this would improve incentives for land owners to develop their land in the most productive way. By freeing up more land for development, such a tax could also have beneficial effects in terms of ensuring housing affordability.

Not only are property tax rates low but owner-occupied housing is currently under-taxed relative to other investments, as mortgage interest payments are tax deductible, yet this is not matched by the taxation of imputed rental income. There is also no tax levied on the capital gains of owner-occupied property. This implies that investment in housing is favoured relative to other investments, and the system strongly favours home ownership instead of renting. The previous *Survey* recommended that the mortgage interest deduction should be gradually eliminated. An alternative – and in principle, better – way of achieving neutrality would involve taxing imputed rents. However, higher property taxes could be considered to be a close substitute for a tax on imputed rental income, and if they are increased sufficiently, then it may no longer be necessary to eliminate mortgage interest deductibility.<sup>16</sup> It should also be noted that the cost of the mortgage interest deduction is around 0.25% of GDP (OECD, 2006b) and that the majority of this benefit accrues to those on higher incomes.

When considering increases in property taxes, policy makers are often concerned about how to treat wealthy households that receive only little in income. For example, pensioners who own a high value property, and yet have only low income, may not be able to pay a high property tax bill. In general, however, there is a correlation between housing wealth and income. And there are a number of studies illustrating that the majority of the benefit of under-taxation of housing accrues to those on higher incomes (Poterba, 1992). Higher property taxes should have the potential to improve the distributional burden of taxation, as long as appropriate allowances are made for certain vulnerable groups. For pensioners, one way of addressing this concern would be to permit people over a certain age threshold to defer property tax payments until the sale of their house or until death. Temporary deferrals could also be permitted for other vulnerable groups, such as unemployed workers.

The Finnish authorities have scrutinised the benefits of higher property taxes. For example, a government working group on municipal finances proposed that the lower limits for tax rates on immovable property be raised (Ministry of the Interior, 2004). However, these proposals were not implemented. Even if they had been, they did not go far enough, since maximum tax rates were retained and no changes were recommended to the tax schedules for secondary residences and vacant lots. Since secondary residences tend to belong to the wealthier, taxing them at a lower rate could be seen as regressive. The recent changes to official property assessment values are a step in the right direction, although the overall impact on property tax revenues is very small. One factor contributing to the visibility and unpopularity of property taxes is the fact they are levied in lump-sum form just once a year. Steps should be taken to increase the automaticity and frequency of property tax payments, and possibilities for deducting them automatically at source could be investigated.

Overall, the current set-up is far from ideal. Further increases in property tax revenues should be sought by raising the target for property assessment values to 100% of market value and by raising the tax rates on property. Since very few municipalities currently levy property tax rates at the maximum (Figure 3.9), removing the maximum band may have little impact. From a political economy perspective, municipalities seem to prefer to raise

Figure 3.9. **Distribution of municipal property tax rates**

Source: Ministry of Interior.

taxes on labour than on property, presumably because property taxes are (politically) unpopular. To improve incentives for municipalities to bring about a switch in tax composition from labour to property, the central government should consider a number of complementary changes to the taxation framework:

- The minimum property tax rate should be raised significantly and property assessment values raised closer to market valuations.
- Maximum tax rates should be removed on all property types, and taxation of agricultural and forestry land should also be considered.
- To improve incentives for municipalities to actually use the additional room for manoeuvre provided, the central government should apply a maximum tax rate on labour income. To ease the transition, a relatively high maximum could be set to start with, with well publicised reductions introduced over time.
- Alternatively, if setting a maximum tax rate on labour is not feasible, municipalities should be obliged to match any planned rise in income tax revenues by proportional increases in property tax revenue.

### **Municipalities should not be funded with corporate tax revenues**

Previous Surveys have argued that corporate tax revenue should be shifted completely to the central government because of its volatility (Table 3.3). Volatile revenues are unsuitable as a source of municipal revenue for two main reasons. First, windfall gains often lead to higher expenditure that is difficult to reverse. These revenues are better managed at the central level, where fiscal discipline is often enhanced by stronger scrutiny by domestic and international observers. The central government's easier access to financial markets also facilitates inter-temporal reallocation. Second, volatility makes revenues unpredictable and also makes it less likely that revenues can be used to reduce the personal income tax rate.

The share of corporate tax revenue channelled to the municipalities was already reduced sharply from about 45% in 1997 to 20% in 2003. However, the share was increased again to 22% in 2005 to keep municipal revenues from this source unchanged when the



Table 3.3. **Volatility of tax revenues**

	1980	1990	1995	2000	2006	Volatility 1980-2006 <sup>1</sup>
	Tax revenue as a share of GDP (%)					
Total tax revenue	35.7	43.5	45.7	47.2	43.5	0.03
Personal income tax	12.8	15.1	14.2	14.5	13.2	0.06
Corporate income tax	1.2	2.0	2.3	5.9	3.4	0.48
Social security contributions	8.4	11.2	14.1	11.9	12.1	0.08
Property taxes	0.7	1.1	1.0	1.2	1.1	0.06
Taxes on goods and services	12.6	14.2	13.8	13.7	13.6	0.02
<i>Memorandum:</i>						
Municipal personal income tax	7.2	8.5	8.7	7.6	7.9	0.06
Municipal corporate income tax	0.6	0.8	1.0	2.2	0.8	0.54

1. Volatility measured by the coefficient of variation for the tax revenue to GDP ratio.

Source: OECD (2007), *Revenue Statistics 1965-2006*.

overall corporate tax rate was reduced from 29% to 26%. While many in the central government support the elimination of the municipal corporate tax, municipal governments are strongly opposed, because of the importance of this revenue source and concerns that they would not be fully compensated by higher state grants. Opposition is particularly strong in areas such as Helsinki where corporate revenues are high. Indeed, eliminating the municipal share of corporate tax revenues would require compensation or a well thought-out transition period (Joumard and Suyker, 2002).

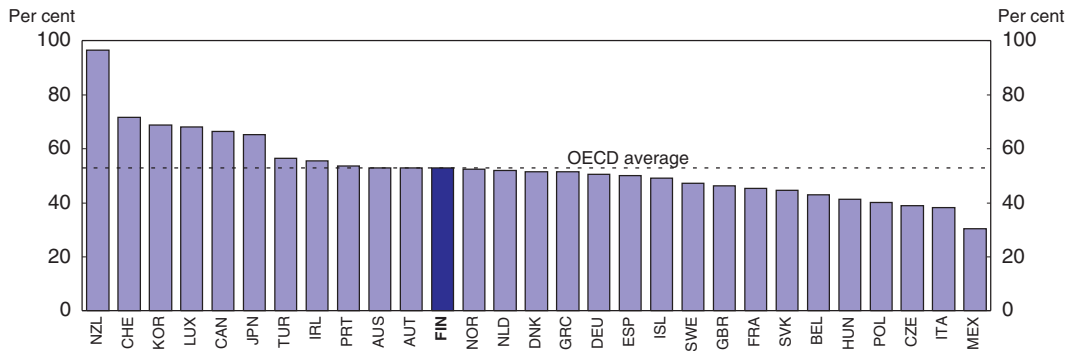
### The VAT base could be broader


Value added tax (VAT) is generally levied on a broad base (as opposed to excise duties that cover specific products) and is therefore an efficient way of raising revenue. Other advantages of the VAT are: it is neutral towards saving and investment decisions and does not discriminate between imports and locally-produced goods; it provides a symmetric treatment of labour and transfer income, thus creating few disincentives to work; and it has commendable self-policing properties since companies have an interest to register to be reimbursed for their own VAT payments. However, opportunities for fraud exist, especially for zero-rated goods such as exports, as businesses can be entitled to net refunds of VAT.

Most countries have lower rates on some products and services and exemptions, as illustrated by the ratio of actual VAT revenues to the potential VAT base (Figure 3.10). A high ratio points to VAT being based on a broad range of consumption combined with effective tax collection. The effectiveness of the Finnish VAT system is just at the OECD average, with a ratio of 53. Several OECD countries have ratios higher than 65 and in New Zealand it is nearly 100. The countries with the most effective systems levy VAT at a relatively low uniform rate with only a zero rate in addition.

Low or zero indirect tax rates and exemptions are often motivated by historical factors and concerns about the impact of indirect taxation on disadvantaged groups (van den Noord and Heady, 2001). Because consumption patterns of basic goods and services (to which lower rates mostly apply) differ little across a wide range of income levels, rate differentiation for income redistribution purposes carries large deadweight losses and may distort choices among consumption or production alternatives. If the policy goal is to assist low income families, targeted support is much more efficient. Unlike reduced rates,

Figure 3.10. **Effectiveness of value added taxes**<sup>1</sup>  
2003



StatLink  <http://dx.doi.org/10.1787/337652465884>

1. Effectiveness of VAT is measured as the effective VAT rate as a per cent of the standard statutory rate, where the effective rate is VAT revenues divided by the potential VAT base (i.e. consumption minus VAT). The effectiveness of the VAT reflects the broadness of the VAT base and the level of compliance.

Source: OECD (2006), *Consumption Tax Trends*.

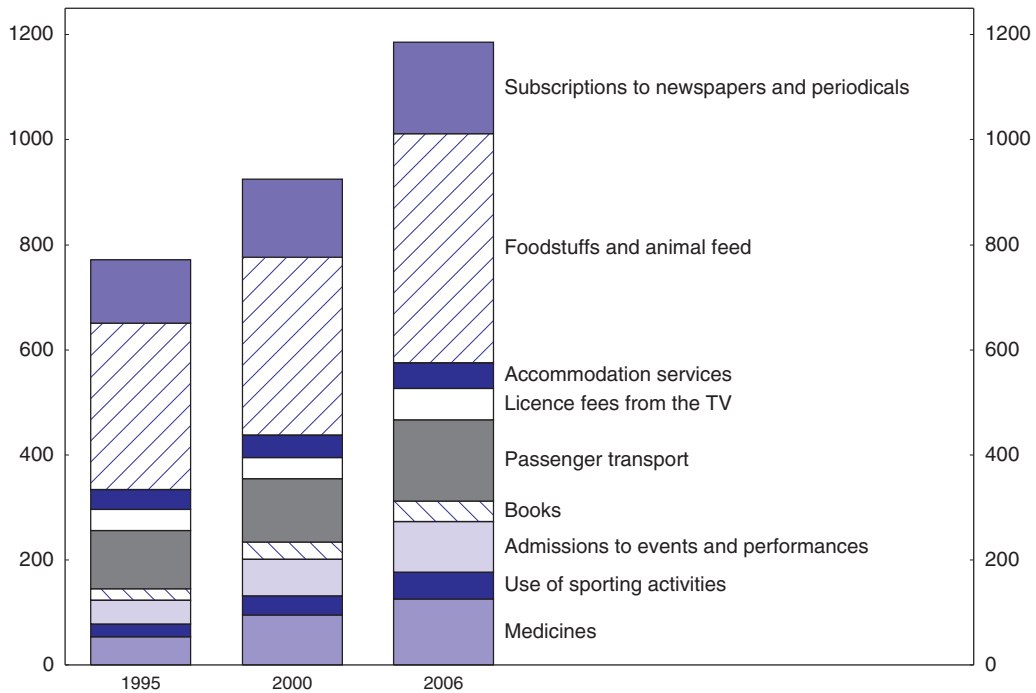

exemptions also break the VAT chain and create specific distortions; the exemption of items used as inputs into production removes neutrality and introduces cascading effects as the non-deductible tax on inputs is embedded in the subsequent selling price and is not recoverable by taxpayers further down the supply chain (OECD, 2006a). OECD experience shows that the complexity introduced by differentiated rates and exemptions creates administrative burdens and reduces the compliance of taxpayers; eliminating exemptions and zero-rating can thus bring in additional revenue and reduce the scope for tax evasion (OECD, 2007b). A single tax rate is also desirable from a political economy perspective since differentiation is an invitation to rent seeking.<sup>17</sup>

In Finland, consumption taxes account for almost one-third of total tax revenues – broadly in line with the EU average. Two-thirds of this is VAT and one-third is taxes on specific goods and services, mostly excise duties. Finland applies a relatively high VAT rate of 22% on most goods, a 17% reduced rate on food, and a 8% reduced rate on some other goods.<sup>18</sup> Several exemptions also exist.<sup>19</sup> On the other hand, there are higher excise taxes on cars and on goods which carry a potential health risk (e.g. alcohol and cigarettes).

Even though it is recognised that the contribution of reduced VAT rates in achieving social goals is rather small,<sup>20</sup> the exemptions and reduced rates apply to a relatively large share of goods and services. Overall, tax expenditures are estimated to be around € 1.2 billion (or 8-9% of VAT revenues) (Figure 3.11). Moreover, from October 2009 the government plans to lower the VAT rate on food from 17% to 12%. The expected revenue loss is estimated at € 500 million per annum, increasing tax expenditures to 12% of VAT revenue (or about 1% of GDP).<sup>21</sup> This is a move in the wrong direction; reduced VAT rates and tax exemptions reduce the yield from indirect taxes, create tax-related distortions on product markets, and increase collection costs (Joumard and Suyker, 2002). Instead of further narrowing the VAT base, a broader base should be sought, together with more efficient policies for helping low income families if that is a concern. The additional VAT revenues raised from the broader base should be used to lower either the main VAT rate or labour taxes more generally.

Figure 3.11. **Tax expenditure resulting from reduced VAT rates**

EUR Million

StatLink  <http://dx.doi.org/10.1787/337657075251>

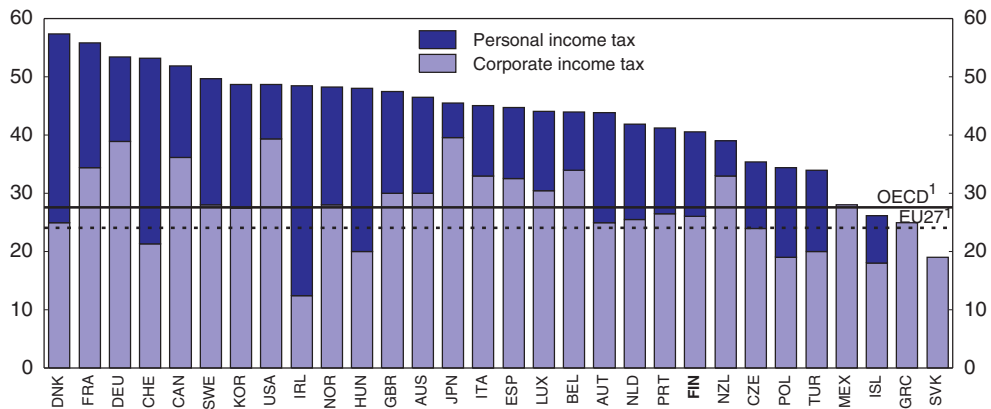
Source: Government Institute for Economic Research (VATT).


## Corporate and capital income taxation

The average statutory corporate tax rate in the OECD has fallen by 6 percentage points since the turn of the century and is now 27.5%<sup>22</sup> (Figure 3.12). OECD (2007c) concludes that there is some evidence that increasing capital mobility has had some impact on corporate tax rates, particularly the statutory rate. This is consistent with competition over the localisation of firms and the tax base. However, some economic theories have predicted a much stronger “race to the bottom”. This is not supported by the literature (Nicodème, 2006), mainly because corporate tax revenues have not plunged with falling tax rates. One reason for this is that tax bases have been broadened, which has rendered the tax system more efficient.

Generally, the location of production is determined by many factors, of which the corporate tax regime is not necessarily the most important. OECD (2007c) highlights three reasons why a “race to the bottom” has not occurred. First, corporations’ production location decisions also depend on the need to serve the domestic market, the advantages of a qualified labour force, the infrastructure, the country’s natural resources, and its technology. Second, the need for corporate tax revenues discourages many countries from engaging in tax competition. Third, governments have increasingly tightened the rules for the taxation of international profit flows, as the awareness of profits flowing to low tax-rate jurisdictions has increased.

Figure 3.12. **Overall statutory tax rates on dividend income**  
2007



StatLink  <http://dx.doi.org/10.1787/337663020071>

1. Unweighted average of corporate income tax. 2006 data for the EU27.

Source: OECD, Tax database, [www.oecd.org/ctp/taxdatabase](http://www.oecd.org/ctp/taxdatabase).

### **Corporate and capital taxation has been adjusted...**

Figure 3.12 shows that Finland's corporate tax rate is between the EU and the OECD average. Steps to encourage entrepreneurial activity began in the mid-1980s with cuts in the statutory corporate tax rate. These reforms also saw a broadening of the base and most of the tax incentives for selected industries were removed.<sup>23</sup> The introduction, in 1990, of the imputation system for dividend payments improved the neutrality of the tax system with respect to corporate financing and prevented double taxation of dividends. However, the imputation credit was only given to domestic source income and most foreigners investing in Finland did not benefit, as few bilateral treaties accommodated them.<sup>24</sup> At the time of the 2005 reform, full imputation was replaced by a partial double taxation of dividends and the net wealth tax was abolished. Under the new system corporate income is first taxed at the company level and dividends are subsequently taxed at the shareholder level, at the same rate as all other capital income (at 28%, with the corporate and capital rate no longer equal). However, the classical system (full double taxation) is strongly modified in that dividends received by individuals are entitled to full or partial relief, depending on the amount paid and whether the dividends are from a listed or non-listed company. Generally, 30% of dividend payments are tax exempt in which case the effective personal rate on dividends is now 19.5%, higher than the zero rate that was previously applied. However, it is lower in some cases as dividends from small unlisted companies (those with dividend payments below € 90 000) are fully exempt (Annex 3.A1).<sup>25</sup> All in all, the 2005 reform increased the taxation of dividends from domestic firms listed on the stock exchange, but slightly reduced the tax burden on foreign owners. The motivation for this change was twofold. First, the previous imputation credit system, favouring domestic owners, was inconsistent with EU legislation. Second, an increase in tax revenue was required to mitigate the loss of revenue from lowering the corporate tax rate and (relatively wealthy) domestic shareholders were an easy target.

### **... but there is room for improvements...**

The recent cut in the corporate tax rate to 26% has brought Finland's rate below the EU15 average. However, the average in the new member states was about 19% in 2006 and

planned changes will bring it down another percentage point. As the latest cut in the corporate rate was not accompanied by any base broadening measures, there is probably still room to broaden the base and lower the rate.

### **... as taxation of capital has become more complex**

The administrative burden of a dual income tax (DIT) system is quite high as a complicated classification system is needed for the splitting of income between labour and capital. The introduction of the partial double taxation of dividends has increased the complexity further (Hietala and Kari, 2006). In the DIT system, the choice of both organisational form (self-employed/partnership or closely-held corporation) and the form of compensation (labour or capital) increases the opportunities for tax planning. There is a risk that tax complexity may contribute to a two-tier market where only some businesses can afford comprehensive tax advice, while for others the cost of advice is greater than the benefit (PWC and the World Bank, 2006). Indeed, Finland ranks relatively high on the average number of hours needed to comply with tax laws, especially in comparison with the other Nordic countries. On the number of tax payments a business has to make each year, Finland's overall performance is close to the OECD average (Table 3.4).

Table 3.4. **Complexity of the tax system**<sup>1</sup>

	Number of tax payments	Hours to comply
Norway	3	87
Sweden	5	122
Denmark	18	135
Finland	19	264
OECD average	18	249
EU15 average	17	222

1. Taxes covered are the corporate income tax, VAT and social security contributions.

Source: PricewaterhouseCoopers and the World Bank (2006), *Paying Taxes: The Global Picture*.

### **... and the income shifting problem persists**

Moving away from full imputation towards partial double taxation of dividends has increased the top marginal tax rate on capital to 40.5% (Figure 3.12), reducing some of the incentives for income shifting. However, the marginal tax wedge on labour income is 59% for a person earning 167% of the average wage. This gives a differential of almost 20 percentage points, suggesting that incentives to classify income as capital instead of labour are still significant. Moreover, the differential is even larger for dividends paid by most non-listed companies, as these are fully tax exempt. Thus, the effective rate on these dividends is the corporate tax rate of 26%, implying a differential with labour of up to 35%. While there are rules that in principle should limit the extent of income shifting, such as the 9% presumptive rate of return rule (Annex 3.A1), in practice many professionals and entrepreneurs still have significant possibilities to transform professional earnings into capital income.<sup>26</sup>

Income shifting is also a problem in other countries with a DIT system. To address this, Norway has introduced a new system of shareholder income taxation which narrows the gap between the tax rate on labour and capital income, thus limiting the incentives for income shifting by corporate owner-managers (Box 3.3). Finland should follow evaluations

### Box 3.3. The Norwegian allowance for shareholder equity tax system

Norway implemented an allowance for shareholder equity (ASE) tax system in January 2006. It introduces a tax-deductible rate-of-return allowance (RRA) for the normal return on equity at the shareholder level to prevent double taxation, while economic rents are taxed at the shareholder level under the personal income tax either as dividends or (realised) capital gains (Sørensen, 2005). The ASE tax is equivalent to a personal level cash-flow tax. Moreover, designed in the proper way it is neutral with respect to investors' choice between debt and equity-financed investments. A key motivation for introducing this system was to limit incentives for owner-managers to reclassify labour income as dividend income – an incentive that is minimised by effectively raising the tax rate on dividends while slightly lowering the tax rate on labour income. In Norway, the RRA is calculated as the purchase price of the share multiplied by an after-tax risk-free interest rate. The interest rate was 3.3% in 2007, calculated as the yearly average of the after-tax return on three-month government bonds for that year (announced in January 2008). Taking into account the corporate tax rate of 28%, the personal tax rate on dividends and realised capital gains of 28% (after deducting the RRA), yields a total maximum marginal tax rate on dividends of 48.16%.<sup>\*</sup> The tax burden on the normal return on equity and interest payments is 28%. Since the top marginal personal income tax rate is around 53%, the differential between the tax rate on labour income and dividend income above the normal return is only around 5 percentage points, lower than the normal 20 percentage point margin in Finland, and much lower than the 35% margin for investments in small non-listed companies.

The main drawback of the system is administrative complexity, as the system requires a central shareholder register recording the acquisition and sale of shares and the payments of dividends by companies. The rate-of-return allowance applies to the shares of both listed and non-listed Norwegian and foreign firms owned by resident taxpayers in Norway. Registration of activity in Norwegian non-listed firms is difficult. However, the valuation of shares and the registration of distributed dividends of listed and non-listed foreign firms might be more difficult, causing new tax evasion opportunities. Moreover, the RRA is only assigned to the shareholder at the end of the year (due to difficulties in calculating the fraction of the RRA if the share is traded during the year) and this might create tax-arbitrage opportunities (Sørensen, 2005). While the ASE system shows considerable promise as a way of reducing incentives for income shifting in dual income tax regimes, the effectiveness of the system should be carefully monitored over coming years.

<sup>\*</sup> If the distributed dividends are lower than the RRA, the surplus tax free amount can be carried forward by stepping-up the basis of the shares with the unused RRA.

of this scheme closely, and consider introducing a similar policy if it turns out to be successful. This allowance for shareholder equity (ASE) system also has the benefit of creating neutrality between different financing sources.

### Box 3.4. Summary of recommendations concerning tax policy

**Change the composition of taxation so that taxes on labour are lower and taxes on immobile factors of production are higher:**

- Continue to lower the taxation of labour. Priority should be given to lowering the top marginal tax rate on labour in order to keep and attract highly skilled jobs and to reduce incentives for income reclassification.

**Box 3.4. Summary of recommendations concerning tax policy (cont.)**

- Property tax revenues should be raised, by setting property assessment values (for tax purposes) equal to 100% of market valuations and by raising property tax rates.
- To raise property tax rates, the minimum tax rates on all immovable property types should be raised and the maximum rates removed. Extending the property tax base by taxing agricultural and forestry land should also be considered. To reduce the impact on property values, changes should be introduced gradually over time.
- To improve incentives for municipalities to raise more revenue from property taxation, the central government should apply a maximum tax rate on labour income (instead of to property as at present). To ease the transition, a relatively high maximum could be levied to start with, with gradual reductions over time. Alternatively, municipalities should be obliged to match any increases in income tax rates with proportional increases in property tax revenues.
- To make property taxes more acceptable: i) update property assessment values annually; ii) levy property taxes more frequently than once a year; and iii) investigate possibilities for deducting them at source.

**Eliminate corporate income from municipal revenue**

- Eliminate the share of corporate income tax flowing to municipalities. The resulting funding gap should be filled by a combination of higher property taxes and higher state grants.

**Broaden the VAT base**

- Raise the revenue efficiency of the VAT by eliminating reduced VAT rates. The additional revenue should be used to lower either the overall VAT rate or labour taxes more generally. Tax cutting potential in the short term should not be used to further lower reduced VAT rates as currently planned.

**Increasing the efficiency of corporate taxation**

- Monitor the success of the Norwegian shareholder equity system with a view to adopting a similar scheme – if successful – to reduce the incentives for income shifting from labour to capital income.

Look for ways to further broaden the corporate tax base and lower the rate.

**Notes**

1. Chapter 4 discusses how the efficiency of public service delivery could be improved.
2. Denmark has re-introduced elements of progressivity in the taxation of capital income, as well as horizontal asymmetries in the treatment of positive and negative capital income.
3. A personal capital income tax rate significantly above the corporate tax rate can create an incentive to accumulate capital within the corporate sector at the relatively lower tax rate applied to corporate earnings. However, if the corporation invests the retained earnings passively on the capital market or within the corporation it may prevent profits from being distributed and invested elsewhere in projects yielding a higher pre-tax return. Such a “locking in” of corporate capital is inefficient (Sørensen, 1998).
4. This is true for a typical taxpayer who spends all income over the lifetime (i.e. who neither receives nor leaves a significant bequest).
5. First, voluntary pension insurance premiums are deductible (from capital income) if, under the contract, the lowest age at which the insurance is payable is 62 years. The maximum annual deduction is € 5 000; also premiums for the taxpayer’s spouse’s insurance may be deducted.

Second, returns on pension fund assets are tax exempt. Third, annuities received from private insurance policies are taxable only in part, with a higher tax on the annuities of older people (justified by the fact that they have shorter time to live and therefore a higher proportion of the annuity is repayment of capital and a lower proportion is a payment of interest). Pensions are taxed at the capital tax rate.

6. Note that the *property and other* taxes category in Figure 3.3 includes not only conventional taxes on property but also taxes on inheritance, capital transactions, wealth, etc.
7. Average earnings were € 34 800 in 2007.
8. The municipal income tax rate is flat but because of the earned income allowance it is partly progressive.
9. The estimated increase is in current prices. In 2006 the deductions amounted to € 9 billion (12.3% of total tax revenues).
10. However, Alesina *et al.* (2005) argued that union bargaining power or employment protection legislation explain much more of the differences in hours worked than taxes.
11. And by 2.4 percentage points for income five times higher than the average.
12. By contrast, a 1 percentage point reduction in the marginal tax rate across all brackets would cost € 500 million (0.7% of total revenue), while a 1 percentage point reduction in employers' social security contribution across all brackets would reduce revenue by about € 640 million (0.9% of revenue). These are government estimates.
13. Finland already has a special tax regime to attract skilled foreign labour (Chapter 7).
14. See OECD (2005) for a more detailed description of the tax equalisation system.
15. An exception is the tax rate on secondary residences, where most municipalities levy a rate that is closer to the maximum than the minimum.
16. Since the property tax rate is applied proportionally, the substitutability of property taxes and imputed rentals is particularly valid for countries like Finland where imputed rents would be considered capital income, and taxed proportionally.
17. On the other hand, Ramsey (1927) argues that the tax rate on a good should be inversely linked to the price elasticity of that good. This could be seen as an argument in favour of differentiation although the implications would be quite different from those seen in practice. For example, if food has a low price elasticity, then its tax rate should be high, rather than low.
18. The 8% reduced VAT rate applies to: books; medicines; passenger transport; use of sporting facilities; admission to sporting events, cultural and entertainment performances; TV licences; and hotel and accommodation. A zero rate applies to newspaper and periodical subscriptions.
19. Exemptions apply to: education, health care and social services; financial and insurance services; several cultural services; property; and self-picked berries and mushrooms.
20. OECD *Economic Survey of Finland* (2002).
21. When Finland joined the EU it was originally planned that the VAT rate on food, after a short transitional period, would be lowered from 17 to 12%. However, due to weak state finances the reduction was not implemented. Constant pressure from the food processing, retail and wholesale sector and primary producers, arguing that the reduced rate on food is much lower in many other EU countries, led the present government to pledge a lower VAT rate during the election and it has been decided that the reduction will come into effect in 2009. Lower VAT on food affects the households in the lowest income decile more than a reduction in income tax, as the share of households paying income tax in this decile is relatively low while at the same time their expenditure on food accounts for a relatively large part of their income (Holm *et al.*, 2007). However, all other income earners also benefit from lower food prices.
22. At the beginning of the 1980s the average unweighted rate for 19 OECD countries was about 50%.
23. A special regime exists for the shipping sector (tonnage tax).
24. It was originally planned that Finland's imputation credits would be extended to cross-border dividends by bilateral treaties. In practice, such agreements were only made with France and Ireland (Helminen, 2001).
25. Full double taxation of corporate equity income increases the cost of equity capital for small- and medium-sized companies by more than for companies whose shares are traded in international stock markets - because the marginal shareholders in these companies are likely to be foreigners



who are not subject to Finnish personal income tax (Sørensen, 2005). This provides the rationale for preferential tax treatment - i.e. full imputation for dividend payments - for small- and medium-sized enterprises (SMEs). Several OECD countries tax SMEs more lightly and full imputation is preferred over differentiated statutory corporate tax rates, as a means of achieving this.

26. This is considered to be a particular problem in the case of doctors and lawyers, reinforced by the recent precedent set by the Supreme Administrative Court which verified as legal the practice of transforming income into dividends.

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## ANNEX 3.A1

*The tax system in brief*<sup>1</sup>

All Finnish residents – persons and companies – are liable to tax on their worldwide income, and all expenses from acquiring or maintaining income are deductible. Most foreign source income receives some kind of relief for taxes paid abroad. The dual income tax (DIT) system, which was adopted in 1993, divides personal income into two components: **capital income** (which includes dividend income, interest receipts, realised capital gains and rental income) is taxed at a flat rate of 28%; and **earned income** (which includes wages, salaries, pensions and social security benefits) is subject to income tax at progressive rates, to municipal and church taxes at proportional rates and to social security contributions. The DIT thus departs from a pure comprehensive income tax, under which a common progressive schedule is applied to household income from all sources.

**Capital income**

The flat tax rate on income from capital is 28% (slightly higher than the corporate tax rate of 26%). Expenses from acquiring or maintaining capital income are deductible from *capital income* at the capital income tax rate. This is in contrast to the comprehensive income tax model where interest expenses are deductible against the more highly progressive marginal rate. However, when income from capital is negative (e.g. due to deductible interest expenses), such losses may be partially credited against *earned income* up to a certain threshold. Capital gains from the disposal of a dwelling are also exempt from tax if the dwelling has been used as a permanent residence continuously for at least two years.

**Dividend income and closely-held corporations**

The taxation of dividend income varies depending on whether the company paying the dividend is listed or not. For dividends received from a listed company, 70% of the amount is considered *capital income* (and taxed at the 28% rate) while 30% of the amount is tax exempt. For dividends received from a non-listed company, or a closely-held corporation, dividends representing an annual yield of up to 9% of the value of the shares are fully exempt up to € 90 000 per shareholder per year. If more than € 90 000 is distributed as dividends (below the 9% yield ceiling), then 70% of the excess is taxable as *capital income* while 30% of the excess is exempt from tax. This implies an effective tax rate of 19.5% on all dividend payments from listed companies, and on the distributed dividend between € 90 000 and the 9% threshold from non-listed companies. If the dividend pay-out exceeds the 9% threshold (either above or below the € 90 000 threshold), then 70% of the

amount in excess of the 9%-limit is taxable as *earned income* (and taxed at a progressive rate), while the remaining 30% is exempt.

### **The split model for small businesses**

A split rule is also used to divide the business profits of partnerships and sole proprietors into the portion that represents a return on capital invested and the portion that represents compensation for labour, entrepreneurial effort and ability. A presumptive rate of return on the net assets of the enterprise (20% since 2006) determines the maximum capital income for tax purposes, while the remainder is classified as earned income, to which the progressive tax structure applies. However, sole proprietors have the option of adopting a lower 10% rate of return, thus giving the less profitable enterprises the opportunity to benefit from the generous tax allowances on the labour income component.

## **Labour income**

Earned income (or labour income) consists of wages, fringe benefits, the estimated labour share of non-incorporated business income and social security benefits, and is taxed at both the state and municipal level. Municipalities tax labour income at a flat rate (of their choice) while a progressive schedule is applied at the state level. Spouses are taxed separately for earned income. No central government income tax is due if the taxpayer's income is below € 12 600 (45% of all taxpayers have earned income below this level). In addition to state and municipal taxes, members of the Finnish state churches (about 85% of the Finnish taxpayers) are liable for a church tax on their labour income – levied at a flat rate varying between 1% and 2.25%, depending on the local ecclesiastical council.

## **Corporate income**

The concept of corporate income is rather broad because it covers several income types such as proceeds from selling merchandise, rental income, fees and compensation for work or services and the profits from financial assets. Corporate tax is levied at the rate of 26% on all corporate income less expenses. Exceptions to this rule are dividends and some capital gains,<sup>2</sup> which are not included as taxable corporate income, and certain expenses related to tax-free income and capital losses. Entertainment costs are deductible at 50% of the actual amount. Costs for acquiring fixed assets are deducted by depreciation and allowances are calculated according to the declining balance method. Losses can be carried forward for ten years. No loss carry back is allowed. The revenue from the corporate income tax is shared by the state, the municipalities and state churches. No local taxes are levied on corporate profit. Companies resident in Finland are liable to pay tax on their worldwide income. Non-resident companies are taxed on their income derived in Finland, and if they have a permanent establishment in Finland, on all income related to the permanent establishment. Business incomes of resident and non-resident companies are usually taxed in the same way.

Dividends received by a resident company from another resident company are normally tax exempt in the hand of the recipient. However, to combat individual shareholders avoiding tax on dividends from quoted shares by interposing a private holding company between them and the distributing quoted company, special tax rules have been introduced for cases where the distributing company is a listed company and the beneficiary is a non-listed company. If the beneficiary owns less than 10% of the company distributing a dividend, 75% of the dividend is considered taxable income and

taxed at the 26% general rate while the remaining 25% of the dividend is exempt. This implies an effective tax rate of 19.5%, minimising incentives for tax avoidance. The same rule applies if the beneficiary is a financial institution, an insurance company or a pension institution, and the shares on which dividends are being received are recorded as investment assets in the beneficiary's balance sheet.

### **Notes**

1. For more details see IFBD (2007) and Ministry of Finance (2005).
2. Capital gains are generally taxed at the corporate income tax rate. However, profits from the revaluation of shares and securities are exempt and a company is exempt from capital gains tax when selling shares that are recorded as fixed intangible assets in its balance sheet as long as the selling company owns 10 % of the target company (in this case profits from the sale of such shares are exempt, and losses are non-deductible).

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## Chapter 4

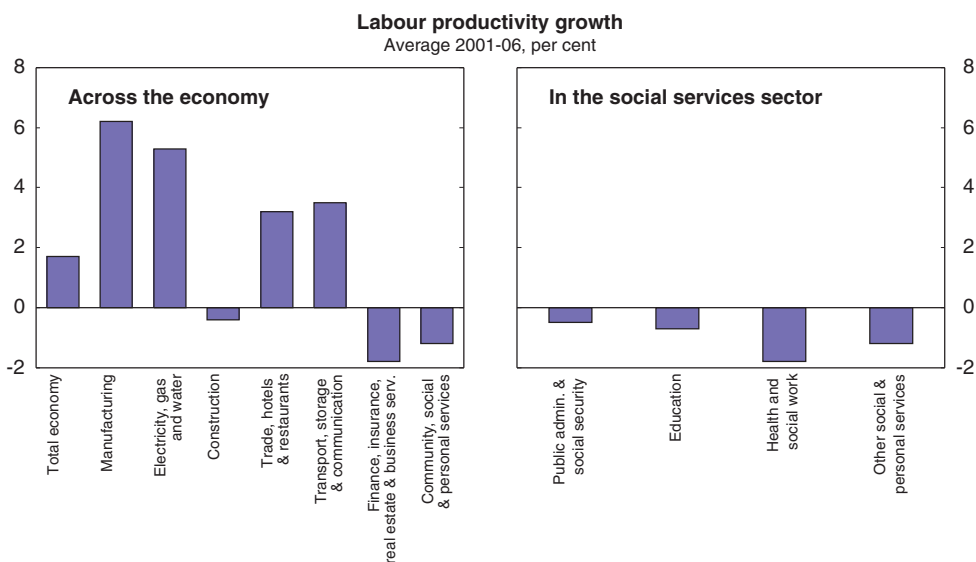
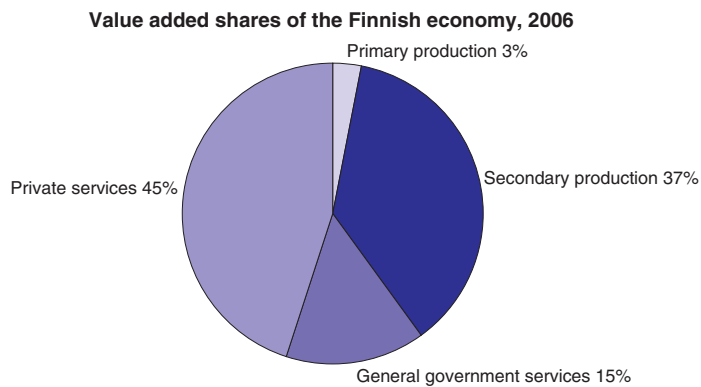
# Reforming the municipal service sector

*To prevent tax rates from rising as ageing puts new pressures on services such as health and elderly care, significant efficiency gains in the provision of municipal social services are needed. But production of many social services is dominated by the public sector and is suffering from falling productivity levels. The government is hoping to improve productivity through municipal mergers, deepened municipal co-operation and improved service delivery methods. However, the evidence from municipal mergers and co-operation in the past decades shows that efficiency gains are not guaranteed automatically. That is why much emphasis has to be put on other policies.*

*This chapter discusses the role that more competition can play in promoting productivity growth and innovation in the social services sector. There is much more that the public authorities should do to facilitate the introduction of new methods for the delivery of social services, by levelling the playing field for greater private sector involvement and competition, while at the same time guaranteeing service quality and funding. Such a strategy should raise productivity, permit slower growth in local government expenditure, and encourage diversification in the provision of publicly-funded services. As Finland's lower-tech industries continue to shrink as a share of total value added, this sector also offers opportunities for economic diversification.*

Services make up almost two-thirds of value added (Figure 4.1) and a similar proportion of total jobs. In some sectors (such as retail and wholesale trade and transport and communications) productivity growth has been quite good in recent years. In addition, the overall cost effectiveness of Finnish social services is better than in many other OECD countries. But productivity has declined in the community social and personal services sector (from here on referred to as the social services sector). This sector – which includes private as well as public sector production – accounts for almost 20% of total economy value added (making it the second most important sector after manufacturing). Measuring

Figure 4.1. The role of the services sector



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Source: Statistics Finland.

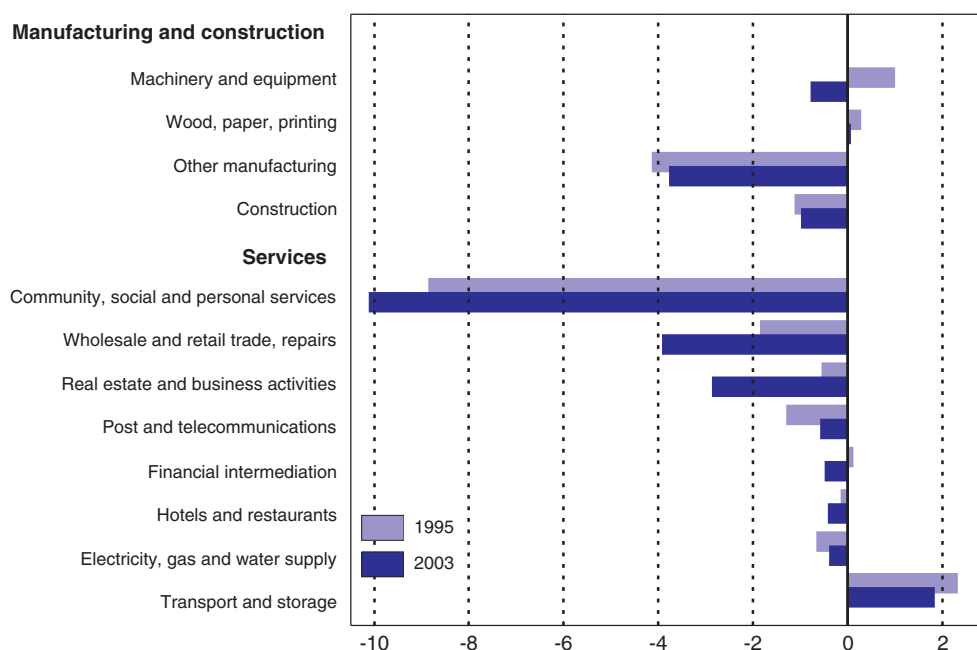


productivity in the service sectors is not easy, since measures of output often do not adequately capture quality changes.<sup>1</sup> This caveat aside, the data suggest that the productivity decline has been particularly significant in health and social work and in other social and personal services (Figure 4.1, bottom right panel).

The problem of poor productivity growth in the public sector is intrinsically related to Finland's fiscal and labour market challenges. Indeed, one striking finding is that a 0.5% gain in productivity growth in the public sector over a sustained period would permit the tax-to-GDP ratio to be 2 percentage points lower than otherwise (Kinnunen, 2002); on the other hand, without reform, almost a quarter of all employees will work in the social services sector in a few decades compared with about one seventh now.<sup>2</sup> Poor public sector productivity is also important from an economy wide perspective, as low productivity in the social services sector explains a large proportion of the total productivity gap relative to the United States (see Figure 2.2 for the total productivity gap and Figure 4.2 for the contributions of different sectors).

This chapter focuses primarily on social services provided by the municipal sector, since these are the ones for which public spending is the most significant – as compared with other services in which municipalities are often involved, such as the network industries of electricity or water provision.<sup>3</sup> A recent OECD study on the role of market mechanisms in sub-central public services illustrates that Finland lags behind the other Nordic countries in the use of market mechanisms in the municipal sector (Blöchliger, 2008). The Finnish private sector does play a very important role in the provision of some social services, such as waste collection. However, in the provision of more politically

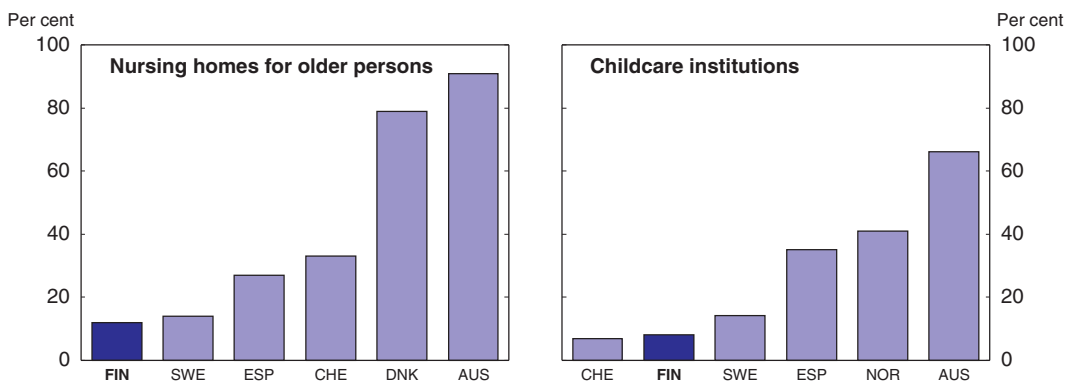
Figure 4.2. **Productivity gap relative to the United States**  
Contribution to the overall productivity gap<sup>1</sup> in selected industries, per cent




StatLink  <http://dx.doi.org/10.1787/337684425034>

1. Productivity measured as value added per employee, converted to US dollars using 2000 purchasing power parities and weighted by employment share.

Source: OECD calculations based on OECD (2007), *Structural Analysis (STAN) database* and Statistics Finland.

Figure 4.3. Share of public services provided by private providers<sup>1</sup>

StatLink  <http://dx.doi.org/10.1787/337722867160>

1. Data shown for all countries for which data on both nursing homes and childcare institutions are available, plus the other Nordic countries where available.

Source: OECD (2007), *Education at a Glance for child care*; Blöchliger, H. (2008), "Market Mechanisms in Sub-Central Public Services", *OECD Economics Department Working Papers* (forthcoming), for nursing homes.

sensitive services, such as nursing homes and childcare institutions, the private sector plays only a very limited role (Figure 4.3).

This chapter argues that municipal authorities require a changed vision of their role in service provision. As outsourcing of public sector tasks to the private sector becomes more common, the role of the public sector is changing, with the public authorities playing less of a role in service production but an increasing role as administrators of contracts, regulators and guardians of competition. The potential benefits of fulfilling these tasks well are considerable. First, better productivity and cost effectiveness would help bring about the improved fiscal discipline in the municipal sector that is required to meet the ageing challenge. Second, a larger role for the private sector could help to ensure a better diversification of the Finnish economy. With a well educated population, there would seem to be significant scope for innovative service design – such as in the use of communications technologies to provide services for the elderly and the remote regions. Finland has already recognised this opportunity in identifying “health and well-being” as one of the five strategic centres of excellence.<sup>4</sup>

## Strategies to raise productivity growth in municipal services

A likely key factor explaining the poor productivity record of the social services sector is the fact that output in this sector is dominated by the municipal government, which may be crowding out private sector participation and damping innovation; compared with other countries, outsourcing in this sector has so far been relatively limited.<sup>5</sup> Municipalities account for almost 40% of total government expenditure, with the share having increased by 8 percentage points in the last ten years (Blöchliger, 2008). Looking forward, the ageing challenge will continue to put increasing pressures on certain components of municipal expenditure (particularly health care and old-age care).<sup>6</sup> Whereas important programmes have been put in place to improve productivity at the central government level (Ministry of Finance, 2007a),<sup>7</sup> it has been difficult to reap the same benefits at the municipal level due to its fragmentation and autonomy. Currently, the only significant central government strategy for raising productivity growth in the municipal sector is through offering incentives for municipal mergers and closer co-operation (Box 4.1).

#### Box 4.1. Recent reforms to municipal structure and financing<sup>1</sup>

Finland is one of the most decentralised countries in the European Union. The constitution grants the 415 local authorities and 231 joint municipal authorities (numbers as of 1 January 2008) extensive autonomy, including the right to determine the tax rate on personal income and manage their own funds. In practice, however, municipalities are not entirely autonomous in their decision making, since the central government imposes high standards for the provision of services, including primary and specialised health care, primary and secondary education, cultural activities, and social services such as day care for pre-school children and social services for the elderly. The limited extent to which municipalities compete to attract residents is reflected in the very narrow band in which tax rates on personal income vary. The property tax rate varies only within a range determined by the central government and the share of corporate tax revenues that municipalities receive is also determined by the central government (Chapter 3). While wealthier municipalities benefit to some extent from the incomes of their residents, much of the difference in revenue-earning potential between municipalities is levelled out by means of fiscal equalisation. This transfer system will be overhauled in 2010 to make it more transparent, and the current system of statutory government contributions from different administrative branches will be unified. Nevertheless, Chapter 3 argues that broader reforms than those already underway are required to improve the efficiency of municipal taxation.

The relatively low density of the Finnish population is partly responsible for the fact that many municipalities are very small. At present the population of municipalities ranges from several hundred to more than half a million, and the average size (at about 11 500 inhabitants) is around one-third of that in Sweden and one-half that in Denmark. Many local authorities are very small; 81 local authorities have less than 2 000 inhabitants and 173 have 2 000 to 6 000<sup>2</sup>. Concern about the inefficiencies associated with very small municipalities has prompted increased co-operation among municipalities in many areas and a number of attempts over the years to encourage mergers. Until recently, however, only a few mergers took place each year.

The 2007 changes to the laws governing municipal structures and financing and other aspects of the project to restructure municipalities have been more successful. These changes have the clear goal of encouraging economies of scale by forcing small municipalities to form either a merger or a partnership area with neighbouring municipalities. This is done by setting a minimum population size for the provision of different services (e.g. 20 000 for primary health care and social services; 50 000 for vocational/basic education). At the moment only a quarter of health centres are located in municipalities with a population of more than 20 000. Exceptions are made for municipalities that are in an archipelago environment, for municipalities that cover very large distances, or in order to safeguard language and cultural rights (Finnish and Swedish speakers, Sami people). In cases where a partnership area is formed, a new joint municipal body must be established for the management of the relevant tasks.

Financial incentives (merger grants) of € 2.0 to € 18.54 million are offered to municipalities that merge between 2008 and 2013, with the incentives more generous for mergers in the earlier years and supplementary grants for mergers of more than two municipalities. However, if the total cost of merger grants exceeds € 200 million in the years 2008-11 then central government transfers to local government will be reduced proportionately. In this case all municipalities that do not merge could face a cut in transfers from the central government. Larger municipalities in a number of urban areas are also required to draw up a plan on how to improve co-operation with neighbouring municipalities, particularly with regard to land use, housing, transport and service provision in regions close to municipal boundaries.

The evidence so far suggests that the reforms will result in 67 fewer municipalities by 2009 (around 15%). Some 43 of the smaller municipalities have applied to be exempted from the merger requirements on the grounds of being in an archipelago, having large distances or for cultural reasons. Some of the municipalities in an archipelago will still merge, but without reaching the 20 000 population minimum that would normally be required for primary health care and social services.

1. Much of the information in this box is based on Ministry of Finance (2007b).
2. These statistics are from the Association of Finnish Local and Regional Authorities ([www.kunnat.net](http://www.kunnat.net)).

The three stated policy objectives of the reforms to municipal structures are: i) to improve productivity in the municipal sector; ii) to slow the recent pace of growth in local government expenditure; and iii) to improve the co-ordination of services organised by municipalities (i.e. to benefit people living near municipal boundaries). However, there are two main reasons why it is unlikely that these reforms alone will be sufficient to meet the first two of these objectives. First, while mergers could be expected to lead to economies of scale, the available evidence suggests that cost effectiveness gains are not necessarily achieved. For example, Moisio and Uusitalo (2003) were unable to find clear evidence of reductions in total spending in those Finnish municipalities that had already merged. Similarly, a comprehensive study of efficiency by Loikkanen and Susiluoto (2005) found mixed evidence: the most efficient municipalities were found to be relatively small, and a large population was found to be detrimental to cost efficiency in the provision of basic welfare services; this may be partly because a narrow range of services makes higher efficiency possible, whereas large municipalities typically provide a wider range of alternatives than small ones. There was some evidence that efficiency was lower in municipalities where a large share of services was produced by other municipalities or joint municipal organisations. Thus, to the extent that mergers reduce the role of joint municipal organisations, there could be some efficiency gains. Importantly, however, Loikkanen and Susiluoto's results also suggest that efficiency is enhanced when a large share of services is provided by the private sector. Overall, the findings from the literature – including in other countries – almost unanimously conclude that municipal mergers do not reduce expenditure. Where efficiencies are gained, they normally translate into quality improvements rather than expenditure savings (Lotz, 2006).

Second, the risk that economies of scale will not be reaped, at least in the short term, is particularly pertinent because the new law forbids municipalities from laying off any workers for reasons associated with the reform for five years from the date of change in municipal boundaries.<sup>8</sup> Given that labour costs amount to more than 40% of total municipal expenditure, and that significant productivity gains may require substantial restructuring of municipal service provision, this restriction would seem likely to significantly impede achievement of the reform goal to allow “cost-effective use of resources”. On the other hand, the average age of municipal employees is currently around 45 years and a significant proportion is expected to retire within the next few years which will permit municipalities to reduce total staff numbers by not replacing all retired workers. Furthermore, without this safeguard, it would be much more difficult for municipalities to gain support from the unions and workers for mergers; Finnish local and joint authorities currently employ close to one-fifth of the Finnish workforce, about four-fifths of whom work in health care, education, and social services. Given the restriction on laying off workers for five years, municipal governments should instead seek to achieve productivity gains by introducing an explicit policy of not replacing all retiring workers, as is the case at the central government level.<sup>9</sup>

A successful strategy for raising productivity in the social services sector will have to go much further than municipal mergers. The remainder of this chapter emphasises three major policy strands. First, a sharper distinction should be drawn between core and non-core services, with municipal resources being increasingly focused on the former. Second, the private sector should be encouraged to play a larger role in the provision of non-core services, at least in those municipalities with sufficient population to ensure competition.

Third, the central government should play a bigger role in terms of setting the framework conditions in which municipalities operate. Each of these is discussed in more detail below.

### **Lessons from the private sector: focusing municipal production on core services**

One of the key productivity lessons that the public sector can take from the private sector is to focus production on their core outputs – such as health and education – while outsourcing support services. While there may be a role for the private sector to play in delivering the core services also, the need to ensure consistently high quality in these services and the difficulty of writing and monitoring contracts with the private sector, argue in favour of municipal bodies retaining a high degree of expertise in the production of core services.

By contrast, competition among providers in the production of other – more peripheral – services should be actively encouraged. By separating provision from funding, municipal authorities should aim to retain the essential properties of a public service while both supporting the development of the private service sector and reaping the efficiency benefits of the private sector. The easiest services to outsource should be those for which it is easiest to write and administer performance contracts (*e.g.* cleaning, vehicle towing, catering<sup>10</sup>), whereas the hardest are those to which the public is most sensitive to quality and those for which writing, monitoring and adjusting performance standards is the most complicated.<sup>11</sup> To date Finnish municipalities continue to be involved in the production of a wide range of non-core outputs that could be potentially purchased from the private sector. In Finland's 12 largest cities, for example, there are municipal enterprises operating in a wide range of market-based activities, from energy and transport to car repairs, waste management, IT services, food services and cleaning (Ekström *et al.*, 2007). The potential for efficiency gains through outsourcing would seem to be significant.

In practice, however, municipalities are often reluctant to outsource services. There is frequently strong resistance from affected government employees, unions and their political allies. To some extent this may simply reflect resistance to change. But it may also reflect a lack of experience and expertise. Levin and Tadelis (2007), who constructed a dataset of service provision choices by more than 1 000 US cities, found that both economies of scope and experience with outsourcing were important; larger cities made the greatest use of contracting out to the private sector, and cities that already had experience with private sector contracting were much more likely to contract out additional services (even after accounting for city size and location). These findings suggest that Finland's larger and more densely populated municipalities should find it easier to contract out the provision of services – partly because the range of private sector providers should be greater and also because larger municipalities should have more experience in administering contracts, lowering administrative costs. For the smaller municipalities, it suggests a potential role for more co-operation and sharing of expertise in administering contracts.

Another source of resistance to outsourcing may come from the fact that 14% of municipal city councillors are also employed by the same municipality (*e.g.* as teachers or nurses) (Leväsvirta, 1999). This creates a potential conflict of interest, with city councillors reluctant to make decisions that may directly impact their own jobs or those of their colleagues, even if it would be in the best interests of the municipality.

### **Levelling the playing field would promote the private sector production of a range of services**

The key message with respect to non-core public services is that just because they are publicly-funded does not mean that they should be publicly produced. However, in contracting out publicly-funded services to the private sector, the government retains a number of important functions – essentially an obligation to ensure: i) that competitive mechanisms in allocating production are allowed to work; ii) that the services are funded adequately; and iii) that a high quality of services is delivered.

Competition is the key to productivity growth, since it is market competition that promotes efficiency and innovation. Where the population base permits it, one of the goals of the municipal authorities should be to encourage the development of a mix of service providers. For some services this may involve competing private sector providers. For other services it might include a combination of public, private (for profit) and voluntary (not-for-profit) providers. To do this, there should be a focus on ensuring a level playing field to promote competition. In some sparsely populated rural areas, however, it may not be possible to have competing providers, implying a continued larger role for public provision.

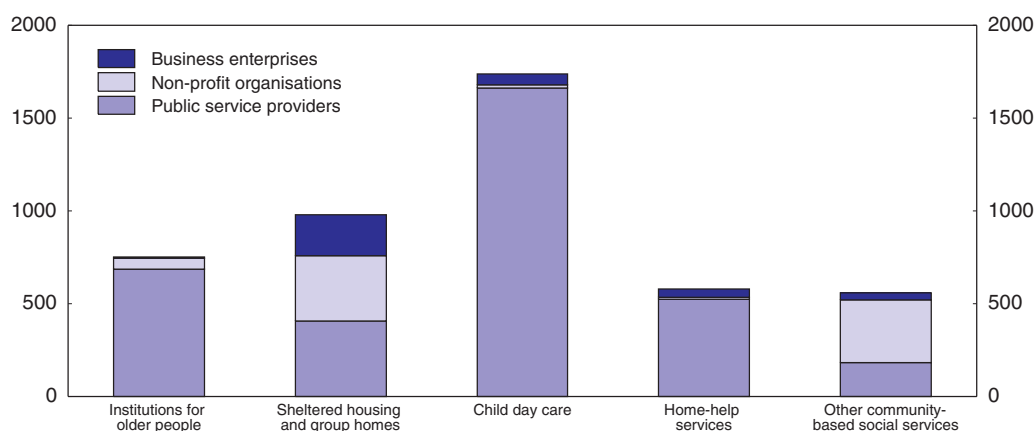
There is substantial evidence that outsourcing of publicly-funded services increases efficiency (Blöndal, 2005). Blöchliger (2008) summarises three distinct channels through which market mechanisms contribute to efficiency gains: they can improve productive efficiency by raising the quality and lowering the cost of providing publicly-funded services; they can increase welfare by making public providers more responsive to consumers' tastes and preferences, thus improving resource allocation; and they can improve budget management efficiency through enhanced awareness of the resource costs of providing services. Specific evidence for efficiency gains from outsourcing in Finnish municipalities has also been documented. As mentioned earlier, Loikkanen and Susiluoto (2005) found that municipal spending efficiency was enhanced when a large share of services was provided by the private sector. Other meta-studies evaluating services at the sub-central level have also found that outsourcing increases productivity, with competition among providers being a much stronger drive than private provision itself. This is probably because private providers tend to have more flexibility in their production processes, are more innovative and are more likely to adapt services to consumer demand (Blöchliger, 2008).

Nevertheless, the extent of outsourcing of social services in Finland is relatively limited. Although the role of the private sector in the field of social and health services has been increasing rapidly in recent years, private sector involvement is largely limited to a few specific sectors (such as shelters for battered family members, mother-and-baby homes, and housing services for people with mental disorders and for substance abusers). These sectors make up only a small percentage of total expenditure on social services, and private sector involvement in the most important sectors remains limited. Where non-government providers do play an important role they are often non-profit enterprises. There would seem to be significant room for the private sector to play a larger role in the following sectors: day care for children; residential care for older people; and home help for older people (Figure 4.4).

The term *outsourcing* has been used so far in this chapter in a very broad sense, and is meant to capture a range of market mechanisms that can be used to increase the efficiency of public service delivery. These include contracting out by tender, introducing

Figure 4.4. **The role of private enterprises is small**

Expenditure in social care, EUR million, 2004

StatLink  <http://dx.doi.org/10.1787/337735605217>

Source: STAKES (National Research and Development Centre for Welfare and Health); Statistics Finland.

mechanisms where money follows the users (such as vouchers), and the use of public-private partnerships (PPPs). Each technique has its strengths and weaknesses (Blöndal, 2005). Vouchers have been successfully used in other countries for the provision of social housing assistance, primary and secondary education, child care services, and care for the elderly. In Finland, there are some voucher trials underway, such as for dental care services in Helsinki. However, there is scope for greater use of vouchers in social service sectors such as day care for children, residential care for older people, and home help for older people. In these sectors Finland currently stands out as having a particularly low participation of the private sector (STAKES, 2007). However, care should be taken with the design of voucher systems to ensure they safeguard equality of access and service quality, and do not substantially raise public expenditure (for instance, in cases where expenditure was previously contained by restricting supply). User fees and performance-related funding can also be used to improve the quality of service provision or lower its cost. Chapter 6 discusses the role that fees could play in improving efficiency in the tertiary education sector.

The decentralised and often fragmented nature of sub-central government poses some special challenges. To deal with these, Blöchliger (2008) emphasises the importance of harmonising tendering rules across jurisdictions and government levels and setting up specialised agencies to deal with contracting out. As the municipal reforms aim to improve service co-ordination across municipal borders, some financial mechanisms for cross-border service consumption are also required. Some other aspects of the framework conditions that may impede outsourcing are discussed in the following section.

The potential benefits from outsourcing, together with the potential for political opposition to dominate an otherwise efficient choice, has led some to argue for introducing mandatory policies to *require* market-testing (competitive sourcing). However, Blöndal (2005) argues that such policies can create an adversarial relationship, suggesting that it is better for governments to advocate mainstreaming of outsourcing policy instead. This could be facilitated by requiring the incorporation of a wider range of municipally-owned activities than is the case at present and/or clarifying public procurement legislation so that competitive bidding would be required when municipalities purchase services from

municipally-owned agencies as well as from privately – and publicly-owned incorporated companies. Other requirements to ensure a level playing field between public and private market participants are discussed below.

### The central government should ensure better framework conditions

As the private sector has made in-roads into the provision of social services, it has become clear that there is a need to better clarify the boundary between private sector and public sector (municipal) activities in order to ensure a level playing field. Public sector businesses can distort competition in markets where they compete with private sector businesses in a number of ways (OECD, 2005), largely because they have artificial competitive advantages that private sector commercial competitors do not have. For example, a municipal-run child care centre does not pay income or property tax, cannot go bankrupt, often receives cheap collateral and may receive favourable treatment in terms of guaranteed business. OECD (2005) discusses steps Finland has taken towards improving competitive neutrality and the transparency of public sector businesses (*i.e.* via the 2003 State Enterprise Act and a government decision on the state's ownership policy in 2004). Nevertheless, the regulatory environment continues to create an uneven playing field in a number of important respects. The main problems are as follows:

- **Market access:** Finland's public procurement act does not require that municipal procurements of services from their own municipally-owned agencies be open to competitive bidding. This means that a potential private sector provider may not be able to access the market if it is dominated by municipal providers. Care should be taken to ensure that this problem does not become worse under the ongoing PARAS initiative (which is seeking new ways to consolidate service production between municipalities without an actual merger). A clear distinction needs to be drawn between those municipally-provided services that involve the production of economic activities and those that do not. All municipal activities that could *potentially* be supplied by the private sector should be judged to be economic activities, and be open to competitive bidding.
- **Public sector commercial advantages:** Incorporated enterprises pay the normal rate of corporate tax and VAT, and face the risk of bankruptcy, even if they are competing directly with municipally-owned enterprises, or non-profit organisations, which do not.<sup>12</sup> In addition, municipal-run activities are not typically required to earn a commercial rate of return and often have access to funds at rates lower than commercial interest rates (sometimes even at zero rates). These inequalities can apply equally to municipal activities that are defined as being part of the core output of the municipality (*e.g.* school catering services) as well as to municipally-owned agencies that are run independently as a business. Municipalities also do not pay tax on their own real estate, which gives them an implicit subsidy relative to private sector enterprises.
- **Tax distortions:** Most services provided by the public sector are classified as non-taxable or tax exempt. This can create distortions between public and private providers, due to the inclusion of "hidden VAT" in the final price charged for such services, and differential treatment in the extent to which VAT refunds are available. The unlevel playing field created by non-taxable tax-exempt status is recognised by the European Union (European Commission, 2004). One step in the right direction was the 2004 EU VAT Directive which proposes to reclassify postal services from tax-exempt to taxable status, although this proposal has yet to be approved by member states. Since broader EU



reform is unlikely in the near term, Finland could limit this problem by finding ways to redefine a broader range of services as taxable.<sup>13</sup>

Private involvement in the provision of social services is a relatively new phenomenon in Finland. However, the effect of the distortions discussed above is increasing as the private sector makes in-roads into these markets. It is time for the rules to change. A 2006 joint assessment of the degree of neutrality in competition by the Ministry of Finance, the Ministry of Trade and Industry and the Finnish Competition Authority noted these problems and concluded that the systems used in income taxation, property taxation and VAT should be neutral across the legal entities (Ministry of Finance, 2006). However, no proposals to rectify the problems have been made.

In addition to ensuring good framework conditions, the central government also needs to play a bigger role in developing the *benchmarking* and monitoring of different municipal service providers. A national benchmarking system for hospitals has been in use since 1998 and the value of such comparisons is recognised. However, relatively little benchmarking of municipal services has been published. The project and forum for best practices in local government (2007-09) is hoped to improve the benchmarking of service practices in the municipal sector. Other OECD countries may provide good models. For example, Norway's KOSTRA system for reporting performance information from municipalities has lessened reporting burdens, contributed to more uniform standards, and facilitated co-operation between municipalities (Norwegian Ministry of Finance, 2006). An increased role for benchmarking should be linked to the development of cost awareness and cost accounting at the municipal level (including the internal allocation of costs to avoid cross-subsidisation). The central government's role should be one of putting in place the systems to encourage efficiency gains at the municipal level, setting high standards for service provision, and ensuring that the local authorities have the capacity and administrative systems to pursue more efficient public service delivery. The proposed reforms to the system of central government transfers are consistent with these recommendations, as they will empower local governments with greater flexibility in public spending. But no explicit policy changes to level the playing field are currently planned. The main recommendations of this chapter are summarised in Box 4.2.

#### Box 4.2. **Summary of recommendations on municipal service sector reform**

##### **Encourage municipal governments to focus production on core functions and (at least in the main cities) encourage outsourcing**

- Open up the municipal purchasing of non-core services to competitive bidding by introducing more mainstreaming of outsourcing policy. All municipal activities that could *potentially* be supplied by the private sector should be judged to be economic activities and the purchase of their services should be open to competitive bidding.
- Promote the implementation of municipal-level productivity programmes, including an explicit policy of replacing only a certain percentage of all retiring workers, as is the case at the central government level.
- Develop more sophisticated benchmarking exercises and put in place other structures to facilitate the sharing of best practice municipal management.
- Continue to promote municipal mergers and favour mergers over partnership areas.

**Box 4.2. Summary of recommendations  
on municipal service sector reform (cont.)**

**Ensure that the tax and accounting systems do not bias municipalities against contracting out services to the private sector**

- Ensure that private sector companies face a level playing field with respect to municipally-owned agencies by encouraging the incorporation of all municipally-owned activities that constitute economic activities.
- Ensure that municipally-produced services do not receive implicit subsidies, by introducing best-practice accounting systems which ensure that internal costs incurred by municipally-owned activities are correctly attributed. As part of this, municipalities should be required to pay tax on their own property.
- In the absence of reform to European VAT legislation, consider modifying national legislation to broaden the definition of activities that are classified as taxable.

**Notes**

1. Statistics Finland has been working since 1996 to develop a system for measuring the productivity of non-market output (public services). Quality adjustments have been developed for inpatient care in primary health care and for institutional care for the elderly in social work. However, such adjustments have not changed the basic conclusion of falling productivity levels.
2. Estimates suggest that without any productivity growth in the welfare services sector, employment will have to rise by over 200 000 by 2040 (VATT, 2007). This would raise the share of the working-age population employed in this sector from 14% in 2005 to 22% by 2040. By contrast, 1% annual productivity growth would permit staff numbers in this sector to remain roughly unchanged.
3. Market mechanisms are already widely used in the network industries. Partly as a result, there is some evidence that these sectors have experienced significant productivity growth over the past decade or so.
4. The other strategic centres of excellence are: energy and the environment; metal products and mechanical engineering; the forestry cluster; and the ICT industry and services.
5. See Lundsgaard (2005) for further discussion.
6. See Chapter 2 of the last *Survey* for an in-depth discussion of the fiscal implications of ageing (OECD, 2006).
7. Within the social services sector, productivity levels have fallen the least in the central government sector (see Public Administration and Social Security, bottom right panel, Figure 4.1).
8. Workers can only be laid off if they refuse to accept a new task or public office offered to them by the employer that is in accordance with the Employment Contracts Act or the Act on Civil Servants in Local Government.
9. The central government's productivity programme for the 2008–11 period aims to cut total staff numbers by about 8 500 person-years. This is equivalent to replacing only 30% of the 12 000 staff who will retire on an old-age pension during this period (Ministry of Finance, 2007a).
10. It has been shown that the public sector produces more meals per year than does the private sector.
11. See Levin and Tadelis (2007) for a model of outsourcing of different services.
12. Non-profit organisations are normally granted a tax exemption on both business income and income from property for five years at a time on application.
13. Article 13 of EU VAT Directive 2206/112/EC states that government bodies "... shall not be regarded as taxable persons in respect of the activities or transactions in which they engage as public authorities" (emphasis added), except "... where their treatment as non-taxable persons would lead to significant distortions of competition". Given the somewhat subjective nature of "distortion of

competition”, this makes the interpretation of the Directive fairly open, giving individual countries scope to influence the range of services that is defined as taxable. Countries also have scope to redefine by law which activities are the responsibility of the public authorities. If an activity is reclassified as being no longer the responsibility of the public authorities, then it can be taxed.

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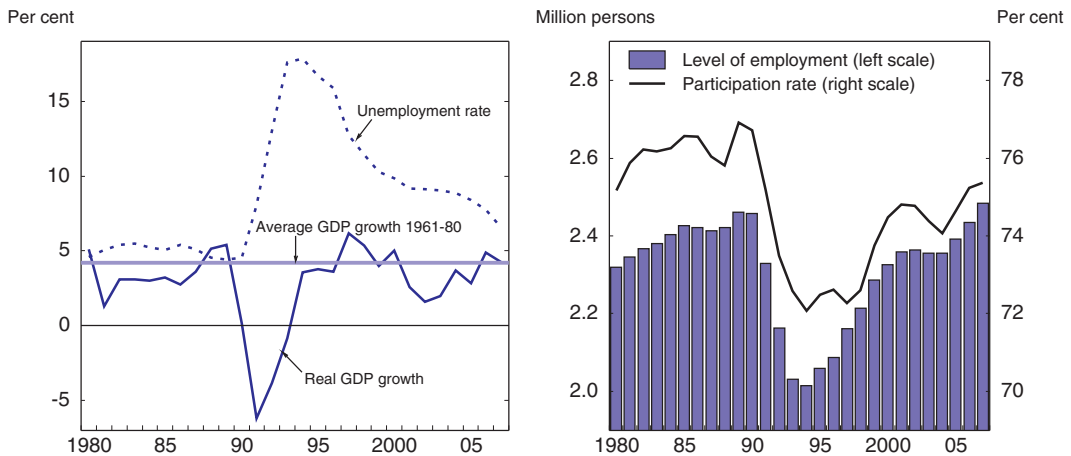
## Chapter 5


# A better functioning labour market

*Finland's embrace of the opportunities offered by globalisation has encouraged the emergence of leading edge industries and has facilitated a steady decline in the unemployment rate to around the EU15 average. Nevertheless, participation rates remain below pre-recession levels, especially among certain age groups, youth unemployment remains uncomfortably high, wage setting remains particularly inflexible, and growing labour mismatches and skill shortages are acting as constraints on the economy. While recent governments have taken steps to address some of these issues, Finland's rapidly ageing population means that these issues need to be tackled with a greater degree of purpose and urgency.*

In recent years Finland has enjoyed improving labour market conditions with the previous government's job-creation target being met and employment increasing by around 350 000 over the past 10 years. With GDP growth rebounding after the deep recession of the early 1990s to rates at or above the historical average, the unemployment rate has steadily declined from a high of close to 17% in 1994 to around 6¼ per cent in the first quarter of 2008 (seasonally adjusted; Figure 5.1, left panel), which is close to the EU15 average. Despite this good performance the unemployment rate still remains higher than in the other Nordic countries. Continuing labour market improvements face two obstacles: labour markets are not sufficiently flexible in the face of the pressures from globalisation, and a rapidly ageing population threatens to undermine the sustainability of the Nordic model.

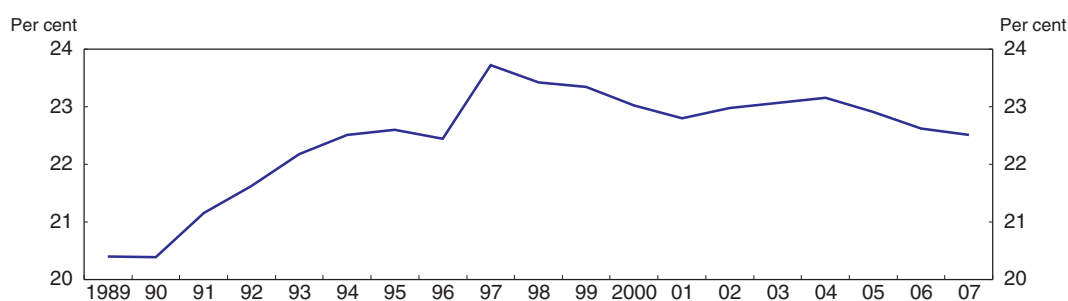
Figure 5.1. **Economic growth and the labour market**




StatLink  <http://dx.doi.org/10.1787/337736636672>

Source: OECD, *Economic Outlook 82* database.

Finland's prime working-age population has already begun to fall and the total working-age population is expected to peak around 2010 and then begin to decline (Ministry of Labour, 2007a) leading to lower economic growth and increasing old-age dependency ratios, both of which pose a risk to sustainable public finances (Ministry of Finance, 2007). Some progress has been made in tackling early retirement but more could be done to lift overall participation and get the large stock of structurally unemployed people back into work. The proportion of the population that is inactive (excluding students and homemakers) remains several percentage points higher than its pre-recession level (Figure 5.2).<sup>1</sup> This suggests that there remains considerable scope to further increase the domestic supply of labour and successive governments have set ambitious targets. The first was to increase employment by 100 000 over the previous government's

Figure 5.2. **Inactive population**<sup>1</sup>

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1. Working-age persons inactive (not including students and homemakers), as a percentage of total working-age population (15-74).

Source: Statistics Finland.

term (2003 to 2007) which implied lifting the employment rate to about 70% in line with the EU-wide Lisbon target. This was all but achieved (Figure 2.3). The current government has set a more challenging target of reducing the unemployment rate to 5% by 2011 (Prime Minister's Office, 2007a) and reaching a long-term employment rate target of 75% (Ministry of Social Affairs and Health, 2006).

While there is some way to go in re-integrating unutilised labour resources, this is juxtaposed against growing evidence of labour market tightness. This tightness is evident in various industries and regions which are recording exceptionally high levels of vacancies coupled with a high nation-wide unemployment rate. Moreover, increasing numbers of firms are reporting skill shortages (Ministry of Finance, 2006; 2007). These imbalances are reflected in the large and growing disparities in performance across regions, both in terms of unemployment and participation as well as the underlying demographics.<sup>2</sup> The emergence of these bottlenecks reinforces the urgency of new policies to reintegrate the large stock of unemployed workers by improving the functioning of the labour market through: i) improved participation incentives in particular through the interaction between the tax and social security systems; ii) enhanced adult skills training and policies to ensure that the education system better prepares young people for the labour market (Chapter 6); iii) better active labour market programmes; iv) improved job matching; v) encouraging greater mobility; vi) removing the impediments that dynamic Finnish firms face when recruiting in the domestic labour market; and vii) taking steps to address high levels of inactivity amongst the current stock of migrants (Chapter 7).

Until recently Finland has benefited from a long period of wage moderation, which has helped to contain inflation, maintain competitiveness and promote employment growth (OECD, 2007a).<sup>3</sup> However, Finland continues to rank poorly in terms of labour market flexibility, being well below its Nordic neighbours in the OECD synthetic indicator of labour market rigidities (OECD, 2007a). This lack of flexibility has led to growing distortions across industries, with lower productivity sectors enjoying wage increases on a par with those of the best performing sectors. This was especially evident in the recent round of wage negotiations in which outcomes did not reflect the underlying productivity performance of individual industry sectors. Wage increases that are unrelated to productivity performance risk igniting inflation (Box 2.1) and put in jeopardy the government's target of reducing the unemployment rate to 5% by 2011. Furthermore, the large increases in the 2007 wage

round have the potential to erode Finland's international competitiveness and put at risk its thriving export sector.

Against this background two important problems emerge. First, rigidities in the wage negotiation process and in the general functioning of the labour market do not provide Finland with the flexibility that is required to maintain a dynamic industrial structure in the face of pressures from globalisation. Second, employment rates are too low to permit the Nordic model to be sustained into the future, particularly in the face of one of the most rapidly ageing populations in Europe. Each of these problems is discussed in more detail below, together with recommendations for what policy makers can do.

## Globalisation and structural change

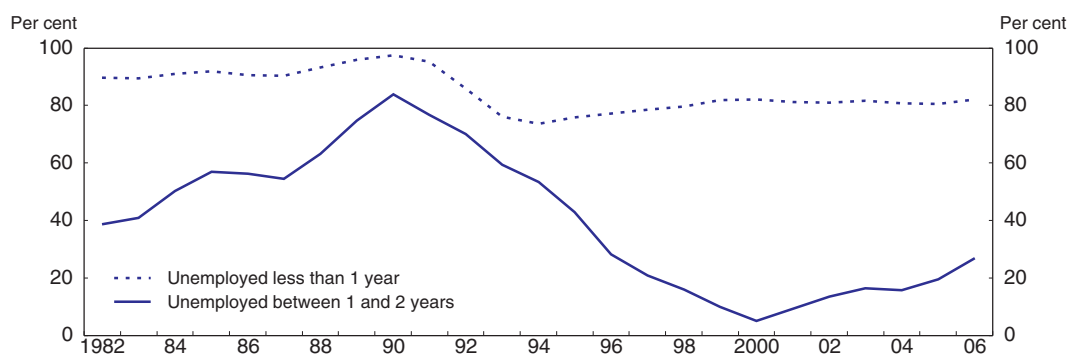
As in most other developed countries, the forces of globalisation, together with technical progress, have generated significant shifts in the structure of the economy, building on those structural changes that were already prompted by the deep and protracted downturn of the early 1990s.<sup>4</sup> While these changes have opened up new markets and brought new production techniques utilising once untapped labour and capital resources, they have also interacted with Finland's relatively inflexible labour market in a way that has led to some sustained labour market imbalances. For example, it is worth noting that if participation had remained at its pre-recession rate, the unemployment rate would have peaked at close to 22% in 1994 and would currently be around 1½ percentage points higher than the headline figure (which was 6.9% in 2007).

One stark feature of the Finnish labour market is the prevalence of older males among the ranks of the unemployed. A number of factors have contributed to this. First the structural change induced by the recession most acutely affected industries in which low skilled male employees dominated (such as the paper and pulp industry and related manufacturing). Second, the low education level of the older generation makes it less adaptable to the new industrial structure that emerged after the recession. Third, early retirement pathways such as disability pensions and the so-called unemployment "pipeline" (discussed below) are readily accessible by the older unemployed. A final factor is the low geographical mobility of the older cohorts who typically have deeper roots in local communities and are less willing and able than the younger unemployed to relocate to buoyant regions. As a result long-term unemployment is particularly acute among the older age cohorts. While the youth unemployment rate is the highest of all age cohorts, the majority of the younger unemployed tend to find employment relatively quickly, albeit often assisted by subsidised jobs.<sup>5</sup> In terms of absolute numbers of registered job seekers, the 50 plus age cohort dominates, accounting for almost 40% of the total despite making up just over 28% of the labour force. Long-term unemployment also remains a problem: only around a quarter of the unemployed are able to exit unemployment during the second year of joblessness (Figure 5.3). This chapter argues that considerably more effort should be made to activate the long-term unemployed.

### **Structural change and "Change Security"**

Partly as a response to the structural effects of globalisation, and as a component of the 2005-07 tri-partite wage agreement, a new "Change Security" programme was introduced in July 2005 which was targeted at assisting workers who lose their jobs due to structural change. The programme puts a lot of emphasis on fostering co-operation between employment offices and the private sector in an effort to get the unemployed back



Figure 5.3. **Unemployment exit rates**<sup>1</sup>

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1. Unemployment exit rates are calculated using labour force statistics data on unemployment durations. The exit rate is the proportion of people who have been unemployed for a specified duration who then exit unemployment over the subsequent year. A low exit rate implies that a large proportion of unemployed from the previous year remain unemployed in the current year.

Source: Statistics Finland and OECD calculations.

into employment as quickly as possible through early intervention, training, and job search assistance. The programme also provides for those who are about to be dismissed to spend part of their work time doing on-the-job retraining and searching for work. Also if a worker takes up training after the dismissal date, a supplement to income support can be paid (Arnkil *et al.*, 2007). While this model mirrors a number of aspects of the well-known Danish “flexicurity” policies, the Finnish model does not include any changes to hire-and-fire rules. The OECD Employment Protection Legislation (EPL) strictness measures suggests that firms in Finland are substantially more restricted in their freedom to dismiss workers when compared to Denmark (OECD, 2007a), particularly for workers with longer durations of service. While rules regarding temporary work arrangements are reasonably flexible, perhaps contributing to its growing prevalence in Finland, the regulation and renewal of fixed terms contracts are more strict. The administrative procedures for dismissals are particularly rigid when compared to Denmark.

Since 2004 a decentralised network of “one-stop-shop” Labour Force Service Centres has been established which brings together the resources of the central and municipal governments, and the Social Insurance Institution to provide more holistic and co-ordinated services to the unemployed including income support, job search, training and activation programmes, as well as other medical and counselling services. The government has also announced the full implementation of an improved profiling system for job-seekers along the lines of a system with which Denmark has had considerable success, which seeks to better target individualised services to the newly unemployed.

An independent evaluation of the “Change Security” programme was recently conducted by Robert *et al.* (2007). They examined the outcome of a target group relative to a control group and found that results for the target group were significantly better. Despite this there remain a number of problems. Activation, training and job search remain fragmented across levels of government and according to durations of unemployment, levels of disability or sickness, and insurance classification. While the new Labour Force Service Centres have attempted to harness co-operation and co-ordination, arrangements remain cross-jurisdictional, particularly from an administrative stand point, with lines of responsibility and accountability not always mutually compatible. Box 5.1 presents a case

### Box 5.1. Case study: the Voikkaa paper mill shutdown

In March 2006 United Paper Mills (UPM) announced the closure of the Voikkaa paper mill factory in Kuusankoski in south-eastern Finland resulting in the loss of 678 jobs. The reason given for the closure was the declining competitiveness of the factory in the face of overcapacity and high input costs including labour and raw materials. With respect to labour costs, it is worth noting that the hourly wage of papermaking plant operators is 30 to 40% higher than the average earned by all plant and machine operators (Statistics Finland, 2007).

UPM was generous in its dealings with the laid-off workers. Full salaries were paid over the seven-month period during which production in the mill wound down regardless of whether the employees moved on to new jobs. Moreover, UPM funded a "From Job to Job" programme aimed at providing support for the retraining and relocation of laid-off workers. The phased closure also provided an extended period of time for public authorities to put in place worker assistance programmes and marshal resources, including obtaining structural adjustment funding from the central government. In addition to providing direct assistance to the laid-off workers, funds were also made available for new business start-ups and to subsidise businesses looking to locate in the old factory premises. In short, the Voikkaa closure was precisely the situation that the Finnish "Change Security" model was designed to address.

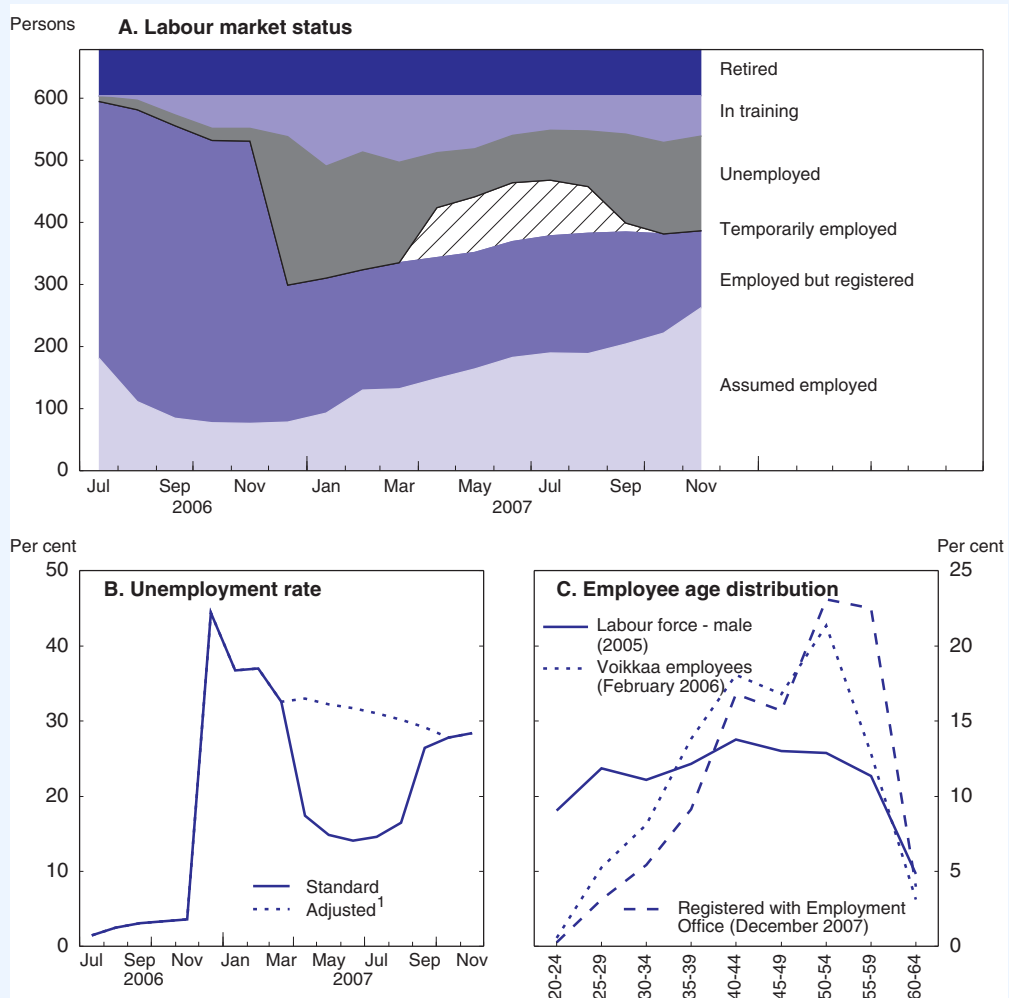
Figure 5.4 (top panel) plots the labour market status of the 678 laid-off workers from a period just prior to the plant shutdown up to December 2007. At the point of closure in December 2006 it is estimated that around 74 people had retired, 66 were in training, 239 people were registered as unemployed, 218 were working but were registered as looking for alternative employment and a further 78 were not registered but assumed employed (though a proportion of those may have left the labour force). This translates into an unemployment rate of 44% as illustrated in the bottom left panel of Figure 5.4. Over the course of the summer of 2007, around 100 of the former employees were temporarily employed in other local UPM mills as summer stand-in staff which temporarily lowered the unemployment rate. However, with a current unemployment rate of close to 30% the outcome for the unemployed has not improved greatly over the period since the plant closed, despite the substantial sums of money and effort directed towards smoothing the structural adjustment. The situation will have deteriorated further in early 2008 when the jobs of around 60 employees who had continued to be engaged in shutdown activities at the Voikkaa plant were completed, meaning that the unemployment rate may climb back to around 40%. A telling juncture will be at the point when those on unemployment benefits approach the end of the 500 days of income-linked benefit payments, although a significant number of these people appear to have been able to reset the countdown by taking up short periods of employment.

Where there has been growth in (permanent) employment over the period since the shutdown, it has come from the group who were engaged in training and not out of the pool of inactive unemployed or temporary employed. While there is undoubtedly a degree of self-selection among those going into training, it does point to the efficacy of directing structurally displaced workers into training.

### Box 5.1. Case study: the Voikkaa paper mill shutdown (cont.)

The difficulty in finding re-employment is likely to stem, in significant part, from the age structure of the former employees (81% of those laid off were men) which was skewed decidedly toward the older age bracket relative to the age distribution of the entire Finnish male labour force (Figure 5.4, bottom right). The high average age of workers is further evidenced by the fact that at least 10% opted for immediate retirement and that of the 153 registered as unemployed as of December 2007, around a third declared that they were waiting to enter the retirement “pipeline”. The predicament of the older cohort is borne out by the fact that the unemployment rate for over 50 year-olds in the Kuusankoski region in mid-2007 was 54%. Nevertheless, anecdotal evidence suggests that firms who attempted to recruit the laid-off workers for jobs elsewhere in Finland had only limited success, due to the reluctance of laid-off workers to relocate. Stricter requirements for unemployed workers to move to accept jobs might have resulted in a better overall outcome.

Figure 5.4. Voikkaa paper mill shutdown



StatLink  <http://dx.doi.org/10.1787/337763554535>

1. Adjusted for temporary employment spells.

Source: Kouvolan Regional Employment Office; Statistics Finland, Labour Force Survey and OECD estimates.

study of the application of the Change Security framework to the closure of the Voikkaa paper mill in December 2006. Just over one year after closure, unemployment remains very high, suggesting that the Change Security framework is not sufficient to get displaced workers back into jobs, particularly in an environment of high local/regional unemployment rates.

The government has recognised that more needs to be done by convening a working group (the SATA Committee) to conduct a comprehensive review of social protection. The remit of the group is to strengthen incentives to work and reduce poverty while maintaining a sufficient level of basic social security. A particular focus will be on improving the functioning of labour markets through changes in taxation, basic security and the unemployment benefit system. The committee should also revisit the issue of the unemployment “pipeline” and examine proposals to taper unemployment benefits for the long-term unemployed. The group should also examine issues relating to the operation and co-ordination of all services offered to those out of work, including the functioning of the Labour Force Service Centres. The group is expected to make its recommendations some time in 2009.

### Wage setting remains excessively rigid

Addressing real wage rigidities was the focus of Chapter 4 of the previous Survey (OECD, 2006a) and reforms in this area remain a priority for Finland. That chapter discussed in detail the benefits of increased wage flexibility and made a number of suggestions as to how the current bargaining framework might be modified to provide better outcomes, particularly for low skilled and younger workers. That chapter also highlighted the inherent trade-off between social equity concerns of wage setting and long-term economic performance and sustainability. Surveys in Finland have shown a general level of contentment with the uniquely Finnish wage setting framework, principally because of the stabilising influence it has on industrial relations and the moderating effect it has had on wage outcomes, at least until recently (Pekkarinen and Alho, 2005). But it is also acknowledged that a less centralised system would bring important microeconomic benefits. Nevertheless there is disagreement as to how far and how quickly to proceed down this path (Alho, 2005).

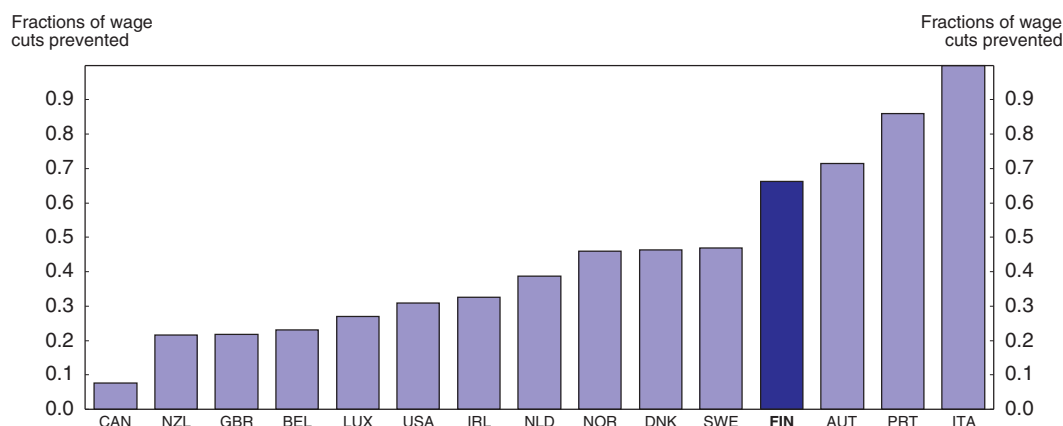
Wage flexibility across industries and regions is a critical element in the adjustment to shocks. Mayes and Vilmunen (1999) show that the impact of the shocks that buffeted Finland in the early 1990s was exacerbated by the lack of nominal wage flexibility so that the burden of adjustment fell on employment, resulting in massive job losses. Moreover because of hysteresis, adjustment was painfully slow where otherwise it might have been smoother and more rapid if wages had been allowed to absorb some of the shock. Over that period, real wage adjustment was mostly a consequence of inflation induced by exchange rate devaluation – a mode of adjustment that is no longer available (Böckerman *et al.*, 2006).

Disparities across regions have been worsening in recent years. Per capita income growth convergence had been a feature of inter-regional disparities over the period prior to the recession. However this process has ceased since the recession (Kuntaliitto, 1999; Loikkanen *et al.*, 2003 and Prime Minister’s Office, 2004).<sup>6</sup> This pattern of permanent differences in growth rates across regions has meant a strong persistence in unemployment rate differentials across regions (OECD, 2006a). Indeed the variance in unemployment rates across regions has increased over the post-recession period (Box 5.2). These persistent and

growing regional imbalances are not, however, reflected in wages because centralised wage agreements provide little scope for regional labour to “price itself in” and thereby attract investment and promote employment. The lack of wage differentials across regions also does not promote mobility from high to low unemployment areas.

Recent work by Holden and Wulfsberg (2007) has quantified the degree of downward nominal wage rigidity in a number of OECD countries by calculating a fraction-of-wage-cuts-prevented (FWCP) estimate.<sup>7</sup> Figure 5.5 illustrates their results showing that Finland ranks only behind Italy, Portugal and Austria in terms of nominal wage rigidity with a FWCP index well above that of its Nordic neighbours. In terms of real wage rigidity the situation in Finland seems to be even worse with Dickens *et al.* (2006) finding that Finland and Sweden together form a pair that performs considerably worse than any of the other 16 countries examined. The authors find that the one common factor that best explains the degree of real wage rigidity is the extent of the role played by labour unions in the wage negotiations which tends to be high in both Finland and Sweden. Böckerman *et al.* (2006) also find high real wage rigidity in Finland relative to other comparable countries, particularly if the exceptional period of the early 1990s recession is excluded.

Figure 5.5. **Downward wage rigidity**



StatLink  <http://dx.doi.org/10.1787/337784108640>

Source: Holden, S. and F. Wulfsberg (2007), “Downward Nominal Wage Rigidity in the OECD”, ECB Working Paper Series, No. 777, July.

In addition to economy-wide wage rigidity there is also evidence of wage inflexibility across industry sectors with wage growth across industries deviating considerably from underlying productivity trends. Alho (2005) finds a divergence between wages and productivity particularly at the lower end of the wage scale in the manufacturing sector, a sector that has suffered especially badly in terms of job losses over the past decade. Unfortunately, developments in the 2007-08 round of wage negotiations have been unhelpful in promoting inter-industry wage flexibility. The most productive and profitable sectors (chemical and technology sectors) completed agreements first and these agreements included substantial progress in increasing flexibility with more scope for local-level performance to be reflected in wage remuneration. In order to achieve this outcome employers agreed to higher wage increases. However, the sectors that followed then sought increases on a par with or exceeding those initial settlements but most troublingly, without the accompanying increases in flexibility negotiated in the earlier

rounds. This is consistent with behaviour in previous rounds (Uusitalo, 2005). The imprudently large wage increases in sectors with low productivity growth threaten competitiveness, risk igniting inflation and could seriously jeopardise the government's target of getting the unemployment rate down to 5% by 2011. The aggregate wage increase over the two and a half years covered by the recent wage negotiations is estimated to be close to 4.5% per annum and with wage drift could be as high as 6%.

### **Reform of the wage setting framework has been limited**

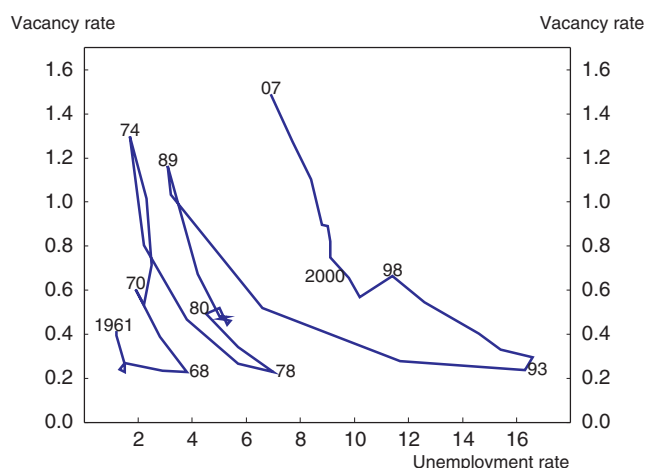
Reform of the wage setting framework has been inching forward. A greater proportion of wages is now set by the so-called local level allowances in the income agreement that allow for part of the general wage increase to be negotiated at the firm, municipal or industry level (Asplund, 2007; Heikkilä and Piekkola, 2005 and Johansson, 2006). However, this component still tends to be handled in a mechanical way and does not result in the degree of flexibility that it could provide (Asplund, 2007). Moreover, the proportion of the total increase made up by these flexible components is still much lower in Finland than in other Nordic countries. The recent introduction of company-level agreements also provides greater flexibility, though to date, it has generally been used only to negotiate working hours. Finally, in the most recent round there was provision for the payment of performance-based supplements to individual workers. However, local representatives generally chose instead to distribute this component of the wage increase evenly across all employees even though doing so incurred a total wage increase penalty of around 1%.

The idea that the national wage negotiations should ensure that no worker falls behind needs to be rethought.<sup>8</sup> More emphasis should be given to dealing with equity issues through the tax and benefit system while labour costs should reflect underlying productivity. Moreover, wage compression in Finland has muted the signals about labour market opportunities that wages send to workers across industries and regions, to students seeking to undertake studies, and to potential migrants. This lack of clear signalling is contributing to the inefficiencies in the Finnish labour market.

The question of whether the Finnish wage setting framework is optimal should be central in the public debate on economic policy. To date reform has only been incremental. While the outcome of the most recent round of industry-level negotiations was disappointing, and likely to have detrimental effects both in terms of inflation and competitiveness, future negotiations should continue to be conducted at a decentralised level so that wage agreements can better reflect labour market conditions for each skill level and occupation. Some degree of government co-ordination of this process might be required. Furthermore, opting out of collective agreements should be made easier and the current practice of enshrining wage negotiation outcomes into legislation (administrative extension) should be re-considered as it constitutes an impediment to intra-sector flexibility. Minimum wage legislation could be put in place to address social equity and other concerns.

### **Labour matching problems and skill shortages**

There is growing evidence of mismatches in various segments of the labour market. At the aggregate level these mismatches are evident in the Beveridge curve (Figure 5.6). In 2007 the national vacancy rate was close to its historic highs while the aggregate unemployment rate was 6.9%. In contrast, the last time the vacancy rate was around this level the unemployment rate was just around 2%. The horizontal shift outwards in the Beveridge curve after the early 1990s also happened in many other OECD countries (Layard et al., 1994)

Figure 5.6. **Beveridge curve**

StatLink  <http://dx.doi.org/10.1787/337807016420>

Source: OECD, Main Economic Indicators – online database.

but it is particularly pronounced in the case of Finland and suggests that the equilibrium level of unemployment has increased by around 4 to 5 percentage points.<sup>9</sup> This is consistent with estimates that the NAIRU was around 4% prior to the 1990s recession before peaking at around 12% in 1994 and falling to around 7½ per cent in 2007 (OECD, 2007b). Moreover, the level of vacancies varies considerably across industries as does the mismatch between the number of vacancies and the number of unemployed in each sector.

Soininen (2007) finds that there has been a significant change in the labour market matching process pre- and post-crisis, and that this can be linked to the pernicious effects of long-term unemployment.<sup>10</sup> Studies for other countries (Petrongolo and Pissarides, 2001) have found that the age structure of the labour force can also have a significant impact on the matching process. Given the age profile of the long-term unemployed, this is likely to be an important factor in Finland, particularly given the heterogeneity of education across age cohorts (see below). The level and duration of unemployment benefits can also have an impact on the efficiency of matching. On the positive side, unemployment benefits offer essential social protection against poverty and hardship and they also give the unemployed the time and resources to find jobs that best match their skills. However, access to very generous and open-ended unemployment benefits may reduce the incentive to search for re-employment (OECD, 2007a).

In addition to simultaneous increases in unemployment and vacancy rates, other metrics of mismatches and shortages include the prevalence of overtime and the time it takes to fill vacancies. Both measures have increased recently. Prime Minister's Office (2007b) shows that the average duration to fill vacancies has increased dramatically since the beginning of 2006. The durations have lengthened most in the mining, construction, industry, transport, stockpiling and IT sectors. A similar pattern emerges when looking at overtime. While in aggregate the proportion of total hours worked accounted for by overtime has been broadly flat, there are a number of sectors including hotels and restaurants, transport and communication, and in particular health, that have shown significant increases in overtime worked. This corresponds with the large number of vacancies reported in the services sectors. Labour market mismatch indices also point to increasing mismatches at a regional level (Box 5.2).

### Box 5.2. Labour market mismatch indices

Outward shifts in the Beveridge curve are often attributed to decreases in the efficiency of the labour market in matching job vacancies with the pool of unemployed. Indices using inter-regional and inter-industry vacancies and unemployment figures can be calculated (see Obadic [2006] for a good exposition) to quantify the degree of labour market mismatch. In the case of Finland unemployment and vacancy data are available at both the industry and regional level.

One class of mismatch indices uses regional or industry vacancies rates and unemployment rates and constructs aggregate indices based on the imbalances between these. The two most frequently used indices of this class (by Jackman and Roper, 1987) are:

$M_1 = \frac{1}{2} \sum_i |u_i - v_i|$  and  $M_2 = 1 - \sum_i (u_i v_i)^{\frac{1}{2}}$  where  $u_i$  is the number of unemployed in a region or industry as a share of total unemployed and  $v_i$  is the number of vacancies in a region or industry as a share of total vacancies. In both cases if the unemployment shares and vacancy shares are equal within each region or industry then the indices will equal zero indicating no mismatch.

The second group constructs mismatch indices based on the dispersion of unemployment rates away from the national average or the best performing regions.

$$M_3 = \frac{1}{2} \text{var} \left( \frac{U_i/N_i}{\sum U_i / \sum N_i} \right); M_4 = \frac{1}{2} \text{var} \frac{u_i}{u_T} \text{ and } M_5 = \log(u_T - u_L)$$

where  $U_i$  is the number of unemployed in a region or industry and  $N_i$  is the number of employed in a region or industry,  $u_T$  is the aggregate unemployment rate and  $u_L$  is the lowest unemployment rate amongst all the regions or industries.

Finally Valleta and Hodges (2006) suggest using the dispersion of employment growth across regions or industries as a simple metric of mismatch, noting that periods with high standard deviations of employment growth rates across the states of the United States corresponded closely with shifts outwards in the Beveridge curve.

In the case of Finland's regions the mismatch indices that use vacancy data ( $M_1$  and  $M_2$ ) all suggest a quite pronounced longer term increase in regional mismatches since the recession of the early 1990s and increasing mismatches over 2005 and 2006 (Figure 5.7, upper left panel).<sup>\*</sup> The more recent increase in the indices has been driven in large part by the concentration of vacancies in the Helsinki/Uusimaa region; indeed over the two years to 2006 almost half of all vacancies in Finland were registered in the capital city region despite the fact that this region accounted for less than a third of total employment.

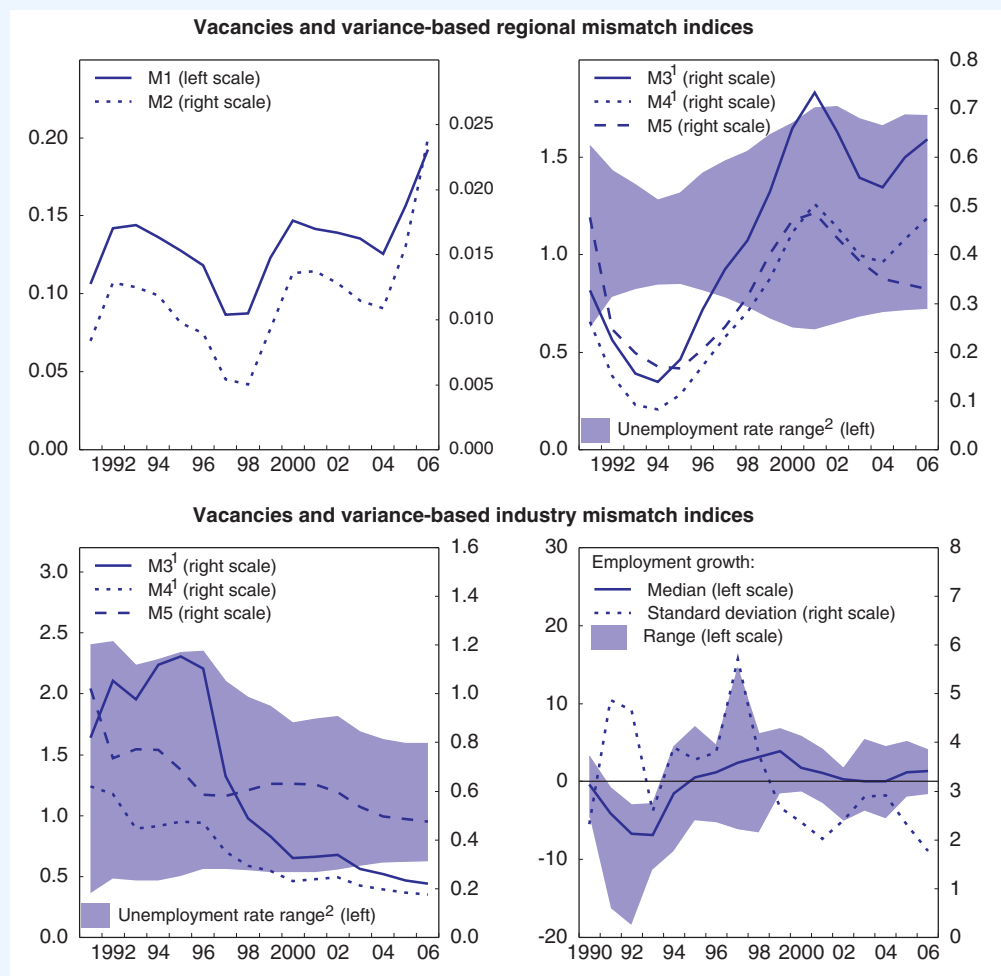
Unemployment dispersion-based mismatch indices ( $M_3$  and  $M_4$ ) also show an increase in the mismatch measure over the past two years (Figure 5.7, upper right panel), although according to this metric, the degree of mismatch is not as bad as in 2001 when the range of unemployment rates was at its widest. In contrast, the unemployment gap index ( $M_5$ ) shows less mismatch over the past few years as the gap between the best and worst performing regions has somewhat narrowed since around the time of an employment growth slowdown in 2002 when all regions suffered equally. All regions have subsequently shared in the pickup in job creation.


Turning now to mismatches across industries, one needs to be more cautious in interpreting the results because the unemployment figures on an industry basis are measured according to the industry in which the unemployed person last worked and therefore preclude the possibility of people retraining and then seeking work in another sector. That said, all the industry-based indices suggest that mismatches have been steady or lessening over the past few years, as vacancy to unemployment ratios, unemployment



## Box 5.2. Labour market mismatch indices (cont.)

Figure 5.7. Regional and industry mismatch



StatLink  <http://dx.doi.org/10.1787/337824611203>

1. M3 and M4 are scaled for presentational purposes.
2. Range of unemployment rate ratios.

Source: Statistics Finland and OECD calculations.

rates and employment growth rates have all tended to converge across most industries over the last decade. This is consistent with a dissipation of the structural adjustment wrought by the recession – an indication that the surviving industries have begun matching workers to jobs more effectively. This cross-industry convergence is illustrated in the lower panels of Figure 5.7.

In summary these indices suggest that the labour market mismatch problem is an inter-regional issue rather than an inter-industry issue. While there appears to be an improving balance between unemployment, vacancies and employment growth across industry sectors, the opposite appears to be happening across the regions, which are diverging in their labour market performance with the high growth southern provinces outpacing the poorer performing northern provinces.

\* Sufficiently long duration data for vacancies are only available for 15 of the 21 regions. Adjustments are made to the aggregate unemployment rates, etc., to account for this.

A typical consequence of labour shortages might be larger wage increases in the affected sectors but there is no evidence of this to date, perhaps in part related to the rigidity of the Finnish wage setting framework. While the 2007 wage negotiations saw relatively large aggregate increases in nominal wages, the variance in wage outcomes across industries (and regions for that matter) appears to be no greater than in previous rounds.<sup>11</sup>

### **Insufficient regional mobility**

One common explanation for the regional mismatch problem is the relatively low geographical mobility. Because geographical relocation is costly for families, the mismatch between jobs in one region of the country and the structurally unemployed in another can persist for extended periods of time. In Finland's case this picture is exacerbated by the age profile of those made unemployed who tend to be older and therefore less willing to move than younger job seekers who are less encumbered by house ownership and family responsibilities.

Contrary to the supposition that Finns are relatively immobile, the Prime Minister's Office (2007b) concludes that the available evidence suggests that Finns are in fact close to average compared with other European countries when it comes to regional mobility. Moreover, Prime Minister's Office (2004) argues that, on the basis of negative relationships between income per capita and population growth rates that strengthen over time, inter-regional mobility has increased in the post-recession period relative to the pre-recession period and that this increased mobility has in part been driven by divergent economic performance. However, the large disparity in inter-regional unemployment rates suggests that mobility is simply not adequate. In addition, using Europe as a metric does not set a good benchmark relative to other better performing regions such as North America and Australasia. Finally, as shown in Kauhanen and Tervo (2002), those workers who do migrate tend to be the more educated individuals rather than those with lower skills and with lower probabilities of local employment.

There are some legal requirements for geographical (and occupational) mobility of the unemployed but these are considered weak compared with Norway and Sweden (Hasselpflug, 2005). For instance, while all unemployed must accept job offers in the same working area, only singles without children must accept permanent full-time offers in other working areas, subject to being able to find accommodation without incurring major additional financial costs. This latter condition is likely to rule out requiring people to move to fast growing regions like Helsinki where accommodation costs are substantially higher than elsewhere in the country.<sup>12</sup> Unemployed married people or people with children are not required to move outside of their working area if offered a job, even if their spouse is also without work. Measures taken in the 2007 Budget to promote greater mobility included an increase in the maximum amount of the deduction for travel expenses. In addition, a new relocation grant was introduced in 2007, the compensation level of the mobility allowance was raised and the period over which the travel allowance could be paid was extended. The interaction between the housing sector and mobility is also an issue, with rapid increases in house prices and rents in Helsinki and other high growth centres making relocation to these areas from other provinces prohibitively expensive for some. The government has sought to address this by offering generous tax rebates for the rental of a second residence (Prime Minister's Office, 2007a) but this initiative is misdirected as it is likely to only benefit those workers who are wealthy enough

to maintain two residences and is likely to have a very minor, if any, effect on the labour mobility of the unemployed. Most recently there have been moves to increase the supply of housing in Helsinki and surrounding regions with municipalities in these areas agreeing to release more land for residential development. As part of this agreement, the central government has undertaken to help improve transportation infrastructure between these regions.

Considerably more needs to be done to tackle mismatches. To this end the government formed a working group in 2007 to make recommendations on what could be done to address these issues, and in January 2008 this group released a number of preliminary recommendations: training should be increased, particularly vocational training for young people, for those made structurally unemployed and for the large stock of unemployed immigrants; the relocation benefit should be extended, both in terms of the amount payable (currently € 700) and in terms of who is eligible (currently only certain groups of unemployed); the government's social security working group will examine ways of getting old-age and disability pensioners back into work; and finally, the work sabbatical system should be scrutinised.<sup>13</sup> These recommendations make a good start. The future status of the sabbatical programme in particular should rest on a thorough assessment of its benefits and costs, particularly the impact of allowing a leakage of skilled and experienced workers at a time of substantial skill shortages. Any assessment of the sabbatical programme should also investigate evidence that it is being misused as a means of renewing the 500-day term of unemployment insurance.<sup>14</sup> However, more needs to be done. In particular, legal requirements for geographical mobility of the unemployed should be tightened, and sanctions and enforcement should be stepped up. Any conflicts between the goal to encourage the unemployed to move to more dynamic regions and the government's regional development goals (see Box 1.2) should be openly articulated and steps should be taken to address any contradictions.

### **Skill mismatches**

Skill mismatches have also grown, and pose an increasing problem now that Finland has matured into a dynamic globalised economy in which the mix of skills required by industry can switch rapidly. This form of mismatch is particularly pertinent given the high levels of unemployment among some graduates. Vocational school graduates, who undertake studies in fields with highly specialised skills and who lack the breadth of studies gained by tertiary graduates, have unemployment rates of more than double that of those with a tertiary education. Also, as pointed out by Economic Council (2006), differences across fields of study are significant. Moreover, there are large disparities in graduate unemployment rates across regions. For instance, the inter-regional disparity in unemployment rates of vocational graduates is largest between Kainuu and Itä-Uusimaa (neighbouring the Helsinki region) at over 16 percentage points. The regional disparity for polytechnics graduates is widest between Lapland and Uusimaa (the Helsinki region) at over 9 percentage points, while the largest regional disparity for university graduates is over 7 percentage points.

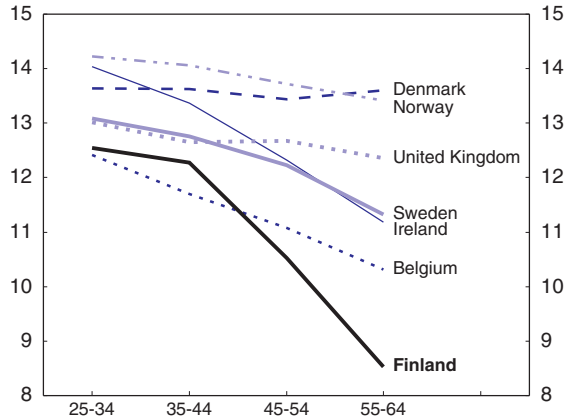
One avenue for satisfying skill shortages is through international migration, and this is a potential solution that has received increasing attention in Finland. However, progress to date has been slow and there remain considerable obstacles to attracting the type and number of migrants needed to fill the emerging bottlenecks in the labour market (Chapter 7).


### Training and active labour market programmes

As outlined in Chapter 6, Finland performs very well in international comparisons of the educational performance of secondary school students. However, Finland also stands out in terms of the generational divide in educational achievement with the number of years in formal education of the 45 plus year-old cohort being very much below that of the younger cohorts (Figure 5.8). Another wealthy OECD country with a similarly stark variance in education levels across age cohorts is Ireland – a country that has, like Finland, undergone enormous structural change and experienced a long period of very high unemployment. In contrast to Finland, however, Ireland was able to rapidly re-employ displaced workers, including the more modestly educated older generation.<sup>15</sup> Along with the United Kingdom and Belgium, Finland stands out amongst the wealthier OECD countries as having one of the largest disparities between the labour force participation of men with tertiary education (90%) and men with less than upper secondary education (68.4%) (OECD, 2007d). This high level of inactivity coupled with low levels of education and skills suggest that considerably more could be done in up-skilling this segment of the population through active labour market programmes (ALMPs). At the same time, however, older workers have a shorter span of time over which to reap returns from any investment in education and skills retraining potentially limiting the effectiveness of such policies. Importantly, a greater degree of flexibility in the labour market, including in wages and conditions, could also assist in reactivating these older workers.

Figure 5.8. **Average number of years in formal education**

Males by age group, 2004



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Source: OECD (2006), *Education at a Glance*, Table A1.5.

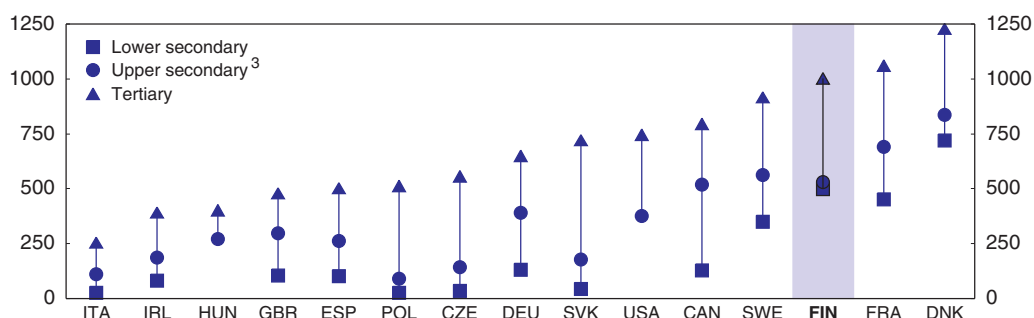
The number of people in active labour market programmes remains high although the mix has begun to switch away from subsidised employment and towards more training-based programmes. Relative to the total number of unemployed persons, the number engaged in ALMP programmes is close to an all time high of around 30%, with 16% in training and 14% in subsidised employment (Ministry of Labour, 2007b). Of those in subsidised employment approximately one-third are placed with municipalities and two-thirds with private companies; this is a reversal of the situation of a decade ago when the majority of those on subsidised employment were engaged in the public sector.

Nevertheless the mix of people engaged in active *versus* passive labour market programmes remains lower than in the other Nordic countries even though long-term unemployment remains a significantly more serious problem in Finland (OECD, 2007c). Moreover, spending on activation of those on disability pensions remains relatively low.

Active labour market programmes (particularly subsidised employment) have tended to concentrate on getting the younger unemployed into work (OECD, 2006a). Indeed it may be the case that employers have used subsidised youth employment to circumvent the relatively high tariff wage that applies uniformly to all workers including those with less work experience. In the case of the older unemployed, given the generally low levels of basic education, it might be worthwhile to further change the mix away from subsidised employment and towards subsidised training. Providing this group of unemployed with the skills necessary to move across industry sectors, rather than subsidising them to remain within the industry from which they were originally displaced, is likely to be a more effective and sustainable remedy in the medium to long term.

The need to continue to rebalance the emphasis towards training is reinforced by the fact that Finland ranks highly in terms of the total number of hours in non-formal job-related training on average across the workforce. The number of hours for the 55-64 year olds (77 hours per annum) is just one-third that for the 35-44 year olds (221 hours) (OECD, 2007c). Moreover, as in other countries, those who participate most intensively in adult education are those with higher education (Figure 5.9). Greater attention should be paid to raising the participation of those with just basic skills. The government aims to increase adult participation in education to 80% by 2008 (Prime Minister's Office, 2007a). However the current adult education NOSTE programme, which is targeted at the 30-59 year olds, has been underperforming to date *vis-à-vis* this target. As the presence of universities in regions may diminish due to declines in the numbers of younger people (and rationalisation), the regions should consider giving the Open University a more important role. Indeed, OECD (2006b) recommends for the Jyväskylä region that the regional role of the Open University be more explicitly recognised and encouraged by the university and regional stakeholders.

Figure 5.9. **Time spent on professional training**<sup>1</sup>  
By level of educational attainment, number of hours, 2003<sup>2</sup>



StatLink  <http://dx.doi.org/10.1787/337846432665>

1. Expected hours spent in non-formal job-related education and training over a forty-year period for persons aged 25-64.

2. 2002 for Canada.

3. Includes post-secondary non-tertiary education.

Source: OECD (2007), *Education at a Glance*.

## The Nordic model requires higher employment

In the coming years Finland will increasingly face the demographic challenge of a declining labour force and rising old-age dependency ratios. The consequent fall in employment poses a sustainability threat to the welfare system, which couples high taxation with a generous social security net. Increasing participation in the labour force is one way to address this challenge and the government has set a long-term employment rate target of 75% (Ministry of Social Affairs and Health, 2006). Achieving this target will not be easy given that at its peak in the late 1980s the employment rate was just above 74% and an already ageing population means a countervailing natural decline in the employment-to-population ratio. Nevertheless there are a number of avenues that could be pursued to raise the employment rate from its 2007 average of just under 70%, which is close to the OECD average but significantly lower than that of the other Nordic countries. In significant part this issue is related to poor participation by the older cohorts.





### A priority is to further raise employment among older people

Part of the government's strategy for increasing labour force participation were a number of reforms made in 2005 that were aimed at improving incentives in the pension system and at tightening access to the so-called "unemployment pipeline". The unemployment pipeline provides older unemployed workers with continued access to income-linked unemployment benefits right through to the old-age pension and thereby effectively encourages displaced older workers to opt out of the labour force altogether. This policy, which was introduced prior to the recession when employment prospects were much better, has been tightened somewhat with the qualifying age being pushed up from 53 to 55 years in 1997 and then again to 57 in 2005 (Table 5.1). The package of reforms made in 2005 also included changes to the pension system itself, such as a significant increase in the pension accrual rate from age 63, an increase in the actuarial adjustment for early withdrawal, and the removal of the cap on the maximum pension (OECD, 2004; Hakola and Määttänen, 2008).

Table 5.1. **Changes to the unemployment pipeline**<sup>1</sup>

Regime period	Age												
1994-96	52	53	54	55	56	57	58	59	60	61	62	63	64
1997-2004	52	53	54	55	56	57	58	59	60	61	62	63	64
2005 – present	52	53	54	55	56	57	58	59	60	61	62	63	64

Index

	500 days of unemployment benefits
	Extra days
	Unemployed pension (abolished in 2005) <sup>2</sup>
	Old-age pension or extra days

1. The unemployment pipeline is represented by the full shaded area in the table.
2. Grandfathering arrangements mean some people have continued to receive the unemployment pension since 1997. In fact, 2007 was the first year that someone aged 57 could no longer expect to qualify for the unemployment pension after reaching the age of 60.

These policy changes, which were discussed at length in the previous *Survey* (OECD, 2006a), have been successful to some extent with the average retirement age increasing by about one year over the first 2 years after the change (Hakola and Määttänen, 2008) and

activation rates among older workers showing some improvement. However, there remains some way to go with Finland's average effective retirement age for men in 2005 still only around 60.5 years, considerably lower than the OECD average of 63.3 years. This gap is even greater in comparison to the other Nordics (OECD, 2006c)<sup>16</sup> and particularly low given Finland's high life expectancy which is close to that of Norway and Sweden and considerably higher than that of Denmark.<sup>17</sup> Moreover, the unemployment pipeline remains relatively lucrative, partly because the unemployment benefits that one receives while in the pipeline accrue pension contributions, thus increasing the final old-age pension that is received. Finally, in the post-reform system, once in the unemployment pipeline, one is not required to pay the early retirement penalty that is normally associated with retiring at the age of 62 instead of age 63.

### ***Disability pension rules should be tightened***

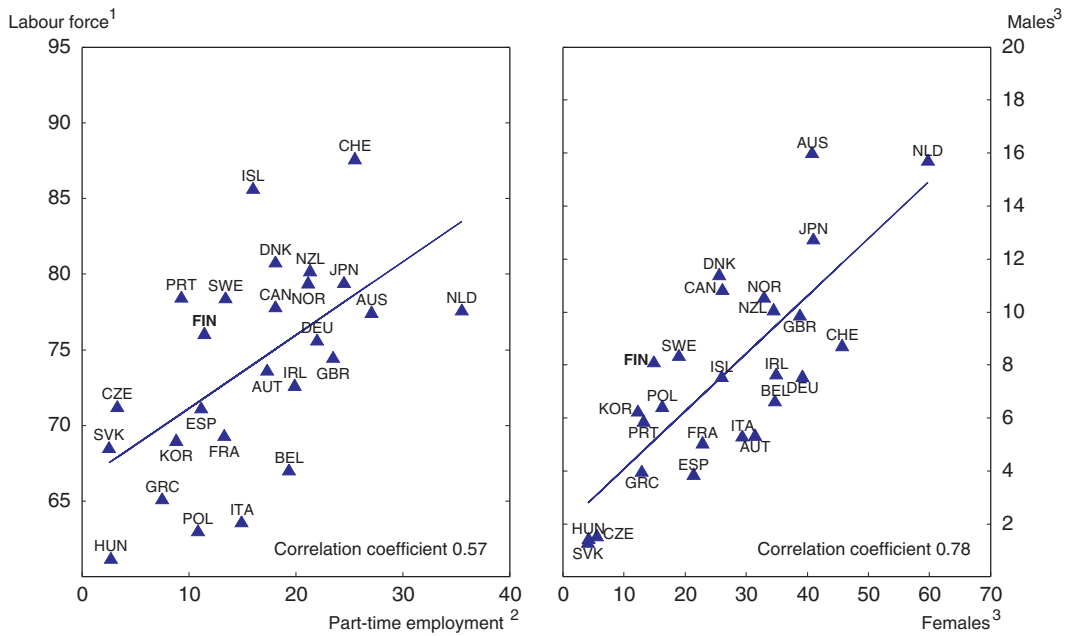

In addition to early retirement, and the unemployment pipeline, disability pensions are another avenue being used, particularly by older cohorts, to exit early from the labour force. More resources should be committed to activating these people through more careful screening, training and workplace assistance. In 2004 around 9% of the population aged 25 to 65 years was receiving a disability pension and for the 50-65 year olds the figure was around 19% (Hytti, 2006). While there has been some improvement in recent years, Finland still performs much worse than most other OECD countries (OECD, 2007c). A number of studies have concluded that the majority of people on disability pensions are fully capable of working, and that a large proportion of the remainder are capable of some form of less intensive workforce participation (see for example Gould *et al.*, 2006). While around 10% of those receiving disability pensions (30 000 people or close to 1% of the labour force) have declared a willingness to engage in some form of work, the low levels of part-time employment in Finland suggest that there may be limited opportunities for those with partial disabilities to engage in an appropriate type of employment (OECD, 2008). In addition to increasing the flexibility of working conditions, more could be done to activate the disabled. The United Kingdom's "Pathways to Work" programme provides a good model of the types of initiatives that might be considered, including the provision of financial incentives for job searching and skills training, and refocusing medical assessments to emphasise work capacities rather than incapacities (see the 2007 Economic Survey of the United Kingdom for more details – OECD, 2007e).

### ***Possibilities to work part-time should be enhanced***

Another way to tackle the challenge of increasing labour force participation is to make the labour market more flexible and open to heterogeneous forms of participation including part-time work, echoing the EU Employment Strategy which urges diversity in work-time arrangements. This is not to advocate that policy be adjusted so as to encourage full-time workers to switch to part-time work, but rather to make it more attractive for those currently outside the labour force to re-enter. This might be especially effective in the case of the older cohort amongst whom participation rates are relatively low in Finland. As shown in Figure 5.10, those OECD countries with a high incidence of part-time employment tend to have higher overall labour force participation. While higher part-time participation may lower average hours worked, it would increase labour market participation, particularly if encouragement of part-time work is limited to older workers, the disabled and mothers of young children. Moreover, as shown in Annex 5.A1, high part-

Figure 5.10. **Part-time employment correlations**

2006

StatLink  <http://dx.doi.org/10.1787/338047842287>

1. Labour force participation rate (of the 15-64).
2. Share of part-time employment in total employment.
3. Percentage of male/female working part-time among male/female employment.

Source: OECD, *Labour Force Statistics – online database*.

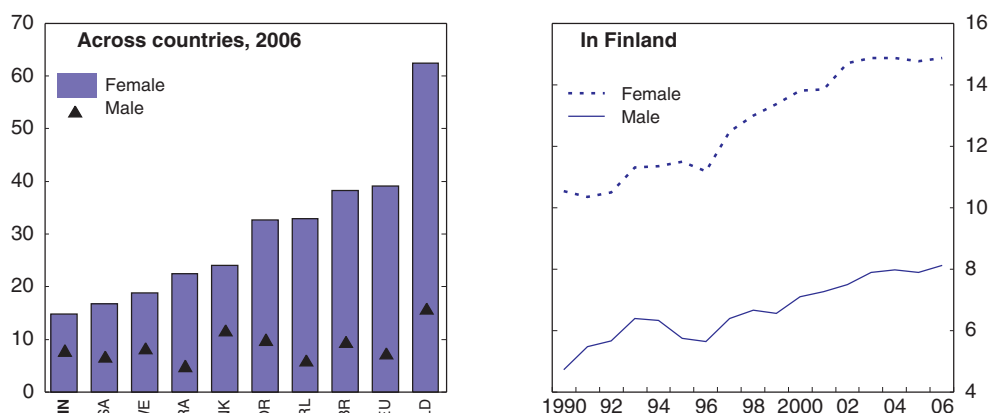
time participation does not necessarily imply lower total hours worked, in part because greater flexibility would likely draw more workers into the labour force, including some of those in early retirement.

There are probably a number of reasons for low part-time participation in Finland, including the industrial structure of the labour market (low service sector share in the economy), inflexibility of child care arrangements, legal and institutional arrangements in the labour market, and the tax and social security (including pension) system and the interaction thereof. For instance, part-time work by old-age and disability pensioners is rare in Finland compared to the other Nordic countries where provision for this type of participation is a common feature in their benefit system design (Hytti, 2006). Part-time work by mothers of young children should also be further facilitated by ensuring easier access to part-time subsidised child care.

Overall, non-gender specific factors play an important role in explaining differences in aggregate part-time participation across countries. Figure 5.10 (right panel) shows a strong positive correlation between female and male part-time employment shares across OECD countries. In some countries, such as the Netherlands, the compositional shift to a greater service sector share of the economy is thought to have contributed to its high part-time participation; for example, Euwals and Hogerbrugge (2006) suggest that the liberalisation of trading hours in the Dutch service sectors might also have played a role in providing more flexibility and promoting part-time employment. This suggests that as Finland's relatively small service sector grows, part-time employment might naturally expand. Indeed, there is some evidence that extended opening hours has prompted growth in part-time



Figure 5.11. **Part-time employment**  
In per cent of total employment



StatLink  <http://dx.doi.org/10.1787/338083756561>

Source: OECD, Labour Force Statistics – online database.

employment (Figure 5.11). Conversely, inflexibilities in the labour market, including constraints in the supply of part-time employees, might be one factor inhibiting the more rapid development of the services sector.

Some countries have enhanced choice by accommodating workers who wish to switch temporarily into part-time work and then back to full-time. This option has been aimed in particular at mothers with young children. However if part-time employment is to be promoted as a way of encouraging greater participation in the labour force, care needs to be taken that it is not used by employers to circumvent employment protection rules and that part-time participants enjoy the same access to career development and training, pensions, unemployment insurance and other social protections that are available to full-time employees. Moreover, a number of existing arrangements mean that the promotion of part-time work as a means of lifting participation might have unintended consequences. For instance, workers are currently eligible for unemployment insurance payments that supplement the income earned from part-time work so that total income adds up to no more than 90% of the wage upon which the unemployment insurance claim was originally based. Also part-time employment over 18 hours per week can generate entitlement to a new unemployment insurance spell. Care needs to be taken to ensure that any policy changes do not result in high levels of subsidised part-time employment or facilitate “carouselling” between short spells of employment and long spells of unemployment. Finland’s high levels of full-time employment serve it well given the demographic challenges that lie ahead, but there are likely to be benefits in promoting part-time employment as a means of keeping the elderly in employment, providing options for the disabled and increasing activity rates of mothers with young children.

### **Improving work incentives by fine-tuning the tax and benefit mix**

Finland’s generous welfare system and high rates of taxation mute the incentives for labour force participation and also for the type of up-skilling that leads to job progression to higher income levels. Opportunities to remain inactive for long periods on high untapered unemployment benefits continue to exist, despite the 2005 reforms, especially for those over 57 years of age. Moreover, the sickness and disability system remains

generous as does the level of financial support available to students (which has recently been increased). Furthermore, there is some cross-country evidence to suggest that high marginal tax rates that set in at low levels of income tend to reduce intensive participation in work (i.e. the average number of hours worked). Finland along with Sweden, Belgium and Denmark, is among a group of countries with the highest marginal tax rates and these countries also record average (full-time) hours worked well below the OECD mean (OECD, 2007c).<sup>18</sup>

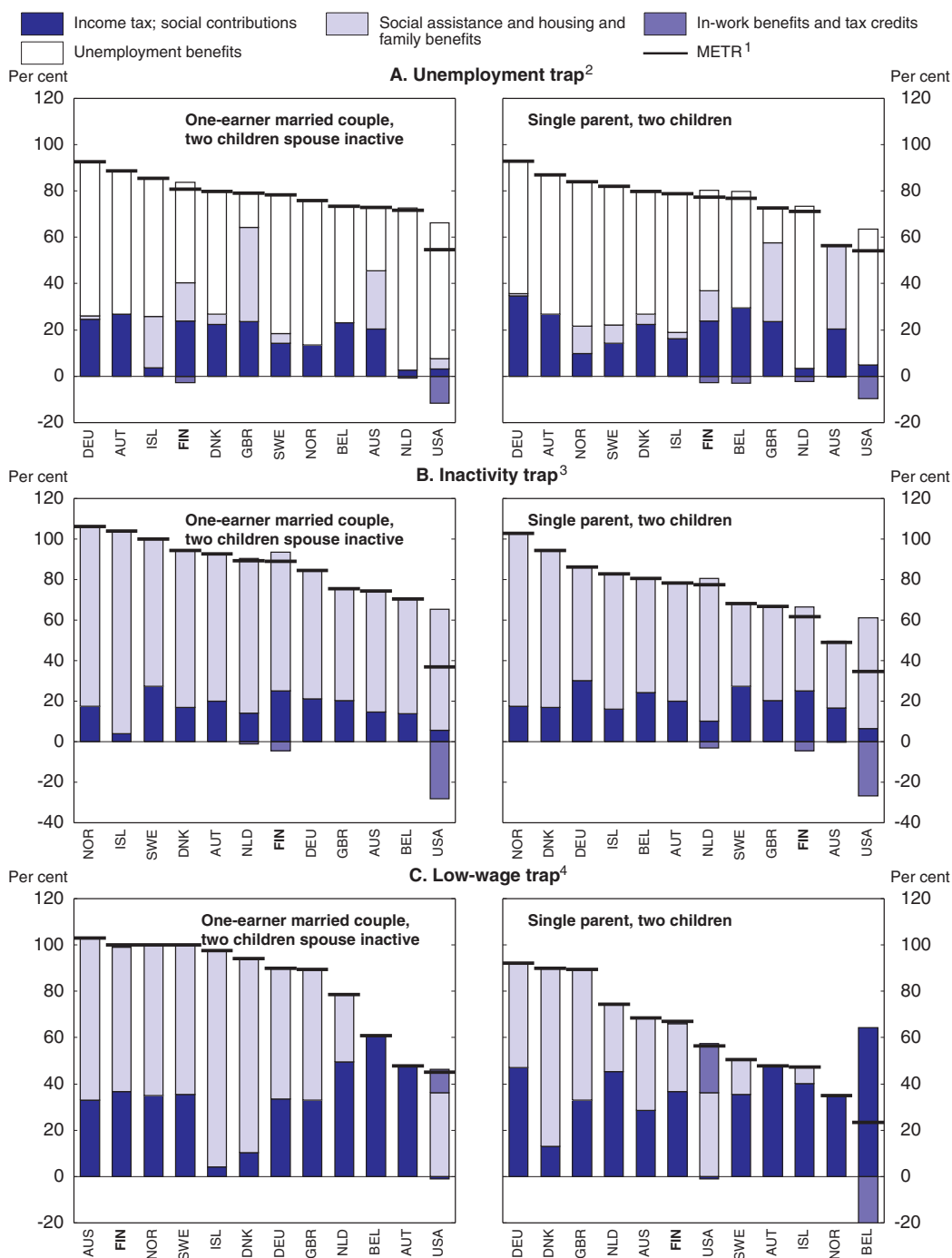

While there has been some progress in addressing these disincentives, there remain substantial obstacles to labour market participation and progression for some family profiles. One of the worst affected family types is the one-earner married couple with two children (between the ages of 4 and 6). For this group participation incentives are badly distorted, regardless of whether the primary earner is considering moving into employment (unemployment trap), moving from inactivity to part-time work (inactivity trap), or looking to increase their earnings from around half average earnings (low-wage trap). In all such cases the marginal effective tax rate is very high and in some cases close to 100% and amongst the highest in the OECD (Figure 5.12). This constitutes a dire disincentive to more intensive engagement in the labour force, including training and up-skilling. In the case of the inactivity trap and the low-wage trap, the majority of the erosion in additional income comes from the withdrawal of in-work benefits and tax credits, while in the case of the unemployment trap the disincentives come from the withdrawal of the relatively high unemployment benefits. In addition to high marginal tax rates muting participation, Finland also continues to suffer from a high implicit tax on continued work at older ages despite the reforms made to the unemployment pipeline (OECD, 2007f). More needs to be done to fine-tune the interface between the tax and benefit systems in order to mute these disincentives to labour market participation.

In addition to their impact on labour force participation, the interaction of the tax and social security system also plays an important role in labour market matching. In understanding this, it is useful to consider the concept of a reservation wage which is defined as the subjective level of income below which a job seeker will not consider taking up a job, as to do so would leave him or her worse off not only financially but also perhaps in other respects including reduced leisure time. A high reservation wage tends to inhibit labour market matching, particularly in an environment where there has been structural change and where the type of job the unemployed person previously had no longer exists. An excessively high reservation wage, elevated by income-linked unemployment benefits that are paid for extended periods, means that the unemployed do not feel compelled to search intensively for re-employment.

The reservation wage depends on the unemployment and other social security benefits received. This can be assessed by the replacement rate, which quantifies the income and benefits received while unemployed, relative to the income received while in employment. Finland's net replacement rates are among the highest in the OECD, and close to or higher than those of the other Nordics across a number of household types. Indeed, for a one-earner married couple with two children, Finland's net replacement rate is the highest in the OECD (OECD, 2007f). Moreover, in contrast to many other OECD countries, replacement rates in Finland do not decline as the duration of joblessness lengthens. Significant tapering of the currently high level of replacement rates thus seems to be the best way of addressing marginal effective tax-related disincentives.

Figure 5.12. **Work incentives for low-income persons**

Combining employee contributions, income taxes and benefit withdrawal, 2005

StatLink  <http://dx.doi.org/10.1787/338123457410>

1. The marginal effective tax rates (METR) are calculated as one minus the ratio between the change in net income and the change in gross income.
2. Unemployment trap: METR on the gross income gain from moving from unemployment benefits to full-time work earning 67% of average full-time earnings for someone having also earned 67% before becoming unemployed.
3. Inactivity trap: METR on the gross income gain from moving from inactivity to part-time work earning 50% of average full-time earnings.
4. Low wage trap: METR on a 10% pay increase from 50% to 55% of average full-time earnings.

Source: OECD (2005), *OECD Employment Outlook*, Chapter 3, updated with 2005 data from OECD tax-benefit models.

Finally, there is some evidence that suggests that the participation of women with children has been curtailed by the existence of extra benefit schemes. That is, while Finland is generous in the provision of guaranteed access to subsidised childcare, the payment of a Home Care allowance tilts financial incentives in the balance of work and care options towards homecare (OECD, 2005): only around half of mothers of young children work in Finland (compared to 70% in Sweden), and only 44% of two-year olds in Finland are in formal child care (compared to 85% in Sweden). Some municipalities also offer Home Care Allowance subsidies that further skew incentives towards home care. The incentive effects of the Home Care Allowance should be reassessed.

Box 5.3 summarises the key recommendations made in this chapter aimed at improving the functioning of the Finnish labour market, including addressing growing labour shortages and persistent regional mismatches, and tackling the challenge of an ageing population.

### Box 5.3. Recommendations for improving the functioning of the labour market

#### Addressing real wage rigidities that contribute to labour market inflexibilities

- Greater effort needs to be made to speed up the process of making wage outcomes better reflect labour market conditions for each skill level and occupation. Wages should continue to be negotiated at the decentralised level although some degree of government co-ordination might be required. Any changes to the wage negotiation framework should also encompass the objective of moderate aggregate wage outcomes with a view to maintaining international competitiveness.
- Opting out of collective agreements should be made easier and the current practice of putting wage negotiation outcomes into legislation should be re-considered as it constitutes a further impediment to wage flexibility. Replacing it with a minimum wage could be considered.

#### Addressing labour shortages and regional mismatches

- More needs to be done to ensure that the flow of new labour market entrants have the right education and skills. This includes a greater role for market signals to students deciding on a field of tertiary or vocational study, to potential inter-regional migrants and to potential international migrants.
- More emphasis should be put on subsidised training rather than on subsidised employment, especially for the older unemployed, to direct them away from declining industry sectors towards more dynamic ones. ALMPs in activities and sectors where demand is low are likely to be wasteful.
- Legal requirements for geographical (and occupational) mobility of the unemployed should be tightened, and sanctions and enforcement should be stepped up.
- The subsidies currently directed at assisting inter-regional mobility should be audited; those that are found to be effective should be supplemented and those (like the second residence subsidy) that are found to be less effective should be abolished.

#### Increasing employment

- Unemployment benefits should be tapered over time as is currently done in many other OECD countries.

### Box 5.3. Recommendations for improving the functioning of the labour market (cont.)

- Access to the unemployment “pipeline” for older workers should be abolished, while enhancing retraining opportunities for the older long-term unemployed that focus on moving the unemployed into growing sectors and dynamic regions of the economy.
- More needs to be done to tighten access to sickness and disability benefits by pairing stricter activation requirements with improved retraining to match skills to the new structure of the economy. Opportunities for more part-time participation would help in this regard.
- Options for part-time work and their effectiveness should be reviewed. In particular, different ways of encouraging retired people to take up part-time work should be explored, disability pension rules should be made more accommodating of part-time work, and inflexibilities in child care arrangements addressed.
- More work should be done on refining the interaction of the tax and social security systems with a view to addressing the disincentives to labour force participation and skills training for those workers who face extremely high AETRs and METRs. Tapering benefits over time would help. The impact of the Home Care Allowance on the participation of women with young children should be reassessed.

### Notes

1. Statistics Finland measures inactivity on the basis of 15 to 74 year-olds rather than the more orthodox 15 to 64 year-olds, the rationale being that even the older 66-74 cohort are potential participants in the labour market and are thus legitimate targets of labour market policy.
2. For instance the 2007 participation rate ranged from a low of around 60% in the Lapland and Kainuu regions to a high of around 73% in Uusimaa (Helsinki). Similarly the unemployment rate in 2006 varied from a low of 5.2% in Uusimaa to 15.7% in Kainuu.
3. That said, wage growth in Finland as measured by compensation per employee has been higher than the euro area average over recent years (1999-2006 average of 3.2% versus 2.2%). The figure for Finland was pushed up by the larger increases during the last union-level wage negotiations in 2000, but compensation per employee also grew more rapidly in Finland over each of the last three years (2004 to 2006) than in the euro area. In terms of unit labour costs Finland’s performance over the 1999-2006 period has been better than that of the euro area but this is largely due to particularly strong productivity performance in the ICT sector.
4. See Ahtiala (2006) and Conesa *et al.* (2007) for an analysis of the impact of the recession.
5. The average duration of completed unemployment spells for 15 to 24 year-olds in 2006 was approximately 6 weeks while it was 18 weeks for 50-54 year-olds, 21 weeks for 55-60 year-olds and 69 weeks for 60-64 year-olds. The latter high figures reflect the impact of the unemployment “pipeline”.
6. Pekkala (1999) finds that, after conditioning for underlying differences, inter-regional convergence had ceased by the early 1980s.
7. FWCP or the Fraction of Wage Cuts Prevented is an index used to quantify the degree of downward nominal wage inflexibility by calculating a theoretical or notional incidence rate of wage cuts based on there being no rigidities and comparing that to actual empirical records of wage cuts.
8. In Finland it is commonly believed that some element of wage scales should be set on the basis of a subjective view about the complexity and skill a job entails, rather than a purely objective correspondence to worker productivity (Asplund, 2007).
9. The shift out of the Finnish Beveridge Curve might be somewhat exaggerated by the fact that prior to the recession of the early 1990s the government guaranteed to find a job for anyone unemployed for over 12 months. This policy was abolished during the recession. Thus, unemployment rates

prior to the recession might have been artificially low and the shift out in the Beveridge Curve might not entirely reflect decreased labour market matching efficiency.

10. By removing the stock of long-term unemployed from the post-crisis analysis, Soininen (2007) finds a more conventional matching process. This suggests that it is indeed the long-term unemployed that are corrupting the normally positive relationship between unemployment levels and hiring rates.
11. Excluding the health sector, and nurses in particular, which was a special case in the 2007. An exodus of nurses overseas had been attributed to the relatively low wages paid to nurses in Finland and the government had made promises during the election campaign to address this. This explains the relatively large wage increases for these workers in the 2007-08 round.
12. There are 59 defined working areas in Finland.
13. The sabbatical programme allows an agreement between an employee and employer for the employee to take an extended period of leave (between 90 and 359 days), during which time an unemployed person is engaged by the company (not necessarily in the exact place of the worker on sabbatical). The intention of the programme is to provide workers with the opportunity to rejuvenate and to give unemployed persons opportunities to gain workplace experience. After the term of the sabbatical the employee has the right to return to exactly the same job. For the term of the sabbatical the employee is paid at 70% of his or her eligible unemployment benefit (excluding the child component). If taken after 25 years of work it is 80%. The government and unions pay the sabbatical employee payment and the employer pays the replacement worker's wage and can get a wage subsidy. In 2006 14 400 (around 0.6%) employees took a work sabbatical.
14. The average duration of sabbatical leave is around 7 months which coincidentally is around the length of the contribution period required to renew entitlement to a fresh 500-day unemployment insurance spell.
15. The unemployment rate for 55-64 year old males in Ireland was 2.5% in 2006 with a labour force participation rate of 68.3%. This contrasts with Finland where the 55-64 year old male unemployment rate was 6.7% with a participation rate almost a full 10 percentage points lower than in Ireland (OECD, 2007c). One possible explanation is the much lower replacement rate received by unemployed people in Ireland.
16. The average effective retirement age in 2005 for Denmark was 64.1, Sweden 65.5 and Norway 63.9.
17. The average life expectancy for 60 year-olds in 2006 was 83.5 in Finland which is just above the EU15 average. It is notable that Finland has the largest female/male disparity in Europe on this measure of life expectancy.
18. Full-time employees in Finland worked an average of 40.3 hours per week in 2006 which is the second lowest level in the EU (average hours worked in Lithuania was 39.9 hours). In comparison to the Nordics, only full-time employees in Norway worked a shorter week (39.4 hours). In contrast when looking at average hours worked for all employees, including part-time employees, Finland ranks above the other Nordics largely because of the relatively low incidence of part-time work (Source: Eurostat Population and Social Conditions database, and OECD Labour Force Statistics database).

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## ANNEX 5.A1

## *Part-time employment, the employment rate, and total hours worked in the OECD*

This chapter recommends that Finland should do a number of things to promote part-time employment as a means of encouraging greater overall participation in the labour market, particularly for those more marginally attached like early retirees and new mothers. As illustrated in Figure 5.A1.1 (bottom panel), the part-time share of total employment across the OECD is positively related to the total employment rate with a 1 percentage point increase in part-time employment's share corresponding to an employment rate approximately half a percentage point higher. However lifting part-time employment will by definition lower average hours worked and this may have important fiscal and other implications. This reduction in average hours worked is illustrated in Figure 5.A1.1 (top left) which plots part-time employment shares across the OECD in 2006 against average hours worked per annum per worker. There is a clear negative correlation, with the Netherlands lying at one extreme with part-time employment constituting over 35% of total employment and average hours worked around 19% lower than the average of the sample of countries. South Korea lies at the other extreme with only 9% of all employment being part-time and with average hours worked a third higher than the average.

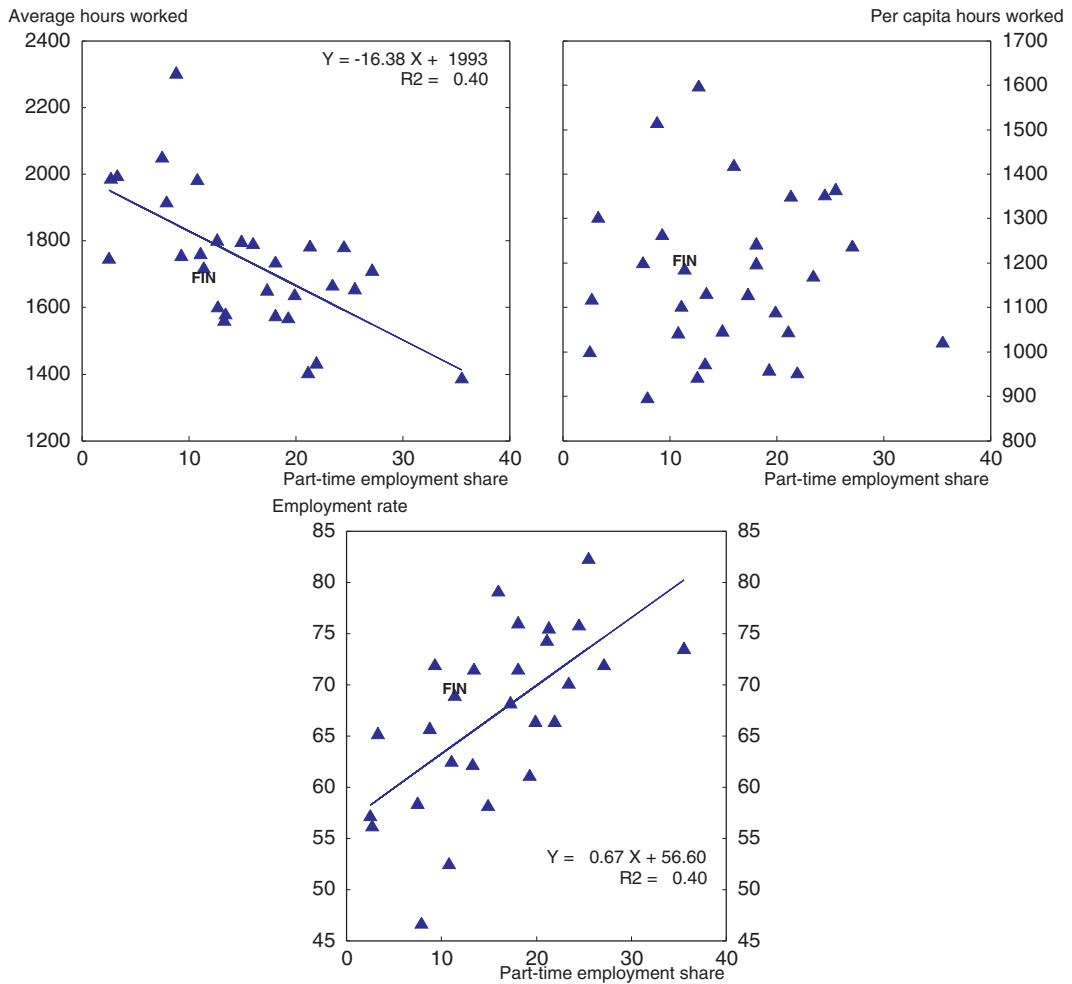
However, while part-time employment lowers average hours worked it may also increase participation (and thus employment) sufficiently so that total hours worked per capita might not be adversely affected. This is precisely what is seen across the OECD in Figure 5.A1.1 (top right) which plots part-time employment shares across the OECD against total hours worked per capita and shows no evident relationship.

The negative impact of part-time employment on the average intensive margin of the workforce does not translate across to a negative impact when looking at per capita total hours. This is because there is a positive relationship not only between the part-time share and participation, but also between part-time employment and employment itself; this relationship is sufficiently strong so that while on average the workforce works fewer hours, there is enough of a positive effect on employment that total hours per capita tends not to be affected. This strong relationship between part-time employment share and the employment rate is illustrated in Figure 5.A1.1 (bottom).

The mechanisms that account for the strong relationship between the part-time share and employment are likely to be both supply and demand related. While a greater supply of part-time labour might encourage existing firms to expand employment, it might also

Figure 5.A1.1. **Part-time share, hours worked and employment**

2006



StatLink  <http://dx.doi.org/10.1787/338157705387>

Source: OECD (2008), *Labour Force Statistics and Average Hours Worked* – online databases.

accommodate the emergence and expansion of those industries that demand flexible part-time employees such as the retail and hospitality sectors, thereby creating additional employment where before there was none.

## Chapter 6

# Making tertiary education as good as compulsory education

*The educational level of the Finnish population has risen considerably in recent decades. Comprehensive schools perform particularly well, as witnessed by the PISA results, providing an excellent foundation for Finland to benefit from the opportunities offered by globalisation. Some aspects of tertiary education could, however, be strengthened. This chapter analyses the inefficiencies in the Finnish advanced education system – especially the slow transition from upper secondary school to tertiary education, where many students spend several years attempting to enter higher education or the field of their choice – as well as other reasons for the late labour market availability of Finnish tertiary graduates. The chapter also proposes a number of ways to respond better to sharply rising labour market bottlenecks in a country where unemployment is still high.*

## The Finnish education system and the knowledge economy

Globalisation can lead to rapid change. This underlines the need for workers to respond swiftly to changing skill needs in the labour market. As it is unclear what kind of knowledge and abilities are needed in the labour market in the future, strong basic competencies and especially the ability to learn new skills are of particular importance. This concerns all levels of education. The ageing of the Finnish labour force also poses important challenges for the education system. Between the beginning of the next decade and 2030, the number of those leaving the workforce will exceed the number of those entering by 11 000 to 12 000 per annum, although regional differences are wide. This underlines the importance of a high level of efficiency in the education system: young people should not be kept in the education system longer than necessary.

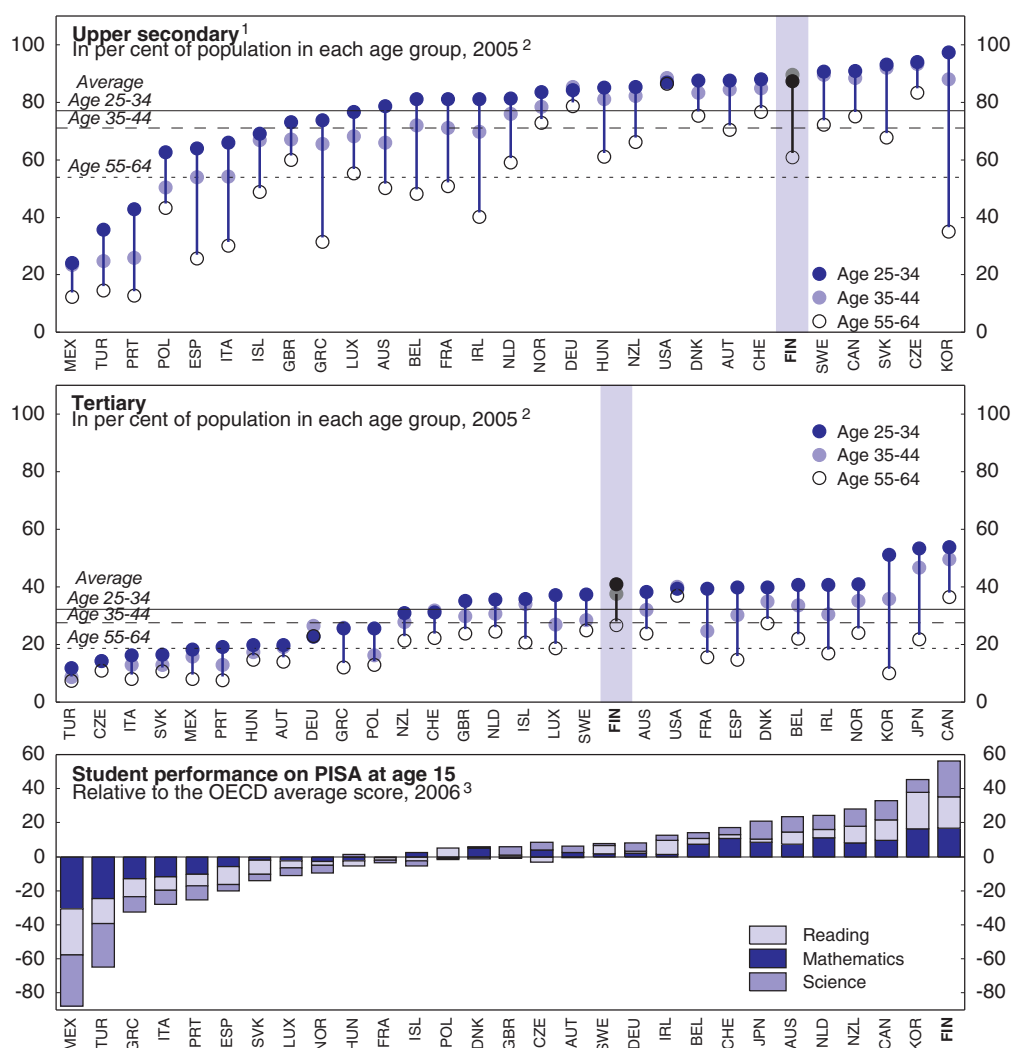
Government policy in the field of higher education is currently focussed on a number of initiatives including reform of the tertiary education network, changing the legal and administrative status of the universities, and a renewed funding model. This chapter, however, focuses more specifically on the labour market aspects of tertiary education. In particular, it assesses reasons for the late labour market availability of tertiary graduates, and asks whether Finnish qualifications are flexible enough to meet the changing demands of the labour market.

At the same time it is acknowledged that in many areas – particularly in compulsory education – Finnish education is a world leader. Indeed, one key to Finland's recent economic success is the high level of education and the emphasis on research and development. In recent decades, the average level of education has increased considerably (Figure 6.1, top panels). The Finnish comprehensive school system (for pupils aged 7-16) has achieved excellent results with regard to learning, as shown by Finland's success in the PISA studies (Box 6.1), as well as with regard to equality and cost efficiency (Sutherland *et al.*, 2007). The provision of equal opportunities between genders, regions and socio-economic groups is a fundamental principle of the Finnish basic education system (Finnish Ministry of Education, 2005). The system aims to ensure that comprehensive education is the same for all.

Half of all comprehensive school graduates continue to general upper secondary school, which finishes with a matriculation examination, while most of the others participate in vocational training. Both routes can lead to tertiary education, although only 20% of vocational graduates continue their education. A small percentage of students do a tenth year of comprehensive school, while close to 6% are left with no other education besides comprehensive schooling. At around 95%, graduation rates from general upper secondary schools are very high, while those in vocational schools are lower but still relatively high (81%).

Tertiary education has a dual structure consisting of practically-oriented polytechnics and academically-oriented universities.<sup>1</sup> Entry rates into tertiary education are high (Figure 6.2), although it should be emphasised that entry into tertiary education often takes

Figure 6.1. Educational attainment by age group and PISA performance



StatLink  <http://dx.doi.org/10.1787/338167440417>

1. Excluding ISCED 3C short programmes except for the United Kingdom where some are included.
2. 2003 for Japan.
3. The bars indicate the average PISA score for each country relative to the OECD average. The contribution of relative performance in mathematics, reading and science is also indicated (these three skills are weighted equally in the total score).

Source: OECD (2007), *Education at a Glance* and OECD (2007), *PISA 2006 – Science Competencies for Tomorrow's World*.

place several years after finishing the upper secondary level (see below). Overall the number of tertiary graduates has increased steadily and the education level of the younger cohorts is much higher than that of the oldest generations (Figure 6.1, top panel). The number of doctoral degrees has more than tripled in the last 15 years.

While Finland is excellent at providing the population with basic skills, improvements could be made in higher education as well as in vocational training – particularly in the transition to these stages. These problems are reflected in shortages of vocational labour, the late entry into tertiary education following matriculation, the high age of university graduates and high unemployment rates in some of the regions. The volatility in qualification requirements brought about by globalisation underlines the need for an

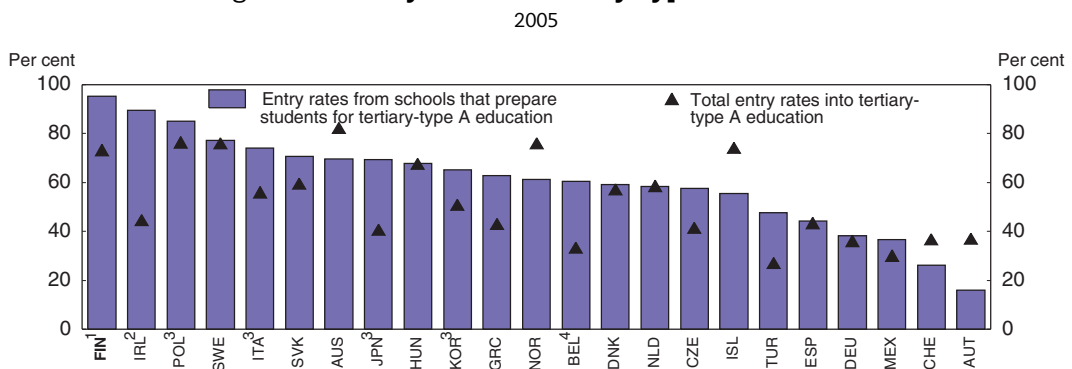
### Box 6.1. The Finnish PISA results

Finland has performed consistently well in the PISA tests. In 2006 (OECD, 2007a), it scored top in science and second in reading and mathematics (Figure 6.1, bottom panel). Moreover, Finland had the smallest percentage of those with the poorest skills and the variance is very low. For instance, in 2006 only 0.5%, 0.8% and 1.1% of the Finnish 15-year olds had poor skills in science, reading and mathematics compared with OECD averages of 5.2%, 7.4% and 7.7%, respectively.

Much of the Finnish success can be attributed to the equality approach in comprehensive education (OECD, 2005). The starting age is 7 and there is no streaming in the system. The small variance in the PISA results can be traced back to the use of four different levels of potential intervention when pupils fall behind – by the teacher, school assistants, the special needs teacher and the multi-disciplinary teams including *e.g.* a psychologist, a social worker or someone from public housing services. Other factors that are considered to have a positive influence are the small size of schools, thorough teacher training and low mobility of teachers and students (OECD, 2005). Finnish researchers attribute the success to a web of interconnected factors related to comprehensive pedagogy, students' own interests and leisure activities, the structure of the education system, teacher education, school practices and the Finnish culture (Väljjarvi *et al.*, 2002).

With such good results there is the danger of becoming complacent. In the future, with the younger generations becoming smaller and the consequent effects on the comprehensive school network, care will need to be taken to maintain the good learning results. Some studies have also emphasised the importance of ensuring that enough attention is given to those who do very well (Kupari *et al.*, 2004 ; Kupari and Väljjarvi, 2005).

Figure 6.2. Entry rates to tertiary-type A education



StatLink <http://dx.doi.org/10.1787/338208605711>

1. 2004 data.
2. Full-time entrants only.
3. Entry rate for tertiary-type A programmes calculated as gross entry rate.
4. Excludes the German-speaking Community of Belgium.

Source: OECD (2007), *Education at a Glance*, Tables A2.1 and C2.4.

education supply that is able to respond to the demands of the labour market, which implies degree structures that are flexible enough to meet different demands. Moreover, the projected shrinking of the labour force puts its own demands on the educational system; especially as it is unsure to what extent Finland can rely on migration to fill these jobs (Chapter 7). Therefore, it is important that the educational system produces people as

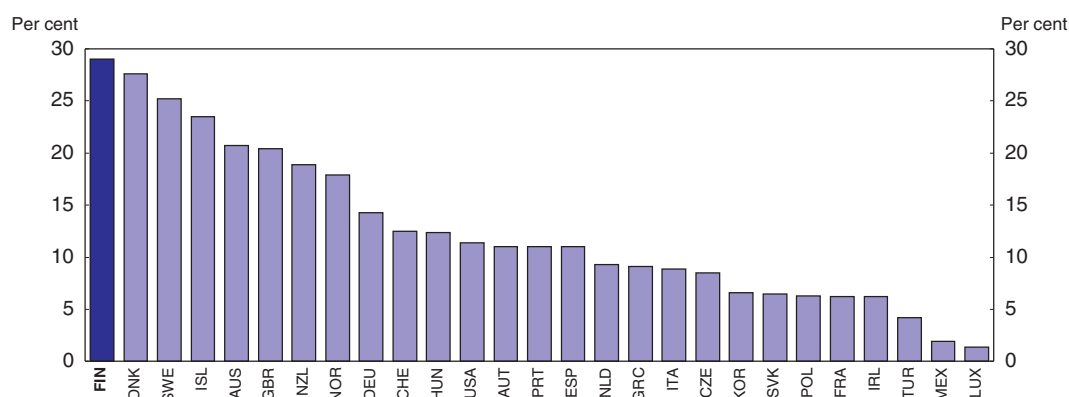
quickly as possible with the right qualifications and with the ability to learn new skills. Life-long learning and skills upgrading are essential in the globalised world and particularly important for Finland as it increasingly depends on older workers as a source of skills and know-how. While Finland fares well in international comparisons of participation in adult education (Chapter 5), the issues related to adult education are not covered in this Chapter.

### Delays in the transition to tertiary education are a major source of inefficiency

The median age of university and polytechnic graduates is 28 and 26 years respectively, clearly higher than in other OECD countries.<sup>2</sup> The two main reasons for the late start of a career are: first, the late starting age in higher education, in large part due to the “matriculation backlog” where only a minority of applicants to tertiary education are admitted to their preferred field of study immediately after completing secondary studies; and second, in universities the long duration of studies, with most finishing university with a Master’s degree. Indeed, enrolment rates peak only at 22 years in Finland – as in Denmark and Sweden – compared with 20 in all other countries. Finland clearly has the highest enrolment rates in the older age groups (Figure 6.3).

Figure 6.3. **Enrolment rates of 27 year-olds**

Full-time and part-time students in public and private institutions, 2005<sup>1</sup>



StatLink  <http://dx.doi.org/10.1787/338215847152>

1. As a percentage of the population in the same age group.

Source: OECD (2008), *Education database*.

The matriculation backlog first emerged in the 1980s following the expansion in the number of matriculated students and the introduction of university entrance exams at the end of the 1970s. It has not diminished. For instance, in 2007, there were 125 000 applicants to the 45 000 starting places in tertiary education, making for slim chances of direct entry for the 29 500 matriculated students and the 32 000 vocational graduates of spring 2007. Only 40% and 28% of the accepted students to universities and polytechnics, respectively, had matriculated the same year.<sup>3</sup> Half of all matriculated students were left in limbo. This rate is clearly too high. The prospective students who are not admitted to their preferred course queue to gain entry, which may take several years (Table 6.1). During this waiting time most young people work, while also preparing to re-sit the entrance exam. Some who enter less enticing study fields, either in universities or polytechnics, attempt to switch later, usually by re-sitting the entrance exams. Indeed, a recent study of the students accepted to the University of Tampere showed that students who already had a polytechnic/university

degree/study place made up 40% of the accepted students (Tampereen yliopisto, 2007). This switching process, which most often implies starting the new degree from scratch without transferring many credits, contributes to a relatively low survival rate in tertiary education. While the survival rate at 71% (2004) is at the OECD average, other countries that also have excellent PISA results and entrance exams in tertiary education, such as Japan and Korea, have higher survival rates (91% and 83%, respectively).

The government aims to increase the proportion of same-year matriculated students in admissions to universities to 55% by the end of 2008, but it is unclear whether this goal is realistic, especially considering that preferential treatment of same-year matriculated students is no longer allowed according to university law. The government's measures to address the problem include streamlining entrance examinations, harmonising scoring systems, encouraging the use of school reports in admissions, promoting the use of joint application procedures and closer co-operation in the selection process among institutions, and moving to an electronic joint university application system in 2008-09. These measures, however, do little to diminish the current backlog, *i.e.* the number of those currently queuing for entry.

Table 6.1. **First-time entry to tertiary education for matriculated students**  
Percentage of matriculated students

Year of matriculation	Same year	+1 year	+2 years	+3 years	+4 years	+5 years
1999 (34 347)	32.2	55.4	69.2	75.3	78.5	80.3
2000 (35 661)	31.3	54.8	68.8	74.7	77.7	
2001 (35 283)	31.3	54.6	68.3	73.9		
2002 (36 224)	35.7	57.9	70.5			

Source: Statistics Finland.

The matriculation backlog is a major source of inefficiency and contributes to the high age of tertiary graduates. The current system of separate entrance examinations for different institutions and courses should be abolished and other steps taken to eliminate the matriculation backlog. Tertiary institutions should be encouraged to accept students on the basis of their matriculation results only (except perhaps in fields such as arts or sport). The institutions justify the need for separate entrance examinations on the grounds that school success does not necessarily lead to success in higher education but the evidence for this is not conclusive.<sup>4</sup> Furthermore, entrance exams clearly put same-year matriculated students at a disadvantage, as they do not have the same amount of time to study for the exam as those who have matriculated earlier, on top of which the exams appear to favour students that already have a study place or a degree (Tampereen yliopisto, 2007). Even if there are some benefits to the current system, these must be offset against the considerable inefficiencies imposed on tertiary institutions, students and therefore the Finnish economy. Basing entrance on matriculation and school success alone would also make students' expectations more realistic regarding the study places they are likely to get.

As changes to the admission rules should be pre-announced, the following innovations should be introduced in the near term to remove the backlog during the transition period to the new rules:

- The number of starting places should be temporarily increased, *i.e.* for a period of, for example, 3 to 5 years with a clear understanding that after this period, the number of



starting places will be reduced and the admission rules changed, although not to the full extent of the backlog (*i.e.* quotas would remain). This would imply a temporary increase in expenditure, which could be mitigated by the introduction of tuition fees. At the same time, steps should be taken to increase the awareness of prospective students of their chances of gaining a study place, succeeding in studies, and employment prospects and wages, so that the matriculating students can make better informed choices about their futures, as discussed below.

- To allow for second chances, the Open University<sup>5</sup> should be permitted to grant degrees, and income-contingent study loans should also be available to Open University degree students. The system for transferring credits between polytechnics and universities should be clarified to improve the transparency of the system.
- Financial support to students to do their degrees outside Finland should be temporarily increased so as to also cover any tuition fees to help remove the backlog.
- Tuition fees should be introduced to help direct students to courses that are best linked to labour market demand. This would also allow an increase in the supply of courses most in demand.

Abolishing the matriculation backlog, which will not be easy, would allow starting places to be cut in the long term, as the government is planning (see below). With 22 000 starting places in universities and 23 000 in the polytechnics, the current number of starting places in tertiary education is already at 73% of upper secondary graduates, which would enable all matriculated students and half of vocational graduates to continue in tertiary education.<sup>6</sup> Eliminating the matriculation backlog would imply additional short-term outlays but these should be set against the costs of the current system: the cost to the universities, the wasted time of students (preparing for entrance examinations, false starts in other subjects, etc.) and the considerable inefficiency of forcing some students to take (unwanted) study breaks. In any case, the increased expenditure would be temporary and in the long term costs would be lower.

### Long study times also contribute to the late labour market availability of university graduates

The average length of university studies is also long in Finland with only around 40% of students graduating in less than 6 years. A major reason contributing to the long study times is the Finnish system of study support (Box 6.2), where the controls imposed on progress in studies do not provide any incentives for rapid graduation. The current minimum annual progress requirement implies a study time of seven years for a Master's degree, while study support is cut off earlier, at 55 months (*i.e.* 6 years assuming a nine-month academic year). Consequently, the median length of studies for a Master's degree is 6.5 years. To shorten study times, the authorities should tighten the annual minimum study credit requirement for eligibility for student benefits, including cheap housing, and also tighten the study time requirement giving eligibility for the student loan tax deduction.<sup>7</sup> Besides tightening requirements, the system of grants should be changed into a system of income-contingent loans, as suggested in Box 6.2.

Another reason for long study times is that most students still graduate from university with a Master's degree, while a post-graduate degree has also been created for polytechnics. The Bachelor's degree was made obligatory in 2005 in line with the commitments in the Bologna process but the share of Bachelor's degrees in total university

### Box 6.2. Study support

The share of study grants (i.e. excluding the loan component of study support) in total public expenditure on tertiary education is 16.7% in Finland compared with the OECD average of 9.9%. While most of the other Nordic countries spend less on grants (only Denmark spends more), students in the other countries receive much more financial assistance in total – due to a higher uptake of student loans. Among this group of countries, Finland has the lowest take-up rate of student loans at 35%. Rather than improve the student loan system, however, the government has increased the study support grant (which is means-tested with regard to the students' other income) by 15% from the beginning of 2008 at all levels of education and increased the other income limit by 30%. To improve incentives for more rapid graduation and given fiscal constraints, further increases in the financial support available to students should come through a re-developed loan system. The government-provided loans – currently loans are government-guaranteed bank loans – would be paid back by income-contingent repayments, i.e. repayments calculated as a percentage of the borrower's subsequent earnings (not dependent on the size of the loan), collected alongside income tax, until the borrower has repaid. A ceiling on borrowing each year and on the number of years for which a student may borrow would offer protection against running up a large debt.

graduates in 2005 was less than 20%, which is low compared with other countries. This is natural as students are still automatically enrolled in a Master's degree when they are admitted to university. Moreover, universities' funding is to a large extent based on the number of Master's degrees they produce. Master's degrees also appear to be preferred by employers, including the Finnish public sector, where a Master's degree is a requirement for a number of positions.

To shorten study times, reduce dropout rates and truly conform to the Bologna requirements, the Finnish authorities should change university acceptance rules so that all students would be initially accepted to do a Bachelor's degree.<sup>8</sup> Automatic access to a Master's degree could subsequently be granted to all Bachelors' graduates or (possibly) only to those in say the top three quartiles. No entrance exams should be introduced for Master's degree admittance. To improve the incentives of universities, the Bachelor's degree should have at least an equivalent standing to that of the Master's degree in terms of financing. In addition to these key measures, OECD (2006a) proposed a number of other ways to improve the standing of the Bachelor's degree:

- Develop the Master's degree as a conversion programme away from the subject of a first degree or as a professional development programme.
- Work with professional and trade associations to identify occupations in which a Bachelor's degree would be likely to provide skills and capabilities suitable to entry-level working life.
- Revise public sector hiring requirements so as to loosen the requirement for a Master's degree, so that a Bachelor's degree (from either a university or a polytechnic) would be sufficient for certain positions but not for all (e.g. the minimum qualification of a Master's would be retained for teachers).

However, it would appear that the government considers that the Master's degree is a minimum requirement for working life. From the point of view of life-long learning,

however, and to ensure a better match between degrees and working life needs – it would be better to think of the Bachelor’s degree as a “check-point” between studies and working life, as is currently the case for polytechnics’ post-graduate degrees. Such a life-long learning approach would increase the emphasis on adult education. The low esteem of Bachelor’s degrees could also be hindering immigration of skilled workers, as suggested in Chapter 7.

Another issue is whether Finnish qualification requirements – at vocational, polytechnic and university levels – are general enough to adjust to the changing demands of the globalising economy.<sup>9</sup> Subject specialisation begins early at all levels and continues in universities straight on to a Master’s degree. The Finnish authorities should assess qualification specificity at all levels, as it is important that the education system provides graduates with a wide skill base that makes it possible to transfer between different tasks, to transfer knowledge between jobs, and to continue studying later on. Assessing the quality of the Finnish tertiary education system is beyond the scope of this chapter, as there is only a limited base for making such an assessment.<sup>10</sup>

About half of Finnish tertiary students work during their studies with two-thirds saying that their work was at least to some extent relevant to their studies. While this is clearly contributing to the relatively high average age of university graduates, working during studies cannot be considered as solely delaying graduation, as the students are an important contribution to the labour market and working surely helps them guide their studies towards skills needed in the labour market. Moreover, it has been shown that work experience gained during studies is associated with higher earnings and employment after graduation (Häkkinen, 2004). To ensure that student work plays a relevant role, it could be considered that credit be given to students for work experience or internships, as recommended in OECD (2006a). Also, since statistics show that working is more common among older students, less relevant work could be reduced by resolving the problems in transition to education, and imposing stricter annual controls on the progress of study, as recommended above.

### The supply-based system has led to inefficiencies

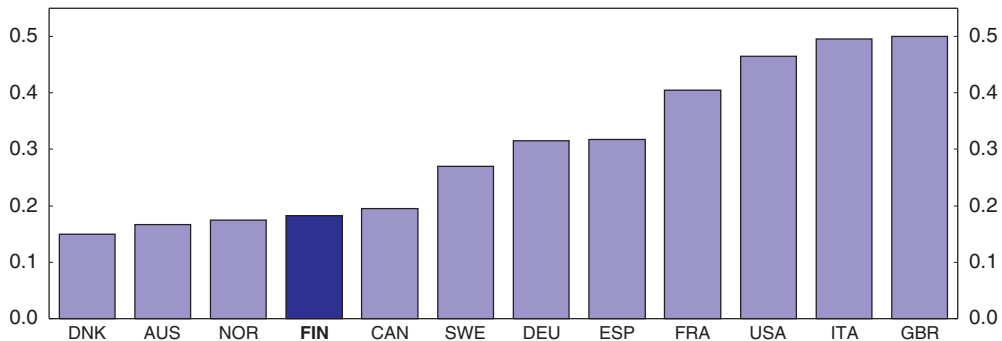
The education system features a strong dose of central planning, especially in higher education. Starting places in tertiary education are determined by a process in which a forecast of labour market needs, adjusted to reflect policy targets of the government, provides the basis for the national Development Plan, a document that provides a five-year framework for education supply, within which negotiations between the Ministry of Education and individual tertiary education institutions take place. The intake for each field of education is agreed between them, and contained in each institution’s performance agreement with the Ministry. Once the starting place quota at each tertiary institution has been allocated, the universities and polytechnics then have a decentralised system of entry, where the institutions and individual departments within them are free to establish their own criteria for the admission of students.<sup>11</sup>


Supply-driven systems encounter three types of problems. First, the authorities may lack the administrative information and management control over study places that are necessary to engage in effective rationing. Second, the administrative allocation of study places according to a forecast of labour market demand – as distinct from student demand – may result in a mismatch of student preferences and an under-supply of study

places. The matriculation backlog is a prime example of this problem. Third, attempts to steer enrolments towards subject fields of “national need” that are not in line with market signals are often doomed to fail – as evidenced by an over-supply of graduates who are then obliged to seek employment opportunities in other countries, or careers in fields other than those for which they were trained (OECD, 2008; Ryoo and Rosen, 2004). In Finland, there would appear to be an excess of starting places in certain areas in relation to the employment opportunities in those areas.

Finland currently has a comprehensive network of universities, polytechnics and vocational schools that cover the whole country. In particular, there are 51 higher education institutions (21 universities and 30 polytechnics) for the total Finnish population of 5.3 million, leading to tertiary degrees being provided in over 100 different locations. Indeed, the higher education network is exceptionally dense in international comparison (Parjanen and Tuomi, 2003). The rationale for such an extensive network is Finland’s egalitarian approach to education, which aims to give all an equal chance to participate in higher education, regardless of their place of residence or social background. Finland has been successful on both counts; 63% of polytechnic students and 46% of university students attend an institution in their home region and Finland fares well in terms of equality compared with other OECD countries (Figure 6.4).<sup>12</sup>

Figure 6.4. **Intergenerational earnings elasticity**  
Estimates from various studies<sup>1</sup>



StatLink  <http://dx.doi.org/10.1787/338238511840>

1. The higher the parameter, the higher is the persistence of earnings across generations and thus the lower is mobility.

Source: D’Addio, A.C. (2007), “Intergenerational Transmission of Disadvantage”, OECD Social, Employment and Migration Working Papers, No. 5.

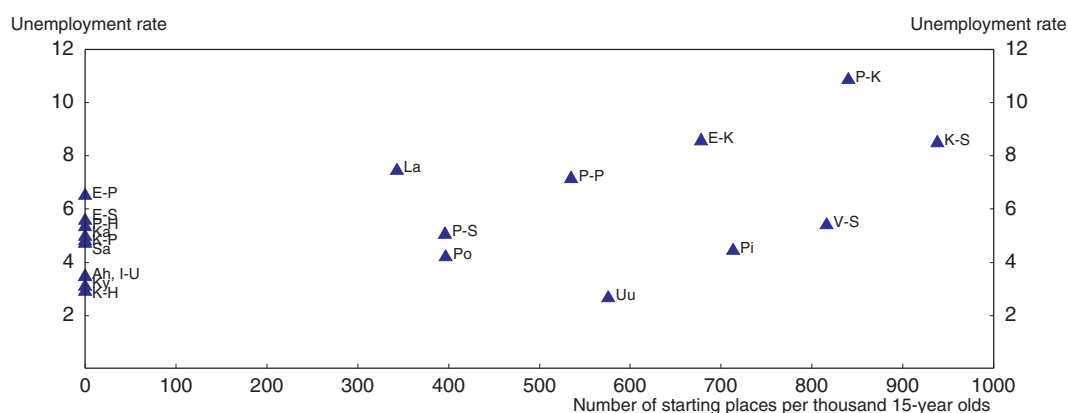
In addition to the equity justification for the regional network, the higher education network also plays an important role in regional policy. Given an implicit goal of maintaining a dispersed population pattern (Box 1.2), the decentralised system of higher education is thought to safeguard the supply of highly educated labour outside the growth centres. However, as noted in Chapter 5, labour shortages are evident in the growth centres, particularly in southern Finland. The significant differences across regions in unemployment rates of polytechnic and university graduates suggest that the number of starting places is too high in some regions and too low in southern Finland (Table 6.2; Figure 6.5).<sup>13</sup> For instance, although average unemployment rates are normally lower for those with higher education, this is not the case in many parts of Finland; Table 6.2 shows that 30-34 year-old polytechnic and university graduates in five regions and polytechnic

Table 6.2. **Regional unemployment rates for 30-34 year olds according to level of education**

2005

	Total	Basic	Vocational	Polytechnic	University
<b>Southern Finland</b>	<b>7.5</b>	<b>20.1</b>	<b>6.8</b>	<b>3.6</b>	<b>2.9</b>
Uusimaa	6.4	18.5	5.4	2.9	2.8
Itä-Uusimaa	6.1	15.1	5.2	3.4	2.2
Kanta-Häme	8.6	21.5	7.4	3.4	2.9
Päijät-Häme	11.5	25.2	9.9	6.6	3.2
Kymenlaakso	11.3	25.8	10.3	6.4	2.9
Etelä-Karjala	12.8	29.9	11.5	7.3	5.9
<b>Western Finland</b>	<b>9.2</b>	<b>22.2</b>	<b>8.5</b>	<b>5.5</b>	<b>4.6</b>
Varsinais-Suomi	7.6	18.9	6.7	3.8	4.4
Satakunta	11.2	24.2	10.7	6.9	3.2
Keski-Pohjanmaa	9.5	18.9	9.3	6.4	4.4
Pirkanmaa	9.5	23.9	8.9	5.8	4.5
Keski-Suomi	12.1	29.1	11.3	7.3	6.8
Etelä-Pohjanmaa	8.5	18.8	7.9	5.7	3.7
Pohjanmaa	6.5	18.6	5.3	3.6	4.5
<b>Eastern Finland</b>	<b>12.7</b>	<b>28.6</b>	<b>12.2</b>	<b>7.0</b>	<b>4.8</b>
Etelä-Savo	12.5	27.5	11.5	7.3	4.0
Pohjois-Savo	11.9	28.7	11.7	6.6	3.5
Pohjois-Karjala	14.3	29.5	13.9	7.5	7.5
<b>Oulu</b>	<b>12.1</b>	<b>27.5</b>	<b>12.6</b>	<b>6.2</b>	<b>5.0</b>
Pohjois-Pohjanmaa	11.3	25.1	12.0	6.1	4.8
Kainuu	16.7	40.4	15.8	7.3	7.3
<b>Lappi</b>	<b>16.3</b>	<b>33.1</b>	<b>15.2</b>	<b>12.3</b>	<b>6.2</b>
Ahvenanmaa	1.9	3.6	1.5	1.6	--
<b>Total</b>	<b>9.1</b>	<b>22.2</b>	<b>7.1</b>	<b>5.0</b>	<b>3.8</b>

Source: Statistics Finland.

Figure 6.5. **Regional unemployment and starting places in universities<sup>1</sup>**StatLink  <http://dx.doi.org/10.1787/338248765184>

1. 15-year olds from the year 2001 and starting places in 2005; regional unemployment data for university graduates in 2005. The zero entries on the number of places are regions without a university.

Source: Statistics Finland and KOTA database.

graduates in nine other regions have higher unemployment rates than do vocational graduates in Uusimaa, which includes the Helsinki area. Moreover, of the ten regions that have a university, six employ no more than one-third of the university graduates who

studied in that region (Työministeriö, 2007). For this reason, the temporary increase in starting places recommended earlier to relieve the matriculation backlog should be directed to the areas where the labour market is the tightest.

While safeguarding the supply of qualified labour outside growth centres is also important, alternative ways of doing so should be considered, such as by attracting the required labour force through the use of financial incentives. It would also appear that possibilities for the young to attend higher education in their region, instead of not attending education at all, could be provided with a less dense network. Consideration should also be given to the possibility that studying in the home region may diminish the likelihood of internal migration.

The latest Development Plan (Opetusministeriö, 2007) foresees an increase in the number of starting places in vocational training and a decrease in the number of places in higher education. This will affect the higher education network, especially as demographic changes are more severe outside the high-growth regions. The Ministry of Education recently revealed its vision that in 2020 there would be at most 15 universities and 18 polytechnics. For the universities this will be realised through current plans of co-operation.<sup>14</sup> Diminishing the number of polytechnics will be more problematic due to the proprietary interest of the municipalities, particularly since the domestic discussion of the reform has largely focused on the role of higher education as an instrument of regional policy. This suggests that alternative approaches to regional policy may be required (as discussed in Box 1.2). It is also important to ensure that mergers are effective, in the sense that they need to go deeper than just continuing as before but under a different name. For instance, a field of study currently offered at all participating universities should only be offered in one to reach critical mass. Possibilities for distance learning should also be considered, as suggested by Parjanen and Tuomi (2003).

The government should move towards a more market-oriented approach in determining the number of starting places. There are a number of reasons why they should do so. Importantly, it has been suggested that the advantages of central planning have diminished, as students are now more well-informed consumers, and more able than planners to make choices that conform to their interests and those of the economy. Arguing that students are unable to choose sensibly seems wrong (Barr, 2005). Moreover, empirical results suggest that changing tertiary education systems in the direction of higher supply flexibility and accountability is likely to increase graduation ratios (Oliveira Martins *et al.*, 2007). Although the government has proposed a reform to increase the financial and administrative autonomy of the universities, it would not change the system of central allocation of starting places.

For Finland, a small country with a shrinking labour force, it is important that the educational system does not waste resources. The adoption of a more market-oriented approach to the provision of education would help to reduce the current inefficiencies in the transition to the next level of education and support the determination of the appropriate size of the regional network of educational institutions. By permitting students to decide where they wish to study, the politically-sensitive issue of the regional allocation of study places would not require government decisions.

Abandoning or at least relaxing the centrally-planned system would involve devolving the decision about the number of starting places to the universities and polytechnics, with financing following the student. The same would also apply to vocational schools,

especially considering that there are no controls over starting places in general upper secondary schools (Box 6.3). There may still be some room for policy to influence student and institutional choices. This could be done by:

- Encouraging students to select high-demand fields of study by providing them with information about labour market outcomes of graduates. To have a functioning system, it will in general be necessary to ensure that better information is provided to applicants, so that they can make informed decisions about their education. This could be done by establishing an easily accessible and frequently updated database for prospective students containing information on wages and employment of recent graduates. The information should be disaggregated to the level of study field and indicate the variability of both wages and employment, so that students can form accurate expectations about future earnings conditional upon their abilities and institutions (OECD, 2008). At the same time guidance and counselling in comprehensive, vocational and general upper secondary schools should be improved.<sup>15</sup>
- Increasing or decreasing the funding of certain targeted disciplines, so as to encourage their provision by institutions.

Measures to shape student and institutional choices could also be used to support regional policy goals. For example, extra funding could be provided to secure provision of education in remote locations (by lower tuition fees), if deemed necessary.

### Box 6.3. Vocational training

Vocational schools, which in principle run in parallel to the general upper secondary schools, are each assigned a number of starting places by the central government, which they are then free to divide between different fields of study. However, there is little rationale for controlling the number of starting places. Shortages of workers with vocational training are already rising and will become more prominent in the future, as acknowledged by the government's plans to increase starting places in vocational training. In addition, not gaining entry into vocational training most likely contributes to young people being left with basic schooling only. In 2007 only two-thirds of those accepted had finished comprehensive school the same year.

A promising innovation, performance-based financing, was introduced in 2006. The system is based on quantitative indicators, with performance targets grouped into the categories of *impact* (55%), *process efficiency* (28%) and *staff* (17%). The impact of education is measured by the labour market entry rate and entries into further studies. Training process results are measured by the student drop-out rate and the duration of studies (completion measure). Staff results are evaluated from the perspective of the formal competence of teaching staff and the resources allocated to staff development. The largest weight (40%) is given to labour market entry, while further studies and drop-outs both get a weight of 15%. The aim of this innovation is to improve the results and quality of vocational training. So far the system appears to be a success as 93% of education providers find the system useful (Virtanen, 2006). To encourage the institutions to direct the increases in starting places according to the needs of the labour market, the share of performance-based financing should be increased from the current 2%, as suggested in the Government Programme. This system could be used as a model for introducing performance-based financing into tertiary education.

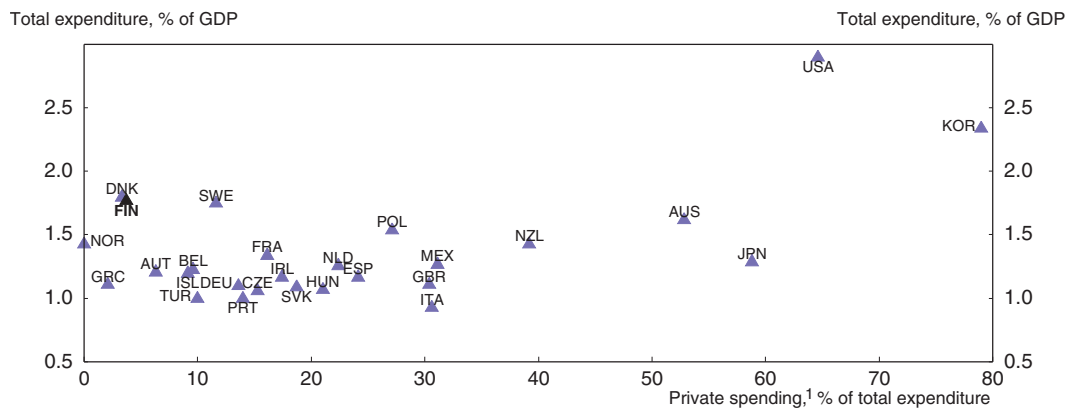
## Tuition fees could help to raise the quality of education and improve efficiency


Finland spends a larger share of public finances on tertiary education than most other OECD countries (1.8% of GDP compared with the OECD average of 1.4%). Compared with the other Nordic countries, Finland's expenditure is roughly the same as in Sweden and Denmark but higher than in Norway and Iceland. However, this share of spending is pushed up by an unusually large proportion of spending devoted to research. Excluding this, Finland's expenditure on educational core services is the lowest among the Nordic countries, and close to the OECD average.

Although the funding of universities will be increased yearly from 2008 onwards, the increase is relatively small. The challenge of ageing implies that there will be increasing competition for public funds, so further significant increases in public education expenditure are unlikely, although the EU has set a target of tertiary education spending of 2% of GDP. To increase the quality of education and research, more financing is most likely needed, as acknowledged in the Government Programme. As can be seen from Figure 6.6, the few countries with higher spending have significant private spending on tertiary education. It seems likely that significant increases in financing will need to come from the private sector. This has also been acknowledged by the Finnish government, which has proposed a new form of university structure (the so called foundation university) which would permit private financing of capital investments

Figure 6.6. **Expenditure on tertiary education institutions**

2004



StatLink  <http://dx.doi.org/10.1787/338273251673>

1. Including subsidies attributable to payments to educational institutions received from public sources.

Source: OECD (2007), *Education at a Glance*, Tables B2.1 and B3.2b.

A tertiary education funding strategy should consider three elements: tuition fees that assist the efficient allocation of resources within higher education; well-designed loans that provide consumption smoothing and ensure that education is still free at the point of consumption; and measures to ensure equitable access, as people from poorer backgrounds might not be fully informed, emphasising the need for some scholarship finance.<sup>16</sup> The benefits from introducing a system of loan-based tuition fees and study support, together with some scholarships for students from poorer families, include:

- Total spending on tertiary education would be higher, permitting quality improvements.



- Channelling funding for institutions through students should help to increase competition between institutions and make them more responsive to students' preferences. Tuition fees would make students more attentive to the quality and subjects being offered, with subsequent effects on their supply.
- Tuition fees would also be equitable, as free higher education amounts to providing a subsidy to persons likely to have relatively high lifetime incomes and often coming from relatively well-off families. In Finland the private internal rate of return for a university degree, at more than 16%, is one of the highest in the OECD, clearly more than the public internal rate of return at around 12% (OECD, 2007b). If reform to taxation results in a lower tax rate on labour (as recommended in Chapter 3) then this private rate of return would tend to increase further. This suggests an economic rationale for introducing tuition fees and income-contingent loans with repayments collected via the tax system in the context of the broader tax reform. Given that the private return to tertiary education exceeds the social return (Salter and Martin, 2000), the introduction of tuition fees is also an appropriate response to increasing labour mobility, mitigating the problem of graduates with fully tax-financed degrees developing their careers abroad without repaying the investment in the form of domestic taxes.
- Improved incentives for students to select their courses of study based on labour market potential.
- Improved incentives for students to shorten study times.

Previous *Surveys* (e.g. OECD, 2006c) have also recommended the introduction of tuition fees and they have been proposed in the domestic discussion as well (e.g. Raivio, 2007). The authorities have consistently rejected the idea, arguing that in such a small country all talent needs to be mobilised and access to education secured, while the purpose of the Finnish student financial aid system is to secure equal opportunities for studying regardless of the students' socio-economic background – i.e. the parents' means or willingness to finance children's studies. Nevertheless, countries such as Australia and New Zealand have higher average entry rates and high tuition fees. There are also concerns about a loan-based system due to the reluctance of Finnish students to take up the current bank loans. This suggests the need for a better-designed loan system (Box 6.2), both to improve students' access to finance and to reduce the need for students to work, thus shortening study durations. Student unions have also argued for free higher education as a selling point of Finnish higher education to foreigners although improved quality over time, enabled by tuition fees, might make a more convincing argument.<sup>17</sup> There are currently only eight OECD countries that do not have tuition fees in public institutions (the Nordic countries, the Czech Republic, Ireland and Poland), so the question remains how long Finland will be able to provide completely free higher education, especially in view of future spending pressures and the high private return on these studies. Finland is, however, planning to introduce a trial system of tuition fees and scholarships for students arriving from outside the EEA, which makes sense, as Finland offers the most English-language degree programmes in continental Europe.

A new financing model for the universities should also be considered. Financing of universities is currently based on quantitative targets; most core funding for universities comes from the number of Master's and Doctoral degrees, while a proportion is based on performance-based criteria. The universities can allocate 95% of core funding at their discretion but increasing amounts of financing are going into rents. As discussed earlier,

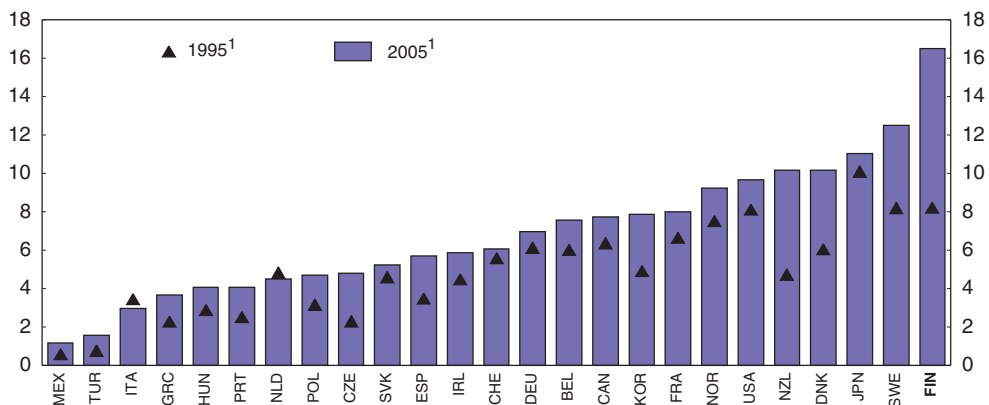
the funding formula should be adjusted to give more weight to the Bachelor's degrees in the core financing of universities. In addition, the performance-based part of the financing should be modified to include factors such as labour market entry rates after graduation and the duration of studies, as is done in the performance-based funding system in vocational schools (Box 6.3). Moreover, a larger role in financing decisions needs to be given to the quality of education. To do this, more evaluations of the Finnish higher education system are needed. This would also increase accountability from the currently low level (Olivieira Martins *et al.*, 2007).

### Increasing numbers of Doctoral degrees raise questions about quality

Finland has the third largest number of Doctoral graduates in relation to population within the OECD after Sweden and Switzerland (OECD, 2006d). The number of Doctorates more than doubled in the 1990s and growth has continued during this decade. Relative to population and GDP, Finland is one of the largest academic publishers in the OECD. The number of publications by Finnish researchers in internationally esteemed scientific journals has increased 2.5-fold during the past 20 years. When measured by the number of citations, Finland ranked eighth among the OECD countries in 2001-05 with its publications receiving 13% more citations on average than publications from all other OECD countries (Lehvo and Nuutinen, 2006). However, compared to the number of researchers, *i.e.* publications per researcher, Finland is not among the top countries, while the number of patents, as well as Finland's share in patents, has been decreasing in the past 10 years.

At nearly 2.5%, the share of researchers in the Finnish labour force is the highest in the OECD (Figure 6.7). In 2005, there were more than 77 000 persons employed in R&D, up from less than 48 000 in 1995. In both years, just over half of the research personnel worked for business enterprises. This leaves a still high number of researchers employed by the higher education sector, posing the question of whether this was a deliberate choice or whether no other employment was available, especially as the unemployment rate of those with a Doctoral degree has been increasing. With rapidly increasing numbers of Doctorates and taking into account the cost of producing Doctoral degrees, more effort should be focussed

Figure 6.7. **Total researchers**  
Per thousand total employment



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1. Or nearest available year.

Source: OECD (2007), *Main Science and Technology Indicators* – online database (October).

on ways to reap full benefits from the contribution of higher education to innovation. The Finnish authorities should pay increasing attention to the quality of researcher training and Doctoral degrees, and consider changing the financing system by introducing performance-based funding that would give weight to subsequent employment of Doctoral graduates as well as to the quality of research.

#### **Box 6.4. Summary of recommendations to improve tertiary education**

##### **Reduce inefficiencies in the allocation of study places:**

- Address the matriculation backlog by allocating additional starting places to areas of greatest student demand and by providing more financial support to students to do their degrees outside of Finland as temporary measures, i.e. for a period of, for example, 3 to 5 years, after which starting places would be cut. Provide more information for students on employment prospects and wages of recent graduates.
- Encourage tertiary institutions to increasingly assess applications using the matriculation exam results only so that by the end of the 3-5 year transition period most students are able to enter tertiary education in the same year that they matriculate. From that point onward, separate university entrance exams in most fields would be abolished. At the same time strengthen the role of the Open University and polytechnics as alternative routes to university for those with poor matriculation results (this would include clarifying the transfer of credits between polytechnics and universities).
- Relax the centrally-planned system of starting places and introduce tuition fees together with an income-contingent loan system that covers tuition fees and living expenses.

##### **Shorten study times:**

- Speed up graduation times by tightening the annual minimum requirement for progress in studies for the study support. Transform the study support system into a system of income-contingent loans. Ensure that student benefits (such as cheap housing and tax deductions on their loans) are available only to students meeting the minimum progress requirements.
- Change university admittance rules, so that students would be automatically enrolled in a Bachelor's instead of a Master's degree. Admission to a Master's degree should be contingent on completion of a Bachelor's degree with a sufficiently high standard but should not include entrance exams.
- Amend university financing, so that a larger weight is given to the number of Bachelor's degrees.
- To strengthen the position of the Bachelor's degree: revise public sector hiring requirements, so that a Bachelor's degree (from either a university or a polytechnic) would be sufficient for certain positions. Develop the Master's degree as a conversion programme away from the subject of the first degree or as a professional development programme.
- Consider giving credit to students for work experience or internships.

##### **Reassess qualification specificity at all levels.**

**Increase the focus on the quality of Doctoral degrees by introducing for example a performance-based financing system that would put emphasis on the employment of Doctoral graduates and the quality of research.**

## Notes

1. The polytechnics were created in the 1990s from post-secondary vocational schools resulting in a significant increase in the supply of tertiary education. Their governance structure is different from that of the universities, as the municipalities are stakeholders in polytechnics with a financing share of 58% (mainly buildings). For a review of the Finnish polytechnics see OECD (2003) and of the universities OECD (2006a).
2. The typical age of graduation from tertiary type-A education that lasts 3-5 years is between 22-26 years in Finland, *versus* no older than 22 in 14 of the 25 countries for which data was available. For programmes that last 5-6 years the typical graduation age is 24-28 in Finland, *versus* no older than 24 in 15 out of the 25 countries (OECD, 2007b).
3. Since these percentages are for students *admitted* to tertiary education, they are not biased by military service attendance. Actual *entry* rates are somewhat lower, due to military service and to some students not accepting a study place, etc. The *entry* rates in 2006 for the 33 000 matriculated students (which includes the 10% who matriculated in the fall and who were not eligible to apply to all education starting in 2006) were: 20.5% in universities, 17.4% in the polytechnics and 4.2% in vocational training, while 7.3% started their military service.
4. Rantanen (2001) found entrance exams to be the weakest indicator for study success in Finnish polytechnics and vocational schools (the best indicators were previous school performance and the applicant's preference as announced in the application). Häkkinen (2004) found that in some fields (engineering, sport sciences and social sciences) entrance exams were better at predicting success, whereas in education past school performance was a better predictor.
5. The Open University provides university-level studies with no requirements for the earlier level of education of the student. Students are charged for the courses, which do not lead to a degree.
6. Some have also claimed that the number of starting places in tertiary education at 70% of the age cohort is too high (e.g. Raivio, 2007). There is, however, currently only weak support for over-education in Finland: OECD (2007c) points towards possible over-education of Finnish women, whereas Kivinen *et al.* (2007) find evidence that points in the same direction. Nevertheless, a high number of tertiary graduates should not be a goal on its own but rather the focus should be on providing high quality education at all levels that produces skills necessary for the labour market, as pointed out in the globalisation report of the Economic Council of Finland (Talousneuvoston sihteeristö, 2006).
7. Those who started their studies after 2005 can get tax deductions for their study loans if they graduate within a certain time frame, e.g. with a Master's degree in 7 years.
8. This proposal has also been made by professors Rousu and Arjas (2008).
9. The Science and Technology Policy Council (Tiede- ja Teknologianeuvosto, 2006) notes that the Finnish system of higher education degrees does not provide sufficient flexibility and does not build on acquired skills when students move from one sector or field to another.
10. The international comparisons of universities do not give a flattering picture of Finnish universities although caution should be used when drawing any conclusions from such studies. Only three Finnish universities appear in the Shanghai Jiao Tong ranking with only Helsinki University making the European top 100 universities compared with nine Swedish and four Danish universities in the European top 100. The Shanghai Jiao Tong ranking is based on criteria related to research rather than teaching output and the methodology is likely to favour English-language institutions and perhaps also larger institutions. Nevertheless, this should still be a cause for concern, as Finnish spending per student on R&D is the fourth highest in the OECD. Other surveys include one from the *UK Times Higher Education Supplement*, a kind of "peer review" which ranks institutions according to subjective opinions of university researchers. Here, Helsinki University is ranked 49th amongst the European universities and 116th in the world compared with the 22nd and 73rd places in the Shangai Jiao Tong ranking.
11. There are 540 units in the Finnish universities that make decisions on entry (Häkkinen, 2004).
12. In other studies, it has been found that (among a sample of 19 countries) Finland has the highest intergenerational education mobility based on the ISCED job classification, i.e. Finnish fathers' educational backgrounds had the least importance for educational outcomes of their children (Foley, 2006).
13. For example, the University of Jyväskylä appears to be "over-sized" relative to the size of the region of Central Finland (Keski-Suomi). The province of Central Finland is a "5% region" in terms of its

- share of total population, share of land area and number of enterprises, while the University of Jyväskylä has an 8-9% share of the university system (OECD, 2006b).
14. The universities of Kuopio and Joensuu are forming the University of Eastern Finland, the Universities of Tampere and Jyväskylä and the Tampere University of Technology are forming the University of Central Finland and similar projects are in progress in Turku, Lappeenranta, Oulu, Vaasa, Rovaniemi and in the Swedish-speaking universities and polytechnics. At the same time the government has decided that the Helsinki University of Technology, the Helsinki School of Economics and the Helsinki University of Art and Design will be merged to form an innovation university.
  15. In vocational schools, an electronic system of application, to be implemented from 2008, will provide applicants with extensive information on available education and training opportunities, entry requirements, application instructions, information on the application and admission process and up-to-date information on applicants (admitted and rejected students). The goal is to make information provision and guidance and counselling more effective, to increase co-operation between different actors, to speed up entry into education and training, to reduce drop-out rates and to speed up graduation. However, there has been no mention of including information on the employment rates and wages of previous graduates.
  16. It should be noted that even though the United Kingdom has one of the highest tuition fees in the EU, fees only cover 20% of the cost of a study place.
  17. Other arguments presented by student unions against tuition fees include equity concerns (with regard to access and the possibility of finishing studies), later graduation because students will have to work to pay for tuition fees, weakened possibilities to change fields, ideological opposition to education determined by market forces, benefits to society from education, concerns that tuition fees would force students to choose a field based on earnings after graduation instead of their interests and abilities, and concerns that tuition fees would turn tertiary institutions into learning factories instead of academic communities (Murisoja and Männistö, 2007).

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## Chapter 7

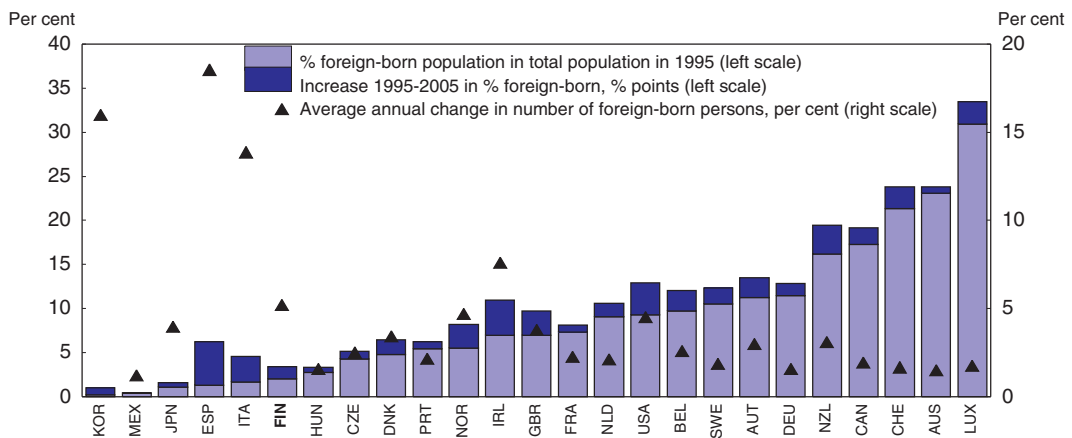
# Accessing and integrating foreign labour


*Accessing foreign workers is one way in which Finland can tackle the challenge of a rapidly declining labour force and address emerging skill shortages. While successive governments have proposed tapping into the international labour market, there has been little progress. The number of immigrants remains relatively low and the employment rate of the current stock of immigrants is significantly lower than that for the whole population. More should be done to promote language and vocational training for foreign-born residents, encourage diversity in the workplace and assist firms in attracting foreign workers with the right skills.*

As outlined in Chapter 5, Finland faces the dual issues of a rapidly ageing population and growing skill shortages in a number of sectors. One way to address these issues is to make a better attempt at accessing the supply of foreign workers. While there is some evidence that the number of foreign workers being engaged in Finland has been increasing recently, particularly in certain sectors like construction, numbers still remain relatively small. Moreover, there appears to be some reticence about fully engaging in the market for foreign labour, particularly in light of the integration problems some of Finland's neighbours have had, especially with asylum seekers. Nevertheless the issue of integrating foreign-born workers is not a new one and as such Finland has a late-mover advantage of being able to learn the lessons of other countries, including her Nordic neighbours, in the hope of not only avoiding their mistakes, but also learning from their successes.

Finland, along with Korea, Japan and Hungary, is one of a few OECD countries with a very low foreign-born population (Figure 7.1). In the case of Finland, only 3.4% of the population was foreign born in 2005. While there are geographical, cultural and historical reasons for this, Finland stands in contrast to her Nordic neighbours who have received large numbers of migrants both through refugee intakes and other channels.<sup>1</sup>

Figure 7.1. **Foreign-born population in OECD countries**  
1995-2005

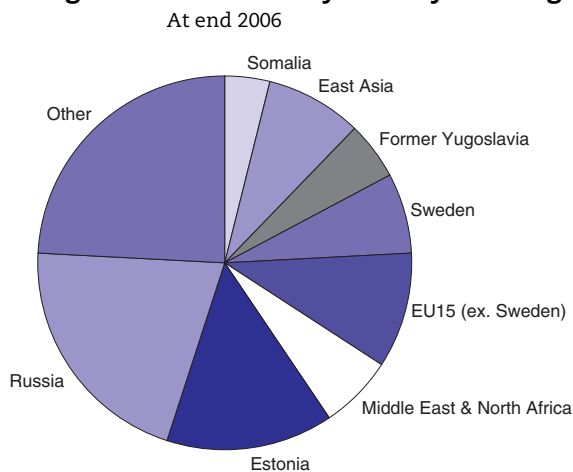


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Source: OECD (2007), *International Migration Outlook*, Chart I.11.

The composition of Finland's foreign-born population is rather diverse (Figure 7.2). The single biggest identifiable group is Russians of Finnish ancestry (Ingrians and Karelians). These migrants began arriving in earnest from Russia after the disintegration of the Soviet Union in the early 1990s, though in many cases their links to Finland were tenuous and there have been considerable integration problems for many Russian-Finns.<sup>2</sup> The second largest group is Estonians who share strong linguistic and cultural links with



Figure 7.2. **Foreign-born residents by country and origin**

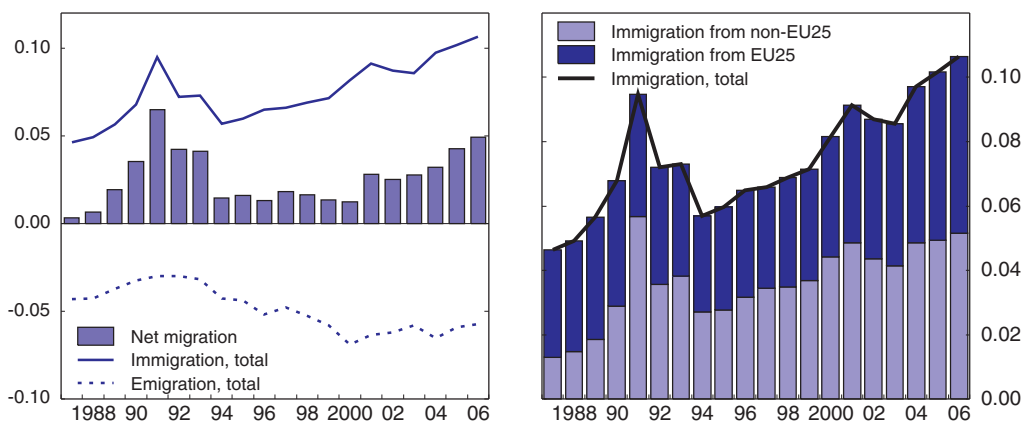
Source: Finnish Immigration Service, Population Registration Center.

Finland as well as geographical proximity. The flow of people between Estonia and Finland pre-dates even *Perestroika* in 1985 with two-way tourist traffic opening up around 1965; this facilitated close personal, family and commercial relationships between the two countries. Another large group is Western Europeans who typically reside in Finland for work or family/marriage reasons including a large number of Swedes reflecting the close geographical, historical and linguistic links between the two countries. Finally, refugees from the Horn of Africa, ex-Yugoslavia, Iran and Iraq make up a substantial proportion of foreign-born residents, and it is among this group that integration issues are most profound, including low engagement in the labour force.

There has been a notable acceleration in the intake of migrants since the late 1980s that was interrupted by the recession of the early 1990s but re-accelerated soon after. In 2007 inward migration totalled a record 25 000 people (Figure 7.3). Over the past few years the largest increase in foreign residents has continued to be from Estonia and Russia

Figure 7.3. **Net migration and sources of immigration**

Per cent of resident population



Source: Statistics Finland.

(OECD, 2007a) while the inflow of refugees has slowed considerably. Despite the recent acceleration in the intake of migrants, net migration as a proportion of the total population remains low. In 2007, Finland's net migration was a modest 2.4 persons per 1000 resident population compared with 17.1 for Iceland, 15.7 for Ireland, 5.6 for Sweden and 5.1 for Norway.<sup>3</sup> Moreover, only a very small proportion (between 5 to 10%) of inward migration is currently work-related (Prime Minister's Office, 2007) and the share of foreign-born workers in the workforce is only 3% (Työministeriö, 2007). Finally, in recent years immigrants have tended to have low levels of education with around 60% of all immigrants between 2000 and 2005 having little education beyond the basic level.

In May 2006 Finland removed restrictions on migration from the eight EU 2004 accession countries while no restrictions were imposed in the case of Bulgaria and Romania who joined in the beginning of 2007. Prior to this citizens of the new member states could get a job without a work permit only if the employment office determined that there was no one else available in Finland to fill a vacancy.

### Foreign-born workers in Finland

Employment and labour market participation amongst foreign-born residents is considerably lower than that of the native-born population, with the employment rate of migrant men in 2005 being 63% *versus* 71% for natives, while for women the figures are 49% *versus* 68%. The differences in unemployment rates are even starker; for example, for foreign-born men the unemployment rate was 23.1% *versus* 9.3% for native men (OECD, 2007a). While there is some evidence to suggest that there has been some recent improvement in the labour market position of foreign-born residents, a very large part of the difference appears to be due to differences in skills and experience. This is evidenced by the finding that low skilled Finnish men have an unemployment rate comparable to that of migrants from non-EU countries (Jean *et al.*, 2007).

As in most other European countries, Finland's foreign-born workers are concentrated in the "other service sector" (which excludes the health, retail and hospitality sectors but does include the domestic help sector). There is also a sizable proportion in the mining, manufacturing and energy sectors (OECD, 2007a). However, unlike Denmark, Norway and Sweden, there are relatively few foreign-born workers in the health care sector. In part this may be due to language issues but it may also reflect uncompetitive wages paid in this sector. Indeed, large numbers of native-born health care workers leave Finland for better paid employment in other countries including the Nordic countries and the United Kingdom.

Another notable feature of foreign-born workers is the prominence of temporary and part-time employment. Around a third of all foreign-born workers are engaged on a temporary basis, double the rate of native-born workers. Only Poland, Portugal and Spain have higher proportions and this is explained in part by the prevalence of foreign-born workers in the agriculture, construction and hospitality sectors in these countries (OECD, 2007a). In the case of Finland, large numbers of temporary foreign workers are engaged in seasonal berry picking. The story for part-time employment is similar with the gap between foreign-born and native-born in Finland being among the largest in the OECD. Furthermore, many of these workers remain in Finland for only short periods and therefore may not be reflected in the statistics, although it has been estimated that these workers make up an additional 15 000 migrants.<sup>4</sup>

## Meeting skill shortages

As documented in Chapter 5 Finland is confronting growing skill shortages in a number of sectors of the economy. Given labour market rigidities, the vacancies are not being filled by domestic labour despite a relatively large pool of unemployed workers. Firms faced with ongoing shortages may be forced to choose between seeking to attract labour to Finland or relocating production (either through offshoring or outsourcing) to where suitable labour resources are available. In the non-tradable sector, however, where shortages are most acute, such as in construction and in the social services sector, offshoring and outsourcing are not viable options.

Finland has not been alone in recent years in enjoying strong economic growth and facing the resultant skill shortages, and ageing will be a feature in many European countries in the coming years. Consequently many other countries are and will increasingly be competing to attract the same workers with the same skills from the same source countries as Finland. If Finland is serious about making full use of migrant labour, it needs to step up efforts to be competitive in this regard. Many countries already sponsor labour fairs in source countries and provide potential migrants with an array of services, including training and other forms of assistance prior to departure from their home countries. The Finnish government, employers and industry organisations have all been late to the game.

In October 2006 the government released a Migration Policy Programme. One of the principal aims is to promote work-related immigration in the face of the imminent decline in Finland's working-age population. The programme outlined broad-ranging plans including simplification of the permit system for guest workers, exploiting Finland's reputation for having a good education system to attract students who might be persuaded to stay on and work after graduation, and setting up employment agencies in source countries that offer help with paper work as well as initial pre-departure advice and training, including language training. The programme also outlined plans to improve recognition of overseas qualifications and degrees. Finally, it suggested that Finland should do more to promote itself as an attractive destination for foreign workers and listed a number of positive perceptions about the country that might be used in such campaigns, including the natural environment, personal safety, political stability, and the high quality of public services.

Currently a tax concession programme for highly skilled foreign specialists operates by which a substantial reduction in state income tax is available for a period of 24 months.<sup>5</sup> The duration of the concession is to be extended to 36 months sometime in 2008.

### **Barriers to attracting foreign workers**

While climate and language are commonly mentioned as barriers to attracting greater numbers of foreign workers, there are a number of other significant factors that constitute negatives in this regard, particularly because Finland is now in competition with other countries to draw skilled workers to its shores. One of the most significant negative factors from a skilled migrant's point of view is the relatively modest level of wages paid in Finland compared with other EU countries, particularly net after-tax wages. Moreover, due to the rigidity of the Finnish wage setting framework (Chapter 5), wages are not free to adjust in the face of supply and demand imbalances in particular sectors, thereby muting the

signalling effect of relative wage adjustments to foreign workers about opportunities in different sectors of the Finnish labour market.

The lack of recognition of foreign qualifications is a problem in many other countries, also posing problems for the participation of migrants in the workforce; it also represents wasted resources from the country's perspective as it is preferable that all the labour resources in the country are used to their best capacity. To this end Finland should continue its participation in international qualification recognition programmes (OECD, 2007b). Also related to qualifications, the preference of businesses in Finland for graduates with a minimum of a Master's degree is problematic (Chapter 6). A minimum requirement of a Masters-level degree may be a disincentive to migrants who have the option of seeking work in other countries where a Bachelor's degree is more than adequate to be employed in most professional-level occupations.

Currently workers from non-EU countries require a permit before entering the country which includes an "immigration work assessment" where the authorities determine whether there is Finnish labour available for the applicant's position. This processing can take over three months which in today's dynamic global economy is too long. The processing of work permits needs to be accelerated and the "immigration work assessment" requirements should either be streamlined or scrapped. Permits should be granted to workers with skills that match shortages. Additional requirements beyond that seem unnecessary. The Canadian and Danish green card systems are good models which entitle persons with certain pre-defined qualifications or experience to enter the country without a job offer.

Discrimination might also be a barrier to foreigners participating in the Finnish labour market. In 2007, the Finnish Institute of Occupational Health published the results of a survey that suggested that foreigners faced considerable discrimination in the labour market even if their language skills were akin to those of a native speaker. That said, a low skill level and high birth rate of the foreign-born population does predispose it to lower participation and higher unemployment. Nevertheless, considerably more could be done to assist the transition of migrants into the workforce including training (language and skills) and more general social support so that migrants can take full advantage of the work-related services available to all Finns, such as child care and occupational health services. The recently constituted government working group on labour market mismatches has made proposals to this effect in its first raft of recommendations released at the beginning of 2008. One element of the working group's recommendations focuses on programmes for the children of migrants. This is in line with a number of international studies that have shown that disadvantage and disconnection from the labour force often continues into the second generation. Research shows that programmes that emphasise intervention at an early age have been most successful; including focusing resources on integrating children from an early age and encouraging parents to have their children participate in pre-school and kindergarten. The US "Head Start" pre-school scheme is often cited as an example of a successful programme of this type (OECD, 2008).

Some labour unions in Finland have been insisting that migrant labour contracts should be subject to additional detailed work inspections. Generally speaking, this should not be necessary given the use of administrative extensions (under which the conditions of employment that are negotiated during wage rounds are applied to all workers in a particular industry, including foreign workers). Some supplementary services for foreign

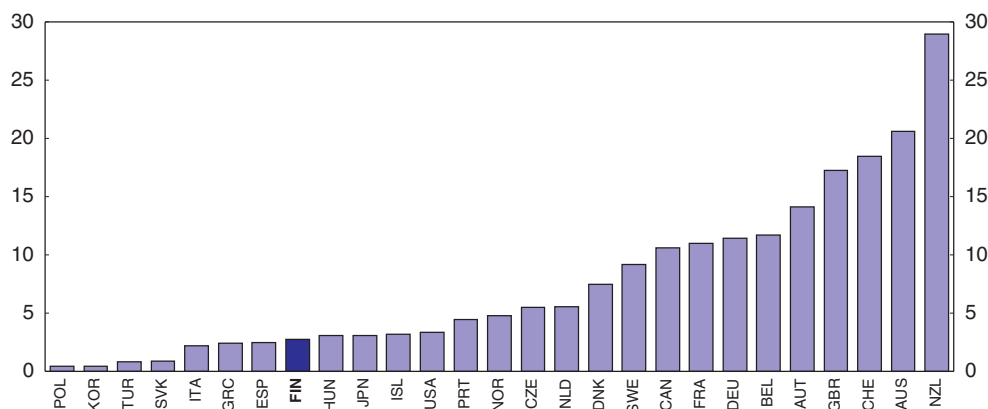
workers could be warranted given language and cultural issues, as well as unfamiliarity with employee rights and employer obligations that might make migrants more susceptible to mistreatment and exploitation. Nevertheless, care should be taken to ensure that any requirements beyond what native Finns are subject to are not costly and unfair, and do not further slow the process of engaging migrant labour or act as a further disincentive to employers engaging foreign labour.

### Attracting and keeping foreign-born students

One of Finland's competitive advantages is its strong education system which should be able to be leveraged to attract students who then might be persuaded to stay on and work in Finland after graduating. This has the advantage of keeping workers with Finnish qualifications and languages skills and who have already been exposed and acclimatised to Finnish society. However, current foreign student numbers are very low (Figure 7.4) with most coming from Russia and China (OECD, 2007a). In addition many are enrolled in English-language-only programmes and may not pick up much Finnish. Provisions already exist that allow foreign graduates to remain in Finland on a short-term residence permit after graduation that allows them to search for work. Permanent status can follow if employment is found. The duration of the short-term residence permit has recently increased from 6 to 10 months.

Figure 7.4. **Foreign students enrolled in tertiary education**

In per cent of all tertiary enrolment, 2005<sup>1</sup>



StatLink  <http://dx.doi.org/10.1787/338332283375>

1. 2004 data for Canada, France and the United States.

Source: OECD (2007), *Education at a Glance*, Table C3.1.

Recent plans to trial fees for foreign students are not likely to assist in attracting students to Finland unless the proceeds of the fees flow to the individual educational institutions themselves and this prompts greater international marketing and improved course quality. Nevertheless, the fiscal rationale for the proposal is understandable. Foreign students have recently been granted the right to engage in employment while studying, which will make studying in Finland more attractive, and is in line with the practice of the majority of native-born tertiary students.

Box 7.1 outlines a number of recommendations aimed at enhancing Finland's access to foreign skilled labour and making better use of the existing stock of foreign-born residents.

#### Box 7.1. Recommendations for accessing and integrating foreign labour

- Streamline the work permit system so that foreign workers with the right skills can be accessed efficiently. Consider adopting a green card scheme like that in Canada and Denmark and doing away with the requirement for an “immigration work assessment”.
- Identify the industry sectors most in need of foreign labour (most likely in a number of services industries where offshoring is not an option) and direct assistance to firms and potential immigrants in these industries.
- Provide greater assistance to Finnish firms competing to attract workers in the European labour market including more promotion of Finland as an attractive destination and co-sponsoring employment fairs in source countries.
- Do more to promote Finland as a destination for foreign students and encourage these students to stay after completing their studies. Extending the duration of the post-study job-search permit should help in this regard.
- In line with the recommendations of the Mismatch Working Group, do more to help the existing stock of immigrants better integrate into the labour market, including by providing substantial resources for basic skills and language training.
- More effort should be aimed at utilising migrant workers to their full capacities through qualification recognition schemes, thereby avoiding the over-qualification phenomena seen in many other OECD countries.

#### Notes

1. In Sweden 12.4%, Norway 8.2% and Denmark 6.5% of the population are foreign born.
2. In 2002 the Finnish government moved to restrict migration of Russians to those who speak Finnish. The existing special regime for the immigration of Ingrians is to be phased out.
3. 2006 figures for all countries except 2007 for Finland. Finland 2007 data from Statistics Finland; other data from OECD, Migration Statistics online database.
4. *Helsingin Sanomat*, 15 November 2007 quoting the Finnish Ministry of Labour.
5. In 2006, 364 persons received this tax break. The numbers have remained broadly flat since 2003 (Source: Finnish National Board of Taxes).

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## Glossary

<b>AETR</b>	Average effective tax rate
<b>ALMPs</b>	Active labour market programmes
<b>ASE</b>	Allowance for shareholder equity
<b>CAP</b>	Common Agricultural Policy
<b>DIT</b>	Dual income tax
<b>EITA</b>	Earned-income tax allowance
<b>EITC</b>	Earned-income tax credit
<b>EPL</b>	Employment protection legislation
<b>EU</b>	European Union
<b>EU-ETS</b>	European Union's Emissions Trading Scheme
<b>FDI</b>	Foreign direct investment
<b>FWCP</b>	Fraction-of-wage-cuts-prevented
<b>GDP</b>	Gross domestic product
<b>GHG</b>	Greenhouse gas
<b>ICT</b>	Information, communication and technology
<b>METR</b>	Marginal effective tax rate
<b>MNEs</b>	Multinational enterprises
<b>PPPs</b>	Public-private partnerships
<b>R&amp;D</b>	Research and development
<b>RRA</b>	Rate-of-return allowance
<b>RSCA</b>	Revealed Symmetric Comparative Advantage
<b>SMEs</b>	Small- and medium-sized enterprises
<b>SSC</b>	Social security contributions
<b>ULC</b>	Unit labour costs
<b>UPM</b>	United Paper Mills
<b>VAT</b>	Value added tax

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