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

The economic situation and policies of Finland were reviewed by the Committee on 9 February 2010. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 26 February 2010.

The Secretariat's draft report was prepared for the Committee by Henrik Braconier and Petar Vujanovic under the supervision of Piritta Sorsa. Research assistance was provided by Isabelle Duong.

The previous Survey of Finland *was issued in June 2008.*

BASIC STATISTICS OF FINLAND (2008)

THE LAND

Area (1 000 km^2)	309.9
Of which:	
Agricultural	22.6
Forests	262.6
Lakes	34.5

Major cities (thousand inhabitants):	
Helsinki	576.6
Espoo	241.6
Tampere	209.6
Vantaa	195.4

THE PEOPLE

Population (thousand)	5 326
Number of inhabitants per km^2 of land area	17.5
Net natural increase (thousand)	10.4
Net migration (thousand)	15.5

Labour force (thousand, 2009)	2 678
Employment (thousand, 2009)	2 474
Employment (% of total, 2009):	
Agriculture, forestry and fishing	4.9
Industry and construction	24.6
Services	70.6

PARLIAMENT AND THE GOVERNMENT

Composition of Parliament (number of seats):	
Centre Party	51
Social Democratic Party	45
National Coalition Party (conservatives)	50
Left Alliance	17
Green League	15
Swedish People's Party	9
Christian League	7
Other	6
Total	200

Government, number of ministers from:	
Centre Party	8
National Coalition Party	8
Green League	2
Swedish People's Party	2
Total	20

Last general election: 18 March 2007

PRODUCTION AND PUBLIC SECTOR

Gross domestic product (billion EUR)	184.7
GDP per head (EUR)	34 756
Gross fixed capital investment:	
% of GDP	20.7
Per head (EUR)	7 181

Public consumption (% of GDP)	22.3
General government (% of GDP):	
Current and capital expenditure	49.0
Current revenue	52.9

FOREIGN TRADE

Exports of goods and services (% of GDP)	47.0

Imports of goods and services (% of GDP)	43.1

Main exports (% of total):	
Metals, machinery and transport equipment	35.7
Electrical and optical equipment	23.5
Wood, pulp and paper	17.6
Other goods	23.2

Main imports (% of total):	
Intermediate goods	34.7
Consumer goods	24.2
Capital goods	23.4
Energy	17.7

THE CURRENCY

Monetary unit: Euro

Currency units per USD, average of daily figures:	
Year 2009	0.7198
January 2010	0.7001

Executive summary

The worldwide recession hit Finland harder than most other OECD countries. *Export volumes fell by almost a third from their mid-2008 peak, reflecting the dominance of income-sensitive capital goods and exceptional exposure to hard hit markets such as Russia. The well supervised and prudent financial sector has weathered the crisis well, although there was some inevitable slowing in credit growth. A significant fiscal stimulus and monetary loosening by the ECB have cushioned the downturn. Recovery has been slow, potentially dampened by deteriorating competitiveness due to an appreciating exchange rate, large industry-level bargained wage increases and slowing productivity growth. Centrally co-ordinated wage deals with more room for local flexibility could deliver more competitive wage outcomes, while in the longer term potential output would be boosted by reforms to higher education. Fiscal consolidation should start once the recovery takes hold.*

The crisis has worsened the fiscal outlook, calling for a clear consolidation strategy supported by a stronger fiscal framework. *The decline in potential output due to the crisis and the permanent nature of many of the stimulus measures have further undermined long-term fiscal sustainability that was already set to weaken by rapid ageing. The fiscal framework, including a central government expenditure ceiling and multiple targets, was severely tested in the recession and has been partially suspended. To restore sustainability Finland should show the same resolve as after the 1990s crisis. A fiscal consolidation plan should be announced as soon as possible and include measures to increase the duration of working lives, contain expenditures and raise taxes on consumption and property. The plan should be supported by improving the fiscal framework by linking it to sustainability and could be accompanied by an independent fiscal council to tighten monitoring. Fast-growing municipal expenditures need to be restrained and municipalities should be encouraged to rely more on property taxes and less on income taxes. The municipalities' declining productivity can be enhanced by more ambitious mergers and structural reforms among local governments.*

While employment has held up relatively well so far, rigidities in the labour market could complicate recovery and worsen the already low participation of older and younger workers. *Swift action is needed to avoid a large rise in long-term unemployment and inactivity, as occurred in the previous recession. Activation measures should kick in earlier during unemployment spells, sufficient resources for the Public Employment Service (PES) should be provided, and profiling of job seekers should be used more extensively. Furthermore, the generous unemployment benefit system needs to be trimmed by both tapering and reducing replacement rates. To increase employment among older workers, the 2005 pension reform needs to be complemented by further reforms to improve incentives to work longer, including abolishing the so-called "unemployment pipeline", making disability pensions subject to stricter medical criteria and raising the minimum retirement age to 65.*

Increasing inequalities challenge Finland's social model and may be aggravated by the crisis. *Although income inequality remains low by OECD standards, it has increased*

substantially in recent years in spite of decreasing unemployment until recently. The incomes of high earners have increased disproportionately since the early 1990s. Several factors have contributed to this development, among which some elements of the dual tax system. This tax regime should be reviewed. Rising inequality also has a regional component, with wealth and opportunities being increasingly concentrated in the Helsinki region along with economic activity. Measures to improve regional mobility would help to address the uneven performance of regional labour markets.

Assessment and recommendations

The recession hit Finland hard and recovery is likely to be slow

While Finland was insulated from the direct effects of the recent global financial crisis due to its prudently managed financial sector, the worldwide recession and collapse in trade hit the country harder than most other OECD countries. Real GDP declined by over 9% from the peak in mid-2008 to the second quarter of 2009, led by declining export volumes which fell by close to one third. This extraordinary collapse in trade can to a large extent be attributed to the composition of Finnish exports, with a high dependence on information and communication technology (ICT) and capital goods, and exceptional exposure to hard hit markets such as Russia. Compared to other OECD economies, exports have also been slow to recover. Fast rising unit labour costs due to high wage increases and an appreciating effective exchange rate have deteriorated competitiveness over the last few years, potentially denting Finland's export performance. The high wage increases boosted household income and sustained consumption through the downturn, but the negative effects on exports from lower competitiveness can weigh more heavily as the world economy rebounds. While underlying inflation in the past was lower than the euro area average, it has been higher since mid-2008 despite a wide output gap.

GDP has now stopped falling, and signs of a turnaround are emerging. A mild economic recovery is projected over the next two years on the back of low interest rates, a pickup in exports and ongoing fiscal stimulus. Growth in household consumption is likely to be muted as wage increases coming out of the current negotiations are likely to be moderate. Business investment is likely to remain restrained, reflecting uncertainty about the longer term outlook for exports. The recovery in housing investment may be more robust given significant underlying demand for housing, particularly in the Helsinki region.

A sustainable recovery calls for moderate wage settlements in line with economic conditions and greater flexibility at the local level

Relative wage flexibility in Finland has been low, partly reflecting a long-standing centralised wage bargaining system. In the 2007/08 round, wage negotiations were decentralised to the industry level to increase wage flexibility. The overall outcome was unsatisfactory however. While the resulting high wage outcomes were in part due to a booming economy, they may also reflect the inability of the less centralised industry-level wage framework to rein in excessive wage increases beyond those justified by economic conditions. Progress on increasing local wage flexibility has also been slow. If the ongoing

negotiations, under a broadly similar framework, are unable to achieve reasonable aggregate wage outcomes and improved local wage flexibility, particularly in light of the current dire economic situation, the negotiating framework may need to be reassessed. *Moving back to a centralised bargaining system with government income policies should not be considered. Instead more co-ordination among and between employers and unions may be needed.* Such co-ordination should, however, be limited to achieving reasonable overall wage outcomes and ensuring international competitiveness, and it should not in any way hinder progress towards greater local wage flexibility.

While co-ordination in wage negotiations is largely in the hands of employers and unions, the government should insist on other avenues being taken to increase wage flexibility. These can include reforms aimed at lowering the currently high replacement rates for the unemployed and generous early retirement schemes (see below). Given that union members only pay a fraction of the total costs of the unemployment insurance, incentives to curtail wage increases that create excessive unemployment are low. *The government and the social partners should therefore consider implementing mechanisms that strengthen these incentives, for example, through experience ratings.*

Together with the compressed wage structure, the lack of flexibility may weigh especially on the labour market outlook for younger and older workers. *Allowing for more wage dispersion by lowering negotiated minimum wages for marginal groups could improve the bleak labour market prospects for young unskilled workers. Partial loosening of employment protection (EPL) beyond the minimum retirement age can help raise labour demand for older workers.*

The fiscal stimulus has been timely and adequate, but its mainly permanent nature has weakened long-term sustainability

Finland came into the recession with a significant budget surplus, a strong net asset position and a pension system that seemed geared to deal with ageing. Due to strong automatic stabilisers and stimulus, the fiscal position has deteriorated more rapidly than in any other OECD country, and the surplus of 5.2% of GDP in 2007 is projected to swing to a similarly large deficit in 2011. The fiscal stimulus was introduced in several steps as the recession worsened amounting to 1.8% of GDP in 2009 and a further 1.5% of GDP in 2010. The thrust of the stimulus has been on tax cuts, primarily focused on lower income brackets, but social security contributions have also been reduced. Additional resources have been channelled towards unemployment support and municipalities. The fiscal stimulus, together with sharply lower interest rates, has cushioned the downturn.

Although the overall size of the fiscal stimulus implemented in Finland during the crisis is similar to the OECD average, it is distinguished by its mainly permanent nature. A significant part of the stimulus consists of permanent tax cuts announced in the 2007 government programme, which were timed on cyclical grounds and implemented in 2009. Only one third of the stimulus was of a one-off nature or for a limited period. The government has so far only announced some consolidation measures and the exit strategy is still to be formulated. The open-ended fiscal stimulus contributes to pre-existing, significant long-term fiscal challenges. Even before the recession, unfavourable demographics implied an unsustainable fiscal position in the long run. The subsequent losses to potential output and the fiscal stimulus have contributed to a further

deterioration. The so-called sustainability gap, which shows the permanent fiscal consolidation needed to cover future fiscal obligations, is estimated to have risen to almost 8% of GDP.

A consolidation plan supported by revised fiscal rules should be announced soon and implemented once the recovery is established

To restore sustainability Finland will need to show the same fiscal resolve as it did following the 1990s crisis. *While it would be premature to start fiscal consolidation now, the government should urgently develop, communicate and be ready to implement a sustainability plan. Such a plan should mainly rely on significant increases in the length of working lives and lower government expenditures, but higher taxes are also likely to be needed.* Due to compounding, the hurdle will increase significantly for every year without consolidation and will add to the burdens of future generations. *Consolidation should start once the recovery firms.*

Finland's fiscal framework has been useful but it should be reviewed and strengthened to support consolidation. The recession led to the breach of both of the fiscal surplus targets, but the expenditure ceiling remains intact and central government spending has remained within these limits. As in most other countries in the European Union, the deficit is projected to exceed the 3% of GDP limit stipulated by the Stability and Growth Pact. *To support consolidation and sustainability the government should consider setting rolling multi-year targets for the structural balance that are explicitly calibrated to achieve sustainable public finances in the long run. Given the size of the unfunded longer term fiscal obligations, the government should aim to close the sustainability gap over the next two four-year electoral mandate periods.*

Fiscal sustainability issues are by their nature complex and entail important trade-offs. *Finland could, therefore, consider establishing an independent fiscal council, to provide more information to the public and policy makers, and to evaluate whether fiscal policy is in line with the government's targets.* This would encourage a wider discussion on and evaluation of fiscal policy and its sustainability. It would also provide support and justification for fiscal consolidation.

Closing the gap may need tax increases, which should focus on broadening tax bases and raising property taxes

The 2007 Government Programme aimed at lowering taxation, especially on labour. As a result, sizeable tax cuts were implemented during the recession. While the goal of lowering the tax burden on labour to encourage further labour supply is laudable, the potential supply side effects of the tax cuts are being undermined by accompanying reductions in taxes on income transfers and tax hikes in the municipal sector. Thus incentives to work may not have been increased substantially by these reforms.

The size of the sustainability gap means that tax increases probably will be needed to rectify the fiscal position. *On a general level, the government should endeavour to broaden tax bases and raise beneficial taxes, while holding off from raising them on corporations or labour.* The recent cut of the value-added tax (VAT) on foodstuffs, which will be broadened to include restaurants, is a step in the wrong direction as it lowers efficiency in the VAT system. *The*

announced increase in the overall VAT rate for 2010 should eventually be accompanied by a full harmonisation of the VAT at this higher level. This needs to be accompanied by targeted compensation for low income earners.

There is room for further increases in property taxes, which in Finland are well below the OECD average. Property taxes tend to be less harmful for growth than other taxes, and have benign distributional effects. Property taxation in Finland is to a large extent decided by the municipalities. The government should encourage a shift towards more reliance on property taxes and less on income taxes in municipalities. The current process to harmonise the assessment of property values to market levels is welcome. *Further increases in the lower bound and an abolition of the upper bound for property taxes are necessary. Taxation of agricultural and forest land should be considered. Such tax increases should be implemented gradually and may need to be accompanied by changes in the transfer system to municipalities.*

Consolidation would be assisted by fine-tuning environmental initiatives including energy taxation and subsidies

Finland is taking seriously its commitments to climate change abatement. In 2009 the government adopted a report on long-term climate and energy policy that extended its climate and energy strategy from the 2020 EU targets to 2050. As part of this effort, the government announced new environmental taxes for 2010. However, further progress is required in a number of areas, as Finland is one of the few countries in Europe that has not decreased its greenhouse gas emission intensity of energy consumption since 2000. While the government´s commitment to the 80% emission reduction target of the 2050 report is welcome, Finland continues to subsidise peat in energy generation on regional development grounds, despite the very high cost in terms of emissions. *The government should formally commit to the targets of the 2050 report, and abolish preferential treatment of peat. An environmental levy on peat should be considered.* Other weaknesses in Finland's energy taxation are the tax refund system for certain energy-intensive industries, including for the agriculture sector. If the objective of these subsidies is to maintain regional employment, this would be better addressed via direct employment subsidies.

Consolidation should focus on containing expenditure growth, especially in municipalities

General government spending has been growing fast, mainly due to fast-growing municipal spending fuelled by buoyant revenues. *The government needs to constrain municipal expenditure growth by limiting the rise in state transfers to local governments and by removing the incentives to increase municipal income taxes,* e.g. *through partially offsetting tax increases with lower state transfers. Ways to decrease the municipalities' dependency on highly-cyclical corporate tax revenues should also be explored.*

The central government expenditure ceiling has been observed and should be strengthened further. The exclusion of cyclical outlays from the ceiling is useful as it ensures that automatic stabilisers can work fully. As there will be little room for raising the ceiling in the coming years, and margins under the ceiling are already thin, the government should boost surveillance to ensure that expenditure programmes do not slip outside the ceiling either through reclassification as cyclical outlays, shifting to local

governments, or as tax expenditure. The government's recent decision on improving methods of measuring and reporting tax expenditures is thus welcome.

Municipal mergers should be stepped up to reverse the decline in efficiency in service provision

Productivity in local government-provided services fell by more than 10% between 2000 and 2008 on the back of strongly growing municipal expenditures. The decentralised fiscal structure and the soft budget constraints faced by local governments have contributed to this development. The increasing inefficiencies should be addressed. *While stagnating or shrinking revenues will spur efforts to achieve productivity gains, structural reforms are also necessary.*

Programmes to increase efficiency in local governments include incentives for mergers, for investment in information technology and the establishment of minimum population-base requirements for school and healthcare districts. During the last few years, there have been considerable efforts in terms of mergers, with the number of municipalities shrinking from 431 in 2008 to 348 in 2009. Still, their average population is 13 000, with the median below 5 000. Moreover, the mergers have not yet produced substantial productivity gains, which can partly be explained by the fact that participating municipalities typically agree not to adjust the workforce for an extended period following a merger. Many small municipalities are struggling fiscally with high dependency on state transfers. As the general population ages, and the working-age population migrates towards large centres, many small municipalities will become even less fiscally sustainable. *A more ambitious programme of municipal reforms should be pursued*. While the recent municipal mergers in Denmark may serve as a model, geographical and other factors particular to Finland need also to be considered.

To improve efficiency in municipal service provision, the strategy for mergers needs to be accompanied by rationalisation in local governance to reap plant-level economies of scale in health care, education and childcare. *While relying on competition to improve efficiency in service provision in small municipalities may be difficult due to the thinness of the market, there is clearly more scope for competition in larger municipalities. Finding cost-efficient and yet equitable ways of providing municipal services will be a challenge, and the government needs to continue to support research on and knowledge-dissemination of best practices among them.*

Swift action is needed to minimise the potential for long-term labour market damage from the crisis and to boost labour supply

Activation policies need to be improved to avoid a jobless recovery. Inevitably the downturn has propagated into the labour market, where employment is falling and unemployment climbing. However, as in many other OECD countries, the labour market response so far has been less severe than patterns from previous recessions would suggest. To some extent this reflects the success of the layoffs scheme in Finland, which now encompasses roughly 3% of the labour force. However, given the slow recovery ahead, these layoffs are likely to eventually spill over into unemployment and inactivity.

The government should act quickly to hinder a repetition of the recession in the early 1990s which led to a substantial increase in long-term unemployment and inactivity for an entire generation. While the government cannot fully replace the fall in labour demand, especially as the shock to a large extent is affecting the export sector, policies can mitigate the shock. The extra funds put forward to maintain the quality of labour market policies are useful in this context. *However, the government should ensure that sufficient resources are made available to the Public Employment Service (PES) to make sure that it is adequately staffed and that the existing profiling system is used to free personnel for activation measures. In the longer run, the PES needs to become more efficient, which would require a higher degree of coordination at the central level.*

Finland spends less on activation measures, and the unemployed are typically referred to active labour market policies later than in other Nordic countries. The late activation contributes to inactivity. While recent reforms to bring forward activation for youth and removing upper age limits are steps in the right direction, more is required. *To maintain the employability of individuals, mandatory activation of the unemployed should take place at 50 weeks or earlier rather than 100 weeks, and refusal should always lead to sanctions. Individuals who face a high risk of long-term unemployment should be activated earlier.*

Fiscal sustainability and labour supply should also be boosted by restricting incentives to early exit and lowering replacement rates

Finland has one of the most generous benefit systems for long-term unemployed in the OECD, especially for low income groups. The combination of generous benefit systems and late activation raises particular concerns and is likely to contribute to high rates of joblessness, inactivity and dependency on transfer systems. *As the generous benefits will be particularly problematic when labour demand starts to pick up, the government should signal now that unemployment benefits will be lowered as the recovery takes hold. Further tapering of unemployment benefits should also be implemented.* The government needs to ensure that current reforms to the housing benefit efficiently address the existing inactivity trap and provide support better targeted to the poor. *Aligning the Basic Income Support (BIS) with the Labour Market Support (LMS) would increase incentives to work.* To enhance accountability, the institutional framework should also be reconsidered. *Municipalities should bear full responsibility for both the BIS and the LMS.*

Earnings-related unemployment benefits are provided by funds associated with unions, but mainly paid for by employers and the central government. The separation of financing and benefit provision may lead to a too lenient treatment of members in relation to existing rules and higher administrative costs. *The government should therefore consider replacing the current system of unemployment funds with a government-administered and -financed system with appropriate experience rating mechanisms.*

Entry into various early retirement schemes should be restricted to minimise the long-term consequences of the recession for labour supply and fiscal sustainability. The past practice of alleviating temporary labour market imbalances by providing ample and generous exit opportunities for older workers has proved to be costly over time. Despite recent improvement, participation rates of older workers in Finland are relatively low in the Nordic context. With unemployment mounting, the pressures on the disability pension

system, the "unemployment pipeline" and early exit into regular retirement are increasing. *The success so far with partial reforms of the unemployment pipeline should be followed up with its full scale abolition. Entry into the disability pension should only be allowed on medical grounds under tighter assessment procedures. The focus on rehabilitation has so far yielded little in terms of outflow from disability, and sheltered employment may be a better way forward. Lower replacement rates in the disability pension should be considered to reduce incentives for early exit from the labour market.*

Further pension reform is needed to deal with escalating costs of ageing and the relatively low effective retirement age

To accommodate the challenges from ageing, Finland should take a multi-faceted approach. Over the next two decades, old-age dependency will increase faster in Finland than in almost any other OECD country. Pre-funding should be enhanced so that the accumulation of net assets, before dependency ratios become too high, mitigates the pressure to raise taxes later. To deal with increasing longevity, working lives need to be extended. In the Finnish pension system introduced in 2005, benefits will be adjusted downwards in line with improving longevity. Although this adjustment clearly reinforces the robustness of the system, further reforms are needed to ensure that sustainable public finances can be achieved without crippling tax increases.

The setup of the disability pension and the unemployment pipeline create strong incentives to leave the labour force before the minimum retirement age in the old-age system. Once an individual has entered any of these streams, the incentives to remain there until taking up the old-age pension are strong. On top of this, individuals face strong incentives to take up the earnings-related pension at the earliest possible age (63). This has led to low employment rates among the 65-69 age group compared to other OECD countries, and especially other Nordic countries, as few workers remain employed after 63. While the average retirement age has increased since the introduction of the new pension system and on the back of a strong labour market, the recession is likely to undo some of these recent gains.

Reforms to the pension system are required to increase sustainability and lift old-age employment rates towards the levels of the other Nordic countries. *Firstly, the government should consider raising the minimum retirement age from 63 to 65. The maximum retirement age could also be abolished, although adjustments in employment protection may be needed to ensure that demand for older workers is not affected adversely. Furthermore, incentives to stay employed beyond the minimum retirement age need to be improved. The increased accrual rate after 53 is costly and should be abolished, although the interaction with disability pensions and the unemployment pipeline should be carefully examined to minimise spillovers. The government should also consider lowering accrual rates during unemployment, parental leave and study.* These reforms would lower fiscal costs and increase labour supply among older age groups significantly.

Tertiary education reforms could boost potential growth

While the recent slowdown in productivity is largely cyclical, potential growth could be boosted in the longer term by reforms to tertiary education. Despite one of the highest densities of researchers and spending on research and development in the OECD, and an excellent performance in the pre-tertiary education sector, more could be done to improve the performance in the tertiary level and boosting innovation. Average tertiary study times are long and students benefit from grants and allowances that are both generous and virtually open-ended. Furthermore, the interface between the secondary and tertiary levels is inefficient. Many high school graduates are forced to wait extended periods before obtaining a place at a university due to entry exams, in addition to a standardised exit test at the secondary level. *Long study times and the lack of labour market signals in the choice of subjects to study could be addressed with the introduction of tuition fees accompanied by a government loan scheme with repayment contingent upon post-graduation income. A more uniform entrance test or greater reliance on the secondary level exit exam could also shorten waiting times to enter university.*

Inequality has increased over the past two decades

Along with GDP, income distribution is an important indicator of well-being. While inequality of disposable income in Finland remains among the lowest in the OECD, it has increased in recent years despite a substantial decline in unemployment rates since the 1990s recession. Like in most other OECD countries this reflects technical change, rising globalisation and shifting demographics. In Finland strong realised capital gains and income shifting promoted by the dual tax system have also been important factors. *Loopholes in the dual tax system therefore need to be addressed.*

Despite growing inequalities, Finland's tax and transfer system remains effective in maintaining material living standards both across the social spectrum, and across the country. Measured by the regional distribution of factor income and employment however, inequality has risen more steeply lately, as a result of greater concentration of economic activity in the south of the country. These developments pose serious challenges for both the central government and the hundreds of municipal governments due to the recession and the need for fiscal consolidation. Efforts to promote regional development seem to have had limited success to date, and any expansion of existing programmes is likely to further strain public finances. While there is little scope to increase the already generous welfare system, the targeting of existing measures could be improved. *A more even distribution of labour market opportunities could be achieved by further promoting the interregional mobility of unemployed workers.*

Chapter 1

Overcoming the crisis and beyond

Finland was among the most affected OECD countries during the crisis as demand for its mainly capital-goods intensive exports collapsed. The financial sector weathered the shock well, but credit contracted, reflecting both demand and supply factors. Employment has been aided by the scheme of subsidies for temporary layoffs, as well as labour hoarding. Despite supportive fiscal and monetary policies, recovery has been slow. This is likely to reflect a muted pick-up in world capital goods trade, structural rigidities in the labour market, potentially weakened competitiveness due to the strength of the euro and large wage increases prior to the downturn, and a slowdown in productivity growth. While the largely appropriate fiscal stimulus and active labour market policies are likely to have mitigated the impact of the crisis on demand, the post-crisis fiscal outlook has substantially worsened due to a largely permanent fiscal stimulus and lower potential output. Consolidation plans should be announced as soon as possible, to be implemented as the recovery takes hold. More attention to structural reforms to increase labour market flexibility and boost competitiveness and productivity would help to restore stronger growth and raise living standards over the longer term.

In the period up to the crisis, Finland enjoyed an impressive economic expansion following a deep recession in the early 1990s, aided by booming world trade, a sharp initial currency depreciation and sound economic management. Macroeconomic stability was boosted by fiscal consolidation and pension reforms that led to structural fiscal surpluses and low public debt, stronger financial supervision that solidified the banking sector, and moderate centrally co-ordinated wage increases. Together with significant success in lowering product market regulation and loosening employment protection, structural reforms in secondary education and investment in research and development (R&D), this boosted productivity and accommodated structural change. The traditional industries, such as forestry and paper, gave way to dynamic new export industries, particularly in the information and communication technology (ICT) sector, which leveraged an increasingly educated and outward looking workforce and exploited rising opportunities in world markets. Unemployment declined steadily and Finland's income per capita converged towards its Nordic neighbours. Inflation remained low relative to other EU and Nordic countries. Finland also topped many international comparisons of education outcomes, competitiveness, quality of life, institutions and the environment.

Nevertheless, the global recession hit Finland harder than most OECD countries. Led by declining exports, output dropped by almost 9% over the year to the second quarter of 2009, the largest decline among OECD countries over this period. Unemployment is set to return to double digits. In contrast to some other developed economies, there were few signs of overheating prior to the recession and the financial sector was in good shape. However, high exposure to the international trade cycle, particularly the ICT and capital goods sectors, and to severely affected markets such as Russia, explains much of the contraction in activity.[1] The strengthening of the euro in the period leading up to the downturn was also an important factor, particularly given the large share of Finland's trade outside of the euro area.

The recession also revealed some underlying structural weaknesses that may prolong the downturn and mute the recovery. Progress in further reforming the still rigid labour and product markets and the generous social security systems had slowed, setting back productivity growth. Potential output may fall further if inflexibilities in the labour markets lower participation rates and tighter credit conditions weigh on investment. A slowdown in productivity growth and large wage increases just prior to the downturn may have adversely affected competitiveness. While there have been recent reforms in the tertiary education sector, a number of issues remain to be tackled which would further promote innovation and productivity. The strong pre-recession economy also hid fiscal slippages, as buoyant revenue growth masked the impact of rising expenditures in municipalities which are not constrained by the expenditure ceiling. Together with the burden of rapid ageing and the fiscal response to the crisis, this raises concerns about fiscal sustainability going forward.

Against this background, returning to sustainable growth puts Finland's policy framework to a new test. This *Survey* deals with the related policy challenges. After reviewing recent macroeconomic developments, the rest of Chapter 1 analyses the authorities' response to the downturn and macroeconomic policy requirements for ensuring a sustainable recovery and providing a credible exit strategy. Chapter 2 looks at structural fiscal challenges highlighted by the crisis and the scale of fiscal consolidation which will be needed to achieve fiscal sustainability. Fiscal consolidation needs to address both revenues and expenditures, broaden tax bases, restrain expenditure growth in municipalities and pursue further pension reforms. Consolidation should be supported by reforms to the fiscal framework. Chapter 3 looks at policies to stem the outflow from the labour market into inactivity. Hindering premature exit from the labour market, maintaining work capacity, getting people back to work, and boosting competitiveness are needed to sustain activity. More proactive labour market policies, making work pay, further reforming the pension system and rationalising wage setting frameworks are of particular importance. Wide-ranging labour market reform can have significant impact on income distribution and labour market outcomes as well. As discussed in Chapter 4, this calls for a better grasp of growing inequalities to facilitate social harmony and acceptability of change. While tax and welfare policies are key to understanding changes in equality, regional disparities in labour market outcomes, demographic change and the viability of a large share of Finland's municipalities need also to be addressed.

A severe downturn led by trade

Finland was primarily hit through the trade channel during the recent world economic downturn. The 9% peak-to-trough fall in output and the close to 30% drop in trade volumes over the year to mid-2009 are among the largest in the OECD (Table 1.1; Figures 1.1 and 1.2). Apart from a high degree of openness, this reflects both the destination and structure of Finnish exports; about two-fifths of exports are from ICT industries with high income elasticities (Box 1.1) and one-tenth were destined to Russia, which has suffered disproportionately through this recession. In contrast, private consumption has held up well, buoyed by strong disposable income growth on the back of large negotiated wage increases and tax cuts, declining inflation, the lagged impact of the crisis on employment, and social transfers (see Annex 1.A1). While household debt-to-income ratios climbed considerably before the recession (Bank of Finland, 2009a), rapidly falling interest rates boosted purchasing power by lowering debt servicing costs. This has also enabled an increase in household savings from the negative ratios which prevailed prior to the recession. While holding up initially, the large decline in external demand and the consequent falls in industrial production led to a collapse in business investment. Inventory adjustments were another drag on growth, accounting for about a third of the decline in output over the year to the second quarter 2009. Conversely, public investment has continued to contribute positively to activity through the downturn, aided by government stimulus programmes.

Unemployment has increased less than expected

As in a number of other OECD countries, unemployment in Finland has increased, but by less than expected given the drop in output. Employment has been aided by subsidised temporary layoffs which by the end of 2009 equated to approximately 3% of the labour force (Figure 1.3) and this has helped to hold the unemployment rate below 9%. Firms are

Table 1.1. **Economic projections**

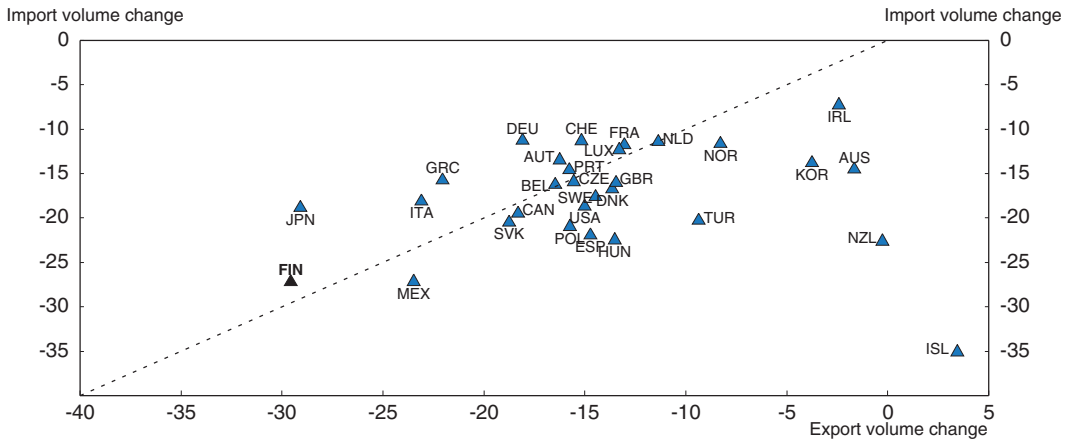
	2006	2007	2008	2009	2010	2011
	Current prices EUR billion			Projections		
		Percentage changes, volume (2000 prices)				
Private consumption	85.9	3.3	1.5	–2.8	0.2	1.9
Government consumption	36.6	0.6	1.7	1.3	0.2	0.7
Gross fixed capital formation	32.3	8.6	0.4	–11.8	–4.4	4.9
Final domestic demand	154.8	3.8	1.3	–3.8	–0.7	2.1
Stockbuilding[1, 2]	4.2	0.3	–0.6	–1.6	0.5	0.1
Total domestic demand	159.0	4.0	0.6	–5.5	–0.1	2.2
Exports of goods and services	75.4	8.1	7.5	–26.5	3.7	6.5
Imports of goods and services	67.2	6.5	6.9	–25.2	0.3	6.4
Net exports[1]	8.3	1.4	1.0	–3.4	1.5	0.7
GDP at market prices	167.2	4.1	0.8	–6.9	0.4	2.4
Memorandum items	. .					
Output gap[3]	. .	2.7	0.2	–8.8	–9.1	–7.6
Harmonised index of consumer prices	. .	1.6	3.9	1.7	1.5	1.4
Unemployment rate	. .	6.9	6.4	8.3	9.7	9.7
General government financial balance[4]	. .	5.2	4.4	–2.3	–4.8	–5.2
Cyclically-adjusted financial balance[3]	. .	4.2	4.1	1.2	–0.5	–1.5
Current account balance[4]	. .	3.7	2.8	0.8	0.9	0.9

1. Contributions to changes in real GDP (percentage of real GDP in previous years), actual amount in the first column.
2. Including statistical discrepancy.
3. Per cent of potential GDP.
4. Per cent of GDP.

Source: OECD, *OECD Economic Outlook 86 Database*.

Figure 1.1. **Trade change during the downturn**

Percentage change between 2008 Q2 and 2009 Q2



Source: OECD, *OECD Economic Outlook Database*.

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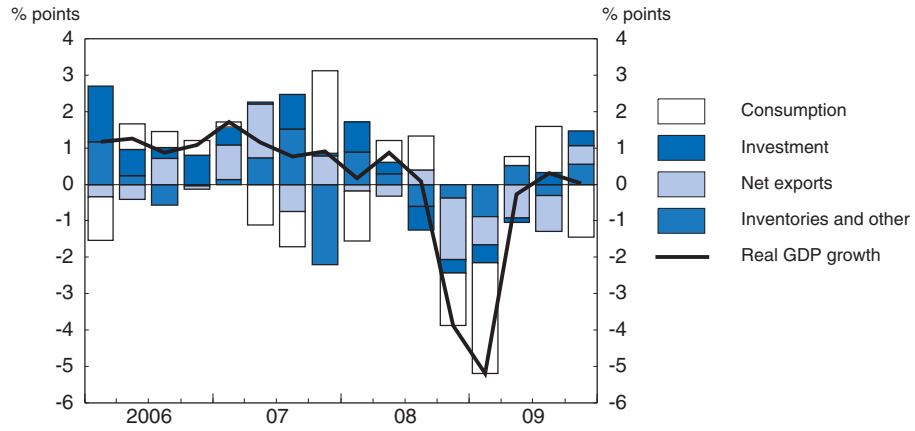
also likely to have hoarded labour given the high fixed costs of firing and hiring in Finland and concerns of future skill shortages as were seen in many industries prior to the downturn. The industrial composition of exports may also have contributed to the muted labour market response to date, as the less labour-intensive export sectors have driven the downturn. In addition, the participation rate began to decline considerably after the first few quarters of the recession (see Box 1.3).

Figure 1.2. **Contributions to real GDP growth**

Change relative to the previous quarter



Source: OECD, *OECD Economic Outlook Database*.

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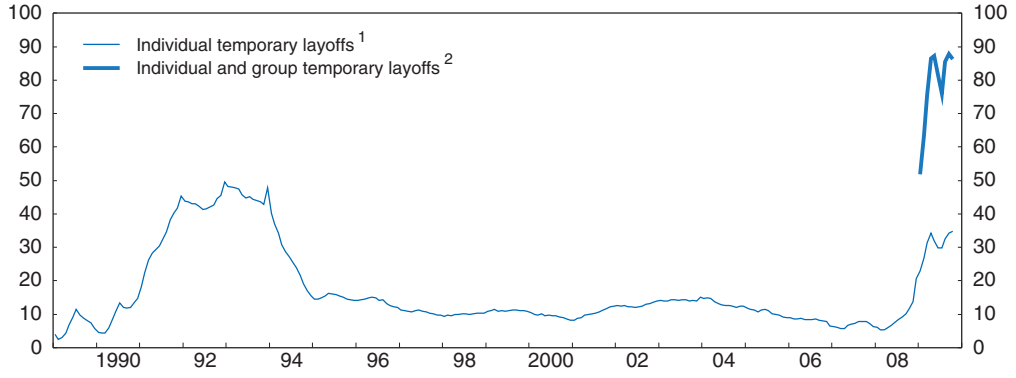
Figure 1.3. **Temporary layoffs**

Thousand persons



1. Temporary layoffs seasonally adjusted.
2. Temporary layoffs adjusted for double counting by Ministry of Employment and the Economy and seasonally adjusted.

Source: Ministry of Employment and the Economy and OECD calculations.

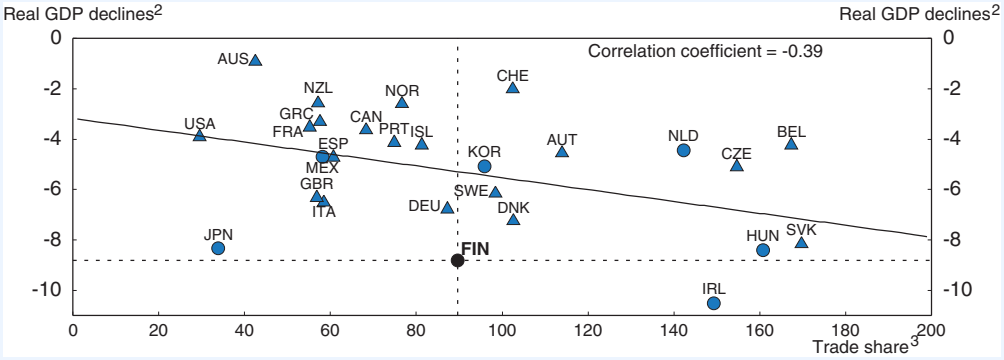
StatLink http://dx.doi.org/10.1787/827207620747

Box 1.1. **The external sector and the downturn**

The collapse of trade in most OECD countries over the past year led to large declines in GDP (Figure 1.4). More open economies have suffered the most, with especially large declines in countries with large shares of volatile ICT exports.[1] The share of machinery and transport equipment (which includes ICT goods) has increased substantially in Finnish exports over the last 15 years (Table 1.2). Together with the high income elasticity of these exports, this explains part of the large drop in trade (Table 1.2), particularly in comparison with past episodes when the composition of exports was considerably different. While a number of other countries with a similar composition of exports have not suffered quite such large export declines, many of them have been aided by competitiveness-enhancing currency depreciations.

Box 1.1. **The external sector and the downturn** *(cont.)*

Figure 1.4. **Trade openness and GDP declines during the current downturn**[1]



1. Countries with circular markers have 2006 ICT export shares equal or greater than Finland. The United Kingdom is excluded due to missing trader inter-community (MTIC) fraud.
2. Real GDP fall from peak to trough (or latest available quarter) in the current downturn.
3. Total trade (exports plus imports) in per cent of GDP, averaged over the 4 quarters prior to peak GDP.

Source: OECD, *International Trade* and *OECD Economic Outlook Databases*.

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Table 1.2. **Demand elasticities for Finland's goods exports with respect to destination country GDP**

Good type	Income elasticity estimate 2008	p-value	% share of total goods exports 1995	% share of total goods exports 2008
All goods	1.7	0.05**	100.0	100.0
Machinery, transport equipment	2.1	0.07*	28.9	43.8
Basic manufactures	1.7	0.14	42.9	27.9
Chemicals and related products	2.7	0.01**	6.3	8.2
Miscellaneous manufactured articles	2.6	0.04**	6.9	5.1

* significant at the 10% level; ** significant at the 5% level.

Note: The income elasticity is estimated for each of the different categories of Finland's goods export values with respect to the change in GDP through the recession in all OECD countries, OECD accession countries and the BRICs (37 countries in total).

Source: *OECD Economic Outlook Database*, Customs Finland and OECD calculations.

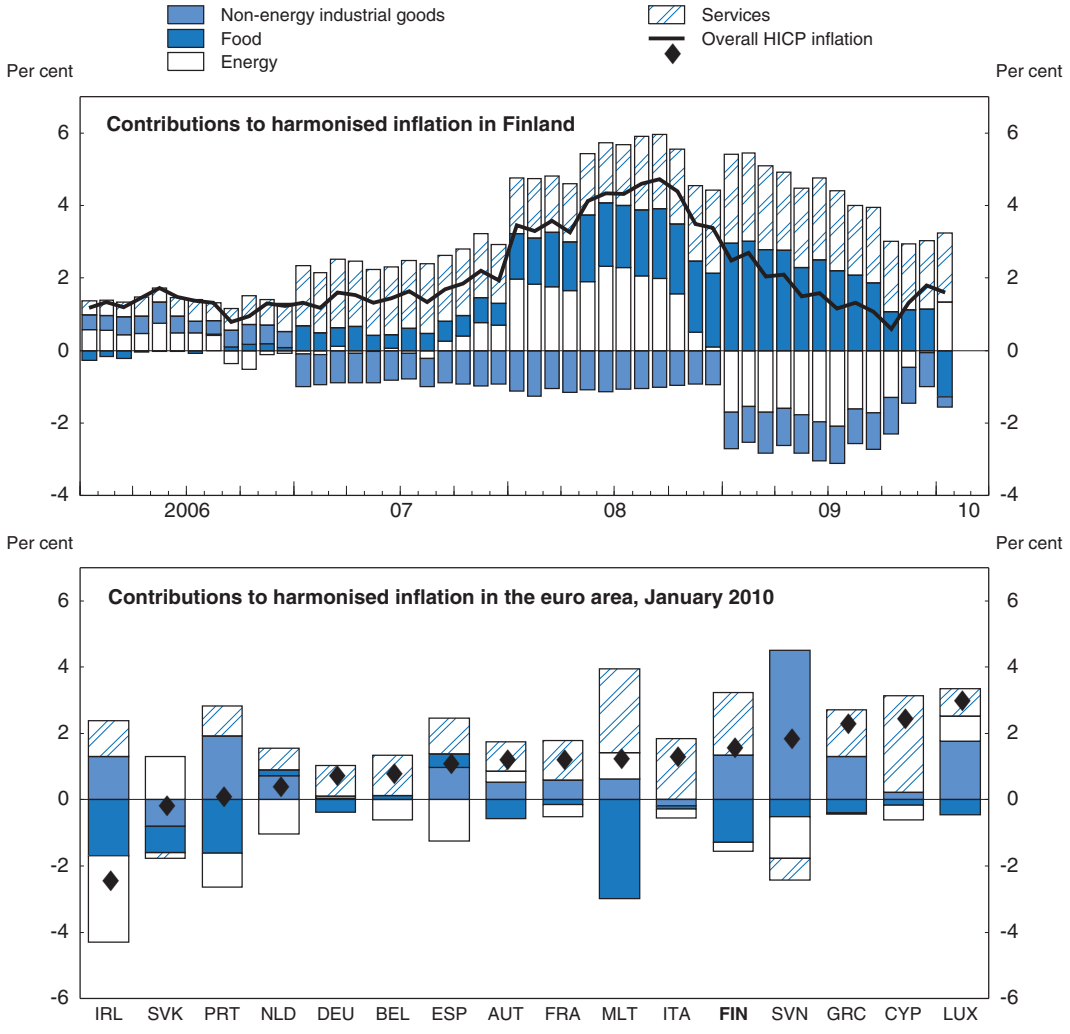
At the same time, Finnish service exports seem to have held up better. Service exports tripled in volume between 2003 and 2008 and were around one fourth of all exports by 2008. Finland is second after Ireland in the OECD in increasing its service exports since 2000. Computer and information services, other business services, and other unclassified business services[2] account for the majority of this growth. While the data on Finland's service exports is sparse, it does appear that they have weathered the downturn better than goods exports. A significant proportion of this trade is intra-group business services, which is likely to hold up comparatively well through a downturn. Also the destination of Finnish services exports is considerably less concentrated than goods exports.

1. ICT goods comprised around 20% of total Finnish goods exports in 2006 (OECD, 2008a).
2. Other unclassified business services include unclassified business services including commission trade, operational leasing and services within an enterprise group not classified elsewhere.

Wages have driven inflation pressures

While inflation in Finland was among the lowest in the euro area for much of the past decade, since mid-2008 it has moved to be well above the euro area average (Figure 1.6, first panel).[2] As in most of these countries, inflation peaked towards end-2008 driven by higher world energy and food prices, and has started to moderate in recent quarters. However, inflation in Finland has not fallen to the same degree as most other euro area countries and is now among the highest in the euro area, despite a large output gap, as food and services prices have continued to increase (Figures 1.5 and 1.6). This is a stark change, as until 2008 Finland was among the best performers in the euro area (Figure 1.6, first panel). While import price developments have been broadly similar across the euro area (Figure 1.6, second panel), Finland stands out as having one of the most rapid rises in unit labour costs (fourth panel). In recent years non-tradable service prices have been driven up on the back of high wage increases in the more productive tradable sectors (the so-called Balassa-Samuelson effect) within the wage bargaining system. Unit labour costs in the

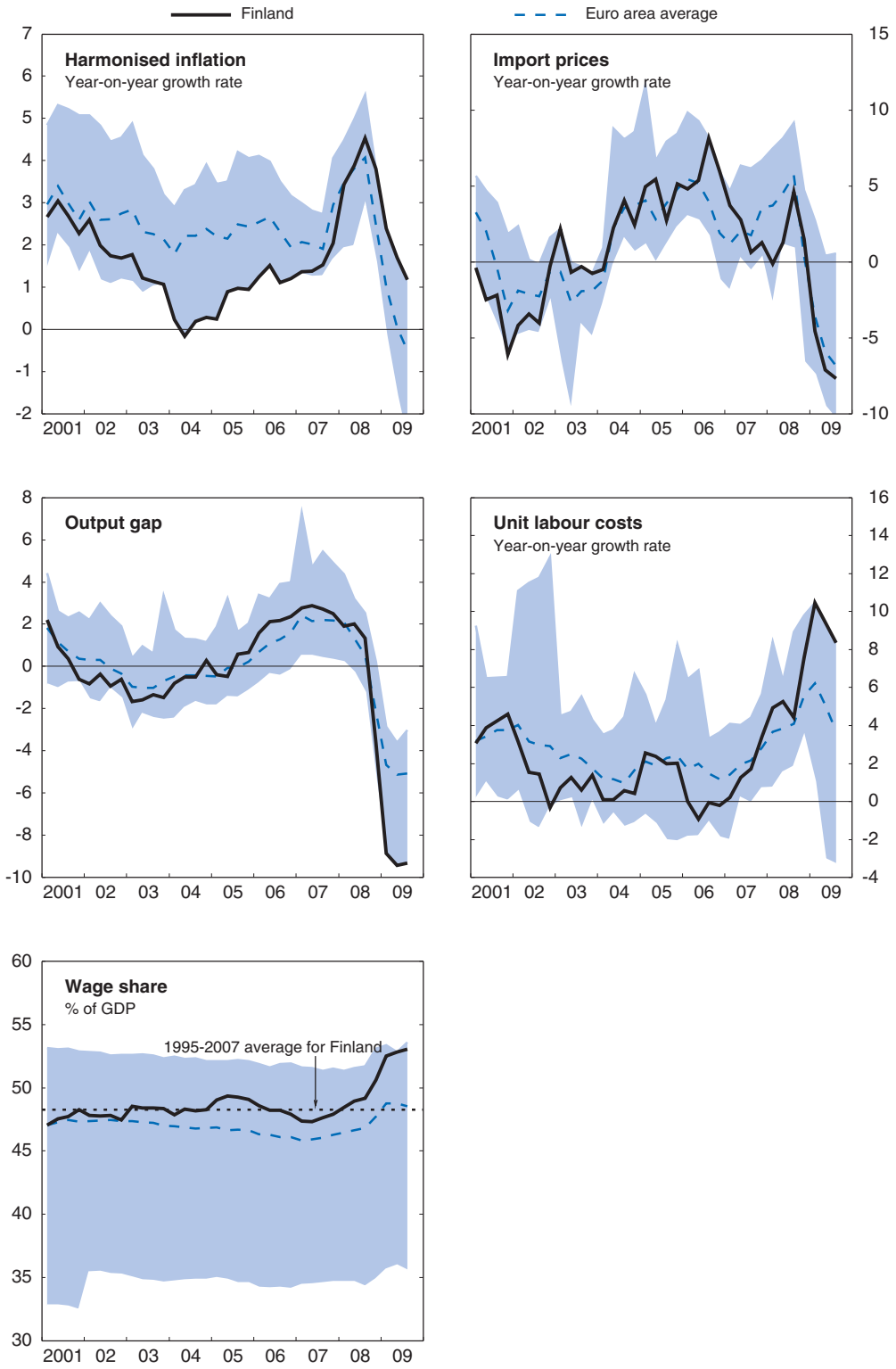
Figure 1.5. **Inflation in Finland and the euro area**



Source: Eurostat.

StatLink http://dx.doi.org/10.1787/827304478567

Figure 1.6. **Comparison of selected indicators**[1]



1. The shaded area indicates the maximum and the minimum among the 12 original euro area countries.

Source: OECD, *OECD Economic Outlook Database*.

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service sector grew by 5.5% in 2008 in contrast to 3.1% in the euro area. The continued rise in food prices may also reflect low competition in the wholesale distribution sector, which is dominated by two large vertically-integrated firms.

The wage setting process is likely to have contributed to the rise in labour costs. Wages in Finland are typically negotiated every three years on a tripartite basis involving the social partners and the government. To increase flexibility in the negotiations and help align wages more with economic conditions, the government adopted a hands-off approach during the 2007 round. However, the result has been a surge in wage growth across all sectors (Figure 1.6). Moreover, the round produced only marginally more flexible wage conditions in a few of the more dynamic sectors, and little progress was made in aligning wages with productivity at the firm level or with competitive pressures across professions. As discussed in the previous *Survey* (OECD, 2008b), the outcome of the previous wage negotiations was suboptimal, with all sectors being awarded high wage increases. Measures to improve wage formation are discussed in Chapter 3.

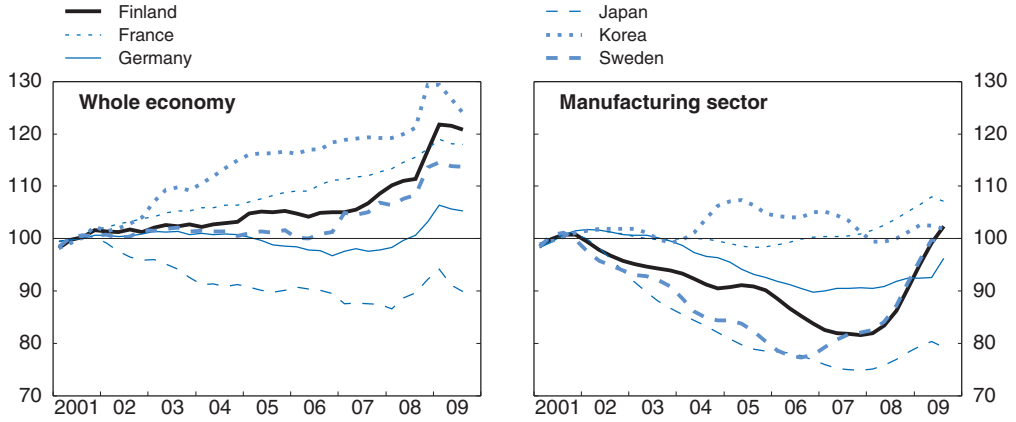
The wage share in GDP did fall after the early 1990s recession (OECD, 2008c; Arpaiaa *et al.*, 2009), but remained fairly constant until 2007 at around its historical average of the past decade and above the euro area average (Figure 1.6, final panel). Thus, claims prior to the last wage round that a general upward adjustment in the wage share was called for seems unwarranted, even though labour outflows in certain sectors, such as the nursing profession, might have required an adjustment. The latest large wage increases have pushed the wage share well above its historical average and it is now among the highest in the OECD, suggesting that competitiveness may be a concern. In fact, the problem may be understated as the labour share may have become increasingly artificially depressed in recent years, as labour income may have been diverted to capital income due to changes in the tax system (see Chapter 4).

Competitiveness is a risk going forward, particularly in light of recent large wage increases

Finnish exporters are likely to face considerable competitive challenges in coming years which makes progress in productivity especially important. Indeed, while wage outcomes across the sectors of the economy have been more or less uniform over the past decade, unit labour costs have diverged substantially as a result of the widening gap in productivity performance. Only since the last wage negotiations in 2007/2008 have unit labour costs in the manufacturing sector begun to climb, as wage costs jumped and productivity in the sector slowed (Figure 1.7). As a result, unit labour costs have risen substantially more than in many of Finland's trade competitors, such as Germany, Japan and Korea since 2007 (Figure 1.7). While some of the recent slowdown in productivity growth is likely to be cyclical, Finland's substantial terms-of-trade decline since 2000,[3] as prices of consumer electronics and ICT-related capital goods have trended downwards, adds to competitiveness concerns. In addition, an appreciating exchange rate has contributed to weaker competitiveness. The impact of these developments on Finland's international competiveness is borne out by the ECB's harmonised competitiveness indicator based on unit labour cost indices for the total economy. The deterioration of this indicator for Finland over the past two years is second only to Slovenia's and considerably larger than the euro area average.[4] Unless these trends are reversed they may slow the recovery from the recession.

Figure 1.7. **Nominal unit labour costs in selected OECD countries**

Index 2001 = 100



Source: OECD, *OECD Economic Outlook Database*.

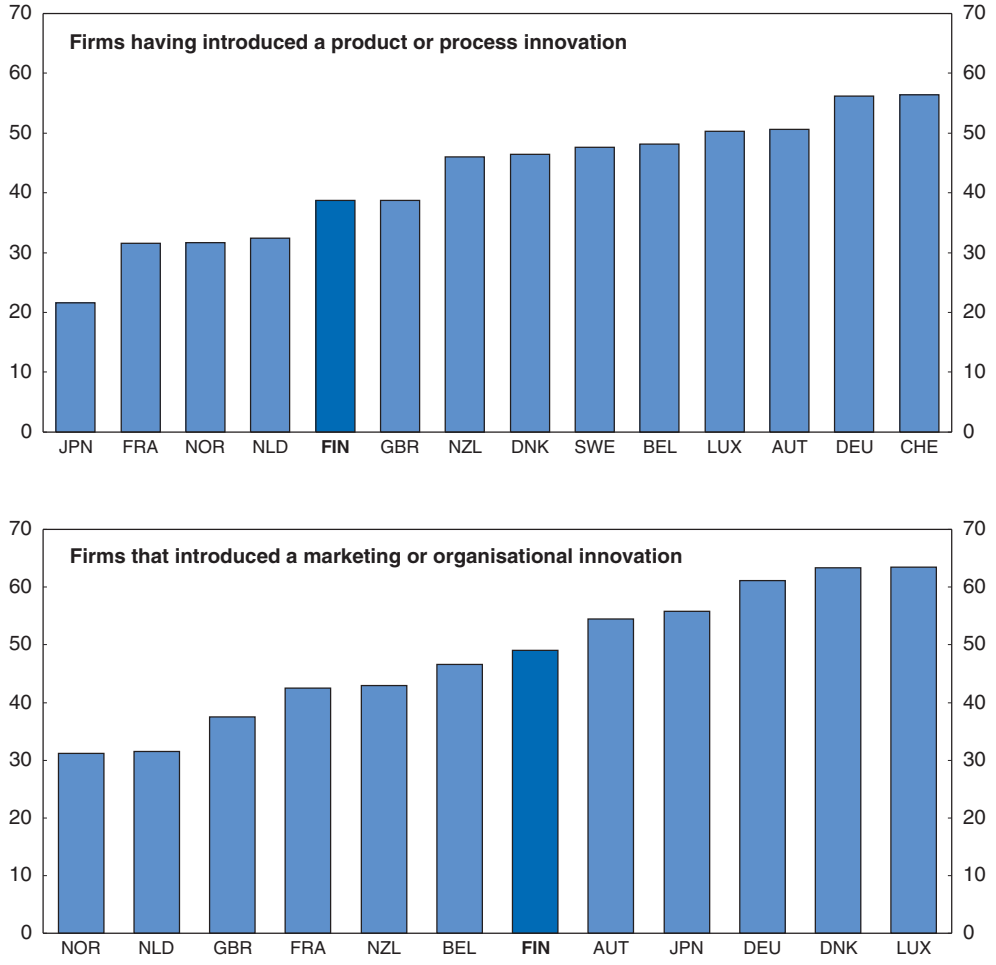
StatLink http://dx.doi.org/10.1787/827355026607

Despite spending 3.5% of GDP on research and development (R&D), on a par with Sweden and Korea, and having a high share of researchers per capita in the OECD context, outcomes seem to have been relatively poor lately with innovation at the firm level not matching the quantity of resources dedicated to R&D (Figure 1.8). This general lack of innovation at the firm level has contributed to low levels of post-entry growth in small Finnish firms. Bartelsman *et al.* (2009) show that even by European standards, employment growth in Finnish firms seven years after establishment is very low. The lack of dynamism at the firm level may be related to Finland's relatively poor ranking in barriers to entrepreneurship (European Commission, 2008), especially in terms of rigid bankruptcy and insolvency regulations. Attempts to boost entrepreneurship through changes to the taxation of capital income in 1993 and again in 2005 have had only a minimal impact. It is too early to assess the effects of recent changes to company formation, auditing, bankruptcy and restructuring laws aimed at promoting entrepreneurial risk taking.[5] In addition, a number of issues remain in the education sector which could also help in improving Finland's productivity performance (Box 1.2).

The recession is likely to lower potential output

The current downturn is expected to lower the level of potential output substantially. Financial crises tend to have significant permanent effects on the level of potential output, including in Finland in the past (European Commission, 2009). While the full long-term effects of the downturn cannot be estimated with certainty, the costs measured in terms of lost output and employment are likely to be large (see *e.g.* Furceri and Mourougane, 2009). The weakening labour market is expected to lead to a rise in structural unemployment, which contributes to an expected reduction in potential output in Finland that is larger than the average in the OECD (Figure 1.10). Recent estimates of the decline range from 3% by the Finnish Ministry of Finance (2009) and the Bank of Finland (2009a) to about 5% by the OECD (2009b).[6] These assume a significant fall in capital intensity as the cost of capital rises with permanently higher risk aversion, an increase in the NAIRU over time from rising long-term unemployment and hysteresis effects, lower participation and lower trend productivity. In Finland the participation effect is likely to be particularly strong given the

Figure 1.8. **Innovation in firms**
In per cent of all firms, 2002-04[1]



1. 1999-2001 for Japan, 2004-05 for New Zealand and 2003-05 for Switzerland.

Source: OECD (2009), *Innovation in Firms: A Microeconomic Perspective.*

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high average age of the workforce and easy access to early retirement options (Chapter 3). A permanent loss in export market share after the recession may also bear on the level of potential output due to the sector's high productivity relative to the rest of the economy.

Apart from a drop in credit growth, the financial sector impact has been small

The direct effects of the international financial crisis on Finland's banks have been relatively minor, although credit conditions did tighten. The memories of the 1990's banking crisis and strong supervision had encouraged prudence in risk taking, and Finnish banks weathered the crisis without recourse to the assistance offered by the government in late 2008. Nor did Finland experience a housing price bubble. Bank credit to non-financial firms continued to grow by 20% per annum until end-2008 (Figure 1.11, left panel), potentially aided by government guarantees to smaller firms. However, as economic conditions worsened through the first half of 2009, growth in loan volumes fell dramatically. This reflected both lower demand and tightening credit conditions as lending

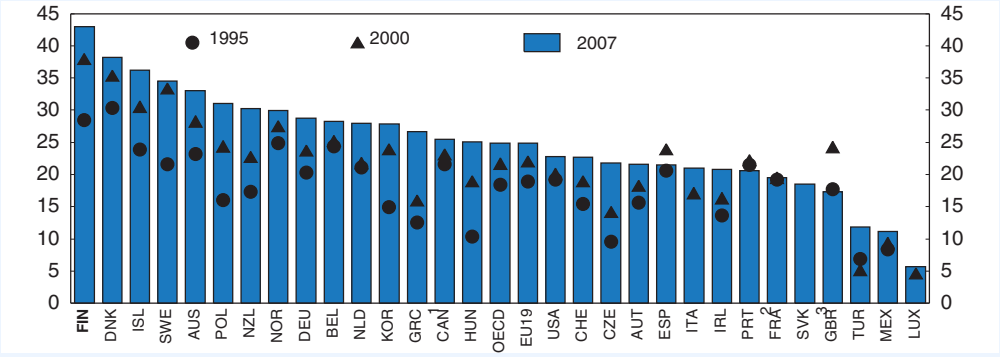
Box 1.2. **Education reforms to promote productivity**

Finland is justifiably renowned for the excellent performance of its pre-tertiary education sector. As highlighted in the previous Survey (OECD, 2008b), Finland topped the 2006 PISA rankings of the performance of students at 15 years of age. However, the previous Survey also pointed out that significant problems remain:

- Drop-out rates at the secondary level, particularly for males, are relatively high, with around 18% of the cohort not ending up with a diploma or qualification after basic education (Prime Minister's Office, 2009).
- The process for students moving between the secondary and tertiary levels of education remains inefficient and has resulted in a large matriculation backlog whereby secondary school graduates can be forced to wait a number of years before gaining entrance to a university or a polytechnic. The previous *Survey* suggested that a more standardised system of university entrance would be helpful rather than the current system where entrance procedures and requirements can vary across different institutions and courses of study. A more widespread use of matriculation results as the basis of entrance into tertiary education would be one way forward.
- Average tertiary study times in Finland tend to be very long compared to most other OECD countries. Around 43% of all 20 to 29 year olds in Finland are students, well above the OECD average of 25% (Figure 1.9). Only 45% of university students complete their studies within the targeted duration (Prime Minister's Office, 2009). Legislation introduced in 2005 limits the study period to seven years, but it appears to be relatively easy to receive permission to extend study times beyond this.
- The courses offered by universities tend to be unresponsive to market signals with the widespread use of *numerus clausus* that restrict the supply of positions in the popular courses and adjustment to these quotas are made infrequently. This is in part related to how universities are funded. Students themselves and the choices they make are insulated from labour market signals by not having to repay any of the cost of their tuition and by having ready access to generous in-study benefits.

Figure 1.9. **Enrolment rates of 20-29 year-olds**

Full-time and part-time students in public and private institutions



1. For Canada, 2006 data instead of 2007.
2. Excludes overseas departments for 1995 and 2000 for France.
3. Break in time series following methodological change from 2006 for the United Kingdom.

Source: OECD (2009), *Education at a Glance*, Table C1.2.

StatLink http://dx.doi.org/10.1787/827408820568

Box 1.2. **Education reforms to promote productivity** *(cont.)*

The government has made a number of reforms focusing on increasing the autonomy of the universities by mandating the composition of their boards with 40% required to be external members. It is hoped that this will give the universities more independence in decision-making and a more outward focus, including being more responsive to labour market signals. The reforms also took steps to increase the financial independence of universities, including broadening the range of funding sources. A program of university mergers has also begun with the view to promoting interdisciplinary innovation.

Currently, Finnish tertiary students do not directly repay any of the cost of tuition while living expenses are covered primarily by government scholarships and grants (55% of students), and government subsidised loans taken with private banks (39% of students) (OECD, 2009c). This contrasts with Sweden where around 83% of students graduate with repayable debt. The 2005 reform of student financing in Finland sought to reduce study times by increasing student dependence on loans and thereby internalising some of the cost of excessive study times. Given the short period of time since these reforms took place, it is difficult to gauge their effectiveness, although preliminary research suggests modest success in reducing study times (Asplund, 2008). There are a number of factors that might explain the difference in take-up rates of loans between Finland and Sweden. In Finland loans are repaid as per a mortgage, while in Sweden repayment is income contingent, as in Australia (see below). Moreover, in Finland interest payable is fixed at 1% during study, but upon graduation the interest rate switches to a commercial rate. In contrast, in Sweden the interest rate is fixed at 2.8% for the life of the loan. Once the full effect of the 2005 reforms becomes clear, further changes might be needed that encourage students to rely more on personally repayable debt rather than grants to further sharpen incentives to graduate as quickly as practicable. This is especially pertinent in Finland where private returns to tertiary study are unusually high by OECD standards (OECD, 2009c).

The Australian HELP/HECS Scheme

As recommended in the previous two *Surveys* (OECD, 2006; OECD, 2008b), the introduction of tuition fees would help to tackle several of the problems identified at the tertiary level. Like in a number of other OECD countries, tuition fees could be financed during study by government loans, and thus repayment could commence upon graduation and be income contingent, as in Australia.

Australia's Higher Education Contribution Scheme (HECS), introduced in 1989, is an income-contingent government loan provided to tertiary students to cover payment of part of the cost of tuition. Currently the student contribution amounts to around one quarter of the total cost of tuition. Repayments are made through the personal income tax system on the basis of post-graduation taxable income and begin only after income exceeds a threshold of around 70% of the average wage. Repayment rates are progressive, starting at 4% of assessed income, rising to a maximum of 8% of income at around 1.2 times the average wage. Interest is not paid on the debt but outstanding debt is indexed to the consumer price index (CPI). While upfront payment is an option which attracts a 25% discount, over 80% of students use the income-contingent deferred payment option. Repayments in addition to what is required through the tax system also attract a 10% bonus.

The scheme is administered jointly by the Department of Employment, Education and Workplace Relations, and the Australian Tax Office (ATO) and is available to Australian citizens and in limited cases to permanent residents. To cover living costs while studying, students may be entitled to Youth Allowance or AUSSTUDY payments, which are means and assets tested. Further assistance is also available in the form of scholarships.

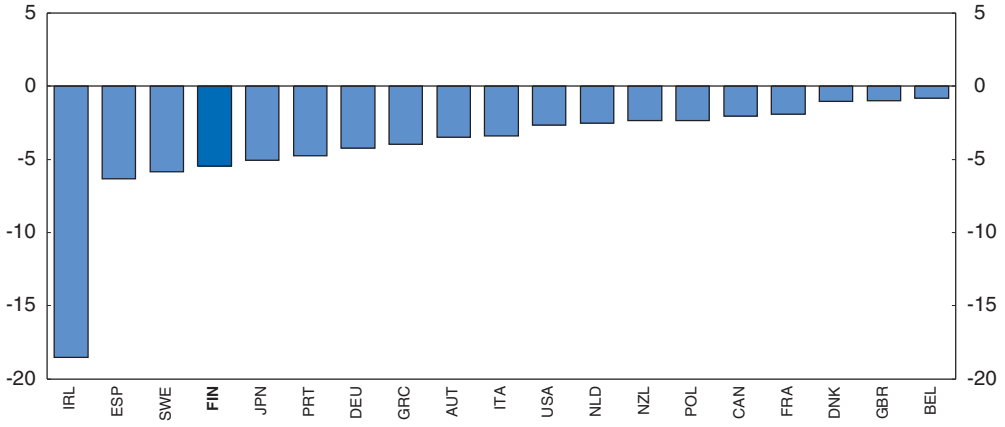
Box 1.2. **Education reforms to promote productivity** *(cont.)*

In 1996 a three-tier structure was adopted whereby debt was accrued at a higher rate for those studying in courses deemed to have high income earning potential, such as medicine and law. A national priority band also exists which currently includes courses in education, nursing, mathematics, statistics, and science, and which attracts lower student contributions. In 2005, the Higher Education Loan Programme (HELP) replaced HECS and included a number of changes, most notably allowing individual universities to raise or lower fees by up to 25% of the standard fee. Study times were limited to 7 years for undergraduate study and a parallel FEE-HELP scheme was put in place for post-graduate study which included life-time limits on total borrowing with some variation across fields of study.

Since the introduction of the three-tiered system, the average debt accrued per student has varied according to course of study. A liberal arts student who graduates on time accrues around AUD 11 000 of debt, while a medical student accrues around AUD 36 000. The liberal arts student earning the average wage would take around 6 years to repay their debt (Long, 2002). Research suggests that the transition from no tertiary fees prior to 1989 to the HECS system of partial fees with income-contingent deferred payment has had no substantive effect on the participation of lower socio-economic groups and had only a marginal effect on the transition to parenthood, with the average level of debt of less than AUD 20 000 thought to be insufficiently large to affect fertility decisions (Marks, 2009; Chapman and Ryan, 2005).

Similar schemes have been introduced in a number of other countries. From 1992, students in New Zealand had access to government loans to cover both tuition and living expenses. From 2006 institutions in the United Kingdom could charge students tuition fees of up to GBP 3 000 per annum, which are repaid once income exceeds GBP 15 000.

Figure 1.10. **Revisions to projected levels of potential output in 2012**[1]

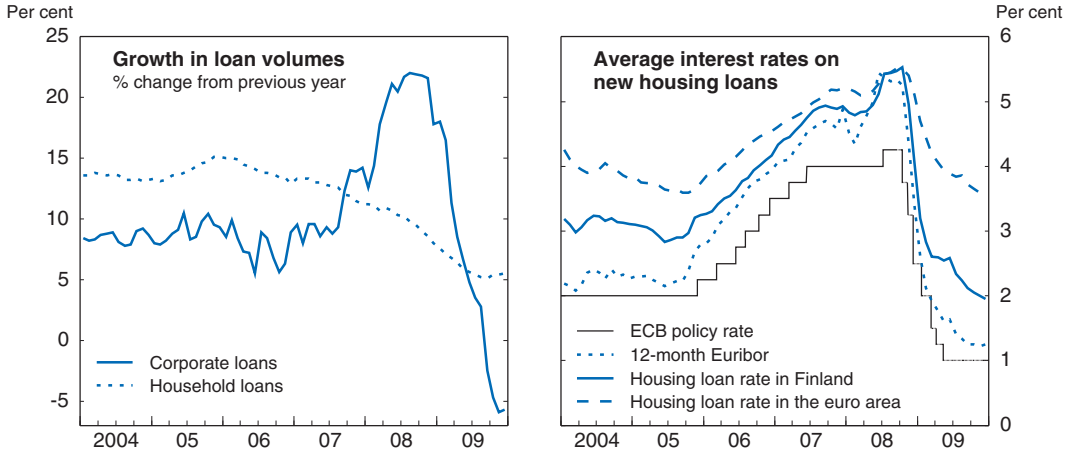


1. Differences in projected level of potential output in 2012 between *Economic Outlook 86* projections and *Economic Outlook 84*.

Source: OECD, *OECD Economic Outlook 84 and 86 Databases*.

StatLink http://dx.doi.org/10.1787/827416658181

Figure 1.11. **Financial conditions indicators**



Source: Datastream and European Central Bank.

StatLink http://dx.doi.org/10.1787/827417810385

margins rose and demand weakened on the back of the deteriorating economic outlook. Some improvement has taken place since mid-2009 when banks started to have better access to funds, and large firms in the non-financial sector raised funds directly. Smaller companies continue to struggle to access credit.

Unlike banks in neighbouring countries, exposure to the Baltic countries poses little direct risk to Finnish banks. Some indirect risks do exist, however, as around two-thirds of resident bank balance sheets belong to foreign bank subsidiaries and branches (Bank of Finland, 2009a) with the parent banks holding significant Baltic exposures. These risks could materialise if the Scandinavian parent banks were forced to repatriate assets in the face of Baltic-related stresses. However, stress tests by the Finnish Financial Supervisory Authority (FIN-FSA) and the Bank of Finland in April/May 2009 indicate that Finnish banks are in a good position to weather these risks, or a further deterioration in economic conditions. This includes any escalation in mortgage defaults as labour market conditions worsen (Bank of Finland, 2009a). A further iteration of the stress tests should be undertaken and the results published, especially as many of the parameters are outdated, including the magnitude of the economic downturn.

The near term outlook remains muted

The economy is expected to stage a modest recovery in 2010-11 as growth in world demand gathers pace (Table 1.1). Exports are projected to pick up only gradually given Finland's specialisation in capital goods. In the current context with worldwide over-investment prior to the recession and lots of spare capacity, this lag may be even more pronounced. Consumption is projected to recover only moderately in light of a weakening labour market and expected modest wage increases. While the recent cuts to VAT on food and income tax will provide some support, these will be partly offset by a general VAT increase in mid-2010 and other fiscal consolidation measures expected in 2011 and beyond. Housing investment should start to recover through 2010 on the back of a turnaround in house prices, low interest rates and evidence of significant underlying demand, particularly in the Helsinki region. However, real estate transactions remain far below their historical average, which suggests that a complete recovery in housing construction is

some way off. Business investment should stabilise in 2010 as the export outlook improves, but growth will remain muted for some time as prospects for Finnish exporters remain uncertain. Restocking is also expected to play a significant role in the recovery.

The unemployment rate is expected to reach close to 10% by the end of 2010, as some of the temporary layoffs flow through to permanent unemployment. The fall in employment will be offset to some extent by an expected large decline in the participation rate, reflecting the loose attachment to the labour force of many older workers who have easy access to early retirement and disability pensions (see Chapter 3). Inflation is projected to remain elevated through the forecast period and stay significantly above the euro area average in part due to previous wage outcomes and despite a one-off deflationary impulse from the VAT cut on food at the end of 2009. A spike in inflation is expected in the third quarter of 2010 coinciding with a VAT increase of 1% across the board, although the rate on restaurants and catering will decrease to harmonise with the recently reduced rate on foodstuffs.

On the whole, risks to the outlook are balanced. Exports may bounce back more quickly than projected as the international outlook and conditions in financial markets improve. On the other hand, the labour market may deteriorate more than projected given rigidities and distortions in the Finnish system and could result in weaker domestic demand than projected. This may also pose risks to Finnish banks, particularly given the weakened state of household balance sheets, which could deteriorate further once interest rates begin to normalise.

While the recovery from the current recession is projected to be muted, even in comparison to other OECD countries, the trough is not likely to be as low as the recession of the early 1990s, and the current recovery is likely to be more rapid (Box 1.3). This is partly due to the different nature of the shocks, as the current export collapse is likely to be more cyclical compared to the severe structural shock in the early 1990s from the long-term collapse of Russian trade. Also overheating and the role of the domestic banking crisis were a serious issue in the lead up to the early 1990s recession, but not today. Domestic demand and employment are expected to decline by less and recover faster in the current downturn, while for exports the shock is larger and recovery may be slower. This reflects the synchronised nature of the current global downturn and the composition of Finland's exports, while the 1990s shock was accompanied by a large depreciation. The recovery may also be slower if competitiveness worsens.

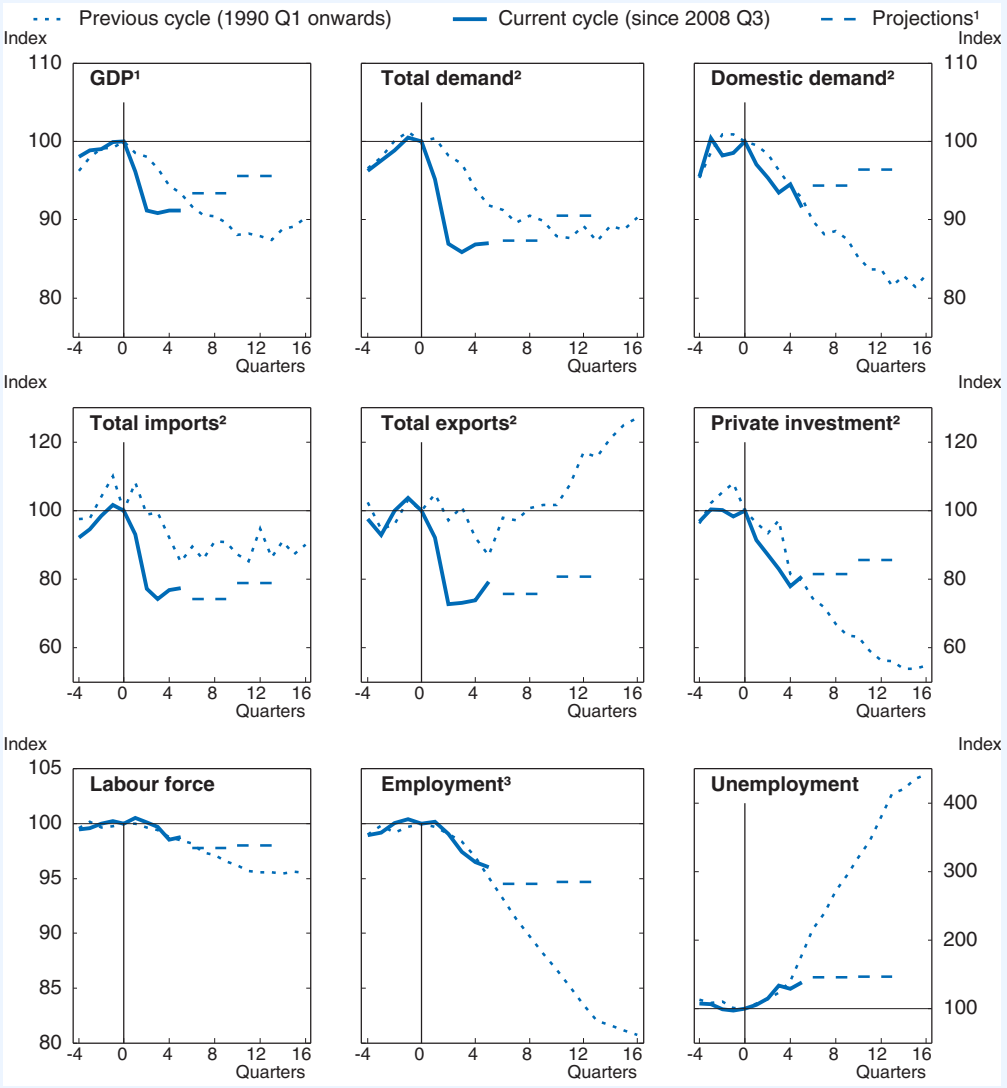
Box 1.3. **Comparing this recession and the last**

In comparison to the recession in the early 1990s, the decline in GDP after five quarters into the most recent recession has been larger (Figure 1.12). This is mostly due to a greater trade impact in the current recession as export volumes fell just over 30%, compared to 10% in the past. This is partly due to the rise in openness since the early 1990s with exports as a share of GDP almost doubling, but also due to the synchronised nature of the current recession and high dependence on income-sensitive exports. However, the overall downturn is expected to be less deep and recovery faster, except on the exports side.

The initial labour market response has, however, been similar with a moderate decrease in employment and muted increase in unemployment, despite the more rapid fall in output during the recent downturn. The labour market is expected to deteriorate less and

Box 1.3. **Comparing this recession and the last** *(cont.)*

Figure 1.12. **Comparison of economic cycles**



1. For 2010 and 2011.
2. In real terms.
3. Same scale as the panel on Labour force.

Source: OECD, *OECD Economic Outlook Database*.

StatLink http://dx.doi.org/10.1787/827422521363

recover faster in this downturn due to a number of factors. In the past, employment outcomes were worsened by abandoning the government's employment guarantee as unaffordable, whereas the current recession has witnessed the wide use of government-subsidised temporary layoffs and reduced-hours schemes (see Chapter 3). The sectoral composition of the two downturns also affects labour market outcomes, as the current collapse of trade is in more capital-intensive manufacturing (Table 1.3). Labour hoarding by employers is also likely to play a role now, given the relatively high costs of hiring and firing in Finland (IMF, 2009) and past skill shortages.

Box 1.3. **Comparing this recession and the last** *(cont.)*

Table 1.3. **Decline in value added and employment across industries**

Year to second quarter 2009

	Change in valued added (%)	Change in employment (%)	Contribution to total value added change (% points)	Contribution to total employment change (% points)
Primary production	0.6	0.7	0.1	0.0
Whole manufacturing	–22.1	–6.9	–6.4	–1.3
Construction	–13.3	–7.5	–0.7	–0.6
Trade, hotels and transport	–11.6	–4.3	–2.2	–1.0
Financial, real estate, renting, business activities	–1.4	–3.8	0.3	–0.5
Other service activities	–0.2	1.7	0.3	0.6

Source: Statistics Finland and Eurostat.

Policy response to the current crisis was adequate while returning to growth will be a challenge

The policy response to the crisis was broadly appropriate. Finnish authorities responded quickly to the economic and financial crisis with a number of policy measures. By the beginning of 2010 these included a significant fiscal stimulus package comprising both tax cuts and increased spending, and specific measures aimed at cushioning the impact of the crisis on the domestic financial sector and on Finnish businesses more generally (Box 1.4). Additionally, European monetary policy was eased significantly from the end of 2008. However, the crisis has revealed important weaknesses in the macroeconomic policy mix in Finland, which pose a threat to a sustainable recovery. Although macroeconomic policies have been broadly prudent over the past decade, the crisis-related weakening of the fiscal stance, structural weaknesses not tackled and the looming ageing problem, all create an extra burden on policy.

Box 1.4. **Policy responses to the crisis**

The government implemented a comprehensive array of policy measures designed to combat the impact of the global financial crisis on Finland:

Business sector measures focused on sustaining activity through the downturn by maintaining access to working capital and export financing:

- Allowing state-run pension funds to purchase commercial paper directly from Finnish businesses.
- Increasing the funding of the export credit agencies (Finnvera and Finnish Export Credit Ltd).
- Providing assistance to the housing construction sector, including subsidies and credit guarantees for new rental property construction and certain renovation projects.
- Phasing out employer's national pension contributions.
- Temporarily increasing depreciation rates.
- Allowing greater forbearance on overdue corporate tax payments. The 2010 Budget proposal extends this through 2010.

Box 1.4. **Policy responses to the crisis** *(cont.)*

Financial sector measures focused on helping banks to maintain lending to households and businesses, as well as being ready to assist banks that might become distressed:

- Guarantees against new debt issuance by solvent banks with maturities between three months and five years with a maximum duration of five years and compensation at commercial rates. The scheme was provisionally open until end-2009 and capped at EUR 50 billion.
- Tier 1 level private equity capital injections with the option of charging interest where banks were deemed able to pay in line with similar measures in the 1990s crisis.
- The government announced that it stood ready to recapitalise distressed banks, including government control and nationalisation, and impose conditions related to remuneration schemes.
- Amendments allowing the government to oblige distressed banks to apply for assistance and proscribe certain market activities including short selling.
- Increasing deposit insurance from EUR 25 000 to EUR 50 000.

Fiscal policy measures focused on sustaining domestic demand while at the same time seeking to minimise the longer term impact of the downturn, particularly on the labour market:

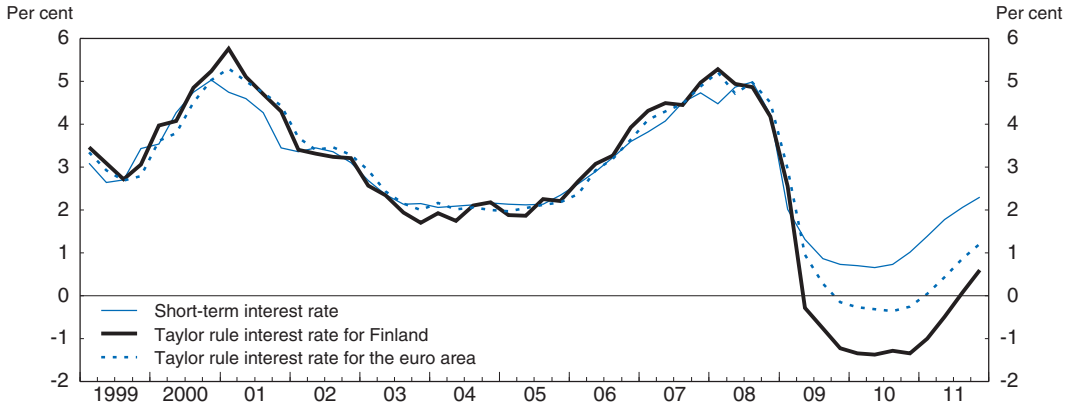
- The 2009 budget included a fiscal expansion of around 1% of GDP including both tax cuts (VAT and income) and increases in spending.
- An amended 2009 budget included support to exporters and assistance in the housing sector.
- In January 2009 the government announced further fiscal measures valued at around EUR 2 billion (1.7% of GDP) with a focus on job training for unemployed youths, as well as transport and other infrastructure spending, and temporary measures to boost housing construction by means of grants and interest rate support for the construction of rental housing. This package also included the beginning of the phasing out of employers' national pension insurance contributions which were then completely abolished in a supplementary budget later in 2009.
- In the 2010 Budget proposal a 1 percentage point increase in the VAT rate is planned for mid-2010, with the rate on catering and restaurants being lowered to 13% to harmonise with the lower rate on food. Income tax is to be cut for lower income earners by lowering the limit on the local government income tax allowance. The excise rate on tobacco is to be increased. The 2010 Budget proposal also includes additional appropriations for labour market spending, and increased transfers to municipalities that are struggling to fund service commitments through the downturn. Finally, the complete abolition of employers' national pension contributions is to be funded in the 2010 Budget.

Substantial loosening by the ECB helped sustain demand

The ECB monetary stance meant a substantial loosening in monetary conditions in Finland despite the appreciating currency. However, measured by a simple Taylor rule (Figure 1.13), which does not account for quantitative easing, the ECB policy stance implied extremely tight monetary conditions for Finland given the substantial drop in activity and the consequent large output gap. In Finland, declines in ECB policy rates were rapidly translated into lower lending rates as most mortgages are linked to the Euribor. The impact

of the loosening on corporate lending has, however, been offset by a tightening in bank lending standards toward the end of 2008, reflecting banks' own funding difficulties and rising perceptions of risk. When conditions in the interbank market improved over the spring, large firms began to turn to the corporate bond market for financing. This was facilitated to some extent by allowing pension funds to enter the market. However, conditions for smaller corporations have been considerably more difficult as access to corporate loans dried up. The government measures (see Box 1.4) may have assisted funding in small businesses to some extent.

Figure 1.13. **Taylor rule interest rates for Finland and the euro area**[1]



1. The Taylor rule interest rate i is calculated as:
i = 0.014 + 0.917 * i(t-1) + 0.163 * Core inflation(t) + 0.243 * Output gap(t).

Source: OECD projections and calculations based on *OECD Economic Outlook 86 Database*.

StatLink http://dx.doi.org/10.1787/827422628633

The fiscal position has deteriorated

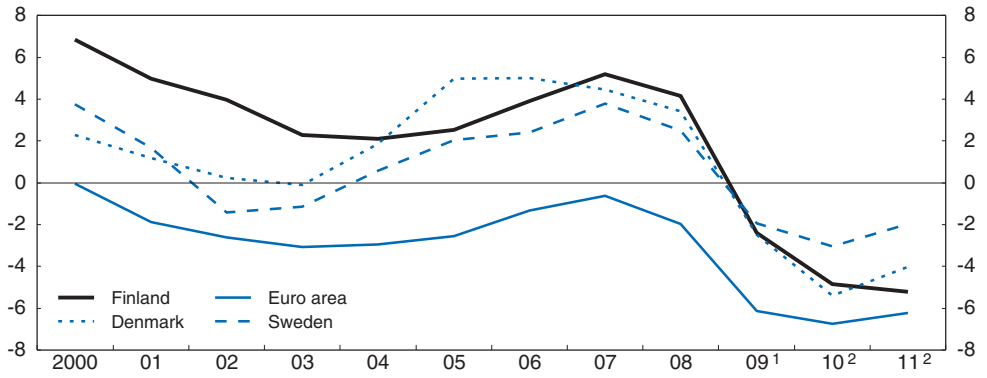
Finland came into the recession with public finances in better shape than most OECD countries (Figure 1.14). The fiscal position was relatively strong with a run of surpluses dating back to the 1990s and low public debt, even though international comparisons of deficits and debt levels are somewhat misleading due to the inclusion of private pension funds in the government deficit in Finland (see Chapter 2). Strengthening of the fiscal framework with multi-year expenditure ceilings in 2003, ambitious surplus targets and a new pension system in 2005 all contributed to the strong initial position. However, while the expenditure ceiling on non-cyclical central government spending remained intact, overall government spending grew rapidly and momentum for tax cuts was accumulating although the government simultaneously did foresee future sustainability problems.

Public finances moved rapidly into deficit in 2009 and the fiscal situation is expected to deteriorate further (Figure 1.15; Table 1.4). Government net lending is projected by the OECD to shift from a surplus of 4.4% of GDP in 2008 to a deficit of more than 5% of GDP in 2011, which is the largest projected deterioration in public finances in the OECD between 2008 and 2011 (Table 1.4).

The exceptional worsening in the fiscal position is due to lower expected potential output, strong automatic stabilisers and the ambitious fiscal stimulus (Figure 1.15). Fiscal policy has been loosened successively during the recession. While some elements of the

Figure 1.14. **General government financial balance**

In per cent of GDP



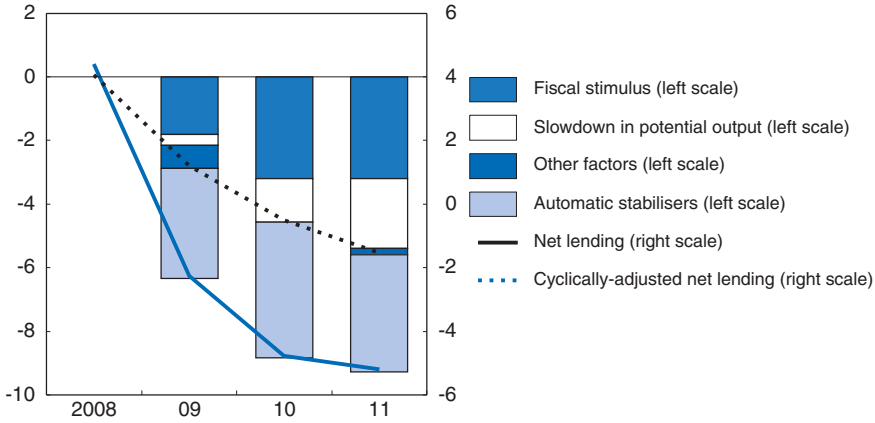
1. OECD estimates.
2. OECD projections.

Source: OECD, *OECD Economic Outlook 86 Database.*

StatLink http://dx.doi.org/10.1787/827422715755

Figure 1.15. **Causes of the worsening fiscal position**

In per cent of GDP



Source: OECD, *OECD Economic Outlook 86 Database.*

StatLink http://dx.doi.org/10.1787/827453700701

Table 1.4. **Recent fiscal outcomes and projections**

In per cent of GDP

	2006	2007	2008	2009	2010	2011
				Projections		
Receipts	52.5	52.6	53.4	53.9	53.9	52.9
Annual growth in receipts[1]	5.7	7.4	4.4	–5.1	1.0	2.5
Outlays	48.6	47.4	49.0	56.2	58.4	58.1
Annual growth in outlays[1]	3.6	4.0	6.3	7.6	5.8	3.0
Government net lending	3.9	5.2	4.4	–2.3	–4.8	–5.2
Cyclically-adjusted net lending	3.2	4.2	4.1	1.2	–0.6	–1.5
Output gap	2.1	2.7	0.2	–8.8	–9.1	–7.6
Gross public debt (Maastricht)	39.2	35.2	34.1	37.0	45.6	55.1
Net financial assets	67.9	71.1	51.1	52.1	46.4	39.5

1. Per cent per annum.

Source: OECD, *OECD Economic Outlook 86 Database.*

expansionary policy mix were in place before the recession, additional measures have been implemented in the budget proposals for 2009 and 2010 and the supplementary budget of 2009 (Box 1.4), amounting to 1.8% and 1.5% of GDP respectively. As the bulk of the measures are permanent, fiscal stimulus will add around 3% of GDP to the structural deficit between 2008 and 2011. The fiscal outlook is also worsened by an expected reduction in potential output as a consequence of the recession (OECD, 2009b). The contribution of weaker potential output to the structural deficit is estimated to 2.2% of GDP. This estimate may be optimistic, as evidence from the 1990s recession suggests that hysteresis effects can be even more pronounced than what current estimates imply (Grönqvist and Kinnunen, 2009).

The stimulus package has broadly helped sustain activity. Although fiscal multipliers tend to be low in open economies, the increased transfers to municipalities and infrastructure investment probably have relatively large multipliers. At the same time, the impact of the measures on activity is likely to be dented by increases in municipal income taxes from 2010 and onward. The stimulus has also mostly been delivered in a timely fashion, although active labour market programmes have been slow to gain traction due to Finland's late activation during unemployment spells (Chapter 3). The permanent nature of the measures do however weigh significantly on fiscal sustainability and remedial action will have to be taken when recovery firms.

The dramatic worsening in the deficit, coupled with the costs of rapid ageing, requires an exit strategy in terms of a credible consolidation plan. While Finland's immediate fiscal challenges are smaller than in most OECD countries, fiscal sustainability is increasingly at risk. Although this issue was covered in some depth in the two previous *Surveys*, the sudden deterioration in public finances has made return to sustainability even more pressing. As shown in Chapter 2, the fiscal sustainability gap is expected to increase from an estimated 3% of GDP before the crisis to 8% of GDP by 2011. Given the scale of the required consolidation, a combination of expenditure cuts, tax increases and policies to increase labour supply should be pursued (see Chapter 2). The proposed VAT increase in 2010 combined with the rise in energy taxes starting in 2011 and additional increases in taxes on tobacco, etc., are only first steps that are estimated to bring only around 0.9% of GDP in additional revenue over a full year (Ministry of Finance, 2009). Even though Finland's net debt levels are low compared to many other European countries, a concerted fiscal consolidation effort needs to be set out, announced and get underway as soon as the recovery gets onto a steady footing. Further consolidation could be initiated from 2012 and onwards. Attempting to reach the government's relatively tight fiscal targets stipulated in the current fiscal framework (see Chapter 2, Box 2.4) would be unwise in the current economic situation. A revised fiscal framework and a fiscal council would support consolidation (Chapter 2).

Return to sustainable growth will also require increasing the flexibility and productivity of the economy with structural reforms. This is particularly important in the context of a fixed exchange rate. To support a strong recovery, more attention is needed on addressing labour market rigidities that tend to hold down participation rates and labour mobility (Chapters 3 and 4). These include inefficiencies in the higher education system, factors affecting regional mobility, and the generosity of certain social benefits. Finland is also facing a number of challenges to its competitiveness from the wage bargaining system, if it continues to result in overall real wage increases well above productivity. Rising inequality may become a problem for adjusting to rapid change. This is particularly important in the Nordic context, where egalitarian values rank high in the social welfare

function. Inequality of incomes and regional inequalities have risen in recent years (Chapter 4). Finally, sustainable development policies will also have to deal with climate change challenges in general, and in particular to energy taxation and subsidies to peat and other energy-intensive sectors.

Box 1.5. **Recommendations on macroeconomic policy and education**

- While supporting the economy still remains a policy priority, the government should now formulate and articulate an exit strategy that includes a consolidation path which is contingent on a firm recovery taking hold.
- Public confidence would be enhanced if further stress testing of the banking system were undertaken and the results published. The previous round of stress tests is outdated, as macroeconomic outcomes have been significantly worse than envisaged at the time, and risks to banks have now shifted from funding and capital adequacy risks to default and external risks.
- Reforms in the education sector would help to boost productivity. These should include addressing inefficiencies in the interface between the secondary and tertiary levels (the "matriculation backlog"), and by the introduction of tertiary tuition fees. Tertiary fees could be facilitated by a scheme of government loans to students for which repayment would be income contingent and commence only upon graduation.

Notes

1. Not only is Finland more exposed to the ICT cycle by virtue of the composition of its goods exports but also through royalty and other service income flows directly related to the ICT and capital goods industries. Over the five years to 2008, the value of Finland's service exports almost tripled, driven by a rapid growth in computer services, royalties and licence fees, and other business services (most particularly transactions within international group enterprises and the centralisation of group activities from abroad). (*Source*: Statistics Finland, *International Trade in Services,* 2008.)
2. Since euro adoption, inflation rates across the EMU countries and volatility within countries have declined substantially (Arnold and Verhoef, 2004). This was particularly notable for Finland which used to suffer from large swings in exchange rates and prices. However, despite this convergence there remains a considerable variance in inflation outcomes across the zone. This can be due to level convergence, changes in bilateral exchange rates (via the differential composition effects on import prices, or via external demand effects) and the output gap. For instance, Ždárek and Aldasoro (2009) show that most of the intra-euro area dispersion in inflation has originated in the non-traded sector, while Honohan and Lane (2003) argue that bilateral exchange rate movements against the euro affect different euro area countries differently and show that this has been an important factor explaining intra-euro area inflation differentials. Arnold and Verhoef (2004) find that the output gap has been an important determinant of inflation differentials in the euro area since the adoption of the euro, although with considerably lags.
3. Between 2000 and mid-2009, Finland's terms of trade declined by over 10% while, on average, the other euro area countries saw an increase in their terms of trade of around 3%, with only Ireland showing a significant decline but still only around half that of Finland.
4. The outlook has changed considerably since the IMF's 2008 Article IV assessment, finalised at the end of 2007, which concluded that Finland's external competitiveness was adequate. Indeed at the time, with moderate wage outcomes, a booming export sector and a healthy current account surplus, this seemed like a justified assessment to make.
5. The Limited Liability Companies Act was amended in 2006. Amendments to the Restructuring of Enterprises Act came into force in 2007. The Adjustments of Private Individual Debt Act was enacted in 2007.

6. Difference between potential output level estimates for 2012 between *OECD Economic Outlook 84* (December 2008) and *OECD Economic Outlook 86* (November 2009). Methodological differences may account for a small part of the change.

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ANNEX 1.A1

Progress in structural reform

This annex reviews action taken to follow recommendations made in the *2008 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 *Survey* (June 2008)
Pension reform	
Increase the effective retirement age to 65 and fully close the unemployment pipeline to retirement.	The government and stakeholder organisations agreed in Spring 2009 on the gradual raising of the retirement age by 3 years by 2025. Two committees have recently finalised the analysis of alternative means. Pipeline not fully closed but entry age raised by two years.
Make study periods ineligible for pension credit accumulation, and scrutinise the effectiveness of the higher accrual rates for older workers.	No action taken.
Tax reform	
Continue to lower the taxation of labour with priority 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.	Average taxes on earnings have been lowered across the income classes. The Finnish Tax Committee has suggested a moderate shift in the burden of taxation from labour to consumption.
Raise property tax revenues by setting property assessment values (for tax purposes) equal to 100% of market valuations and by raising property tax rates.	The new system of property tax base valuation is in progress. Furthermore, it takes energy saving improvements into consideration as well.
Raise the minimum municipal tax rates on all immovable property types and remove the maximum threshold. Extend the property tax base to agricultural and forestry land.	Both the minimum and the maximum rates of municipal property tax were raised in 2010, but the maximum was not removed. No extension to agricultural and forestry land.
To improve incentives for municipalities to raise more revenue from property taxation, 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, and then gradually reduced over time. Alternatively, oblige municipalities to match any increases in income tax rates with proportional increases in property tax revenues.	No action taken.
Eliminate the share of corporate income tax flowing to municipalities. Fill the resulting funding gap by a combination of higher property taxes and higher state grants.	The share of the corporate income tax revenues directed to the municipalities was temporarily raised from 22% to 32% due to the economic downturn.
Raise the revenue efficiency of the VAT by eliminating reduced VAT rates. Use the additional revenue 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.	The VAT on food was lowered in 2009 from 22% to 12%. The food served in restaurants is taxed accordingly in 2010. All the VAT rates are raised by 1 percentage point each on 1 July 2010.
Consider ways to further broaden the corporate tax base and lower the rate.	The Finnish Tax Committee is considering reform to corporate taxation.
Municipal reform	
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.	The new service bond legislation in social and health care services can in the future open up the markets in municipal services. It gives the residents the right to choose their service producers.

Recommendations	Action taken since the previous *Survey* (June 2008)
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.	The central government currently promotes municipal-level productivity programmes in co-operation with the 20 largest cities, which is planned to be extended to all municipalities. Each municipality sets its own targets for the amount and percentage of replacing retiring workers. The central government monitors how the municipalities meet their targets.
Develop more sophisticated benchmarking exercises and put in place other structures to facilitate the sharing of best practice municipal management.	The Best Municipal Service Practices project has collated means of achieving efficiencies in municipal services and surveyed examples of good service practices.
Continue to promote municipal mergers and favour mergers over partnership areas.	Municipal merger legislation has been renewed. The new Act (in force from January 2010) will support and promote the merger processes better.
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.	A committee has been set up to define how competition neutrality can be guaranteed when the public sector is acting in the market.
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.	To be handled by above-mentioned committee.
In the absence of reform to European VAT legislation, consider modifying national legislation to broaden the definition of activities that are classified as taxable.	No scope for improvement without changes in the EU VAT legislation.
Labour market reform	
Continue to negotiate wages at the decentralised level with some degree of government co-ordination. Maintain the objective that any changes to the wage negotiation framework encompass the objective of moderate aggregate wage outcomes with a view to maintaining international competitiveness.	No action taken.
Make opting out of collective agreements easier and re-considered the current practice of putting wage negotiation outcomes into legislation as it constitutes a further impediment to wage flexibility. Consider replacing this with a minimum wage.	A minimum wage act has not been considered by the government.
Put more emphasis 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.	Labour market training for young unemployed, temporary laid-off workers and recently dismissed workers in order to prevent long-term unemployment is a priority in the ALMP during the economic crisis (Supplementary budgets for 2009 and Budget proposal for 2010).
Tighten legal requirements for geographical (and occupational) mobility of the unemployed, and step up sanctions and enforcement.	Sanctions or other legal requirements not tightened.
Audit the subsidies currently directed at assisting inter-regional mobility. Supplement those that are found to be effective and abolish those (like the second residence subsidy) that are found to be less effective.	No special auditing or independent evaluation. Maintenance allowances, which are paid during the active measures, will be increased on 1 January 2010.
Taper unemployment benefits over time as is currently done in many other OECD countries.	No action taken.
Abolish the unemployment "pipeline".	Access restricted.
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.	No action taken.
Review options for part-time work and their effectiveness. Make pension rules more accommodating of part-time work. Expand part-time work opportunities for disabled workers. Address inflexibilities in child care arrangements so as to promote greater part-time participation of mothers.	The current part-time pension is deemed by the government to work poorly. There is access to part-time care for children.
Refine 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 average and marginal earning tax rates. For instance, taper unemployment benefits over time. Reassess the Home Care Allowance with a view to improving incentives for the labour market participation of women with young children.	No action taken.
Education reform	
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. Provide more information for students on employment prospects and wages of recent graduates.	Two working groups appointed by the Ministry of Education: *i)* on the development of student selection in Higher Education Institutions (HEIs); *ii)* on speeding up the transition to the education and taking off the degree.

Recommendations	Action taken since the previous *Survey* (June 2008)
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 should 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).	No action taken.
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. 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.	The New Universities Act 2009 makes it possible to charge tuition fees on a trial basis (2010-14) to students from outside EU/EEA countries who are taking part in separate master's programmes, provided that the arrangements include a scholarship scheme. On 2 March 2009 the Ministry of Education appointed a committee to look into the development of student financial aid and put forward proposals for the structural reform of the student financial aid scheme to give more incentive for full-time study. In the opinion of the committee: 1. The student financial aid should encourage students to pursue planned, full-time studies. The committee proposes that: • student financial aid be granted first for the completion of the first cycle degree in accordance with the two-cycle degree structure, and only then for second-cycle studies; • the withdrawal of only housing supplement would be taken into account in the calculation of the time during which the aid has been granted; • the monthly study attainment requirement used in the monitoring of study progress be raised to 5 study points and the system for monitoring progress in studies will be further reviewed during the spring of 2010 as part of the assignment; • the maximum aid for academic postgraduate studies be set at nine months; and • separate means-testing of salary received for trainee periods or a scholarship awarded by the higher education institution be discontinued. 2. The student loan should be made more feasible as a form of financing studies. The committee proposes that: • the state guarantee for student loans be granted to everyone entitled to study grant; • the loan guarantee amount for studies abroad be raised up to EUR 600; • the income limits used in the granting of the interest subsidy be revised in accordance with the rise in the income level, and • the system of tax concessions relating to student loans to be reviewed. 3. The student financial aid must be sufficient to enable students to concentrate on studying full-time. The committee proposes that: • the student financial aid be bound to an index, • the amount of meal subsidy for higher education students be raised, and • a supplement in the study grant be made in the case of students with dependent children. No decisions based on working groups' proposals have been made.
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.	The Higher Education Evaluation Council will conduct an evaluation of the degree structure in 2010. The degree structure will be reassessed as a whole after this evaluation.
Amend university financing, so that a larger weight is given to the number of Bachelor's Degrees.	The number of Bachelor's degrees has been added to the University budget formula for the period 2010-12. The focus on degree-based funding will switch from targets to outputs. The extent of education (40% of total state university budget) will be determined according to specific criteria (see Table 1.A1.1).

Recommendations	Action taken since the previous *Survey* (June 2008)
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.	No action taken.
Consider giving credit to students for work experience or internships.	No action taken.
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.	The new budget formula for Universities puts more weight on the quality of research. The quality and effectiveness of the research and researcher education will be determined on the basis of specific thematic entities and criteria (35% of total state university budget) (see Table 1.A1.2).
Labour migration policy	
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".	The Government has proposed that the permit system for labour immigration shall be simplified in 2011. Every residence permit issued to a foreign national will include the right to work. The system of determining the availability of Finnish labour for a given position will be phased out but the employer must first advertise the post in Finland and the EU and EEA and Switzerland. A residence permit for ten months (instead of six) shall also be introduced for foreigners completing a degree or qualification in Finland to enable them to seek employment.
Identify the industry sectors most in need of foreign labour and direct assistance to firms and potential immigrants in these industries.	No action taken.
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.	An Action Plan on Labour Migration was adopted as a Government Resolution in November 2009 including description of current situation, strategic guidelines and proposed measures. The Plan has been drafted for 2009-11. Examples of ongoing measures funded by the European Social Fund: initiative guidance system, attraction strategy and regional labour migration pilot projects.
Do more to promote Finland as a destination for foreign students and encourage these students to stay after completing their studies. Extend the duration of the post-study job-search permit.	See above.
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.	Labour market training in the State budget for 2010 includes EUR 34 million for basic skills and language training for immigrants. This includes an increase of EUR 4 million compared to 2009 budget. The pre-contract between State and local authorities of the metropolitan area has been signed on the 8th of December 2009. The aim of the pre-contract is to promote the integration of the immigrants and fasten the process into the labour market by fostering the human resources of the employment and business offices. Custom-based processes between the local authorities will be clarified. The pre-contract will be implemented and reported during the years 2010-12. New and innovative ways of employing immigrants and supporting their integration will be explored in the context of a pilot programme established by the Ministry of the Interior in 2009. The aims of the project include developing new and innovative ways of employing immigrants and supporting their integration, training municipalities to recognise and prevent problems in residential areas with a high number of immigrants. Additionally, municipal services will be developed to meet the needs of the immigrants.
Improve foreign qualification recognition schemes so that migrant workers are utilised to their full capacities and to avoid the over-qualification phenomena seen in many other OECD countries.	No action taken.

Table 1.A1.1. **University budget criteria**

	Weighting %
1. Computational number of students	30
a) Full-time equivalent degree students	*85*
b) The calculated number of full-year students in the Open University and the calculated number of full-year students with a separate right to study in total	*15*
2. Goals of the first- and second-cycle higher education degrees	35
a) Total number of first-cycle higher education degrees agreed upon in the agreement between the Ministry and the university	*25*
b) Total number of second-cycle higher education degrees agreed upon in the agreement between the Ministry and the university[1]	*75*
3. Completed first- and second-cycle higher education degrees	35
a) Number of completed first-cycle higher education degrees at the university	*25*
b) Number of completed second-cycle degrees at the university[2]	*75*

1. In the calculation, the goal of those second-cycle higher education degrees with no equivalent first-cycle degree is multiplied by 1.3. This applies both to the goals and completed degrees.
2. In the calculation, the degrees obtained by field of education are taken into account up to a maximum of the goal for the agreement period.

Table 1.A1.2. **University research-funding criteria**

	Weight %
1. Research funding competed for nationally	60
a) Academy of Finland funding used by the university	*75*
b) Tekes funding used by the university	*25*
2. Scientific publications	20
a) Number of refereed international publications	*70*
b) Number of other scientific publications	*30*
3. Internationalisation of research	20
a) Amount of international research funding competed for[1]	*60*
b) The overall amount of teacher and researcher mobility[2]	*40*

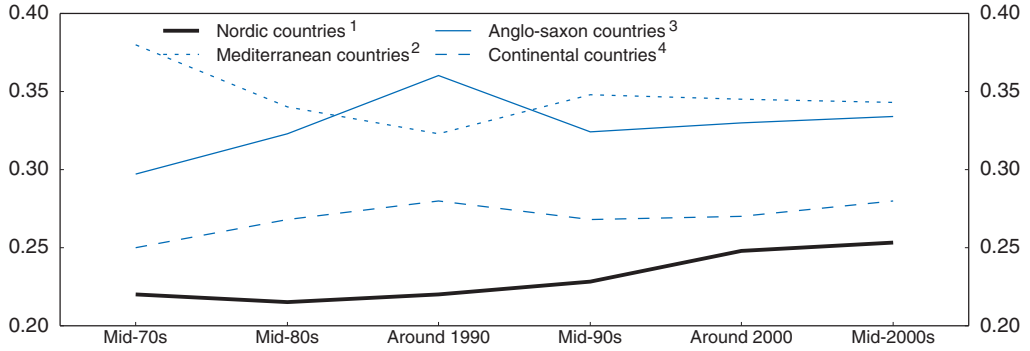
1. Funding does not include enterprise funding or EU Structural Funds.
2. The overall amount of mobility to and from Finland (minimum 2 weeks).

ANNEX 1.A2

The Nordic model, recessions and economic performance

Social model literature often classifies mature OECD economies into four groupings: Anglo-Saxons, Continentals, Mediterranean and Nordic according to the extent of redistributive policies, social and employment protection (equity), and product market competition (efficiency).[1] The Nordic system has often been touted as a role-model, as the Nordic countries have achieved high incomes with low unemployment and relatively equal income distributions. (Figures 1.A2.1 and 1.A2.2). The Nordic model is characterised as promoting equity with high tax rates (Figure 1.A2.3) and large social transfers, while at the same time fostering efficiency with high productivity growth supported by modest levels of employment protection and strong competition in product markets (Sapir, 2005; OECD, 2009).

Figure 1.A2.1. **Gini coefficients since 1970**



1. Exclude Denmark and Norway for mid-70s, Finland and Norway for around 1990.
2. Exclude Italy and Spain for mid-70s, Portugal for mid-80s and Greece for around 1990.
3. Exclude Australia and Ireland for mid-70s, Australia for mid-80s and Australia, Canada, Ireland for around 1990.
4. Exclude Austria, France and Germany for mid-70s, and Austria for around 1990.

Source: OECD (2009), *Income Distribution – Inequality, online Database* (September).

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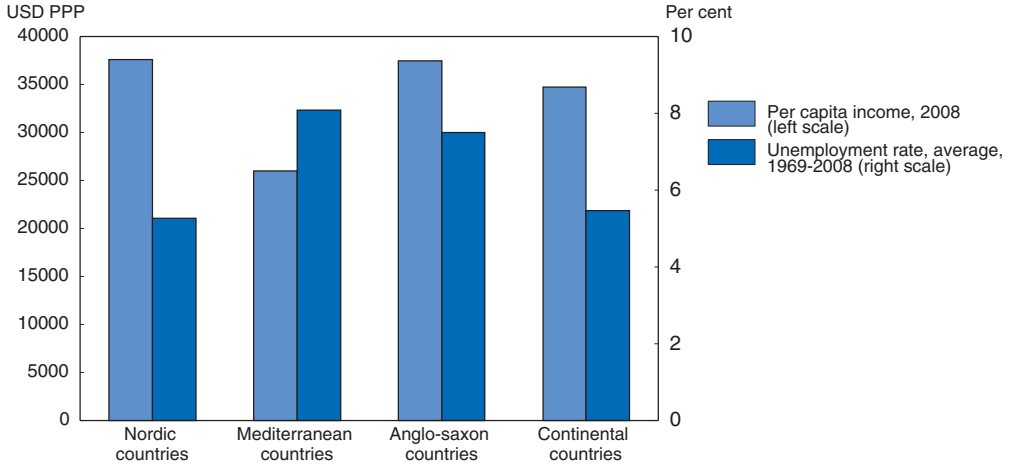
There are concerns that the Nordics (and also the Anglo-Saxons) may pay a price for higher long-run efficiency by experiencing more macroeconomic volatility (Figure 1.A2.4). Large differences in changes in unemployment among countries during the recent economic crisis have also raised questions of the impact of various social or economic models in smoothing recessions and sustaining growth and welfare (Reverchon, 2009; Rodier, 2009; Bini Smaghi, 2009). The Nordics, with the recent exception of Norway, and the

Figure 1.A2.2. **Per capita income and unemployment**



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

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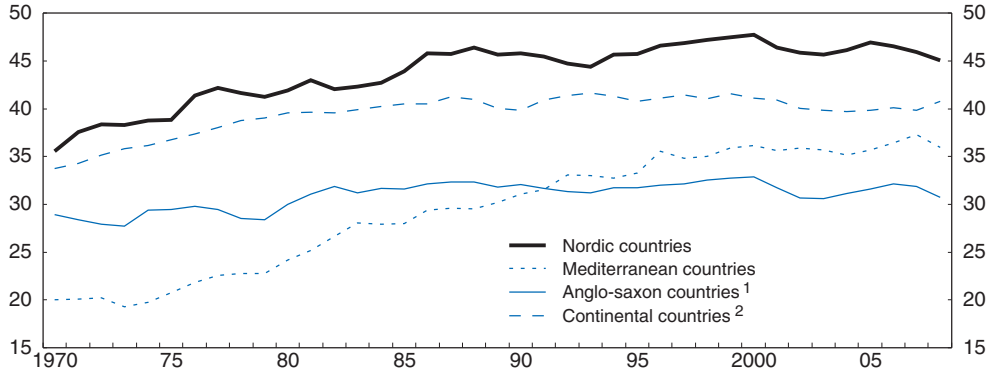
Figure 1.A2.3. **Tax burden**

In per cent of GDP



1. Exclude Australia in 2008 due to unavailability of data.
2. Exclude the Netherlands in 2008 due to unavailability of data.

Source: OECD, *Tax Revenue Statistics Database.*

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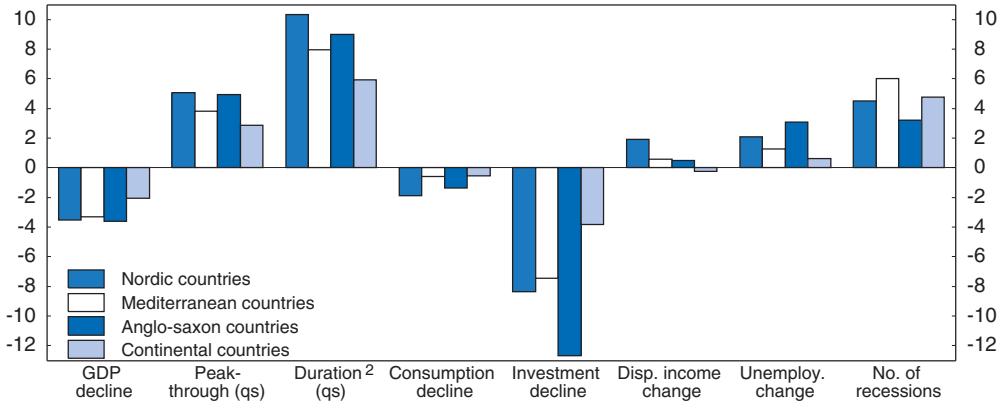
Anglo-Saxons have been among the worst hit by recessions since the early 1980s. Declines in employment, investment and consumption have been larger, and longer lasting among the Nordics than in the Mediterranean or Continental groups (Figure 1.A2.4). While the results are partly influenced by country size,[2] the Nordics' greater flexibility also probably contributed. At the same time, the Nordic model of large social transfers and automatic stabilisers has performed best in protecting disposable incomes (Figure 1.A2.4) during downturns, and thereby mitigated social costs. Volatility and social protection have not been at the cost of growth, which has been robust over the period, sustained by strong total factor productivity gains (Figure 1.A2.5).

Figure 1.A2.4. **Characteristics of recessions since 1980s**[1]



1. Average percentage change from peaks to troughs; for unemployment, in percentage point change; qs = quarters.
2. From onset of recession to recovery to pre-recession peak.

Source: OECD, *OECD Economic Outlook Database*.

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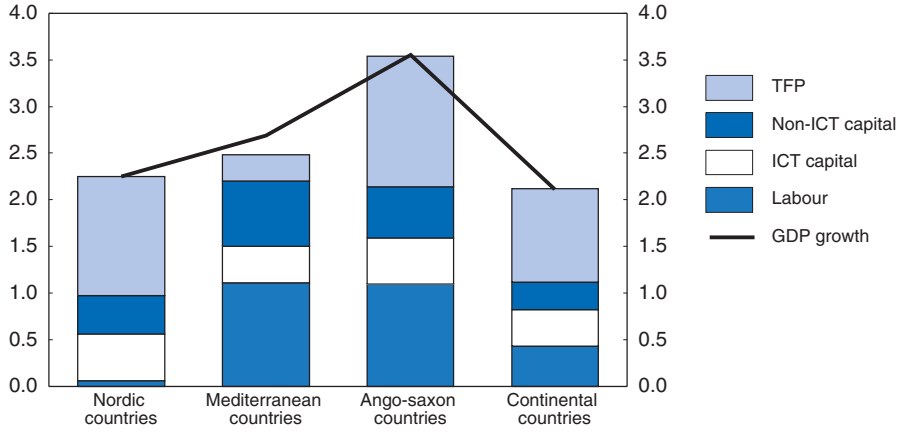
Figure 1.A2.5. **Factors contributing to growth**

Per cent, 1985-2008



Source: OECD, *OECD Economic Outlook Database*.

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Notes

1. See, for example, Esping-Andersen (1990), Sapir (2005) and Andersen *et al.* (2007). Following Esping-Andersen (1990) large mature OECD countries are divided into four groups – Nordic: Finland, Denmark, Norway, Sweden; Anglo-Saxon: Australia, Canada, Ireland, the United Kingdom and the United States; Mediterranean: Greece, Italy, Portugal, Spain; Continental: Austria, France, Germany and the Netherlands.
2. Controlling for openness did not show any consistent pattern in terms of duration or depth of recessions.

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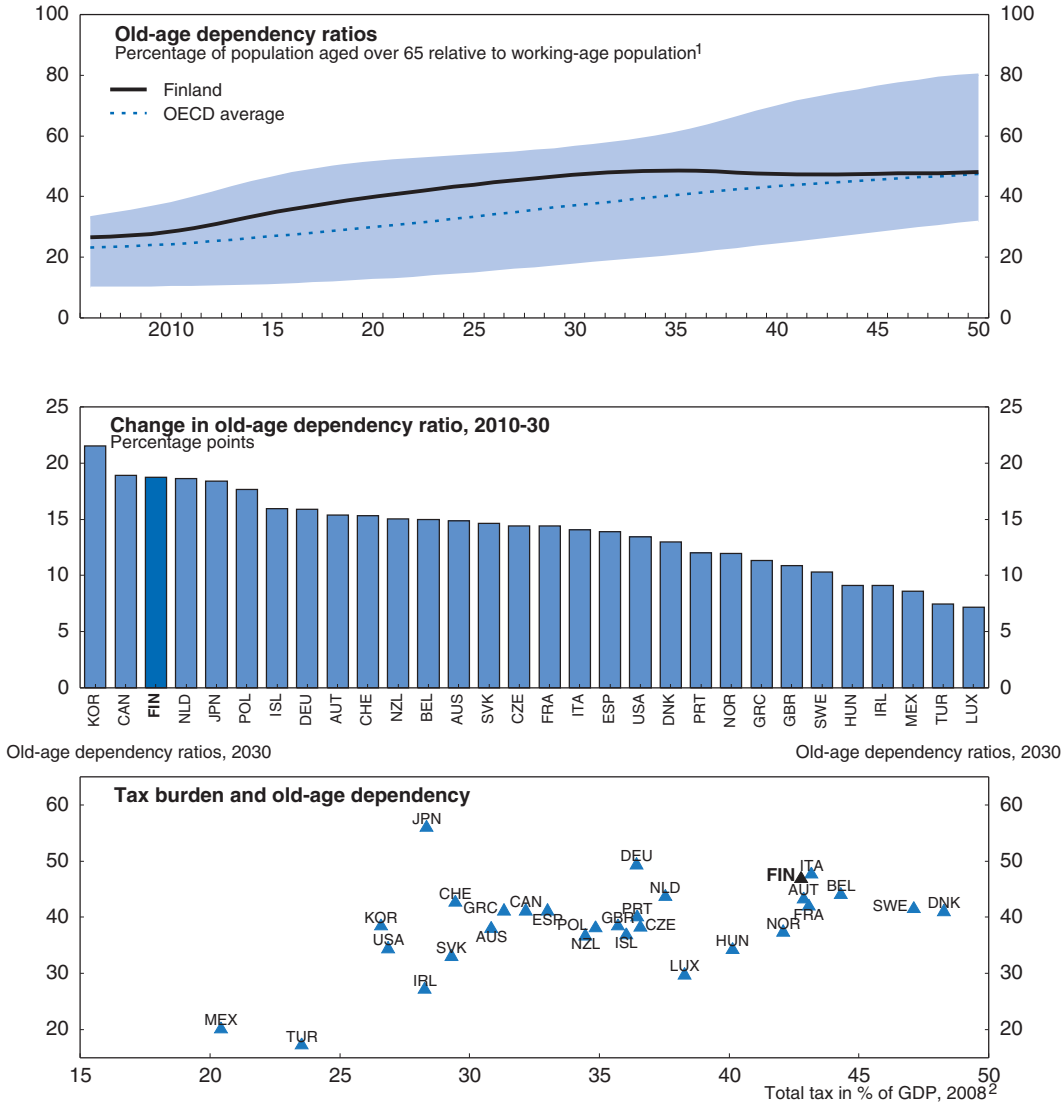
Chapter 2

Paving the way for sustainable public finances

The costs of the recession and ageing are a challenge to fiscal sustainability. The estimated fiscal sustainability gap has increased from 3 to 8% of GDP due to a sizeable permanent stimulus and lower potential output. A consolidation plan should be articulated now to ensure a smooth exit from stimulus once the recovery firms. Consolidation should encompass efficiency-enhancing tax measures such as an upward harmonisation of the value added tax (VAT) and higher property taxes, and constrain rising expenditures in municipalities. As discussed in Chapter 3, sustainability would also benefit from pension reforms that include tightening of benefits and eligibility conditions which would lower overall spending and boost labour supply. Tuition fees and a switch from grants to loans in tertiary education would also alleviate expenditure pressures (Chapter 1). A major overhaul of the municipal system could increase efficiency in service provision. Consolidation would be facilitated by revising the currently over-targeted fiscal framework and linking it more to long-term sustainability targets. This should include a lengthening in the fiscal planning horizon and linking structural annual deficit targets to long-term sustainability targets as well as setting up a fiscal council to monitor fiscal policies.

Finland's fiscal outlook has significantly worsened during the recession. The rise in the old-age dependency ratio in the next 20 years is expected to be among the fastest in the OECD (Figure 2.1). Furthermore, the working-age population is set to start contracting already in 2010. The tax-to-GDP ratio is high and leaves little room for tax hikes in rectifying the fiscal position. The strains from ageing on Finland's public finances have

Figure 2.1. **Dependency ratios are increasing**



1. The shaded area indicates the maximum and the minimum dependency ratios among OECD countries.
2. Or latest available year.

Source: OECD, *Revenue Statistics* and *Population Databases*.

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been pointed out in previous *Surveys*, but the fiscal stimulus and weaker potential output following the current recession have worsened the fiscal outlook substantially. This chapter presents simulations of Finland's longer term fiscal outlook. It then discusses the need for a clear consolidation strategy within a revised fiscal framework, together with measures both on the tax and expenditure side that can help Finland reach sustainability once the recovery is on a firm footing.

Fiscal policy is on an unsustainable path

Fiscal sustainability can be defined in different ways, but most commonly it relates to the ability of governments to finance interest payments on current debt and cover future costs of programmes (Box 2.1). The analysis in this chapter is based on the so-called S2 indicator, which defines the immediate permanent improvement in the cyclically-adjusted primary balance (CAPB) that is needed to ensure that the discounted value of future surpluses is equal to the current level of debt. Assumptions and detailed results of three different long-term scenarios until 2050 are presented in Annex 2.A1.

The recession has substantially widened the fiscal sustainability gap, *i.e.* the difference between the estimated CAPB and the CAPB needed to achieve sustainable public finances. As discussed in Chapter 1, the CAPB is expected to worsen by roughly 6% of GDP between 2008 and 2011, mainly due to losses in potential output (2.2%) and permanent fiscal stimulus measures (3.2%). In the baseline scenario, where fiscal policy is assumed to remain unchanged,[1] the primary balance would stabilise at close to –8% of GDP from 2030, while the general government financial balance and government net financial liabilities would worsen continuously after 2015 (Figure 2.2). According to the S2 indicator, the CAPB would need to improve permanently by almost 8% of GDP from 2012 onwards to ensure sustainability. The "consolidation scenario" illustrates how the sustainability gap can be closed from 2012 and onwards, with fiscal consolidation equivalent to 1.5% of GDP per annum during 2012-15 and further consolidation amounting to roughly 2.5% of GDP in total during 2016-18.

Box 2.1. **Measuring sustainability**

Sustainable public finances can loosely be defined as a set of policy paths that ensure the ability of a government to finance interest payments on current debt and cover future costs of programmes. There is no unique definition of a sustainable fiscal position, nor is there a unique indicator of sustainability. Different indicators have different purposes and horizons and may therefore end up with different estimates.

Two widely used measures are the S1 and S2 indicators that are being used by the European Commission to evaluate the sustainability of public finances in EU member countries (European Commission, 2009). The S1 indicator shows the permanent adjustment to the cyclically-adjusted primary balance (CAPB) that is needed to reach a gross debt ratio of 60% of GDP (*i.e.* the threshold in the Stability and Growth Pact) in 2060. The S2 indicator shows the permanent adjustment to the CAPB that is required to fulfil the intertemporal budget constraint, *i.e.* ensuring that the present value of future fiscal surpluses will be equal to the current stock of government gross debt. This is the sustainability measure that is used in this *Survey*. In Finland the two indicators point to roughly the same amount of needed consolidation. The S2 indicator shows a need for a permanent improvement in the CAPB of 8% of GDP, while the S1 indicator points to 7.5%.

While Finland's fiscal challenges are substantial, significant uncertainties surround estimates of the sustainability gap. In the government's Stability Programme Update 2009 (Ministry of Finance, 2010), the gap is estimated to roughly 5½ per cent of GDP. The difference between the two estimates can largely be attributed to the government estimating a smaller impact from the crisis on potential GDP and assuming a higher rate of return on pension fund assets.[2] Sensitivity analysis illustrates that much of the projected worsening in public finances is explained by growing age-related spending, which is projected to increase by 5.4 percentage points in relation to GDP.[3] This is apparent in the difference between the baseline and "unchanged age-related spending" scenario, where age-related expenditures are assumed to be constant as a share of GDP (Figure 2.2). However, even without the increase in age-related expenditures, fiscal consolidation would be required due to the large initial structural fiscal deficit (the difference between "unchanged age-related expenditures" and "consolidation"). All scenarios above are stylised in the sense that there are no feedbacks from the fiscal position to other parts of the economy, for example, in terms of interest rates or labour supply.

Two key assumptions in the analysis can be used to illustrate the sensitivity of the results. First, employment rates are assumed to increase from 71% in 2008 to more than 73% in 2030. As analysed in Chapter 3, there is a clear risk that this increase in employment rates may not be achieved on current policies. For example, if the average retirement age were to be one year lower in 2030, the sustainability gap would increase by roughly 1.4 percentage points (Kinnunen, 2009). Another key assumption is the rate of return earned on government assets. With gross government financial assets worth close to 100% of GDP, a 1 percentage point increase in the rate of return would lower the sustainability gap by 1% of GDP.

Planning for consolidation should start early to facilitate a smooth exit from the stimulus

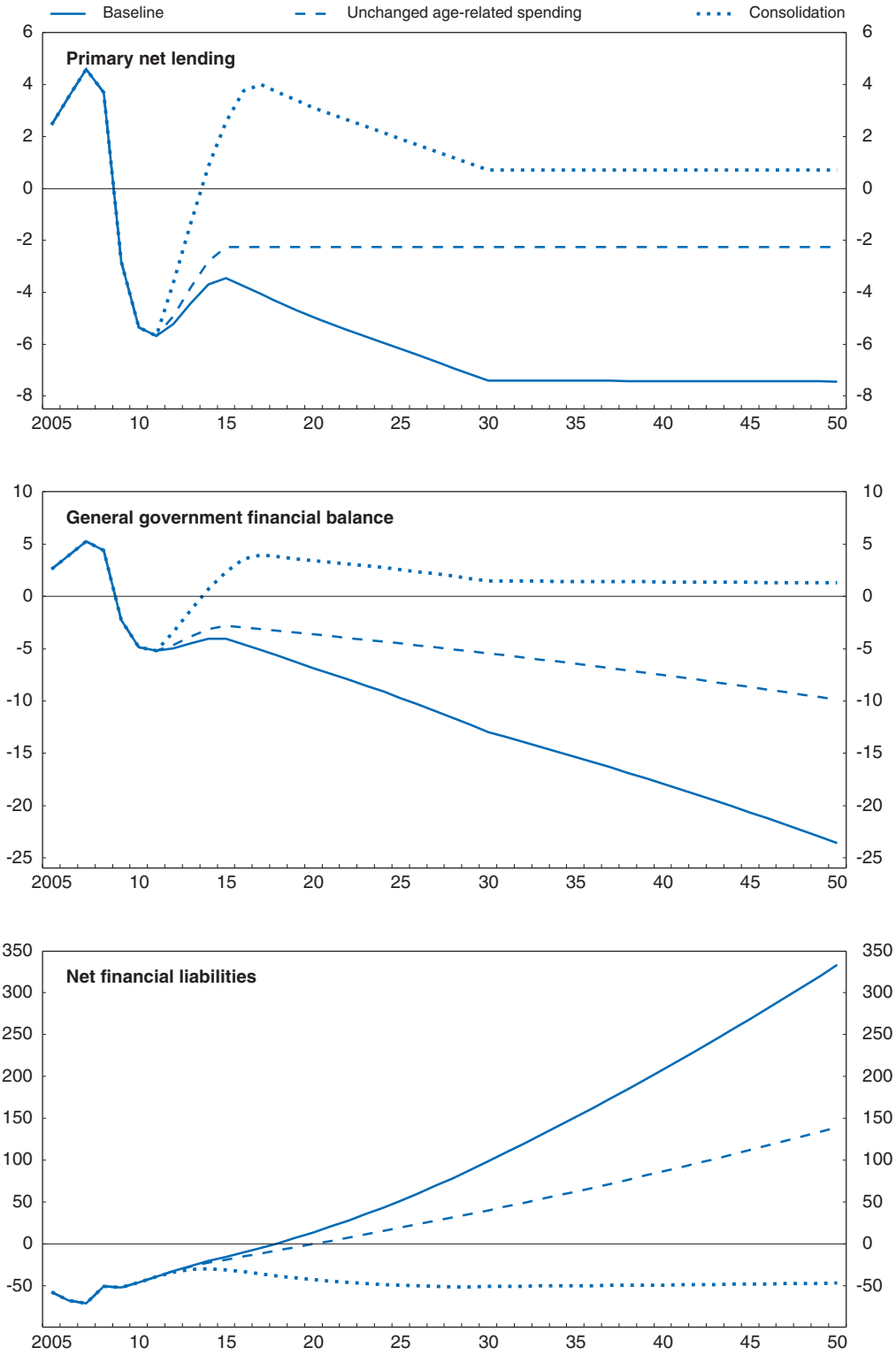
Given the large sustainability gap, the fiscal stance needs to be tightened as the recovery takes hold. While the timing and extent of fiscal consolidation must be contingent on the pace of the recovery, a consolidation programme should be presented and enacted as early as possible to maintain confidence and ensure that appropriate actions are taken. Successful fiscal consolidation tends to be accompanied by clear prior commitments (Guichard *et al*., 2007). By being clear about its intentions to consolidate, the government can reassure households and financial markets that corrective action will be taken in due time. This ensures trust in the fiscal position. Furthermore, early action would also be beneficial from a political economy perspective, as the willingness to accept consolidation is likely to be greater during a crisis (Henriksson, 2007).

It is also cheaper to consolidate earlier than later. The risk of a "snowballing" effect from interest payments on debt favours early action. For example, if consolidation were to start in 2015 rather than 2012, it would need to be 0.4% of GDP larger in order to achieve sustainability.

Intergenerational fairness also favours immediate action. The costs of the recession in terms of lost output and fiscal deficits should be shared between current and future generations (Box 2.2). Without rapid consolidation, the fiscal burden of the recession increasingly falls on future generations through high underlying deficits and large projected increases in debt and interest payments. While there are arguments in favour of not letting the current generations of retirees bear the full costs, as their ability to respond to changed conditions is more limited, other currently living generations should contribute fully.

Figure 2.2. **Fiscal sustainability requires extensive consolidation**

As a percentage of GDP



Source: OECD, *Economic Outlook 86 Database* and OECD calculations.

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Box 2.2. **Strategies for tackling fiscal sustainability – pre-funding in Finland**

Two different paths are available to meet future fiscal obligations. Firstly, governments and individuals can decide to *pre-fund* to cover future obligations by building up assets today that will allow future primary deficits and net borrowing. This can be done within the pension system or by household savings outside the pension system. Secondly, governments can strive to increase *resilience* to future developments and shocks by improving the future primary fiscal position, for example, by raising future labour supply, reforming the pension system or credibly cutting back on future expenditures (See Chapter 3 for recommendations on these issues). Fiscal consolidation to improve sustainability needs to address both channels. From a welfare perspective, different shocks should typically be tackled with different tools. For example, an increase in future longevity could lead to further expenditure pressures but also benefits future generations in terms of longer lives. Consequently, it is logical that future generations that would benefit from the increase in longevity bear the costs, for example, by raising future retirement ages (Andersen, 2008). On the other hand, if current generations want to benefit from a higher quality old-age care when they are old, pre-funding would be a natural response.

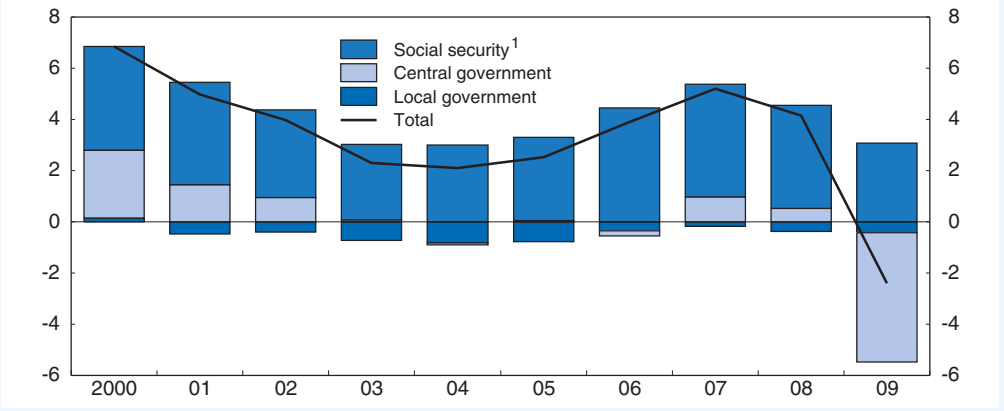
In practice, the choice of tools is more complex. Intergenerational fairness can be defined in many ways, and other considerations need to be taken into account. Factors pointing in the direction of more focus on pre-prefunding include issues of time-inconsistency in political-economy processes and overly optimistic assessments of the long-term impact of reforms. A factor suggesting less focus on pre-funding (as opposed to resilience) is the difficulty for governments to maintain large positive asset positions over long periods.

Pre-funding for ageing in Finland

Finland has been preparing for ageing by pre-funding through fiscal surpluses for a relatively long period, although the fiscal position worsened dramatically in 2009 (Figure 2.3). The general government surplus in Finland has to a large extent been reflected in the surplus in the social security funds (which include the employment pension funds), with lower surpluses in the central government sector and deficits in the local government sector.

Figure 2.3. **Government financial balances by sector**

In per cent of GDP



1. Including employment pension funds.

Source: Statistics Finland.

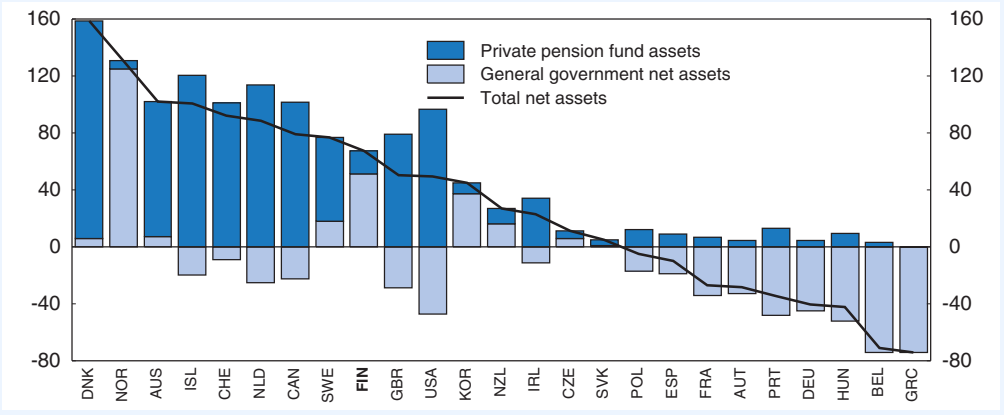
StatLink http://dx.doi.org/10.1787/827660731332

Box 2.2. **Strategies for tackling fiscal sustainability – pre-funding in Finland** *(cont.)*

As a consequence of a national decision in 1993 and confirmation by the European Commission in 1997, Finnish employment pension institutions are classified in the general government sector. This means that contributions to mandatory pension schemes for private sector employees that are administered by private pension institutes are recorded as government receipts. Similarly, the assets of the pension funds are included as general government net assets, which inflate Finland's fiscal position compared to other countries. One way of more accurately gauging pre-funding across countries is to add together government net financial assets and private pension assets. Private pension assets are important in a number of countries (Figure 2.4), and their inclusion changes the relative fiscal position of Finland significantly. It should be stressed that there is no obvious "correct" way of treating pension funds in this regard. However, it is important that evaluations of pre-funding capture the differences. By fully including future pension liabilities in the government's balance sheet, the classification issue would be less important. The sustainability indicators presented in this *Survey* as well as by the Finnish government incorporate future spending on pensions and are thus not sensitive to those classification issues.

Figure 2.4. **Government and private pension net financial assets**

In per cent of GDP, 2008[1]



1. Or latest available year.

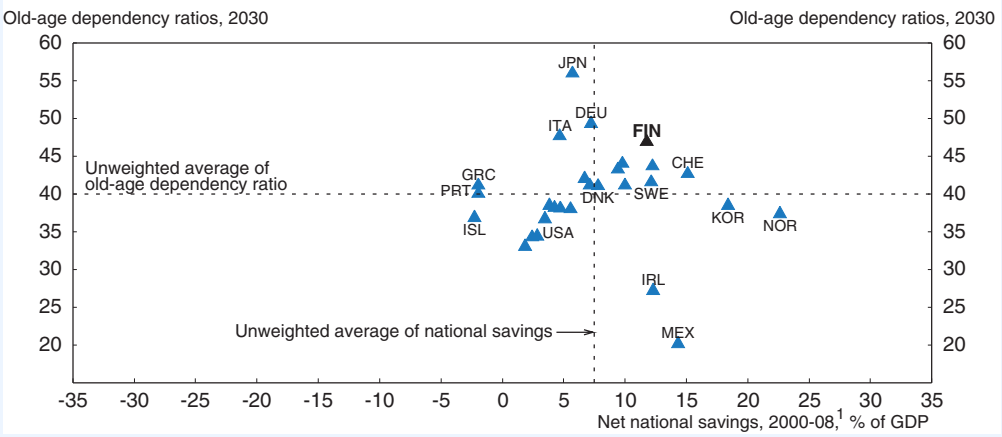
Source: OECD, *Global Pension Statistics* and *OECD Economic Outlook Database*.

StatLink http://dx.doi.org/10.1787/827684502008

While adding together government assets and private pension assets gives one measure of pre-funding and preparation for future costs related to ageing societies, these measures have clear limitations. Societies may accumulate real and financial assets outside the pension system. In this context total domestic savings, which is equal to net capital formation and the current account surplus, may be a better indicator of a country's accumulation of resources (Figure 2.5). While net national savings in Finland are higher than the OECD average, ageing is also a more pressing concern and therefore Finland should save more than the average OECD country.

Box 2.2. **Strategies for tackling fiscal sustainability – pre-funding in Finland** *(cont.)*

Figure 2.5. **Net national savings and old-age dependency**



1. Or latest available year.

Source: OECD, *Annual National Accounts and Population Databases.*

StatLink http://dx.doi.org/10.1787/827707527583

However, fiscal consolidation should wait until recovery becomes established as the economic outlook for Finland remains uncertain and the output gap is wide. On current OECD projections a firmer recovery is expected during the course of 2011, suggesting that fiscal consolidation should take place from 2012 onwards, preferably starting with reforms to extend working lives, tax increases and restraints on general government spending, while elevated levels of labour market programmes should be kept in place longer.

The composition of consolidation matters

Apart from directly improving sustainability, a consolidation plan may yield additional indirect benefits or costs. Lowering replacement rates in unemployment insurance and further pension reform as outlined in Chapter 3 are, for example, likely to stimulate employment and growth which would further strengthen public finances. Consolidation through tax hikes that decrease incentives to work and invest may instead be self-defeating, as tax bases deteriorate and expenditures increase (see Box 2.3). This avenue should, therefore, be avoided if possible. The already high tax burden in Finland also leaves little room for further tax increases (Figure 2.1, third panel). International evidence also suggests that spending-focused consolidation tends to be more successful than tax increases, as the former typically is associated with higher GDP growth (Ardagna, 2004).

The successful fiscal consolidation in Finland after the 1992 crisis took place without significantly increasing the overall tax burden.[4] However, expenditure restraints and cuts were accompanied by substantial increases in the tax wedge on labour. The income tax rate for an average earner increased from 32% in 1991 to 38% in 1995 (Grönqvist and Kinnunen, 2009). While such tax hikes tend to have detrimental effects on incentives to work and invest in human capital, the scale of the required consolidation at that time meant that expenditure cuts needed to be accompanied by tax increases.

Box 2.3. **Two different consolidation scenarios**

The composition of reforms is important for the efficiency of fiscal consolidation in a general equilibrium context. While policymakers have to consider political, distributional and regional concerns apart from the pure public finance aspects of reforms, this analysis highlights the role of labour supply and output in consolidation.

In the first scenario, income taxes and social security contributions are assumed to be raised by 4% of GDP each, amounting to a fiscal tightening of 8% of GDP. Such an increase would raise the tax wedge on labour income by roughly 15 percentage points, which in turn would increase unemployment by roughly 4.5 percentage points according to OECD estimates. If the higher unemployment rate then fully transforms into lower employment and GDP, primary net lending would deteriorate by a further 2.3% of GDP.* Thus under this scenario, significant further consolidation would be needed. These estimates are likely to err on the conservative side, as labour market participation may also decline and the compressed wage structure in Finland may prevent tax shifting to workers, which may exacerbate employment effects.

An alternative consolidation scenario consists of a combination of measures. Firstly, increases in less growth-hurting taxes such as the property tax (yielding 1% of GDP), and a uniform VAT of 23% (yielding 1-1.5% of GDP) could be implemented. Lowering excessive accrual rates in the pension system (see Chapter 3) could add savings to the pension system equivalent to roughly 2% of GDP (OECD, 2006). Containing real municipal expenditure growth through a tax ceiling, and freezing transfers to municipalities so that the recent 10% productivity loss is recovered, could shrink government expenditures by almost 1.5% of GDP relative to the baseline. Further savings could be made through the proposed changes to the financing of tertiary education (Chapter 1), lowering replacement rates and restricting access to early retirement pathways (Chapter 3). Raising returns on government assets would also help shrink the sustainability gap. All in all, such a fiscal package could achieve the required savings without negative repercussion on labour supply and growth. Indeed, if combined with employment-enhancing reforms as suggested in Chapter 3, the need for fiscal consolidation could be lessened substantially.

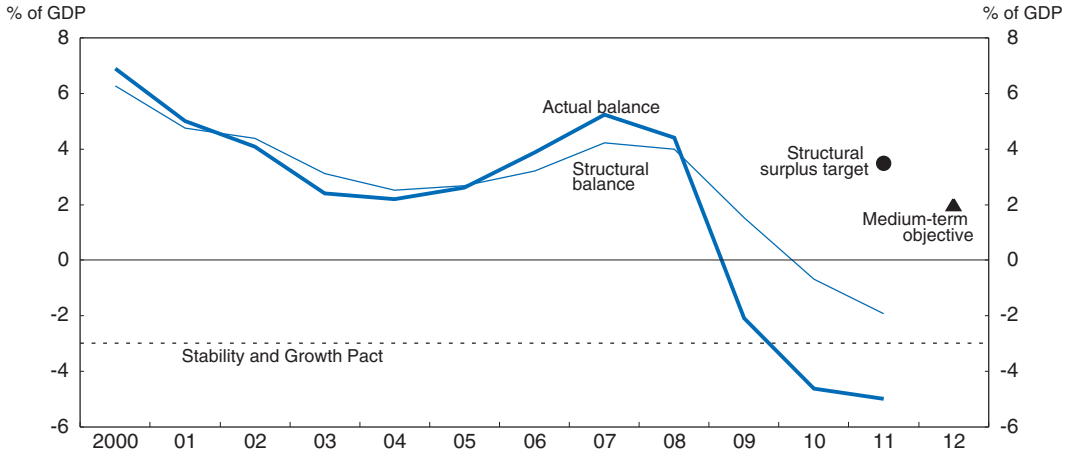
* The elasticity of unemployment with respect to the tax wedge is taken from Bassanini and Duval (2006). The semi-elasticity of the primary balance with respect to GDP is assumed to be 0.48 (Girouard and André, 2005).

Although the structural reforms in the labour market outlined in Box 2.3 are an attractive way to close the sustainability gap, the size of the gap means that substantial efforts would be needed. For example, consolidation achieved through increasing the retirement age would require raising it by five additional years on top of the two years already assumed in the baseline scenario. This would mean bringing the average effective retirement age from 60 in 2007 to 67 years by 2030, roughly a 20% increase in the average working life. Even with significant structural reforms to work incentives and the pension system (see Chapter 3), such an improvement in labour supply and employment would prove challenging. Thus the extent of the gap is likely to require further action in terms of expenditure cuts and tax increases. Such measures should be undertaken in a way that minimises any adverse effects on resource allocation and work incentives. In this regard the planned increase in the VAT rate from July 2010 is one small step in the right direction, although it fills less than 10% of the total sustainability gap.

Reaching sustainability will require new fiscal targets

The fiscal surplus targets in place prior to the recession will not be met, although the central government expenditure ceiling remains intact (Figure 2.6). Along with many EU countries, Finland is expected to experience deficits beyond the 3% of GDP deficit threshold stipulated by the Stability and Growth Pact (SGP). In Finland, the SGP target was complemented by an ambitious set of fiscal targets set by the government in its Government Programme of 2007 (see Box 2.4). Most of these, as well as the government's employment and unemployment targets, will not be met. Apart from the deep recession, this also reflects the partial coverage of the expenditure ceiling and the multiplicity of fiscal targets.

Figure 2.6. **Targets for the general government financial balance prior to the recession**



Source: OECD, *OECD Economic Outlook 86 Database*.

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Fiscal policy needs to target several different goals

Revised fiscal rules, if set up appropriately, can simplify and reinforce the required consolidation effort. Research suggests that rules tend to facilitate fiscal consolidation and enable larger and more sustained consolidations (Guichard *et al.*, 2007). On a general level, fiscal policy should contribute to stability, efficiency, sustainability and distributional goals. When setting fiscal targets and designing a fiscal regime, consistency with overall policy objectives is therefore paramount (Barker *et al.*, 2008). Fiscal policy rules can help policymakers take longer term considerations into account by increasing the costs of short-sightedness in decision making. Thus these rules can help to achieve more time-consistent fiscal policy making (Calmfors, 2005).

A revised fiscal framework needs to make more room for stabilisation

The 2011 surplus target and the deficit floor left little room for stabilisation policies in the recent recession, forcing the government to suspend them. Although the depth of crisis forced many OECD countries to take extraordinary action, the Finnish targets would most likely not have been sufficiently flexible to deal with even a more normal downturn in an efficient way. Already in the Stability Programme update for 2007, the government foresaw

Box 2.4. **Fiscal and labour market targets**

The Stability and Growth Pact (SGP) deficit floor was complemented by several national targets set by the government in 2007:

- A medium-term objective of a general government structural surplus of 2% of GDP in 2012. In the Stability Programme update 2009 (Ministry of Finance, 2010) the medium-term objective was set to 0.5% of GDP in 2013.
- A central government structural surplus target of 1% of GDP by 2011 (roughly equivalent to 3.5% surplus in general government finances according to the Stability Programme update for 2008). This target was suspended in February 2009.
- A central government deficit floor of 2.5% of GDP. According to the Stability Programme update 2009 (Ministry of Finance, 2010), central government deficits will exceed 2.5% of GDP for the period 2009-13.
- A commitment to the multi-annual spending limits adopted in May 2007 covering non-cyclical central government spending.

The fiscal targets have been accompanied by a set of labour market targets:

- A specific employment target for 2011 (72% employment rate) and a long-term employment target (75%).
- Unemployment should be reduced to below 5% on a permanent basis.

that the central government structural surplus would significantly undershoot the 2011 target. Trying to achieve the surplus targets set by the government for 2011 and 2012 would thus have implied significant pro-cyclicality in the face of a recession. While the utilisation of numerical targets typically improves budgetary outcomes, allowing sufficient flexibility so that they do not hamper fiscal stabilisation is important (Debrun *et al.*, 2008).

A future fiscal framework should allow sufficient flexibility to deal with normal cyclical downturns. While such flexibility has been provided on the expenditure side by excluding cyclical expenditures from the central government expenditure ceiling, more flexibility in terms of surplus targets is needed. The recession has highlighted the importance of discretionary fiscal policies in stabilisation and the need for flexibility in the fiscal framework. The extent of the needed flexibility depends on both the size and the type of shocks that affect an economy, but also on related adjustment mechanisms including monetary policy and real exchange rate flexibility. Real exchange rate adjustment is slow in Finland due to a fixed exchange rate, the low overall inflation target and wage rigidity. A small country with high output volatility and relatively large automatic stabilisers requires relatively high short-term flexibility in the fiscal targets. Furthermore, monetary policy for euro area members is set in accordance with the needs of the whole zone rather than Finland alone. As Finland has a small weight in the ECB's inflation target and differs significantly from the average member in terms of industrial structure, trade patterns and its monetary transmission mechanism, the role of fiscal policy in stabilisation could be expected to be larger than in the average euro area country (Chapter 1). Fiscal flexibility can be achieved by targeting the structural deficit rather than the actual deficit, so that the automatic stabilisers are allowed to work fully. The government should avoid reinstating the deficit floor or setting numerical targets for the actual deficit in specific years as they are too inflexible and vulnerable to developments

outside the government's control. Fiscal stabilisation should also be made more flexible by making more use of sunset clauses on stabilisation measures to avoid the permanent weakening of the fiscal outlook that recent packages have been responsible for.

The fiscal targets should be closely aligned to longer term goals

A new fiscal framework should be based on long-term sustainability analysis, and include targets for further pre-funding, structural reforms or less generous future benefits (Box 2.5). The government's fiscal documents stress the importance of achieving fiscal sustainability (Ministry of Finance, 2009), which is monitored by annual submissions under the Stability Programme. The government has also acknowledged that there is a funding gap, which needs to be addressed through increasing labour participation or more pre-funding. However, no operational links have been introduced between the fiscal framework, fiscal sustainability and policies to increase participation so far. Based on an assessment of the fiscal sustainability gap, concrete measures to close the gap should then be outlined and implemented in the budget process (Swedish Fiscal Policy Council, 2009). While compliance with fiscal targets should be gauged on a yearly basis, new long-term targets could be set with a lower frequency to let the target work as a more stable anchor in the fiscal process.

Box 2.5. **An outline for a revised fiscal framework**

- Estimate the fiscal sustainability gap based on current policies on a less frequent basis (*e.g.* when the government program is launched and when the mid-term review takes place).
- Set out a 4-year rolling fiscal plan in terms of the structural surplus that is consistent with closing the sustainability gap. The fiscal plan should include a combination of structural reforms, expenditure ceilings for central government non-cyclical expenditures and tax policies.
- Reassess and modify the fiscal plan on a yearly basis according to the economic situation, new priorities, etc.
- Let an independent agency prepare yearly evaluations of the government's fiscal plan (and the sustainability estimates when relevant) to be published well ahead of the upcoming next budget. Ensure that the government has to respond to the evaluation, *e.g.* in the *Budget Review*.

Enforcement and monitoring could be enhanced

Although Finland has a strong fiscal track record compared to most other OECD countries, the introduction of a Fiscal Council could contribute further to the quality of decision making and reaching fiscal targets. The central government, the Bank of Finland, research institutes, government bodies and social partners all contribute to public discussion on fiscal policy. While this is useful, a more institutionalised framework may improve the public discussion even further. While institutional arrangements vary, a good example is the Fiscal Policy Council set up in Sweden in 2007. It assesses fiscal policy objectives (including sustainability), the efficiency of policies to reach those targets and the quality of the government's forecasts and analysis. Although it is an agency under the

Swedish Ministry of Finance, the council's independence and credibility are assured by the reputational status of its mainly academic members. Ideally, a Fiscal Council in Finland should be an agency under parliament, with a legal status similar to the National Audit Office, and should evaluate the government's assessment of sustainability and assess to what extent fiscal policy is in line with fiscal targets. In setting up such a council, issues of intellectual independence, competence and expertise are also crucial. The fiscal framework and public finances are likely to gain from an open and informed discussion on future challenges to the Finnish welfare state by experts. This is especially true given the complexity of fiscal issues and economic consequences of policy actions.

Consolidation can be facilitated by a more efficient tax structure

The revenue structure can be more efficient

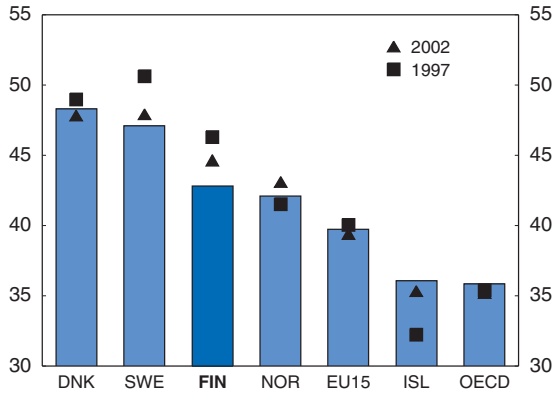
It is important that revenues are raised in the most efficient way, which often implies broadening tax bases, lowering tax expenditures and taxing less mobile factors (OECD, 2009a). The composition of tax revenues influences growth in GDP per capita (Johansson *et al.*, 2008). While corporate taxes tend to be the most harmful for growth and recurrent taxes on immovable property the least harmful, taxes on personal incomes and consumption lie in the middle. Evidence of the effects of social security contributions on growth is less clear, as the connection between contributions and benefits affects work disincentives created by these measures.

The relative success of Finland and the other Nordic countries in terms of combining high levels of GDP per capita and an extensive welfare state show that there is no one-to-one relationship between high taxes and GDP per capita. Still, in countries with high tax-to-GDP ratios, there is always a risk that incentives for work, education and investment may be blunted. The Government Programme of 2007 also stresses the importance of tax policies in fostering employment and growth. The need for fiscal consolidation only strengthens this conclusion.

In several respects, the Finnish tax system is relatively efficient and well adapted to the country's needs. While general government revenues in relation to GDP have decreased from the record levels of the 1990s, they still remain well above the OECD and EU averages. At the same time, they are lower than in Finland's Nordic neighbours (Figure 2.7). Taxation on corporate profits and capital is flat, broad-based and in line with the OECD average (Figure 2.8). However, taxes on labour are somewhat higher than the OECD average, though they have come down since the 1990s. High taxes on labour are likely to adversely affect incentives for working longer hours and investing further in education, even if hours worked per employee and returns on education in Finland are well above the other Nordic countries (OECD, 2008). As discussed in Chapter 4, the dual tax system could be improved upon.

Recent income tax changes have been substantial. The statutory top tax rate on labour income has been reduced by 5 percentage points over the past ten years, although at over 50% in 2009 it remains high in an international perspective.[5] In addition, tax credits and deductions in the tax system have increased. While these increases have improved work incentives (OECD, 2008), these "carrots" have implied significant fiscal costs and need to be complemented by tightening access to and the amount of benefits in the welfare system to be effective in increasing labour supply (see Chapter 3).

Figure 2.7. **Aggregate tax-to-GDP ratio**
2008[1]



1. 2007 for EU15 and OECD.

Source: OECD (2009), *Revenue Statistics Database*, December.

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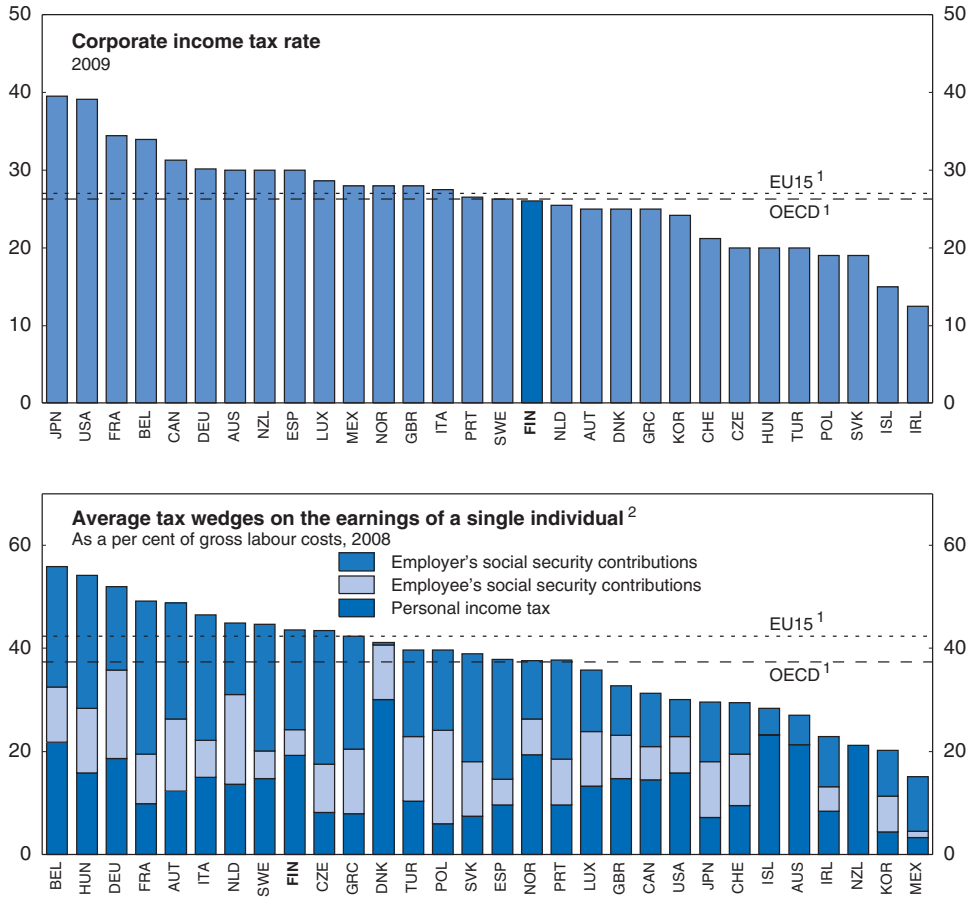
Figure 2.8. **Corporate and personal income tax rates**



1. Unweighted average.
2. 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).

Source: OECD (2009), *Taxing Wages 2007-2008* and *OECD Tax Database*.

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In its 2007 programme the government set out to further lower income taxes to increase employment. The 2010 Budget also focuses on tax cuts by increasing the basic and earned income deductions, adjusting brackets and easing taxation on pensions. While these cuts will give a welcome short-term boost to demand, their longer term effects on labour supply are likely to be small. They do not improve work-incentives significantly because tax cuts apply to both labour and transfer incomes. Given that expenditure ceilings will need to be set tight in coming years (see below), extra vigilance should be pursued in order to hinder any use of tax expenditures to circumvent the expenditure ceiling which could hollow out the tax base. The government's recent decision to improve methods of measuring and reporting tax expenditures is thus welcome.

For a number of years municipal income taxes have increased, partly offsetting state income tax cuts. More than one-third of the municipalities plan to raise income taxes in 2010, in some cases by as much as 1.5 percentage points. This is likely to reduce the impact of the stimulus package (see Chapter 1) and raise tax wedges across the board. Reining in expenditure growth in municipalities in the longer run to stop further tax hikes should be a priority so as to minimise effects on work incentives and improve productivity in municipalities (see below).

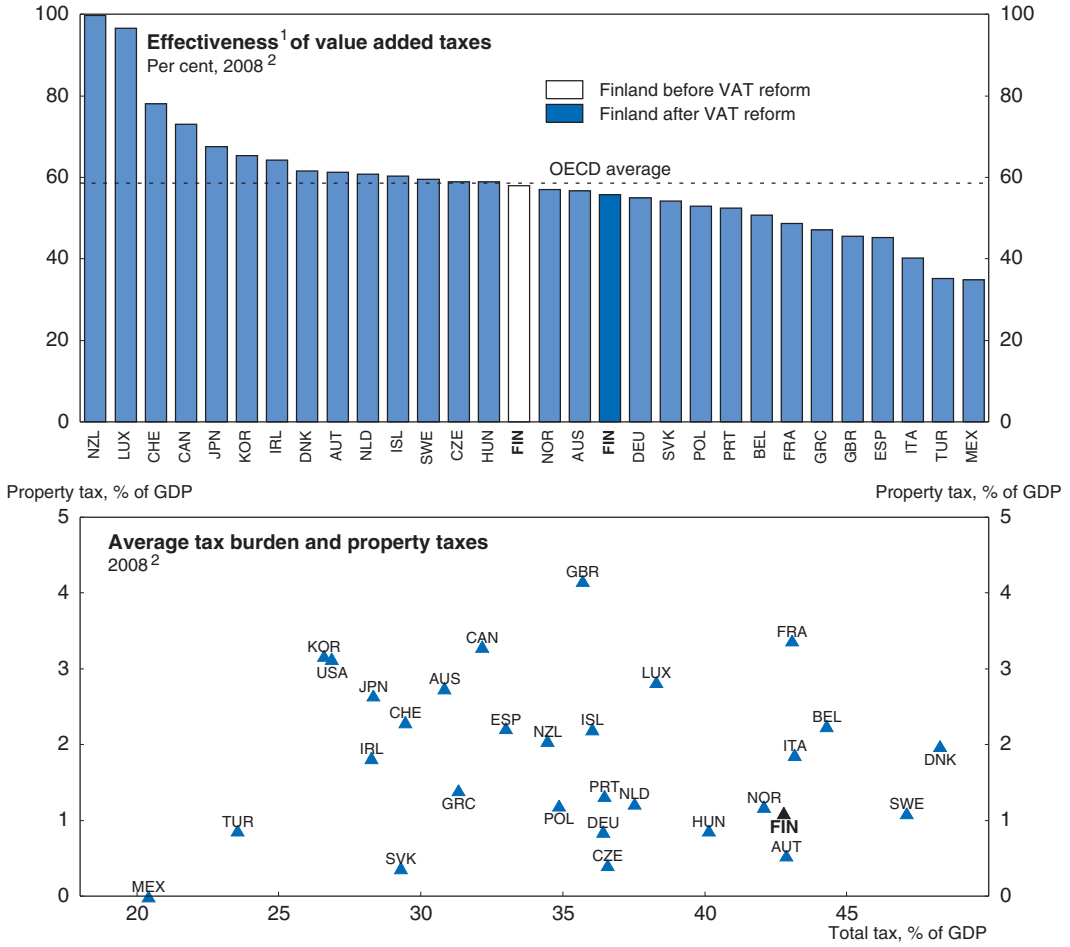
Preferential VAT rates should be increased

There is room to raise and broaden indirect taxes. The Finnish VAT system has three rates: the standard of 22%, a 12% reduced rate on food (reduced from 17% in October 2009) and a further reduced rate of 8% on a range of commodities such as accommodation services, books and passenger transport. In line with the OECD average, taxes on goods and services make up roughly 30% of total revenues. The 2010 Budget envisages a 1 percentage point increase in all VAT rates from July 2010, but the recent cuts on food, together with another announced cut on restaurant services from 22% to 13% weakens the tax base. Although there may be theoretical gains from differentiating VAT rates in terms of efficiency and equity, in practice this tends to create distortions and increase collection costs (Joumard and Suyker, 2002). The cut in VAT on food and restaurant services will decrease VAT efficiency in Finland, and the VAT revenue ratio is projected to decline from 61% to 58% due to the reform. This is well below best performing New Zealand, Luxembourg and Switzerland (Figure 2.9). Given that this tax cut is estimated to cost EUR 500 million per annum and that the distributional effects of reduced tax rates on food are relatively small, the authorities should at a minimum reverse the changes that have decreased uniformity in the VAT system. Distributional concerns could more efficiently be addressed by targeted transfers to the most affected groups, such as families with children, pensioners on basic pensions and students. A bolder step towards fiscal consolidation would be to move to a uniform 23% rate, which could increase revenues by 1-1.5% of GDP.

There is also room to further increase property taxes and environmental taxes

Recurrent taxation on immobile property is one of the most efficient sources of tax revenues as the tax base is immobile and evasion is difficult (Joumard and Kongsrud, 2003). Against this background, it is striking that Finland, along with the other Nordic countries with high overall tax burdens, tax property less than countries with lower tax burdens (Figure 2.9, bottom panel). Although property tax rates have increased during the last 10 years, the revenues generated have barely kept pace with GDP and have fallen

Figure 2.9. **Tax efficiency could increase**



1. Defined 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).
2. Or latest available year.

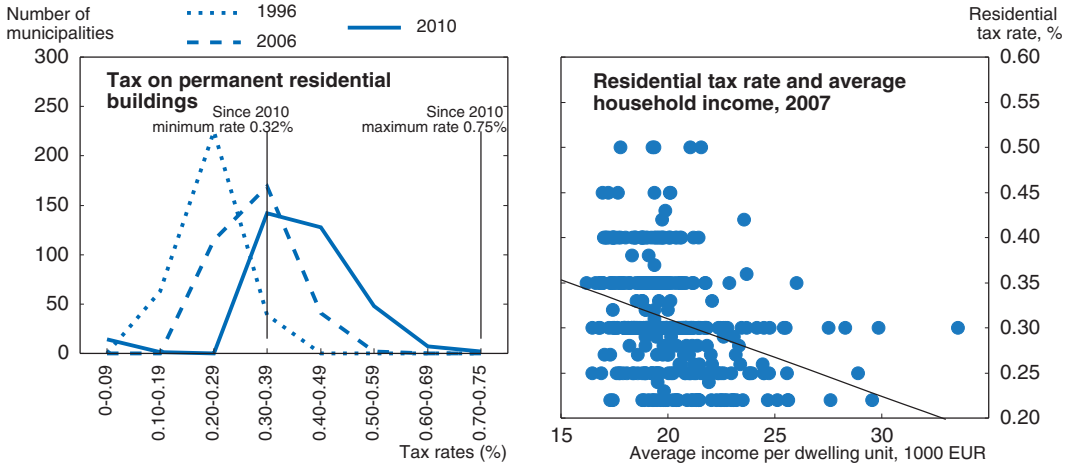
Source: OECD, *National Accounts*, *Revenue Statistics* and *Tax Databases*, December 2009 and OECD calculations.

StatLink http://dx.doi.org/10.1787/827772006404

significantly in relation to house prices. This is due to valuation assessments lagging behind market prices. This is now being addressed by tax authorities. Property taxes typically also have benign distributional effects. A number of studies point to high income households gaining disproportionately from under-taxation of housing. Higher property taxes may also improve intergenerational distribution of wealth (Barrell and Weale, 2009).

In Finland, property taxes are set by the municipalities within a range prescribed by the central government. While decentralised decision-making to the municipal level may enhance accountability, stronger centralisation could improve efficiency. Municipalities struggle to raise property tax rates, as local tax competition and lack of technical skills seem to keep rates close to averages (Figure 2.10) and well below the maximum, although they have increased recently. Currently, residential tax rates are regressive, as municipalities with high average incomes tend to set lower rates (Figure 2.10, right panel). Although efficiency and equity could be increased by nationalising the property tax, this is barred constitutionally.

Figure 2.10. **Municipal property tax rates**



Source: Ministry of Interior.

StatLink http://dx.doi.org/10.1787/827772323471

In the previous *Survey* (OECD, 2008), the OECD recommended that the minimum property tax rate should be raised substantially. From 1st January 2010, the minimum tax rates applied to permanent dwellings and the general property tax have been raised slightly. To improve the efficiency of the tax composition and increase tax revenues without worsening income distribution, the government should consider:

- Ensuring that property valuations are close to market levels. The current process to harmonise the assessment of property values to market levels is therefore welcome.
- Further increasing the minimum property tax rates significantly and abolishing the maximum rates. This applies in particular to the tax on permanent residential dwellings, where rates are the lowest and the tax base is widest. The government should also consider taxation of agricultural and forest land.
- Constraining other sources of municipal revenues, such as income taxes (see below) and government transfers.
- While tax increases on property have to be phased in over an extended period to avoid disrupting the housing market, revenues from property taxation should at least move to the OECD average of 2% of GDP.

The government recently committed to the target of reducing CO_2 emissions by 80% by 2050. While not yet outlining the path to achieving this target, there are a number of existing schemes that effectively subsidise emissions and that the government should abolish, including the use of peat in energy production (Box 2.6). An environmental levy on peat should be considered.

Box 2.6. **Climate change and environmental taxes**

Climate change abatement targets are an important part of the government's policy agenda as articulated in the Government's Climate and Energy Strategy in 2008. It specifies how Finland would achieve the EU climate and environmental objective of cutting greenhouse gas emissions by 20% relative to 1990 levels by 2020. Other measures taken include amending taxation of motor vehicles by basing the tax rate on emissions. In 2009 the government also adopted a report on long-term climate and energy policy that extended its climate and energy strategy to 2050. This Foresight Report sets the ambitious target of cutting carbon dioxide (CO_2) emissions by at least 80% from the 1990 level by 2050. As part of the effort to achieve these targets, the government announced new environment taxes to be introduced in 2011. These are principally increases in fuels excises and, along with the changes made in 2008, go some of the way in lifting Finland's relatively low implicit tax rate on energy. This was around EUR 104 per tonne of oil equivalent in 2007, which was lower than the EU average of EUR 167 and close to half the rate of Sweden, Germany and Denmark.*

A number of areas remain where further progress could be made. Finland is one of the few countries in Europe that has not decreased its greenhouse gas emissions intensity of energy consumption since 2000 (EuroStat data). One reason for this is the use of peat in energy generation. In 2007 peat accounted for just 7% of all total energy production in Finland but comprised 15% of Finland's total CO_2 emissions. Finland has the ninth largest stock of peat (roughly on a par with Sweden) and the world's highest rate of peat emissions per capita (Wetlands International, 2009). While the Foresight Report sets a target of gradually phasing out the use of peat (and other fossil fuels) in energy production, the government has not yet formally committed to implementing all the recommendations of the report. Nor has it articulated plans to phase out the special treatment currently provided to the peat industry – due to regional policy objectives, peat is tax exempt in heat production and receives a subsidy in electricity production. The government should not extend the special treatment for peat when the current measures expire in 2010. There are other weaknesses in Finland's energy taxation policy related to the tax refund systems for certain energy-intensive industries and the agriculture sector, that should be also addressed.

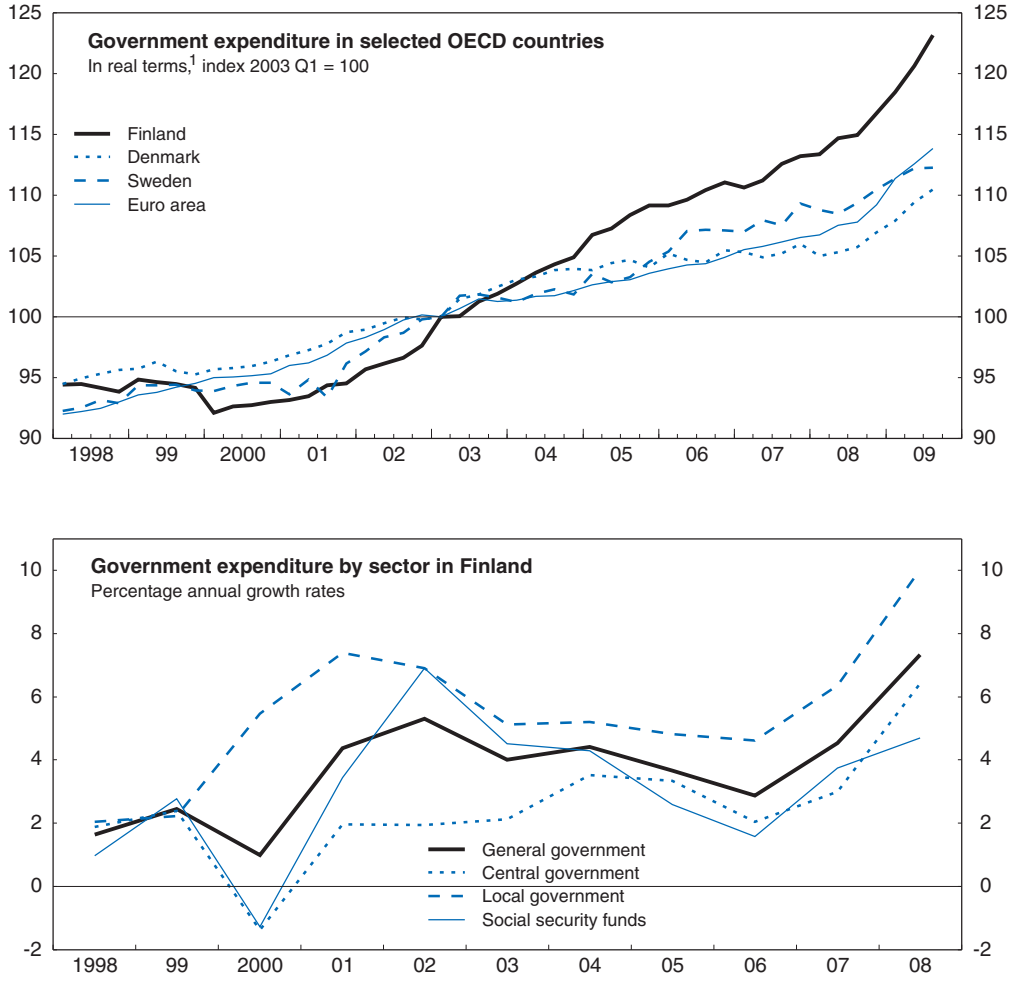
* *Eurostat Database*. Implicit tax rate on energy: euros per tone of oil equivalent.

Expenditure growth needs to be reined in and efficiency improved

The expenditure ceiling has not been able to contain overall government spending

The current central government expenditure ceiling was introduced in 2003 to curb spending growth and was further developed in 2007. It is set in real terms for a four-year electoral period, which is currently 2007-11, and covers non-cyclical, central government expenditures. The expenditure ceiling has been successful in containing central government expenditure during the years of buoyant revenues. The government estimates that the budget appropriations will stay within the spending limits between 2009 and 2011, but contingency margins are small at less than 1% of the expenditures under the ceiling (Ministry of Finance, 2009). While expenditure rules in general tend to promote fiscal consolidation and improve the functioning of fiscal frameworks, general government spending growth has remained relatively high in Finland. Although expenditures were reined in significantly in the late 1990s and early 2000s, more recently they have increased at a much higher rate than in *e.g.* Denmark, Sweden or the euro area (Figure 2.11). To ensure fiscal consolidation, real expenditure ceilings should be set on a declining trajectory from 2012 onwards until a sustainable fiscal position is reached.

Figure 2.11. **Expenditures have been increasing rapidly**



1. Deflated by the private consumption deflator.

Source: Statistics Finland and OECD, *OECD Economic Outlook 86 Database*.

StatLink http://dx.doi.org/10.1787/827860177615

The excessive expenditure growth has mainly taken place in spending categories outside the ceiling and primarily in the municipal sector. As the ceiling applies to about a third of total government spending, growth in other categories has been pushing up outlays rapidly. In line with international evidence (Afonso and Hauptmeier, 2009), the high and increasing level of decentralisation in spending in Finland seems to have contributed to the fast growth in overall expenditures. The most rapid growth during the last ten years has been in municipalities (Figure 2.11, bottom panel). The central government may be contributing to this by implementing programmes that push expenditures to the local level. More importantly, municipalities have soft budget constraints, and are likely to have weaker fiscal discipline due to less exposure to negative spillovers from high labour taxes in terms of increasing unemployment, etc. Consequently, municipal expenditures soared while revenues were buoyant. As the previous *Survey* showed, the reliance on highly cyclical revenues, such as corporate taxes, has tended to ratchet up expenditures in good times. The subsequent decline in revenues has led to requests for further grants and municipal tax hikes.

To rein in permanent expenditure increases enabled by temporary buoyant corporate tax revenues, the central government should consider taking over these revenues and amending the transfer system. Municipalities could be compensated with a transfer based on the cyclically-adjusted corporate tax base. From a theoretical perspective, caps on municipal spending could be considered in order to increase fiscal discipline, but this would prove impractical due to the large number of municipalities. The government therefore needs to pursue other means, like ceilings on the municipal income tax, or changing the transfer system so that municipal income tax increases automatically lead to significant partially offsetting grant cuts. While the introduction of the current block grant system seems to have improved budgeting procedures in municipalities (Moisio, 2001), the easy access to the tax instrument contributes to spending pressures. To constrain spending pressures, the government should also consider freezing transfers to municipalities or just adjusting them for increases in consumer prices to ensure that municipal spending as a share of GDP is lowered over the consolidation period.

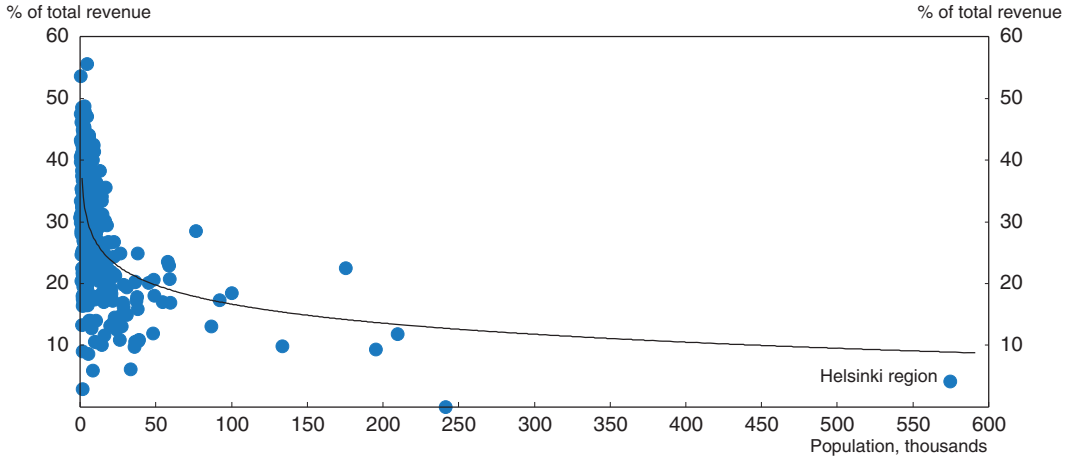
The efficiency of municipal service provision could also be improved. Public services in Finland are generally of good quality and relatively cost-effective. World class basic educational attainment is achieved at relatively modest costs (OECD, 2009b) and health care outcomes are good in relation to spending (OECD, 2009c). However, the persistent decline in the productivity in the provision of many public services points to growing inefficiencies. Overall productivity in local government fell by more than 10% between 2000 and 2008. The fall has been widespread, but is particularly pronounced in the social work (–15%) and health (–12%) sectors. The buoyant resources channelled to the municipalities have contributed to the decrease in efficiency and seems to have created significant slack. Inefficiencies are especially large in municipalities where incomes are high and have been growing fast.[6] Programmes implemented during the last few years to increase public sector productivity through administrative simplifications, better use of IT, establishment of minimum population-base requirements for school and health care districts and increased competition have yet to produce tangible results. One important factor behind the slump in productivity in municipalities seems to be that required plant level adjustment of inputs is not taking place.

Restructuring municipalities would support fiscal efficiency

Many municipalities are struggling to meet their service delivery obligations in the face of a rapid increase in old-age populations and dwindling tax bases due to demographics and migration towards economic centres (see Chapter 4). Finnish municipalities retain a remarkable degree of independence, so that even very small municipalities take decisions on complex issues such as tax policies and provision of education. It is likely that many of them lack sufficient expertise in those areas, given that the median population is lower than 5 000 inhabitants. Many small municipalities are also highly dependent on state grants and are therefore exposed to the fiscal situation within the central government (Figure 2.12).

The government's key strategy for municipal reform has been to encourage mergers and restructuring through financial incentives. The number of municipalities was reduced by over 80 between 2006 and 2009 to 348, but compared to other Nordic countries mergers have been timid (Box 2.7). As was discussed in the previous *Survey*, the mergers conducted so far do not seem to have produced measurable cost reductions. This is not surprising, given that merging municipalities typically agree to not lay off any workers for five years

Figure 2.12. **Grants to municipalities by population size**



Source: The Association of Finnish Local and Regional Authorities and Statistics Finland.

StatLink http://dx.doi.org/10.1787/827865151776

Box 2.7. **Municipal mergers in the Nordic countries**

Successive governments have recognised potential advantages of rationalising Finland's fragmented municipal system. The scheme to restructure local government was overhauled in 2005 to promote larger, more viable units. This included revisions to the criteria for granting central government support for mergers to encourage them between several local authorities. These incentives led to some consolidation, with a significant number of mergers taking place between multiple municipalities. The total number of municipalities was reduced from 415 in 2008 to 348 in 2009. While the mergers aimed at increasing viability and efficiency of service provision, political compromises required to make some of them happen led to inefficiencies. In some instances long-term employment levels and conditions were grandfathered and highest costs or least efficient practices were maintained.

While the recent merger incentives in Finland have had some limited success, recent reforms in Denmark illustrate that dramatic restructuring can be achieved rapidly once there is political consensus. A committee established at the beginning of 2004 already had concrete proposals by the middle of the year, which were passed through parliament by mid-2005. This coincided with a window during which municipalities could merge voluntarily, including by signing cooperation agreements with larger neighbouring municipalities. Thereafter, mergers were enforced and by January 2007, 270 municipalities had been consolidated into 98 larger units, most of which now have at least 20 000 inhabitants. The aim was to give new municipalities greater financial and professional sustainability. One factor that drove reforms in Denmark was a concern that expertise was being spread too thinly, which had resulted in low capacity in smaller municipalities to effectively and efficiently manage themselves and the services they delivered.

In Sweden major reforms took place through the 1960s and 1970s, which reduced the number of municipalities from over 1000 to below 300. However, there has not been any further major consolidation subsequently. Unlike in Finland, the smallest Swedish municipality has over 2 500 residents, and around one quarter have populations below 10 000 compared to three-quarters in Finland. Only four municipalities in Denmark now have a population smaller than 10 000.

for reasons associated with the reform. It is also questionable whether reforms have been sufficiently radical to achieve municipalities of a sustainable size. Notwithstanding geographical and other factors, including the remoteness and low population densities of some Finnish municipalities, more profound measures may need to be considered, including wholesale mergers along the lines of the Danish example.

While there is a strong case for municipal mergers in terms of sustainability and efficiency in handling tax responsibilities and effective labour market policies, the case for scale economies in service provision is weaker. Municipalities with larger populations tend to have higher cost in service provision than smaller ones.[7] There is some evidence, however, that increasing municipal size towards 24 000-37 000 people would lower average costs in comprehensive schooling (Aaltonen *et al.*, 2006). Mergers of municipalities alone are not likely to be a sufficient condition for containing costs and increasing efficiency in local government provision of services. A stronger focus on core services and restrictive replacement of retiring employees (especially in shrinking activities such as childcare) should contribute, which also has been stressed in the ongoing project (PARAS) to restructure local government and services. Furthermore, municipalities that rely more on private sector services enjoy higher levels of efficiency and there is clearly more scope for competition in larger municipalities. While achieving competition in core service provision in small municipalities may be difficult, creating incentives for reaping plant-level economies of scale through concentration and adjusting staffing to needs more readily should be a priority. The central government has few direct channels to influence productivity in municipalities, but restraining resources through tax caps and real cuts in transfers could contribute. Furthermore, the government should support research and benchmarking to lower the large disparities in efficiency of basic service provision across units and municipalities.

Public spending priorities need to be reconsidered

A number of overall spending cuts and changes in priorities should also be considered to improve the fiscal position. One area relates to how to pay for the costs of ageing, where non-pension age-related expenditures are expected to rise significantly, from 14% in 2005 to more than 18% of GDP in 2030. Raising the level of co-financing would contribute to lower costs and should be considered. In Chapter 1 and Chapter 3 a further number of spending cuts are considered including:

- The introduction of tuition fees (Chapter 1).
- Lowering accrual rates in the old-age pension system for the 53-65 year olds and raising the minimum retirement age; lowering the accrual rate for parental leave, unemployment and studies in the old-age pension system (Chapter 3).
- Abolishing the unemployment pipeline. Consider lowering unemployment benefits and replacement rates in the disability pension system (Chapter 3).

Box 2.8. **Summary of fiscal recommendations**

Fiscal sustainability and the fiscal framework

- Establish and communicate a fiscal consolidation plan as quickly as possible to achieve sustainable public finances. Start implementing consolidation measures when recovery firms.
- Revise the fiscal framework to enhance longer term sustainability and flexibility. The new targets should aim at closing the long-term sustainability gap with a four-year rolling fiscal planning horizon with annual sub-targets. The targets should be set in terms of the cyclically-adjusted balance and should consider the need for stabilisation. Given the size of the current sustainability gap, the government should aim for a 1.5% of GDP structural consolidation per year during 2012-15. This would leave a gap of 2.5% to be closed in the period after 2015.
- Strengthen the fiscal regime and support external assessment of policies through the establishment of a fiscal council.
- Consider more radical municipal mergers along the line of the Danish example.

Tax policies

- Raise revenues and the efficiency of the VAT regime by harmonising VAT to a single 23% rate.
- Further raise the lower bound on municipal property taxes and abolish the ceiling. Raise property valuations to market value.
- Consider ways to make municipalities less dependent on volatile corporate taxes either by transferring taxation to the central government or making those revenues less dependent on the business cycle.
- Consider a tax ceiling for municipalities' income taxes to restrain expenditure growth. Alternatively, the municipal transfer system should be amended to significantly weaken incentives for municipal income tax hikes.
- The government's commitment to address climate change is reinforced by its adoption of the 2050 report targets. Achieving this would be assisted by replacing the preferential treatment of peat with a levy and abolishing other distorting refund schemes for energy-intensive industries including the agriculture sector.

Expenditures

- Contain public expenditure growth by setting tight expenditure ceilings over the four-year cycle from 2012.
- Consider freezing transfers to municipalities or just adjusting them for inflation during the consolidation.
- Improve measures of and reporting on tax expenditures.
- Increase competition in service provision in larger municipalities to help reversing the decline in local government productivity.
- Use benchmarking, restructuring and mergers to increase efficiency and reap economies of scale in basic service provision in municipalities.
- Consider central government spending priorities, for instance by switching to more loan-financing and reduced grants in the tertiary education system and introducing tuition fees (see Chapter 1).

Notes

1. Unchanged policy is defined as keeping tax rates constant (implying an almost constant tax-to-GDP ratio) and maintaining expenditure shares of GDP, with the exception of old-age related spending which will develop according to pension rules and demographic developments.
2. The OECD estimate is based on an expected real annual return of 2.7% while the government's estimate relies on an expected 4% annual real return.
3. The government estimates that ageing-related costs will rise by 5.7 percentage points of GDP by 2030 (Ministry of Finance, 2010).
4. Between 1992 and 2000, underlying total receipts in relation to potential GDP increased by 0.3 percentage points, while underlying current disbursements excluding interest rates in relation to potential GDP fell by 8.1 percentage points.
5. The top rate varies across municipalities as it consists of a state tax rate (30.5%), a communal tax rate (average 18.6%) and a church tax rate (average 1.3%) yielding an overall average of 50.4%.
6. See Loikkanen and Susiluoto (2005) and Järviö *et al.* (2005).
7. These estimates have to be taken cautiously, however, as larger municipalities may provide more complex services than smaller ones.

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ANNEX 2.A1

Fiscal scenarios

The macroeconomic scenario up to 2011 is based on the *OECD Economic Outlook 86* (OECD, 2009d). The output gap is assumed to close by 2015. Thereafter the assumptions on growth and inflation are close to the government's assessment in the Stability Programme update 2008 (Ministry of Finance, 2008). The interest on government gross debt is assumed to be 4.7% and the interest rate on government gross financial assets is set to 3.1%, implying a differential in line with the historical average of 1.6%. Gross government financial assets in relation to GDP are assumed to remain at their 2011 level at 101% and property income, apart from interest income, is assumed to remain constant as a share of GDP from 2011 and onwards. Age-related expenditures are assumed to increase by 5.4 percentage points of GDP between 2011 and 2030 in line with Kinnunen (2009) and remain more or less unchanged thereafter.

Table 2.A1.1. **Summary of macroeconomic assumptions**

	2008	2011	2012-15	2016-30	2031-50
GDP growth (%)	0.8	2.4	3.3	1.5	1.3
Labour productivity growth (%)	–0.5	1.4	2.3	2.0	1.8
Employment growth (%)	1.6	0.2	0.4	–0.5	–0.5
Inflation (GDP deflator, %)	1.8	1.5	2.0	2.0	2.0
Interest rate on government debt (%)	3.7	3.2	4.5	4.7	4.7
Interest rate on government assets (%)	2.0	2.2	3.0	3.1	3.1

Source: OECD, *OECD Economic Outlook 86* and OECD computations.

In the "unchanged age-related spending" scenario, non-interest expenditures are assumed to stay constant as a share of GDP. The "consolidation" scenario assumes that primary net lending improves by 1.5% of GDP per annum during 2012-15 and by an average of 0.8% during 2016-18.

Table 2.A1.2. **Summary of fiscal projections**

As a percentage of GDP

	2008	2011	2012-15	2016-30	2031-50
Baseline scenario					
Primary net lending	3.7	–5.7	–4.2	–5.7	–7.4
Net lending	4.4	–5.2	–4.4	–8.6	–18.3
Net debt	–51	–39	–24	39	216
Gross debt	41	62	77	140	318
Unchanged age-related spending scenario					
Primary net lending	3.7	–5.7	–3.4	–2.3	–2.3
Net lending	4.4	–5.2	–3.6	–4.2	–7.7
Net debt	–51	–39	–25	12	90
Gross debt	41	62	76	113	191
Consolidation scenario					
Primary net lending	3.7	–5.7	–0.4	2.4	0.7
Net lending	4.4	–5.2	–0.4	2.8	1.3
Net debt	–51	–39	–32	–45	–48
Gross debt	41	62	70	56	53

Source: OECD, *OECD Economic Outlook 86* and OECD computations.

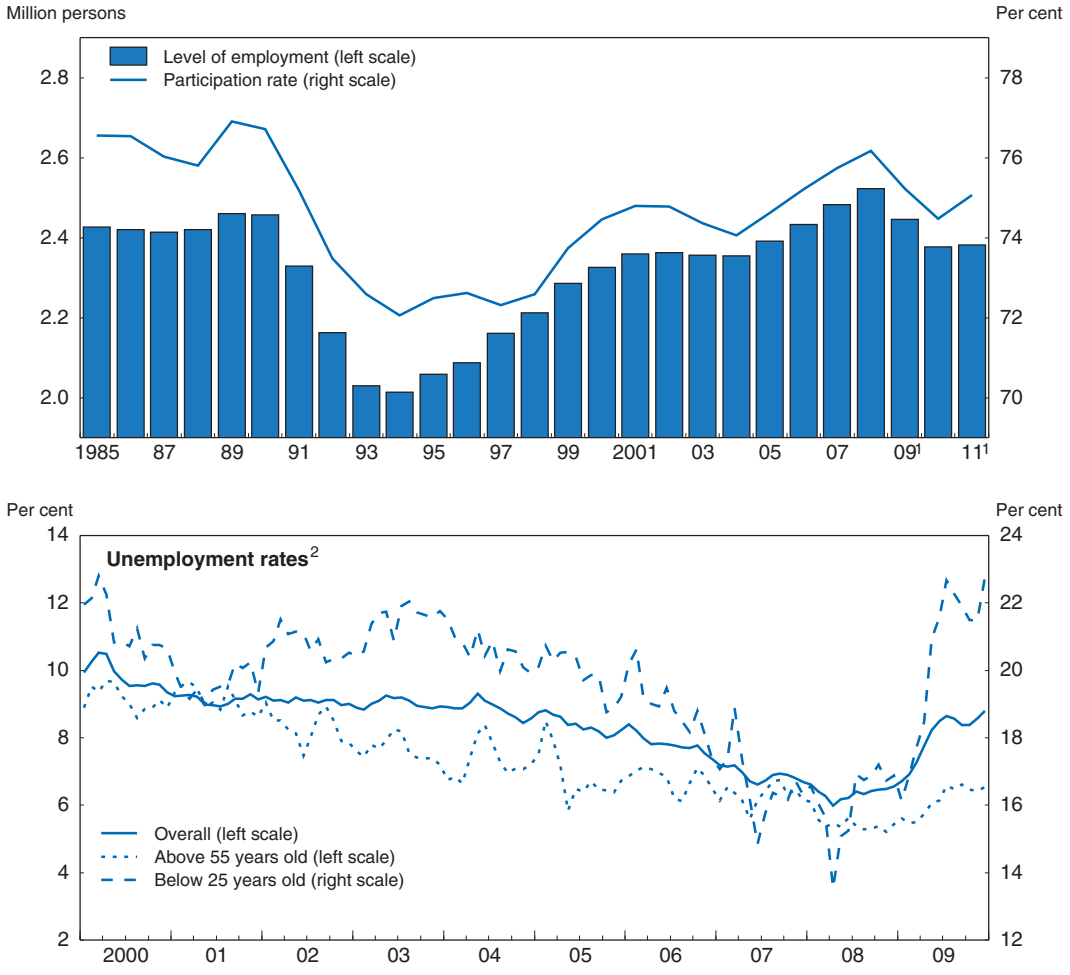
Chapter 3

Coping with the job crisis and preparing for ageing

Maintaining high participation and employment in the face of the current recession and a rapidly ageing population are major challenges for policy makers. The recession of the early 1990s showed that high unemployment can leave long-lasting scars on labour markets, while rapid ageing requires longer working lives to ensure sustainable public finances. Minimising the effect of the recession on the labour market calls for nominal wage increases in line with economic conditions, greater flexibility in wage setting, ensuring earlier activation of unemployed and reforming unemployment and social benefits to better support work incentives. Finland has an unusual combination of elevated unemployment replacement rates and late referral to labour market activation, which contributes to high levels of inactivity and a large number of beneficiaries. This combination risks building up greater structural unemployment over time. More ambitious activation needs to be accompanied by lower replacement rates in the unemployment insurance and related schemes to support labour market participation, job search and employment. Institutional responsibilities in labour market policies should be simplified and made more transparent. With an already low effective retirement age, additional early permanent exit from the labour market needs to be discouraged. The recent success of restricting access to the unemployment pipeline should be followed up by a complete abolition of the system. Stricter criteria for entry into disability pensions should also be applied. The 2005 pension reform was a step in the right direction, but the old-age retirement system should be further adjusted to lower fiscal costs, raise the minimum retirement age and increase work incentives for older individuals.

After 15 years of almost continuous increases in employment, the labour market started to worsen in 2008 as the global recession gained momentum (Figure 3.1). While unemployment has risen significantly, its increase has been surprisingly small so far. This is mainly due to a surge in temporary layoffs, which by the end of 2009 covered approximately 3% of the labour force, and rapidly falling labour supply (see Chapter 1). With few signs of a significant turnaround in the economy, the labour market is projected to continue to worsen through 2010, with temporary layoffs gradually spilling over into unemployment, inactivity and labour market exit. A major challenge for the Finnish

Figure 3.1. **Labour market outcomes**



1. OECD estimates and projections.
2. Three-month moving averages and seasonally adjusted.

Source: Statistics Finland and OECD, *OECD Economic Outlook* and *Employment Databases*.

StatLink http://dx.doi.org/10.1787/827870844686

economy is to prevent a repetition of the results of the deep recession in the early 1990s, specifically the rise in long-term unemployment (Verho, 2008 and Chapter 1). These scarring effects still affect labour market outcomes: for example, employment rates for cohorts born earlier than 1960-64 (who were 30-35 years old at that time) have never recovered their pre-recession employment levels.

A number of similarities in the current labour market situation with the past recession may complicate recovery. Wage increases coming into the recession have again been substantial and real wages remain among the least flexible in the OECD. This time, real wage adjustment will have to take place under a fixed exchange rate, putting more burden on nominal wage adjustment. Another similarity is the high share of the working-age population that depends on income-replacement benefits. The dependency ratio of 26% in Finland was well above the OECD average of 19% in 2004 (Duell *et al.*, 2009). In addition, replacement rates in the unemployment benefit system remain high, although in line with the other Nordic countries. Low activation rates due to late intervention on unemployment and a highly decentralised system of Employment Offices still characterise the Public Employment Service (PES). Retirement ages remain well below the OECD average, and lag Nordic neighbours even more.

This chapter discusses the challenges faced by labour market policies in preventing a repeat of the adverse employment outcomes of the previous recession and dealing with the challenges of an ageing workforce. It first discusses key characteristics and developments in Finnish labour markets before and during the crisis. It then looks at the impact of wage formation, labour market policies, unemployment benefits and social benefits. Finally, it analyses the effects of various retirement regimes on incentives to work and labour supply, and how these should be reformed to improve employment outcomes.

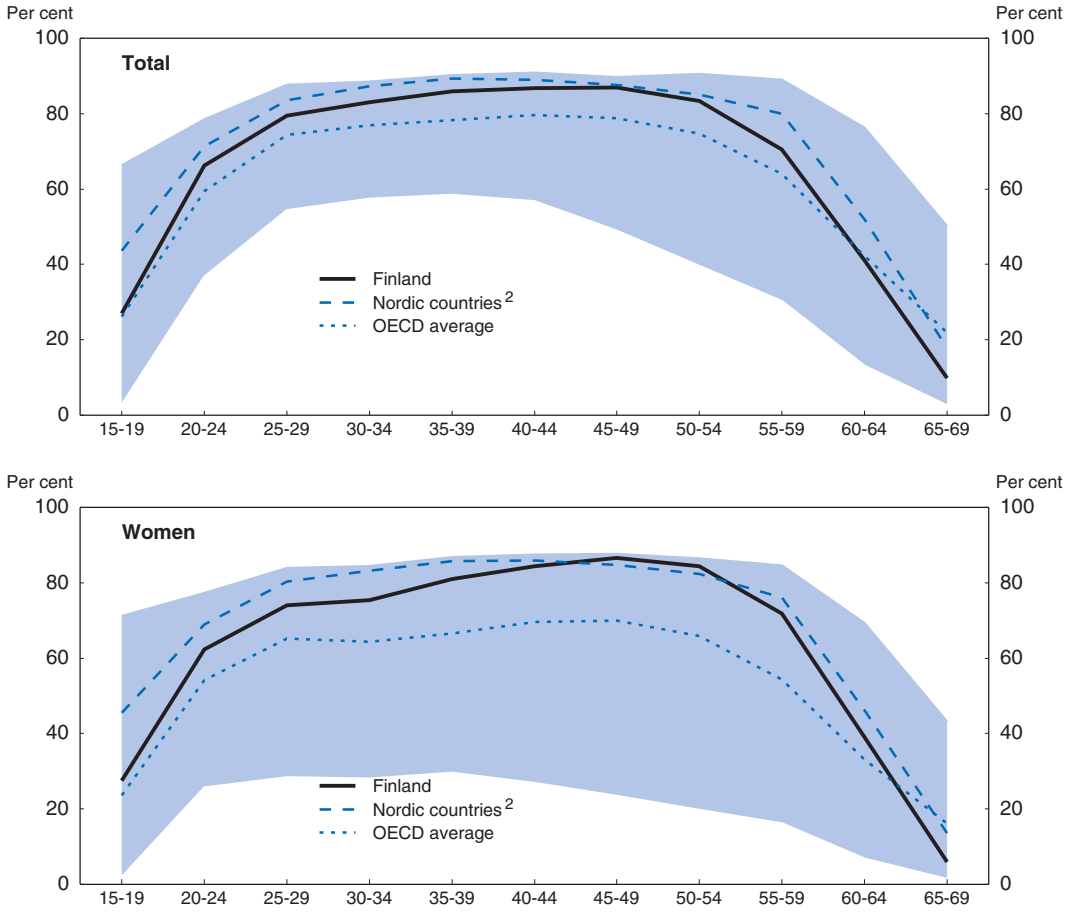
The recovery may be slowed by rigid labour markets

Labour market outcomes remain weaker than in the other Nordic countries

Although the labour market has recovered since the 1990s recession, employment and participation remain low (Figure 3.2). While overall employment and participation rates have risen to levels well above the OECD average, they remain below those prevailing before the 1990s recession and in the Nordic neighbours. Finland's relative underperformance in terms of employment rates *vis-à-vis* other Nordic countries is mostly due to low employment rates among younger individuals, women of child-rearing age and, especially, older age groups (Figure 3.2).

Overall labour utilisation in Finland, along with the other Nordic countries, is close to the OECD average (Figure 3.3). Compared to Denmark, Norway and Sweden, lower employment rates in Finland are compensated for by higher average hours worked. This reflects the low prevalence of part-time work in Finland, which to some extent is linked to low employment among groups that typically work part time (young, old and women). As discussed in the previous *Survey* (OECD, 2008a), the relatively low share of the service sector in the economy, inflexibility of childcare arrangements and the tax and social security system (including pensions) are likely explanations to the low prevalence of part-time work. Employment among women with very young children is also constrained by the relatively generous Home Child Care allowance and possibly the child supplement in the unemployment insurance.

Figure 3.2. **Employment rates by age group**
2008[1]



1. The shaded area shows the area between the highest and lowest employment rate for each age group over all OECD countries.
2. Unweighted average of Denmark, Norway and Sweden.

Source: OECD (2009), *Labour Force Statistics – online Database* (December).

StatLink http://dx.doi.org/10.1787/827874355671

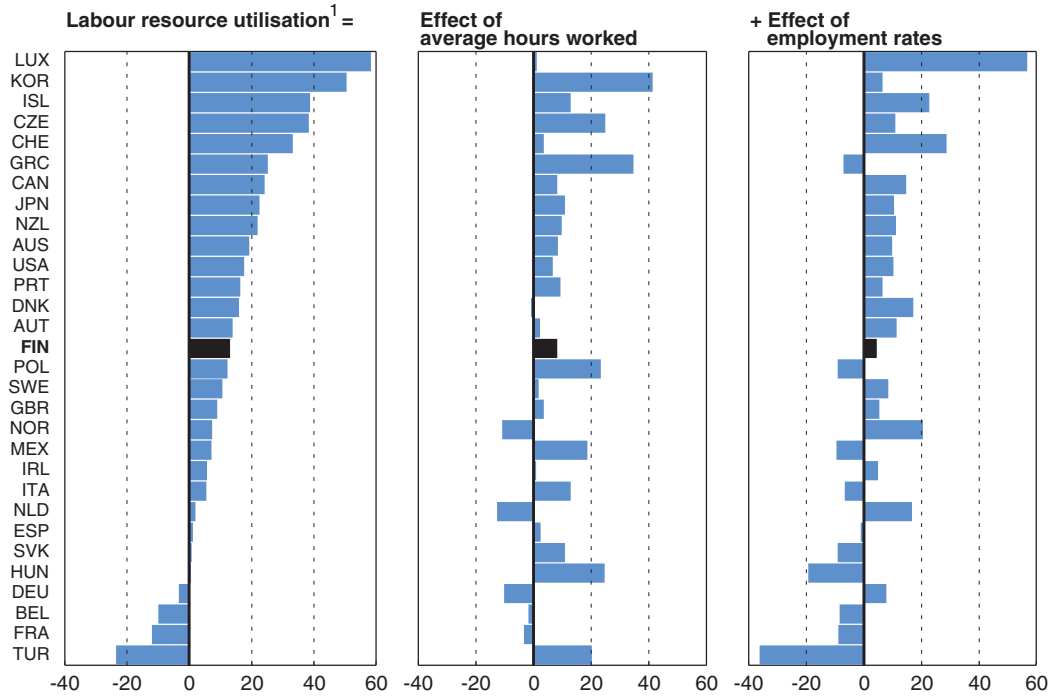
Aligning wages better with economic conditions would help employment

Wages in Finland are among the most rigid in the OECD, which can hamper the recovery and contribute to further unemployment (Holden and Wulfsberg, 2007). The high rigidity partly reflects the tradition since 1970 of centralised wage negotiations between unions, employers' federations and the government. The settlements also often included agreements on income policies (Johansson, 2006). While centralised or co-ordinated wage bargaining has been shown to produce lower aggregate wage outcomes, decentralisation would allow real wage flexibility and promote employment among weaker groups in the labour market (OECD, 2006a).

Finland recently moved to a more decentralised wage bargaining system to improve relative wage flexibility. In the 2007/08 round, wage agreements were made at the industry level with very little government intervention, but as discussed in the previous *Survey*, the overall outcome was highly unsatisfactory, with large wage increases beyond those justified by economic conditions and no substantial improvements in local wage flexibility

Figure 3.3. **The sources of differences in labour utilisation**

Percentage gap relative to the EU12, 2008



1. Labour resource utilisation is measured as total number of hours worked per capita.

Source: OECD, *Annual National Accounts* and *Productivity Databases*.

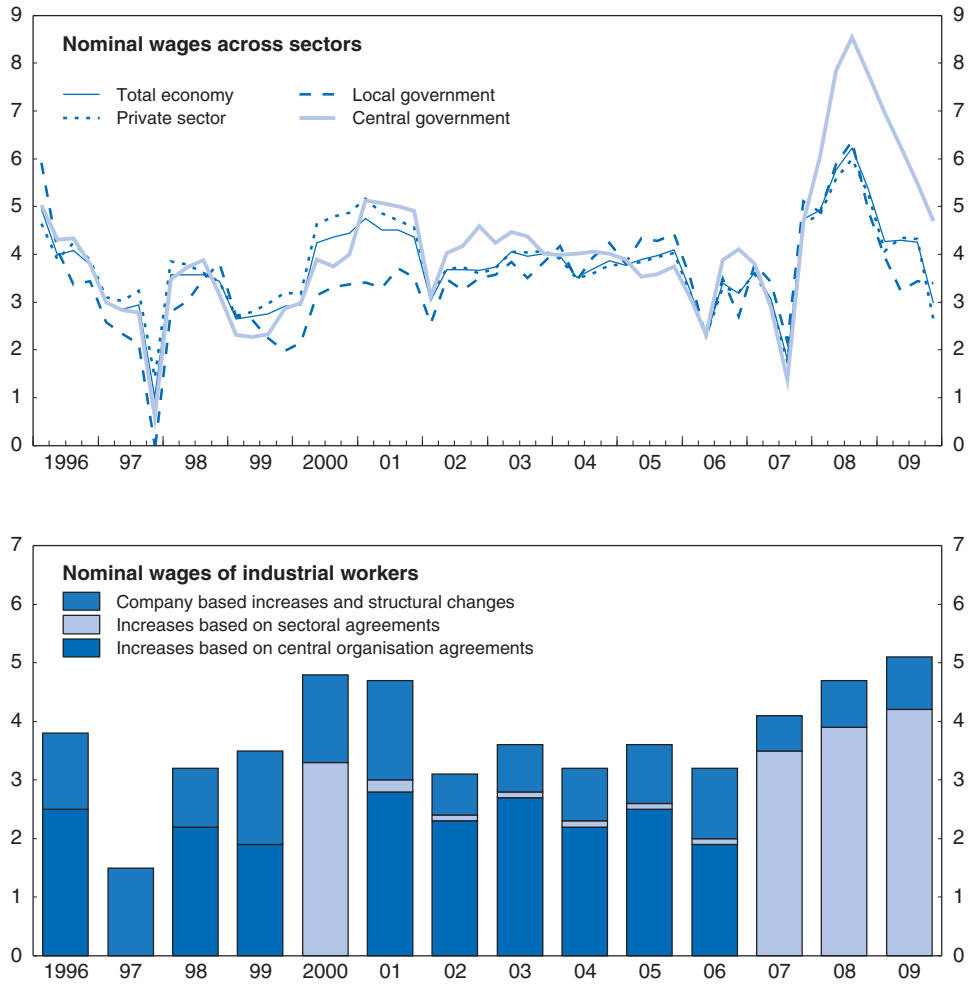
StatLink http://dx.doi.org/10.1787/828010627545

(Figure 3.4). While high wage increases have supported domestic demand, thereby helping to cushion the current slump, they are spilling over into higher prices and lost competitiveness with potentially adverse effects on employment (Chapter 1). Local wage allowances rose as a share of the settlements, but as these were used in a fairly mechanical way they contributed little to aligning wages to local productivity conditions (Asplund, 2007).

The ongoing round is taking place in a similar institutional setting, but at the depth of a severe recession and against a background of rising unemployment and severe constraints on public finances. In such conditions, a properly functioning decentralised bargaining framework needs to deliver moderate wage increases. Yet, although the final results are still not known, there are risks that the moderate increases already negotiated in some export-related areas will not carry over to the government sector. This could in turn feed into additional compensatory demands from other sectors. In addition, there is little evidence that the settlements so far have increased relative wage flexibility.

The onus is therefore on the social partners to negotiate wages consistent with the weak cyclical situation and international competitiveness. If they fail, the authorities should consider alternatives to the current system. One option would be to increase co-ordination among and between employers and unions and agree on a reasonable aggregate wage outcome. This would foster more moderate overall settlements. Greater co-ordination would however also tend to hamper the intended movement towards greater local wage flexibility. This outcome might be avoided if the aggregate agreement did not impose further restrictions on industry level negotiations, and if bargaining at the industry

Figure 3.4. **Wage developments**
Year-on-year growth rate, per cent



Source: Statistics Finland; Ministry of Employment and the Economy; and Confederation of Finnish Industries wage statistics.

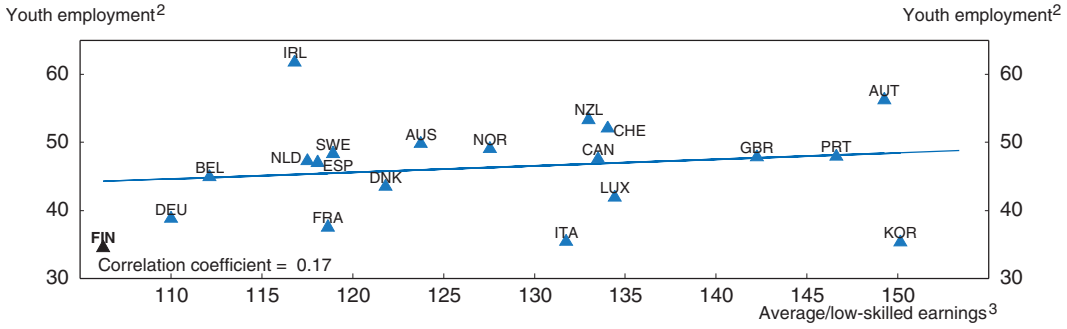
StatLink http://dx.doi.org/10.1787/828034040237

or firm level took the opportunity to match wages better to their specific economic situations. This type of centrally co-ordinated and yet locally flexible wage negotiation framework has been successful in moderating wage increases in Sweden since 1997.[1]

Other measures to raise local wage flexibility should also be considered. One option is to reform the unemployment insurance system, which may have contributed to both high overall wage outcomes and reduced flexibility. As employers and the government are the main contributors to the unemployment insurance scheme (see Table 3.1), this may have given rise to insider-outsider mechanisms, where employed union members give less consideration to the social costs associated with too high wage outcomes. Therefore, the government and the social partners should consider setting up mechanisms that strengthen incentives to achieve low unemployment, for example through experience ratings. Furthermore, as is recommended below, lower replacement rates in the unemployment insurance and tightened access to early retirement could reduce reservation wages and hence constrain excessive wage increases.

As in other highly unionised countries, such as Belgium and Sweden, Finland has a compressed wage structure.[2] Centralised bargaining contributes to wage compression which is likely to lower employment levels among marginal groups in the Finnish labour market. While there is no robust evidence that high minimum wages contribute to unemployment in general, some studies find negative employment effects for young workers (OECD, 1998). Low-skilled young individuals may be especially at risk from high minimum wages, which may explain part of the relatively low youth employment in Finland (Figure 3.5). Lower minimum wages for young unskilled workers could enhance their employment opportunities.

Figure 3.5. **Wage compression**
2007[1]



1. Or latest available year.
2. Employment rates of young people (aged 20-24) not in education as a share of total population aged 20-24 not in education.
3. Earnings of upper secondary and post-secondary non-tertiary education (average) relative to below upper secondary.

Source: OECD (2009), *Education at a Glance*.

StatLink http://dx.doi.org/10.1787/828071727305

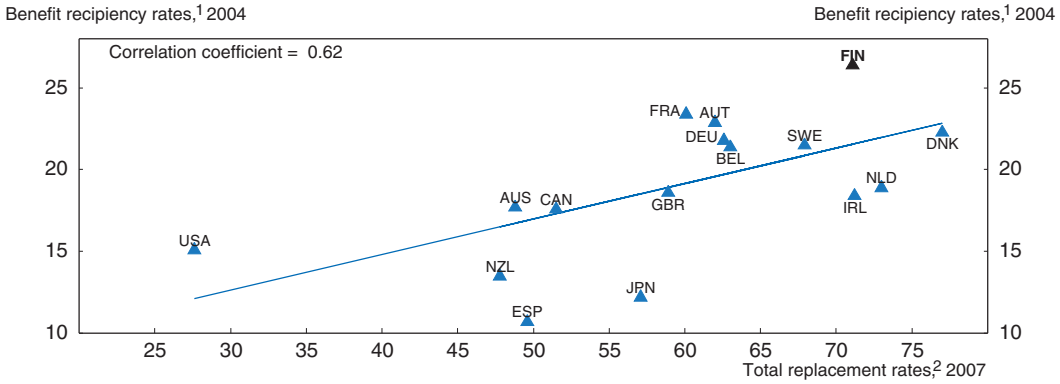
Inactivity benefits are generous and with long duration

Replacement rates are among the highest in the OECD area for the long-term unemployed, reducing incentives to enter or return to work (Figure 3.6 and Box 3.1). The high replacement rates reflect generous and extended allowance periods and the interplay with special rules, such as the "unemployment pipeline" and other social security schemes. While high replacement rates can to some extent be compensated for by aggressive activation, as in Denmark, the Finnish combination of generous long-term replacement rates in combination with late activation is unusual among OECD countries.

The mix of high replacement rates and late interventions raises several concerns. First, there is strong evidence that high replacement rates hamper search intensity and in general tend to increase unemployment (Bassanini and Duval, 2006). The introduction of the increased Earnings-related Allowance (Box 3.1) has also been shown to decrease chances of re-employment (Uusitalo and Verho, 2007). Furthermore, there are strong arguments in favour of letting replacement rates fall over the unemployment spell to balance the individual's need for insurance *versus* the incentives to keep up search intensity (Fredriksson and Holmlund, 2006).

In order to maintain work incentives, the government should not only lower replacement rates over the full 500-day unemployment period, but also maintain or even

Figure 3.6. **Income-replacement and benefit recipiency rates**



1. Share of the working-age population that receives income-replacement benefits.
2. Average net replacement rate over a five-year unemployment spell based on unemployment benefits, social assistance and housing-related benefits.

Source: N. Duelll, D. Grubb and S. Singh (2009), "Activation Policies in Finland", *OECD Social, Employment and Migration Working Papers*, No. 98, Table 4.1 and OECD (2009), *OECD Employment Outlook*, Figure 1.19.

StatLink http://dx.doi.org/10.1787/828084431167

increase the decline in the replacement rate with the length of the unemployment spell.[3] Although cuts in replacement rates should not be implemented during the depth of the recession, clearly signalling that such changes will take place when the economy recovers, would contribute to higher search intensity.[4] Additionally, the government needs to ensure that the Social Protection Reform Committees (SATA), proposed reforms to the housing benefit efficiently addresses the inactivity trap created by the Basic Income Support (BIS) combined with housing benefits (Box 3.1). The government should also consider ways to equalise replacement rates and activation for the non-means-tested Labour Market Support (LMS) and the BIS for those that have work capacity.[5] When implementing welfare reforms such as reforming the housing benefit system, the government needs to ensure sufficient targeted support to the poor (*e.g.* to support poor retirees and poor families with children).[6]

Box 3.1. **Replacement rates from unemployment benefits and social benefits are high**

Unemployment benefits in Finland come from two alternative schemes; the Earnings-related Allowance financed by voluntary unemployment funds, or a Basic Allowance for those that are not entitled to support from the earnings-related scheme. Membership rates in the unemployment funds are high, and thus for the majority of unemployed the earnings-related scheme remains most relevant. Both the Earnings-related and the Basic Allowances are available for 500 days (100 weeks). After 500 days, 180 additional days of Labour Market Support (LMS) without means-testing is available. After 680 days the unemployed have access to means-tested LMS or Basic Income Support (BIS, social assistance from the municipality) or a combination of these.

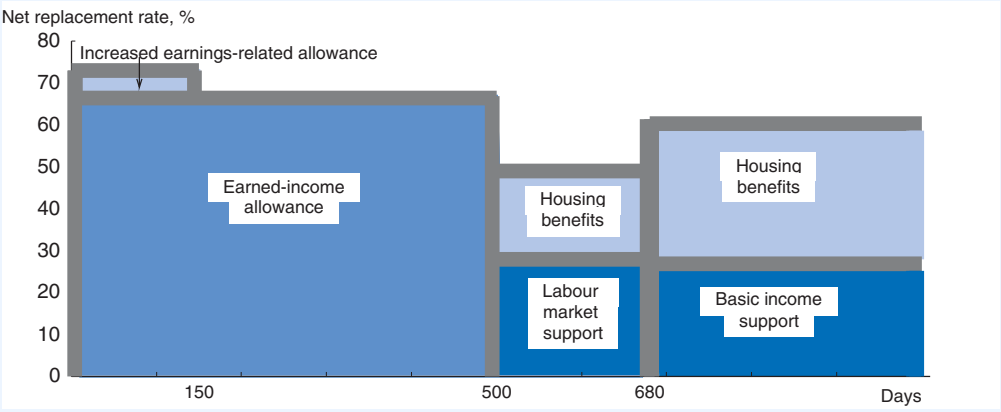
The Earnings-related Allowance generates fairly high replacement rates compared to other OECD countries, although they are capped at 90% of the previous wage. For a wage earner on 67% of the average wage, net replacement rates in Finland average 79%, in line

Box 3.1. **Replacement rates from unemployment benefits and social benefits are high** *(cont.)*

with the other Nordic countries (average of 81% in Denmark, Norway and Sweden) and well above the 70% average in the OECD area (Duell *et al.*, 2009). Furthermore, there is a child supplement on the Earnings-related Allowance of a maximum of EUR 9.19 per day for three children. For employees made redundant and who are willing to participate in activation, replacement rates are further topped up the first 150 days through the increased Earnings-related Allowance, which raises replacement rates by an additional 6 percentage points. A further supplement for laid-off workers who participate in active labour market programmes was introduced on 1st of July 2009. The Basic Allowance is much less generous and provides only EUR 23.91 per day.

Replacement rates are typically much lower once the unemployed individual moves into the LMS, but the beneficiary can also claim means-tested housing benefits and in some cases BIS, making the fall in replacement rates less steep (Figure 3.7). After 680 days or by refusing activation, the individual may move into means-tested BIS. While the BIS only replaces a fraction of the original wage, it covers 100% of housing expenditures up to a threshold. This yields a fairly high net replacement rate, sometimes significantly higher than the LMS. BIS also covers additional supplementary expenditures related to housing (electricity, insurance, etc.) and health care. For households and individuals who expect wages close to the minimum levels and who have high housing costs, replacement rates can be close to 100%.

Figure 3.7. **Net replacement rates in unemployment**[1]



1. Calculated for a single individual at 67% of average wage, living in Helsinki, with monthly housing expenditures of EUR 500 per month.

Source: Ministry of Finance; N. Duell, D. Grubb and S. Singh (2009), "Activation Policies in Finland", *OECD Social, Employment and Migration Working Papers*, No. 98; and OECD calculations.

StatLink http://dx.doi.org/10.1787/828123547338

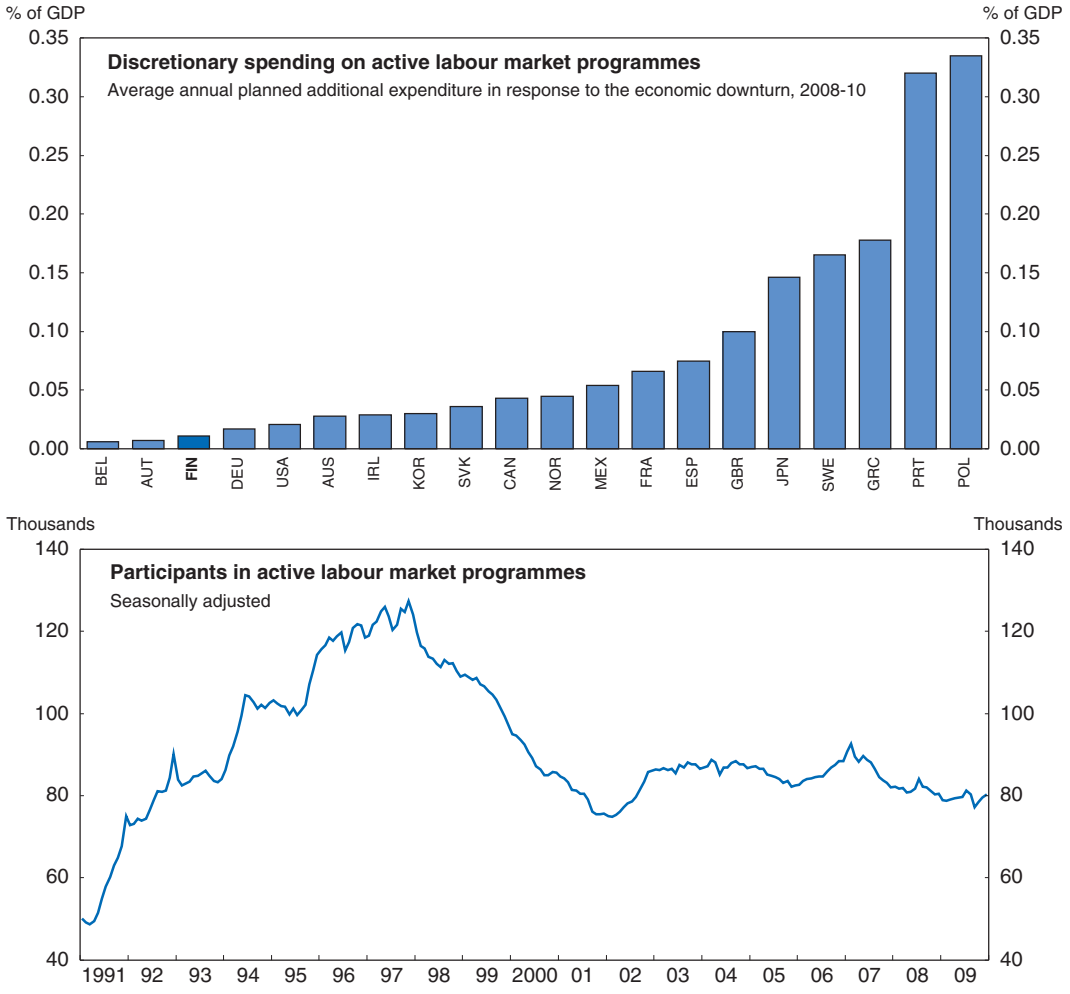
Activation policy should be more ambitious

Weak activation policies can delay recovery in employment and allow long-term unemployment to take root. Although activation policies have only a limited impact on employment during a recession, they can help maintain search capacity and employability until the labour market starts to improve (OECD, 2009a). In 2007, the costs of labour market policies in Finland amounted to 2.3% of GDP. This is roughly twice the OECD average, but

comparable to Denmark, Norway and Sweden. However, the proportion of resources spent on active measures was only 38%, which is well below that in the three other Nordic countries (56%). Furthermore, increases in spending on the Public Employment Service (PES) and Active Labour Market Policies (ALMPs) during the recession have trailed other OECD countries (Figure 3.8, first panel).

Activation tends to take place late in the unemployment spell compared to other Nordics. Referral to an active labour market programme takes place after 100 weeks compared to a mandatory referral after 300 days (*i.e.* 60 weeks) in Sweden and 9 months (*i.e.*, 40 weeks) in Denmark. The late activation has shown up in a fall in the number of participants in ALMPs since the recession started in 2008 (Figure 3.8, second panel). Finland's late activation also contributes to the weak performance in terms of benefit dependency, as illustrated by the exceptional deviation from the regression line in Figure 3.6. Some steps towards earlier activation have been taken recently by removing the upper age limit on the compulsory activation requirement and formulating individualised

Figure 3.8. **Active labour market programmes**



Source: OECD (2009), *OECD Employment Outlook*, Figure 1.18 and Ministry of Employment and the Economy, Employment Service Statistics.

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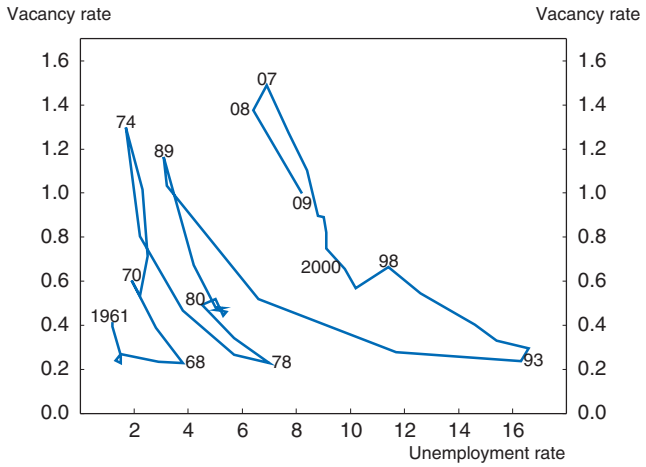
work plans and guaranteeing work or training for youth if the duration of the unemployment spell goes beyond 3 months.

Mandatory activation measures should also be implemented much earlier than after the current 500 days. As the SATA Committee has recommended, the government should consider mandatory interventions after 50 weeks or earlier, to be implemented as quickly as possible. This reform would require more personnel and resources in the PES. Existing profiling systems (see below) should be used early during the unemployment spell to identify individuals that have a high risk of ending up in long-term unemployment. These individuals should be subject to mandatory interventions as early as possible. Refusal of activation should always lead to sanctions. The government should put forward extra funding on a temporary basis to finance early interventions and ensure that these resources are quickly transformed into activation measures in order to dampen the decline in activation to unemployment ratios.

The overall efficiency of labour market matching has fallen over a long period of time (Figure 3.9). This tendency can to some extent be attributed to growing regional mismatches (see Chapter 4) and insufficient labour mobility (OECD, 2008a). There are also considerable differences in matching efficiency between regions, indicating that the efficiency in provided employment services may differ significantly. Estimates show that average unemployment rates could have been 2.4 percentage points lower if all labour market offices operated at the same efficiency as the best region in terms of matching between unemployed and vacancies (Hynninen *et al.*, 2009). While these estimates suggest considerable potential for increases in efficiency, they do not signal that fiscal resources are the most important part of the explanation. In fact, resources in terms of staff expenditures per unemployed seem to be only weakly correlated with matching efficiency across regions (Figure 3.10).

To address inefficiencies in the PES system, more centralisation is needed. The fragmented nature of the institutional framework (Box 3.2) increases the risk that different local offices apply different procedures and criteria in handling cases. The decentralised setup also increases the risk of conflicts of interests within the Labour Committees. To

Figure 3.9. **Beveridge curve**



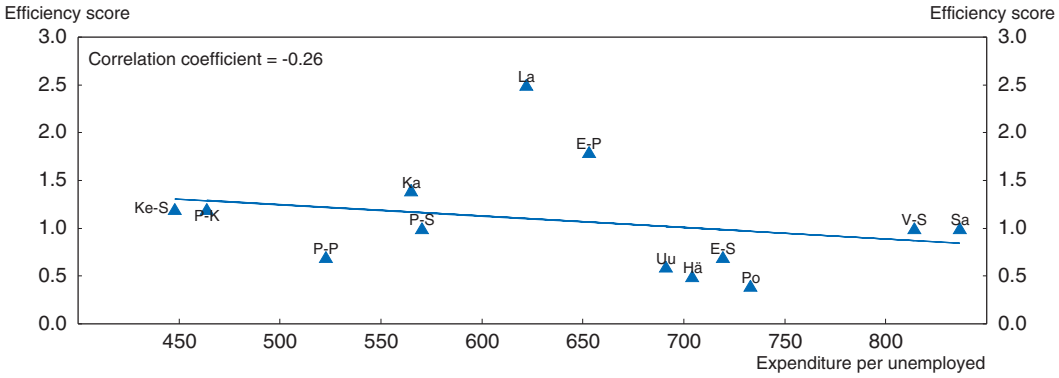
Source: OECD (2010), *Main Economic Indicators – online Database* (March).

StatLink http://dx.doi.org/10.1787/828140674031

Box 3.2. **Many institutions influence the Public Employment Service (PES)**

The responsibility for employment policies and their financing is split among a large number of actors. Three line ministries (Employment and the Economy (MEE), Social Affairs and Health, and Education) are involved in policy making, together with the 348 municipalities, the Social Insurance Institution (KELA), the 34 unemployment funds, the unions and the employer organisations. In the PES, front line services are supplied by the 74 Employment and Economic Development offices (also known as T&E offices), which are financed by the MEE. There is no central body for the PES system at the national level, but the MEE implements employment policies through 15 regional T&E centres, which in turn manage the T&E offices. Decisions on eligibility and benefits are taken by local Labour Committees associated with local employment offices, where the PES, the municipalities and the social partners are represented. In 2004 the PES was reformed by setting up *i)* Job-Seeking Centres in order to improve information sharing to job seekers, and *ii)* Labour Force Service Centres (LAFOS) to deal with more difficult to-place unemployed. The latter centres are jointly staffed by municipalities and the PES. In 2009, a further reform of the operations of the T&E offices was initiated, aiming at integrating labour and business services better.

Figure 3.10. **Labour market matching and expenditures**[1]



1. Expenditures are measured as labour market office staff expenditures in euros per unemployed in 2008. The efficiency score shows the potential lowering in unemployment if the region moves to the efficient frontier.

Source: Statistics Finland and S.-M., Hynninen *et al.* (2009), "Matching Inefficiencies, Regional Disparities and Unemployment", *VATT Working Papers*, 4/2009.

StatLink http://dx.doi.org/10.1787/828141334383

achieve similarity in interventions and criteria across offices, clear instructions on interventions and sanctions should be available to all desk officers. The central government should make sure that the current benchmarking of labour market offices is used to harmonise intervention procedures and equalise the efficiency in service provision. The current system of performance-related pay should be stepped up.[7] As skill levels in the employment offices are typically quite low and a large share of their workforce is temporary, human resource issues need to be addressed (Duell *et al.*, 2009).

Given that resources in the PES will be strained during the next few years, a wider use of the existing profiling system should be considered. Apart from liberating case officers from some duties, profiling may also be used to identify individuals in need of early activation measures and the use of a mechanical system to allocate individuals to ALMPs

may seem fairer than the alternatives. Profiling systems may also be used more extensively by *e.g.* allocating individuals to different types of ALMPs (Fröhlich *et al.*, 2004).

Regional mobility should also be enhanced. As recommended in the previous *Survey* (OECD, 2008a), the allowance for work-related second residences should be phased out as it is likely to only benefit those that are wealthy enough to maintain two residences. Further tightening legal requirements for geographical mobility in job search would help and the recent extension of the required commuting radius is a move in the right direction. High replacement rates and the high cost of housing in areas with relatively stronger labour markets remain obstacles to mobility however.

Financial responsibilities for benefits are fragmented

Financial responsibilities for unemployment and related benefits are shared among many actors, which may blunt incentives. The central government pays for the infrastructure and activation programmes (Box 3.2). The costs of the LMS, housing subsidies and the BIS are split between the central government and municipalities. Recent evidence from reforms *e.g.* in the Netherlands in 2004, suggest that the number of beneficiaries could be lowered through replacing the shared cost formula by a block grant system where the local government bears the full responsibility for delivery (Duell *et al.*, 2009).

Although the unemployment funds carry the financial responsibility for earnings-related benefits, their financing is opaque. Typically these funds are associated with unions. Employees' contributions and membership payments make up only 17% of the funds' total revenues, which has contributed to high membership rates. The rest of the costs are covered by government and employers' contributions (Table 3.1). There is evidence from some OECD countries that unemployment funds outside strict government control may be more generous to their members than prevailing rules allow (Duell *et al.*, 2009). While increasing the member and employee contributions significantly could dampen perverse incentives, evidence from Sweden since 2007 suggests raising rates may mean that a large fraction of the insured exit the insurance system. Therefore, the government should instead consider whether a nationalisation of the (already largely government-financed) fund system would not be the best way to deal with these problems.

Table 3.1. **Revenues and expenditures of the unemployment funds**

In EUR million, 2008

Revenues	EUR Mn	% of total	Expenditures	EUR Mn	% of total
Membership payments	131	9	Benefits	1 445	95
Government	560	37	Management	64	4
Insurance contributions	822	54			
Of which:					
Employers	*699*	*46*			
Employees	*123*	*8*			
Other revenues	19	1	Other expenditures	19	1
Total revenues	1 531	100		1 524	100

Source: Data provided by the Ministry of Employment and the Economy, and OECD computations.

Keeping people employed longer would help meet costs of ageing

The programme of the present government has identified a rapidly ageing population and early exit from the labour market as the most serious challenges to growth and sustainable public finances going forward (Prime Minister's Office, 2007). The current crisis can magnify these problems if exits from the labour market increase and the effective retirement age falls. Although the pension reforms of 2005 (Box 3.3) helped increase the retirement age through abolishing the unemployment pension and raising the minimum retirement age, more needs to be done to return to sustainability. As the disability pension, the unemployment "pipeline" and the old-age pension system are interconnected, any reforms should address those systems jointly.

The labour market for older workers has so far held up relatively well through the downturn. Unemployment rates have increased, but not differently from prime workers (Figure 3.2, second panel). Employment rates have declined, but the expected retirement age actually increased in 2009. There is however substantial uncertainty related to the temporary layoffs, where some information suggests that older workers are overrepresented in this category.

Box 3.3. **The Finnish old-age pension system**

The Finnish old-age pension system that was reformed in 2005 has two major components: an income-tested basic pension (national pension), and a number of statutory earnings-related schemes, all being constructed in similar ways. The importance of the national pension has decreased over time and less than one in ten retirees receive only a basic pension, although roughly half of retirees received some part of their retirement income from this system in 2007. The earnings-related system can be characterised as a defined-benefit (DB) system with substantial buffer funds. It is financed by contributions paid by employers and employees. From 2005, pension accrual is 1.5% of pensionable earnings at ages 18-52, 1.9% at ages 53-62 and 4.5% at ages 63-67. Pension rights are also accrued while studying, on parental leave and while unemployed. The retirement age is flexible between the ages 63 and 68, with an early old-age pension option from 62 (with a significant penalty on retirement income) and a possibility to defer old-age pension after 68. However, there is no actuarial adjustment of pension rights during the retirement window, which reduces incentives for further work. For the median male earner, the net replacement rate is 62%, which is lower than the OECD average of 72% (OECD, 2009b). From 2010 onwards, new earnings-related pensions will be reduced in line with increased expected longevity. This adjustment will mean that retirement incomes in relation to wages will fall, unless future retirees respond by staying longer in the labour market.

The earnings-related schemes are handled by insurance companies, company pensions and industry-wide pension funds. The Finnish Centre for Pensions (ETK) co-ordinate data and payments and the Ministry of Social Affairs and Health and the Financial Supervisory Authority supervise the funds. The national pension is administered by the Social Insurance Institution (KELA) and supervised by Parliament. The public sector earned-income scheme has its own providers.

In Finland, pension provision reflects agreements between the labour market organisations that are later codified into law. Thus unions, employers and the government all influence legislation. As described in Chapter 2, the financial assets and the transactions of the pension funds are in the general government accounts for Eurostat's

Box 3.3. **The Finnish old-age pension system** *(cont.)*

statistical purposes. However, this and other similar systems are classified as private sector in to the OECD's pension classification scheme (OECD, 2009b). Moreover, from a strict legal point of view, the funds are private entities. In this *Survey* however, they are treated as part of the public sector. Contributions into the system will be seen as social security contributions and the ultimate fiscal responsibility will be assumed to rest with the government.

The fact that the Finnish pension system can almost entirely be described as a defined-benefit system affects the distribution of risk across generations. A shock, for example, in terms of a permanent drop in asset values, will not affect accrued benefits, but will require increases in future contributions. This effectively lets current young and future generations bear a larger share of the risk. The exception is longevity risk, where the longevity adjustment allocates demographic risk to the generation receiving the pension.

Compared to most OECD countries, third-pillar defined-contribution systems play a minor role. A larger reliance on defined-contribution schemes would be useful from a risk-sharing perspective, even though the government should be careful not to pursue such objectives with distorting subsidies.

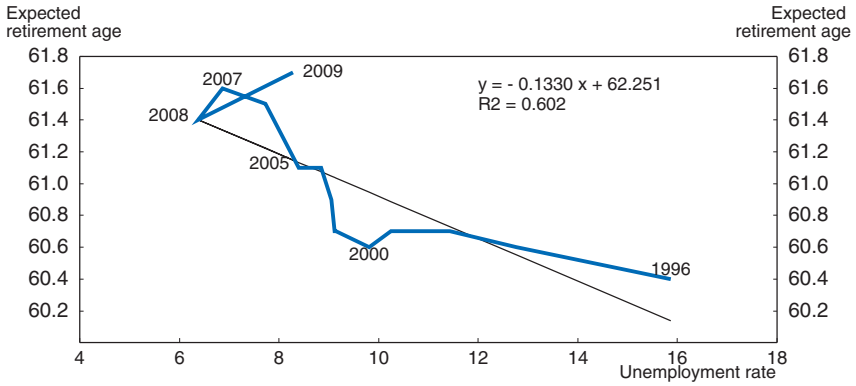
The expected retirement age has been increasing, but may fall due to the recession

Labour supply in Finland is reduced by the relatively low retirement age. The average age of retirement remained roughly constant at 58.4 years between 2003 and 2008. According to an indicator constructed by the Finnish Centre for Pensions that reflects the age composition of the population, the expected retirement age for an individual at 50 years of age increased by 0.8 years between 2003 and 2009 to 61.7 years, and to 59.8 years for a 25-year old.[8] While this is a significant increase, it partly reflects a normalisation as the effects of the crisis in the early 1990s have faded from the labour force with recession-hit cohorts moving into old-age retirement (Grönqvist and Kinnunen, 2009). Furthermore, the increase has taken place during a period when labour markets were improving strongly (Figure 3.11). In fact, the fall in the unemployment rate can explain most of the increase in the expected retirement age since 1996, although the significant increase observed in 2009 when the labour market deteriorated is encouraging. The historical relationship between unemployment and the expected retirement age suggests that the expected retirement age may fall back during the next few years due to the recession.

The 2005 pension reform is expected to increase labour supply by raising the effective retirement age. It is too early to evaluate its full effects though (Box 3.3), as retirement decisions are still influenced by incentives and rules under the old system. For example, the previously available unemployment pension has not yet been fully phased out, and it continues to give a strong contribution to the number of retirees in Finland. An increasing share of new pensioners is retiring through the old-age pension however, and the share exiting through the unemployment and disability pensions has decreased significantly (Table 3.2). Some estimates show that the 2005 pension reform would increase the old-age retirement age by 8 months (Hakola and Määttänen, 2007). Nonetheless, the average retirement age would still remain well below the OECD average, and compared to the other Nordics it would be 4 years lower for men and 2 years for women.[9] The government's target is to increase the average retirement age by 3 years by 2030 (Ministry of Finance, 2008), but

Figure 3.11. **Expected retirement age[1] and unemployment rate**

1996-2009



1. The expected retirement age of an individual who is 50 years old.

Source: Finnish Centre for Pensions; OECD (2009), *OECD Economic Outlook 86 Database* and OECD calculations.

StatLink http://dx.doi.org/10.1787/828183527651

Table 3.2. **New retirees**

2001 and 2008

Ordinary old-age pension	Early old-age pension	Unemployment pension	Disability pension	Special pensions for farmers	All new retirees[1]	Part-time pension[2]
2001						
13 858	3 872	14 802	24 082	1 263	57 406	8 995
24%	7%	26%	42%	2%	100%	16%
2008						
28 949	3 400	12 613	27 638	1 136	72 668	7 032
40%	5%	17%	38%	2%	100%	10%

1. Excluding part-time pension.
2. Share of all new retirees excluding part-time pension.

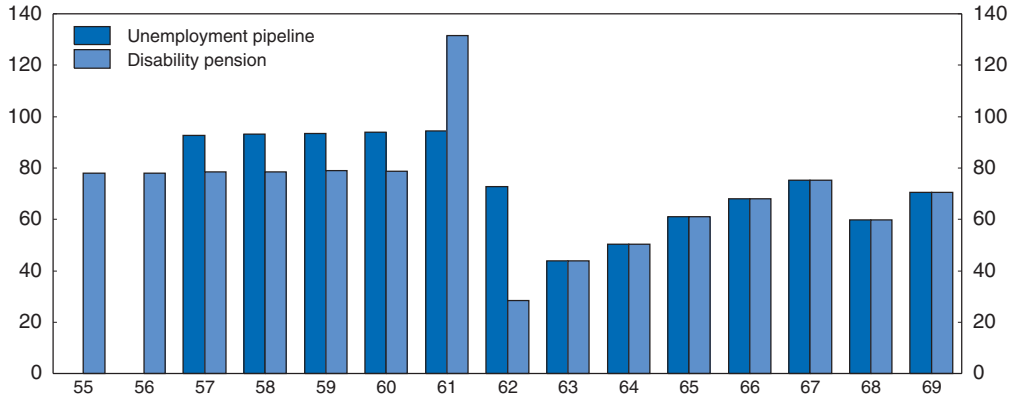
Source: Finnish Centre for Pensions and OECD calculations.

it is unclear to what extent this target incorporates effects of already implemented measures.

Retirement through the unemployment pipeline and disability pension needs to be restricted

The actual retirement age in Finland is lower than official statistics suggest, due to various early retirement schemes. Older workers tend to effectively withdraw from the labour market through the "unemployment pipeline" from 57 years of age and onwards. This pipeline provides unemployment benefits for an additional 3 years on top of the 500 standard days and allows individuals to retire to old-age pension at 62 without the penalty typically associated with early retirement. One indicator of incentives to continue to work instead of retiring is the change in net pension wealth accrued through working one additional year (additional benefits minus additional contributions), which can be regarded as the implicit tax on continued work (Duval, 2003). If the implicit tax is zero then the system is said to be "actuarially neutral". For an unemployed individual in the "pipeline" who is offered a job at the average wage, the implicit tax on working an additional hour on accrued benefits is close to 80%, while a job offer at 60% of the average wage would incur an implicit tax of close to 95% (Figure 3.12). The weak incentives to

Figure 3.12. **Implicit tax on work on early retirement paths**[1]



1. Implicit gross tax if working one additional year for an individual at 60% of the average wage. After the age of 62, both groups switch to the old-age pension system.

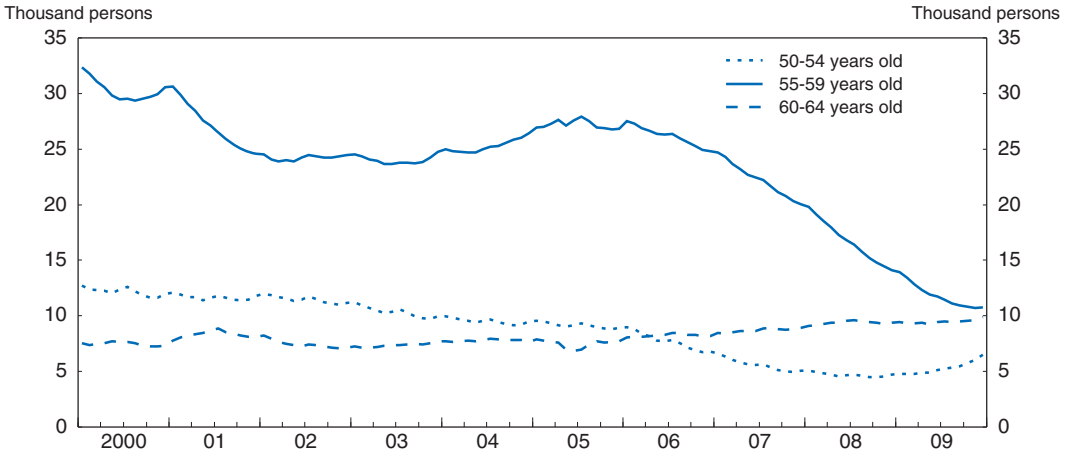
Source: OECD calculations.

StatLink http://dx.doi.org/10.1787/828234050818

engage in job search under these conditions is illustrated by the fact that the number of unemployment beneficiaries among older individuals are much higher than the number of unemployed according to the Labour Force Survey (LFS) data. This means that many individuals receive unemployment benefits but do not consider themselves job seekers.

Entry into the unemployment pipeline has been tightened on several occasions and the impact of these partial reforms has been substantial. In 2005 the qualifying age for the pipeline was raised from 55 to 57, meaning that the last cohort to enter the old system was 55 years old in 2004 and turned 60 in 2009. The fall in long-term unemployment in the 55-59 age group has been dramatic since 2005 and much more pronounced than for the (unaffected) 50-54 age group (Figure 3.13).[10] Long-term unemployment among the 60-64 years old has increased substantially relative to the 50-54 age group during the same period, as the unemployment pension is being phased out and replaced by access to the unemployment pipeline.

Figure 3.13. **Long-term unemployment for older workers**



Source: Ministry of Employment and the Economy, Employment Service Statistics,

StatLink http://dx.doi.org/10.1787/828238368084

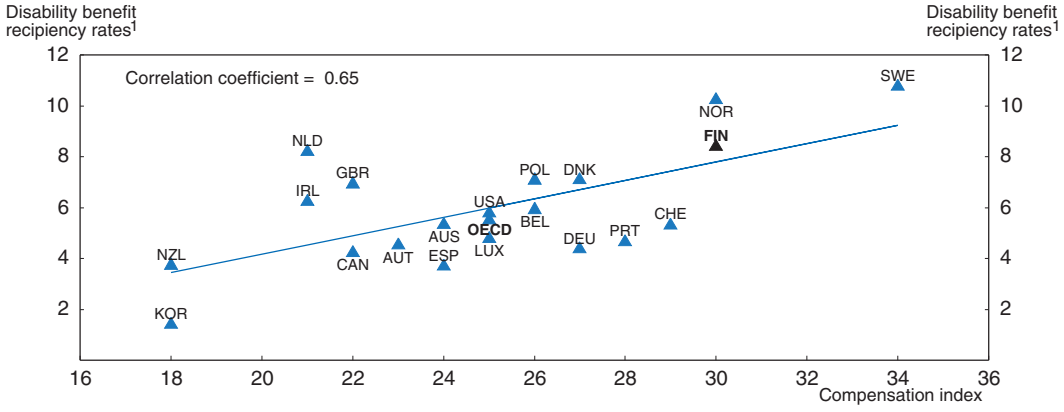
The recession will increase pressure on the unemployment pipeline. Employers are more likely to permanently or temporarily lay off older workers who have access to the unemployment pipeline and thus to a secure income. Although long-term unemployment only has increased marginally so far, it may double within the coming two years if historical relationships between the headline and long-term unemployment still hold.[11] In order to restrict early withdrawal from the labour market, the government should follow up the success of previous reforms of the unemployment pipeline with a full-scale abolition, as recommended in the previous *Survey*, especially as there are looming labour shortages ahead.

Labour supply is also influenced by a large share of early retirements to disability pensions. Roughly 8.5% of Finland's working-age population receives disability benefits, a measurable decrease from the 10% prevailing in the early 1990s, but still among the highest in OECD. This rate has remained stable since 2001. While it is influenced by numerous factors (OECD, 2009a) generous replacement rates, durability and relatively lax assessment procedures (all measured by a compensation index) tend to be correlated with disability recipiency rates across the OECD area (Figure 3.14). With high replacement rates and less stringent assessment procedures in Finland relative to many other OECD countries (OECD, 2008b), it is not surprising that levels of disability pensions are high.

In most OECD countries it has proved difficult to affect the stock of disability recipients by increasing the outflow. In Finland, the outflow in 2006 was estimated to be 0.5% of the total stock, with roughly half of those exiting directly into unemployment (OECD, 2008b). The outflow is even lower for individuals who are older than 55 who face very high implicit tax rates if moving from the disability pension to work (Figure 3.12). The current focus on rehabilitation measures has also yielded little in terms of exit. Measures to lower the inflow into disability have proved more effective. Recent reforms in the Netherlands and Poland have shown significant success by tightening assessment procedures and restricting access to permanent benefits (OECD, 2009a). In Finland the initial medical examination and report is made by any qualified medical practitioner that the applicant chooses (typically a general practitioner) rather than by specialist insurance

Figure 3.14. **Disability benefits**

2007



1. As a percentage of the working-age population.

Source: OECD (2009), *OECD Employment Outlook*, Figures 4.1 and 4.7.

StatLink http://dx.doi.org/10.1787/828283257126

doctors (OECD, 2008b). This system makes it more likely that non-medical criteria are taken into consideration. The strong correlation between regional unemployment and disability pension suggests that local labour market considerations may influence disability pension decisions. Rehabilitation, assessment and financial responsibilities for disability benefits are also fragmented, potentially contributing to easy approvals.[12] With costs and responsibilities shared among many different agents, achieving a stricter assessment process and providing consistent rehabilitation quality and sheltered job offers become more difficult.

Rules should be changed such that disability pension is granted only on pure medical grounds. Shifting the initial medical evaluation away from patients' GPs towards insurance teams would help to achieve more consistency and increase focus on medical conditions. Vocational limitations should be minimised. Lower replacement rates in the disability pension should be considered in order to maintain incentives to remain in the labour force. Offering new entrants the choice between lower benefits and sheltered employment may be more efficient than current rehabilitation measures, but additional measures to increase labour demand for this group may be warranted. Furthermore, the government should reform the assessment and rehabilitation system so that one institution bears the full responsibility through the whole process. As municipalities bear the main costs for the related systems, such as BIS, they may be the most natural choice.

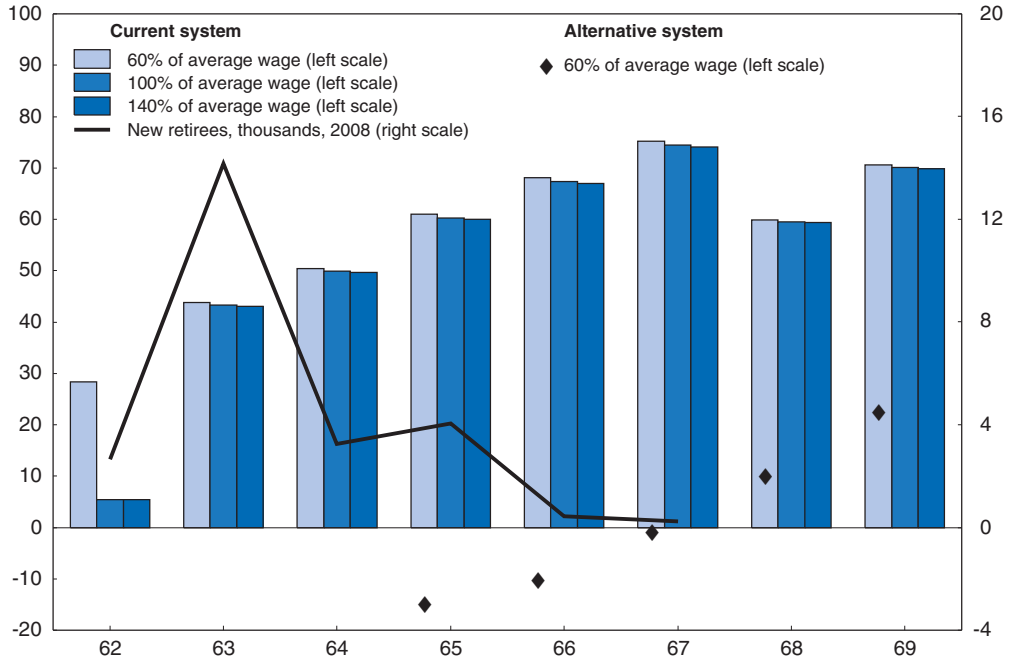
Old-age retirement ages remain low

Labour supply is also reduced by early old-age retirement. The 2005 pension reform increased the minimum and maximum retirement ages and introduced a mechanism for longevity adjustments, whereby retirement income will be lowered when expected longevity increases (see Box 3.3). Even though this reform significantly improved fiscal sustainability, the average retirement age into old-age pension has remained stuck at 63 years since 2003. While current retirement patterns are affected by the transition from the old system, the average retirement age is unlikely to rise, as incentives in the 2005 system are skewed towards retirement at 63. On one hand, there are relatively weak incentives for early old-age retirement at 62, as the implicit tax on working is low due to the heavy penalties applied to retiring early at 62 (Figure 3.15). On the other hand, the implicit tax on further work becomes much higher from 63 years onwards, as the 4.5% accrual rate is overwhelmed by the fact that no actuarial adjustment is applied during the 63-68 window of retirement (Börsch-Supan, 2005). Consequently, the number of individuals retiring at 63 is more than 5 times higher than at 62.[13] As few remain in the workforce after 63, new retirees reach much lower volumes at 64 and 65, whereafter there is virtually no one left to retire. The lowering of the statutory retirement age from 65 to 63 with the 2005 reform has resulted in a significant fall in the number of individuals staying in the labour force until 65 years of age.

Further pension reform is needed

Finland needs to ensure that working lives increase considerably in order to achieve sustainable public finances (see Chapter 2). To finance the current system, the Finnish Centre for Pensions estimates that contributions in relation to wages will need to increase by 5 percentage points over the next 15 years. Building on the 2005 pension reforms,

Figure 3.15. **Implicit tax on further work**[1]



1. The implicit gross tax if working one additional year for an individual at 60%, 100% and 140% of the average wage instead of taking out old-age pension. The alternative is based on a retirement window of 65-70 years, 1.5% accrual rate (6% for 65-70 years) and actuarial adjustment for all age groups.

Source: Data provided by the Finnish Centre for Pensions and OECD calculations.

StatLink http://dx.doi.org/10.1787/828327814677

further reforms should be pursued to raise the average retirement age and reduce costs. Reforms should be based on three broad types of measures:

- Incentives to continue working after the minimum retirement age should be strengthened. From an efficiency perspective, the marginal rate of taxation on labour for old workers should eventually approach zero, meaning that marginal implicit taxes on pensions should be negative.
- Deadweight losses related to excessive compensation during some phases of pension accrual should be minimised in order to lower costs.
- Early retirement paths should be discouraged through a combination of incentives and stronger gatekeeping, in order to make sure that less favourable accrual conditions do not spill over into early retirement, disability pension or unemployment. Hakola and Määtänen (2009) show that if the minimum retirement age was raised from 63 to 65, little would be achieved in terms of reducing labour market exit, as outflow would take place through the (unreformed) unemployment pipeline and disability pension system.

These goals could be reached by a set of reforms to the current system. Firstly, the minimum retirement age should be raised from 63 to 65 years of age and the upper retirement age abolished. Secondly, pension accrual up to 65 should be lowered to 1.5% and increased to 6% from 65 and onwards. Thirdly, actuarial adjustment should be applied during the full working life, including the period after the minimum retirement age.Such a reform would lower implicit taxes on further work dramatically and enhance incentives to continue to work after the age of 65 (Figure 3.15, "alternative system"). It should be

accompanied by less stringent employment protection legislation (EPL) on dismissals after the minimum retirement age of 65 in order to raise employer's willingness to recruit and maintain workers older than 65, as older workers may be perceived to imply relatively large productivity risks. By lowering the accrual rate during ages 53-64 and considering lower accrual during non-working periods (unemployment, studying and parental leave), the deadweight costs of overcompensation are lowered, creating substantial savings for the earnings-related pension system equivalent to almost 2% of GDP (OECD, 2006b). To achieve these savings, substantial tightening of early retirement schemes would need to accompany these reforms as alternative paths of exit, such as the unemployment pipeline and disability pension, will become relatively more attractive. The minimum retirement age needs to be raised in order to counteract the high implicit taxes that would otherwise apply at ages 62-64. The costs of raising accrual and actuarial adjustment for older workers would be minimal as there are virtually no deadweight losses.

It is difficult to evaluate the overall effects of wide ranging reforms, especially if they encompass changes in the disability pension and the unemployment pipeline where implementation and gate keeping issues are key. Some initial assessments of the employment effects for the 65-69 years old age group can be made though. Given the more than 60 percentage point difference in the implicit tax rate for the 65-69 years old relative to the current system, participation rates should be able to increase by roughly 20 percentage points for this age group, amounting to an overall increase in participation of 1.2 percentage points.[14] Such an increase would move participation among 65-69 year olds in Finland above levels in Denmark, Sweden and Norway but remain significantly below Iceland. On top of that, an increase in the minimum retirement age, combined with tightening of entry into early retirement and a loosening of EPL for older workers could yield significant gains.

Pension reforms to boost the labour supply of older workers should be accompanied by measures to stimulate labour demand for older workers too. In 2006, the government introduced a payroll subsidy scheme aimed at employees older than 54 years with low wages in order to increase labour demand for this group. However, this reform seems to have had little success in raising employment levels so far (Huttonen *et al.*, 2009). Although the payroll subsidy for older workers has not been effective so far and may need to be reconsidered, the government should continue to search for ways to raise labour demand for older workers. Employers also need to develop strategies to make better use of older employees, *e.g.* in terms of offering transition to part-time positions, especially in the light of a greying workforce.

Box 3.4. **Summary of recommendations on wage formation, labour markets and pensions**

Wage formation

- If the current round fails to achieve moderate wage outcomes in line with economic conditions, the industry-wide agreements may need to be replaced by arrangements with a higher degree of co-ordination to stop the decline in competitiveness. Wage flexibility also needs to increase to better reflect local productivity differentials.
- The high minimum wages that are likely to contribute to low employment among unskilled youth should be re-considered and experience rating mechanisms strengthened.

Box 3.4. **Summary of recommendations on wage formation, labour markets and pensions** *(cont.)*

Work incentives

- Unemployment benefits should be lowered and further tapered as the unemployment spell lengthens. Announce as early as possible but implement when recovery firms.
- The government should consider equalising replacement rates and activation for the Labour Market Support (LMS) and the Basic Income Support (BIS) for those that have work capacity.
- The recently proposed change to the housing benefit is welcome but the government needs to assure that it efficiently addresses inactivity traps and is supported by allowances better targeted at poor households.
- Let municipalities shoulder the full responsibility of the LMS in order to be responsible for both the LMS and the BIS and finance them with block grants.

Matching

- Ensure earlier mandatory activation for the unemployed. Increase the funding for the Public Employment Service temporarily to deal with increasing caseloads and step up volumes of activation measures.
- Make sure that available profiling tools are used by the local labour market boards to identify individuals with high risks for long-term unemployment to focus resources and activation measures to the most needy.
- Strengthen central coordination in the Public Employment Service to harmonise intervention procedures across local labour market boards and improve efficiency. Extend performance-based pay in the Public Employment Service.
- Phase out allowance for work-related second residence. Further tighten legal requirements for geographical mobility in job search.
- Consider nationalising the unemployment insurance.

The pension system

- Abolish the unemployment pipeline immediately.
- Tighten access to the disability pension and ensure that it is awarded on purely medical grounds. Consider lower replacement rates in the disability pension. Shift focus from rehabilitation to sheltered work. Consider giving municipalities the full responsibility for the disability pension.
- The minimum retirement age in the old-age pension system should be raised from 63 to 65 years. The maximum retirement age should be increased or abolished.
- Apply actuarial adjustment also during the period after the minimum retirement age to improve incentives to remain employed after the minimum retirement age.
- Abolish the increased accrual rates applicable from 53 years of age and upwards. Consider lowering accrual during non-working periods (unemployment, study, parental leave).
- Consider loosening EPL for workers above the minimum retirement age as well as other measures to support demand for older workers.
- Consider measures to encourage a more significant defined-contribution third pillar, to improve intergenerational risk sharing.

Notes

1. Under the industrial agreement (*Industriavtalet*) of 1997 in Sweden, the unions and the employers agree on overall average wage increases, while actual negotiations take place on the industry or even individual level. The unions and the employers also share a joint economic council (*Industrins ekonomiska råd)* to gauge economic development and suggest a range of reasonable aggregate wage increases. Furthermore, the National Mediation Office (*Medlingsinstitutet*) and the National Institute of Economic Research (*Konjunkturinstitutet*) provide annual information and recommendations on wage formation.
2. This holds for both the incidence of low pay and for the relative wage of the lowest wage decile compared to the highest (D9/D1) or the average (D5/D1) decile. Finland is among the few OECD countries that do not have a statutory minimum wage, as minimum wages are determined by collective agreements and later enshrined into legislation.
3. In Sweden, a number of reforms to the unemployment benefit system was made in 2006 and 2007 including abolishing the first 100-day top-up and lowering maximum benefits from 80% to 70% after 200 days and to 65% after 300 days. These reforms have been estimated to lower the structural unemployment rate by 0.5 percentage points (OECD, 2007).
4. There are strong reasons to believe that an optimal unemployment insurance should be countercyclical, *i.e.* providing higher and longer replacement during recessions (Andersen and Svarer, 2009). To construct an efficient and credible framework for implementing such a model would be difficult, however.
5. While the recently ended pilot scheme on privileged income, which let households keep up to 20% of income without affecting the level of the BIS, dealt with some issues related to inactivity traps, its effectiveness has not yet been evaluated.
6. In 2007, roughly 45% of the households below the poverty line (60% of average disposable income) did not receive housing benefits. 43% received child benefits and 30% received pension (Statistics Finland: Income Distribution Survey microdata from 2007).
7. Bonuses are capped below 7% of the average wage, while productivity differences among case officers are likely to be much higher. In discussions with government officials, it has been stated that "30% of case officers do 90% of all placements".
8. See Kannisto (2004) for further details.
9. See *www.oecd.org/document/47/0,3343,en_2649_34747_39371887_1_1_1_1,00.html* for further details.
10. The fall in long-term unemployment has been accompanied by corresponding increases in employment, while there is no evidence of larger inflow into disability pension for that age group during 2005-08.
11. Estimated over the sample 1991:1-2009:3 using a simple ordinary least squares of long-term unemployment on lagged total unemployment.
12. Rehabilitation, assessment and financial responsibilities for disability benefits are fragmented and could involve pension providers, KELA, the PES and municipalities (OECD, 2008b).
13. It should be noted that the unemployment tunnel most likely contributes to raising retirement at 62 years of age relative to 63, as individuals taking the tunnel can move into the old-age pension system at 62 without the penalty.
14. Based on estimates from Duval (2003). These estimates are likely to define an upper bound as they are estimated on the 60-64 age group.

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Chapter 4

Rising inequalities challenge Finland's social model

Income distribution in Finland remains among the most equitable in the OECD, although, as in a number of other countries, disparities have widened considerably over the past decade. While the tax and transfer system has been effective in reducing income inequality, changes made to the income tax system in the early 1990s have contributed to rising disparities by encouraging income shifting among high earners. Disparities have also been increasing across regions, particularly in labour market outcomes. This reflects the dramatic structural change that has occurred since the early 1990s, and the lack of policy success in tackling this transition. These growing disparities in regional labour market outcomes have contributed to serious demographic imbalances building up in the regions. These are especially prevalent in the smaller municipalities and challenge the very sustainability of these entities. Misuse of the tax system by high income earners should be addressed, and regional labour market discrepancies should be tackled by increasing the flexibility of the labour force. This includes sharpening incentives for retraining that would promote sectoral and regional mobility. Sustainability of the municipalities system requires further rationalisation, including forced mergers.

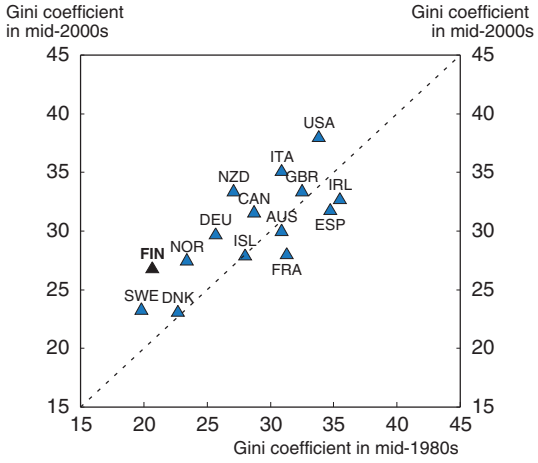
Rising GDP has been accompanied by increasing inequality

Apart from GDP, income equality is an important aspect of well-being. While GDP has continued to rise, income distribution has worsened in almost all OECD countries over the past decades. This has been influenced by the quick pace of globalisation, rapid technical progress, and changes in social structures, which have raised the relative returns to skilled labour and reduced those to unskilled workers. The rapid transition has made it difficult for welfare systems to bridge the growing income gaps. In Finland, this took place against a deep recession in the 1990s, which led to a sharp rise in unemployment and reduction in participation rates, as many left the labour force to live on social assistance or pensions. There was also considerable structural change, with the traditional forestry and paper industries losing competitiveness and giving way to buoyant new industries with a dramatic expansion in openness. At the same time, this transformation increased regional concentration of economic activity, which contributed to growing income disparities across the country. For example, over half of the increase in GDP between 1995 and 2005 was generated by only one of the twenty regions in Finland (Uusimaa, the Helsinki region with 11% of the population).[1]

While the Nordic countries have among the most even distributions of income in the OECD, they have seen some of the most rapid deterioration in income dispersion in recent years (Figure 4.1).[2] The importance of income equality in countries' social welfare functions differs, but is particularly important in the Nordic countries, including in Finland. Acceptability of change and related reforms are also more difficult if large sections of society are perceived to be worse off. Reconciling closer integration with the global economy and managing the changes that it entails, while maintaining a fair distribution of resources and opportunity is an important challenge going forward (Anderson *et al.*, 2008).

This chapter looks at the challenges of maintaining income equality in the face of widening earned income differentials and growing disparities in regional outcomes across Finland. It looks at various measures of inequality, including income distribution, poverty rates and regional income and employment differences, and what factors may have contributed to increasing inequality. Apart from global trends, such factors include the impact of domestic policies, including education, labour market, reforms in the welfare system, and distortions in the tax system. Income and labour market disparities have become particularly stark between regions in Finland given the concentration of economic activity in the South. The chapter concludes by discussing policy issues stemming from balancing income transfers and work incentives. The role of municipalities as providers of many social services and education is particularly important, especially in the light of growing fiscal and demographic pressures.

Figure 4.1. **Income inequality in selected OECD countries**



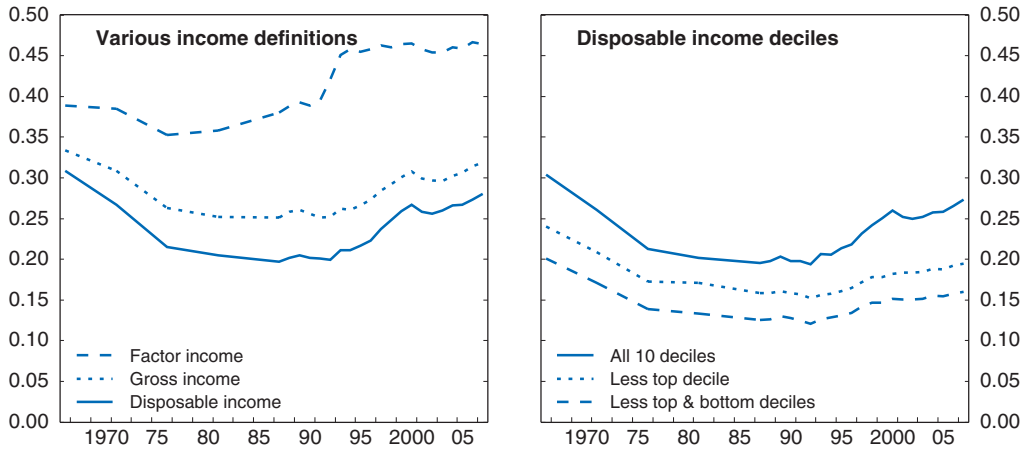
Source: OECD (2008), *Growing Unequal? Income Distribution and Poverty in OECD Countries.*

StatLink http://dx.doi.org/10.1787/828351441561

Income inequality has widened in Finland in recent years

Income inequality declined steadily until the early 1990s in Finland aided by an increasingly generous welfare transfer system. To assess the sources of inequality the Gini coefficient can be decomposed into *i)* factor income (before-tax labour, entrepreneurial and property (capital) income); *ii)* gross income, which includes the impact of social security and other transfers; and finally *iii)* disposable income, which incorporates the effects of taxation (Box 4.1). Both gross and disposable income inequality trended downwards until early 1990s, while factor income inequality remained largely stationary (Figure 4.2, left panel). This points to the important role of social transfers in distributing income (including tax progressivity and transfers, Mahler and Jesuit, 2009; Brandolini and Smeeding, 2007). The compression of the wage distribution due to incomes policies also played a role during this period (Uusitalo, 1989). By the mid-1980s income inequality in Finland was among the lowest in the OECD (Figure 4.2; Atkinson *et al.*, 1995; Förster and Mira d'Ercole, 2005; OECD, 2009a).[3]

Figure 4.2. **Gini coefficients**



Source: Statistics Finland and OECD calculations.

StatLink http://dx.doi.org/10.1787/828355411247

Income distribution started to worsen after the 1990's recession. The sharp rise in unemployment due to the recession increased factor income inequality. The impact of joblessness on disposable income inequality was muted by the transfer system, as indicated by the more gradual worsening in disposable income inequality. But social transfers were not enough to maintain the degree of equality as unemployment spells lengthened, unemployment insurance expired and retrenched workers moved on to more modest unemployment benefits, and disability and other pensions. The worsening also reflected considerable cuts in the welfare system motivated by the need for fiscal consolidation, and to reduce unemployment rates that had peaked at over 18% (Van Gerven, 2008). For example, prior to the recession, employment was guaranteed for those out of work for longer than 12 months. The government also fully subsidised such employment for the first 6 months, which reset unemployment benefits to another 23 months, resulting in churning. The guarantee of subsidised employment was abolished in 1992 and the renewal of earnings-related unemployment insurance by participating in subsidised work was restricted in 1997. The increase in factor income inequality after the recession, despite improving labour market conditions, also reflects the quick recovery of asset values as compared with employment rates that never quite fully recovered from the 1990s recession (Figure 4.2, left panel). Another factor is the increase in high paying jobs in the newly emerging industrial sectors.

Box 4.1. **Components of disposable income**

Factor income = *Wages and salaries + Entrepreneurial income + Income from property*

i) Wages and salaries (including fringe benefits and incentive stock options).

ii) Entrepreneurial income

iii) *Income from property* = Interest income + Dividends + Rental income + Imputed net rents of owner-occupied dwellings + Realised capital gains + Pensions and compensations based on private insurances.

Gross income = ***Factor income*** + *Current transfers received*

iv) Current transfers received = Occupational pensions + National pensions + Other social security benefits + Social assistance allowances + Other current transfers received

Disposable income = ***Gross income*** – *Current transfers paid*

v) Current transfers paid = State income tax + Municipal income tax + Other current transfers paid

Factors driving rising income inequality

The distribution of disposable income has become more uneven in most OECD countries over the past two to three decades (Figure 4.1). There are a number of common factors that have contributed to this phenomenon (OECD, 2009a). Trends in population and social structures are impacting on measures of income inequality in many OECD countries. Household units are becoming more atomised. Rather than the traditional model of two parents and children under the one roof, the trend has been towards fewer children and more solo living, particularly among the low income older and younger age cohorts. The result is that income surveys, which are done on the basis of household income units, measure greater numbers in the low income deciles. Moreover, increased

fragmentation into smaller household units means reduced economies of scale and co-operation in domestic production, and lost economies of scale in consumption (Ringen, 2007). That said, only a small proportion of the change in Finland's disposable income Gini coefficient over the past two decades can be attributed to altered age and household structures (OECD, 2009a).

The inclusion of growing numbers of employed students in the income survey can inflate numbers in the low income deciles and may account for some of the increase in aggregate inequality in Finland over recent years. The proportion of tertiary students who work has increased to 26% in 2007 from 14% in 2000. While it is difficult to be sure what types of jobs these students are engaged in, it is likely that they are employed part time in the services sector in relatively low wage jobs.

Changes in the population structure can also impact on developments in income inequality over time as poverty tends to be more prevalent among the old and young age cohorts, and single parent households. Although Finland is ageing earlier and more rapidly than most other OECD countries, these factors have been shown to account for only a small proportion of the increase in Finland's aggregate Gini co-efficient between 1995 and 2005 (OECD, 2009a). Nevertheless, removing both the top and the bottom income deciles, income equality within the remaining 80% of households has continued to show a mild upward trend since the mid-1990s (Figure 4.2, right panel) pointing to some "hollowing out of the middle class" (OECD, 2009a).

Considerable research has been undertaken exploring the degree to which globalisation (trade, foreign investment and migration), skill based technological change and labour market institutions play a role in explaining the trend of increased income inequality in OECD countries. Globalisation and technical change are likely to play an important role in Finland where openness has increased dramatically over the past two decades and the structure of the economy has been transformed, while labour market institutions have remained relatively rigid. This literature is commonly motivated by the trend decline in labour shares witnessed in many countries over the past three to four decades. However, there does not appear to be any cross-country correlation between changes in aggregate income shares and changes in household disposable income distribution (Harjes, 2007). As shown in Chapter 3, wages in Finland are more compressed than in any other OECD country.

Trends in patterns of employment have also impacted on income distribution. The growing incidence of non-standard employment (part-time, contract and casual work) has contributed to the widening of the distribution in factor income. This is also reflected in the increased concentration of capital and self-employment income in many OECD countries. The trend towards increased labour market participation and higher employment rates (female participation being an important factor), and the lessening of the gender wage gap, have both offset the increased dispersion in labour income over time.

Finally, the amount of public resources spent on income redistribution is a very important determinant of disposable income equality across the OECD. This is especially true in the Nordic countries where social benefits are both progressive and generous, and income tax rates are high. While this redistributive mix seems prudent, given research that suggests that social benefits appear to be the most efficient means of affecting disposable income distribution, it can come at the cost of blunting labour market incentives.

Moreover, high tax rates on top income earners can motivate tax avoidance, blunt work incentives and make it difficult to keep and attract skilled labour.

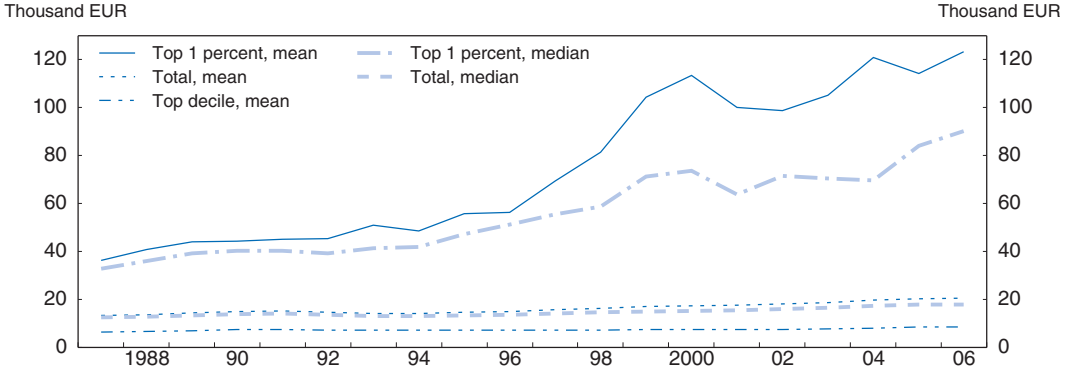
The sharp rise in incomes of the highest earners has been an important factor in rising income inequality

Much of the rise in inequality over the past decade is due to a disproportionate increase in disposable income accruing to top income earners in Finland. If the top income decile is removed from the Gini coefficient, the rise in inequality is muted considerably from around the mid-1990s onwards (Figure 4.2, right panel). Over this period, income accruing to the top quintile in Finland increased by 4.6% per annum on average compared to 1.6% for the bottom quintile and 2.5% for the middle three quintiles. This is by far the largest increase in top quintile income relative to the mean of any country in the OECD over this period and contrasts with earlier periods when income in the top quintile actually declined relative to the mean (OECD, 2009a). Furthermore, income accruing to the top 1% increased more than six times faster than total income between 1990 and 2002 (Riihelä *et al.*, 2009). The increase in the mean income of the top 1% is also considerably larger than the median, suggesting that much of the increase is concentrated in just a small upper proportion of the 1% of top income earners (Figure 4.3). For a small country like Finland, this means a very small number of people.

Rising realised capital gains and dividends contributed heavily to the large increase in the measured income of top income earners. Through the 1990s, equity prices climbed dramatically in Finland on the back of the emergence of the ICT sector, and this is reflected in a considerable climb in the share of total disposable income in the top decile derived from capital gains. Dividends also increased rapidly through this period, in part due to the increased profitability of Finnish firms through this period. However, total dividends increased vastly more than profits: between 1994 and 2005 real profits increased by around one half while over the same period real dividends to households increased by almost a factor of ten (Statistics Finland, National Accounts). Part of the surge in dividends to top earners can be traced to a major tax reforms during the same period. Following the

Figure 4.3. **Developments in disposable income**[1]

Top one percent, top decile and total



1. Median and mean disposable income at 2006 prices.

Source: Statistics Finland and Riihelä, M. (2009), *Essays on Income Inequality, Poverty and the Evolution of Top Income Share*, Government Institute for Economic Research, *Publication* 52, May.

StatLink http://dx.doi.org/10.1787/828385058713

example of other Nordic countries, Finland introduced a dual income tax (DIT) system in 1993. This aimed at removing the unfavourable tax treatment of capital income by combining a progressive labour income tax with a flat tax rate on capital income. Its rate was initially set to the lowest marginal tax rate on labour income (initially 25% but later increased to 29%) and thus well below the top marginal tax rate on labour income (see Box 4.2). The reforms also included the full imputation of dividends.[4] Apart from improving the tax treatment of legitimate capital income, this opened an opportunity for high income earners to reclassify labour income as capital income to take advantage of the lower tax rate.

Box 4.2. **The Dual Income Tax system**

The Dual Income Tax (DIT) model is attractive on a number of efficiency grounds. Taxing capital income results in double taxation; once when the income that is used to purchase the capital is earned, and again when income is earned on that capital. This is analogous to taxing future consumption at a higher rate than present consumption. A policy consequence of this is that capital income should be taxed at a lower rate than labour income (indeed, the tax on capital income could arguably be zero). Moreover, if inheritance taxes address the equity concerns of capital transferred across generations, then a preferential treatment of assets saved for retirement is an argument in favour of lower capital income taxation. Finally, capital may be more internationally mobile than labour, and may have become even more so in recent decades, and therefore easier to evade taxation, so governments might treat it preferably. Indeed, in some continental European countries the dual tax system has been proposed as a means of addressing tax competition from the transition economies (GCEE, 2006).

On the basis of these principles, in the late 1980s and early 1990s the Nordic countries each implemented a system of taxation that differentiates between labour income and capital income. The latter comprised income derived from interest, dividends, capital gains from financial assets, imputed rent on housing, accrued returns on pension savings and profits from personal enterprises. This base therefore includes some forms of capital income that had been completely untaxed under the previous system. Capital income is then taxed at a rate close to the lowest marginal rate on labour income, and corporate taxation is also harmonised to this rate with imputation allowing close integration of the capital and corporate tax systems.

Simplified compliance is an argument in favour of this system with the DIT model making the demarcation between capital income and labour income, in principle, better defined. This means that administrative costs should also be lower. However, this is not to say there are no problems, and a number of them have started to challenge policy. Not least of these has been the division of entrepreneurial income into its labour and capital-derived components (which are indistinct from profits) and, given the preferential tax treatment of capital income, personal business owners have an incentive to categorise as much profit as capital income as possible. This possibility seems to have motivated individuals to incorporate into business structures.

Each Nordic country has taken a different approach to this problem (Kanniainen *et al.*, 2007). One solution is to impute average returns to business capital (the so-called presumptive rate of return) but this is unlikely to reflect the true returns and could reduce entrepreneurial incentives. Multiple imputation rates would complicate administration. Moreover, this whole approach invites political lobbying, as Christiansen (2004) documented happening in Norway.

Capital income accruing to top income earners has increased substantially following the reforms. With the highest effective marginal tax on labour income rate at roughly 61% (taking into account indirect taxes but not employers' social security contributions; Pirttilä and Selin, 2006), the motivation to minimise tax was strong. Capital income of the top 1% of income earners increased from 28% to 54% of their total disposable income between 1994 and 2006 (Riihelä, 2009). While some of the increase might be attributable to a trend toward greater equity-based remuneration of senior executives, particularly in the high-tech sectors (where the "superstar phenomenon" is prevalent), much of this is due to income shifting. As a result, immediately following these changes progressivity was reversed for those earning above EUR 60 000 per annum (Riihelä, 2009).

The increase in measured dividend and realised capital gains after the 1993 tax reforms may in part be due to statistical coverage issues. In the pre-1993 tax system it was easy to wholly avoid taxation of profits by realising them as untaxed capital gains, in which case they were not recorded in the revenue statistics. In fact, it was possible to take out profits without paying the corporate income tax, as coverage of this tax base was patchy. With the reform, taxation of capital gains was tightened, as was the tax base of the corporate income tax by *e.g.* removing the possibility to distribute profits not subject to corporate income tax. As a result, revenue from the corporate income tax increased dramatically. Distribution of profits in the form of (statistically recorded) dividend income also became more prevalent, which partly explains the impact of the 1993 reform on the recorded household income distribution.

Recent reforms to the DIT system increased the taxation of dividends. The imputation system was abolished and a partial classical model of dividend taxation was introduced. After the reform, 70% of the dividends received from listed companies are taxed as capital income. Dividends from non-listed companies under the 9% return margin (*i.e.* return in relation to the company's net assets) are tax free up to the EUR 90 000 threshold and 70% of the exceeding amount is taxed as capital income. If the dividend income exceeds the 9% return margin, 70% of the exceeding amount is taxed at the progressive labour income tax rate. To diminish income shifting a special rule on the taxation of so-called work related dividends was added to the Income Tax Act. According to the rule, dividends from non-listed companies are taxed as earned income if the dividends are based on the agreement concerning the work effort of the receiver.

Incidence of poverty has increased with joblessness

Although poverty in Finland remains low in the OECD context, it has substantially worsened in recent years by most measures (Riihelä, 2009; OECD, 2009a). This is the case for all household types except those with two income earners, which have seen a very marginal decline in poverty rates (using the 50% of median income definition) between the mid-1990s and the mid-2000s (OECD, 2009a).[5] Apart from social transfers and wage levels, poverty rates tend to be related to employment status (OECD, 2009a). The number of households in poverty in Finland was 34% when no one was working but declines to 10% with one worker and to just 1% with two workers. Joblessness has undoubtedly been a very important factor in explaining poverty rates in Finland, in view of the high unemployment rates in the 1990s and since it has taken a decade to halve them. Many of the unemployed also exited the labour force to live on social assistance or pensions, and even by 2008 participation rates had not recovered to the levels prior to the 1990s recession. This

underscores the need for policy makers to focus their attention on getting people engaged in the labour force and into work as the most effective means of combating poverty.

Regional labour outcome disparities are also on the rise

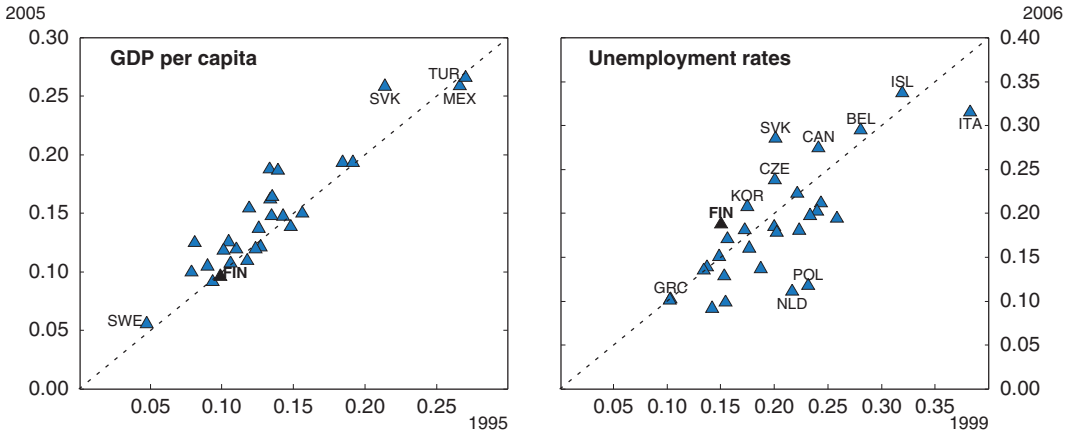
Another dimension of well being and equality is the regional distribution of labour market outcomes, which also shows a worsening trend in Finland. As with income inequality at the aggregate level, Finland ranks comparatively well within the OECD in terms of disparities in per capita GDP across regions. The Gini coefficient of per capita GDP across Finnish regions is well below the OECD average and has been relatively stable between 1995 and 2005 (Figure 4.4, left panel). Moreover, the degree of dispersion in disposable income across regions has also been broadly static since the mid-1990s (Figure 4.5).[6] However, inter-country studies of inequalities can mask important differences across regions of individual countries arising from local conditions and geography, or the differential impact of globalisation and structural change on individual regions. For example, socio-economic outcomes vary increasingly in Finland across the three hundred plus municipalities. Moreover, inter-regional disparities are a significant factor in the growing aggregate-level income and social inequalities in Finland outlined above.

Labour market outcomes are an important aspect of inequality, as well as being a determinant of income dispersion. Unemployment is uneven across regions of Finland (Figure 4.6), and has contributed to increasing regional factor income inequality in recent years. The increasing variance in labour market outcomes across the regions is reflected in greater factor income dispersion (Figure 4.5). However social transfers seemed to have been effective in offsetting its impact on disposable income differences between regions (Figure 4.5).

The rise in the dispersion of regional unemployment rates in Finland was amongst the highest in the OECD between 1999 and 2006 (Figure 4.4, right panel). This leaves Finland above the OECD average by 2006 (OECD, 2009b). Paradoxically, this deterioration occurred during a period of steady declines in the aggregate unemployment rates.

Figure 4.4. **Regional GDP per capita and unemployment rates**

Gini indices



Source: OECD (2009), *Regions at a Glance*, Figures 15.3 and 18.3.

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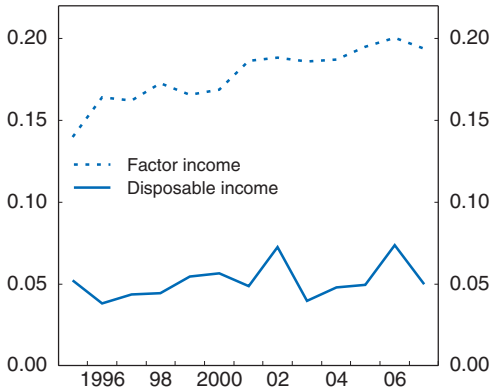
Figure 4.5. **Variance in regional factor and disposable income inequality**[1]

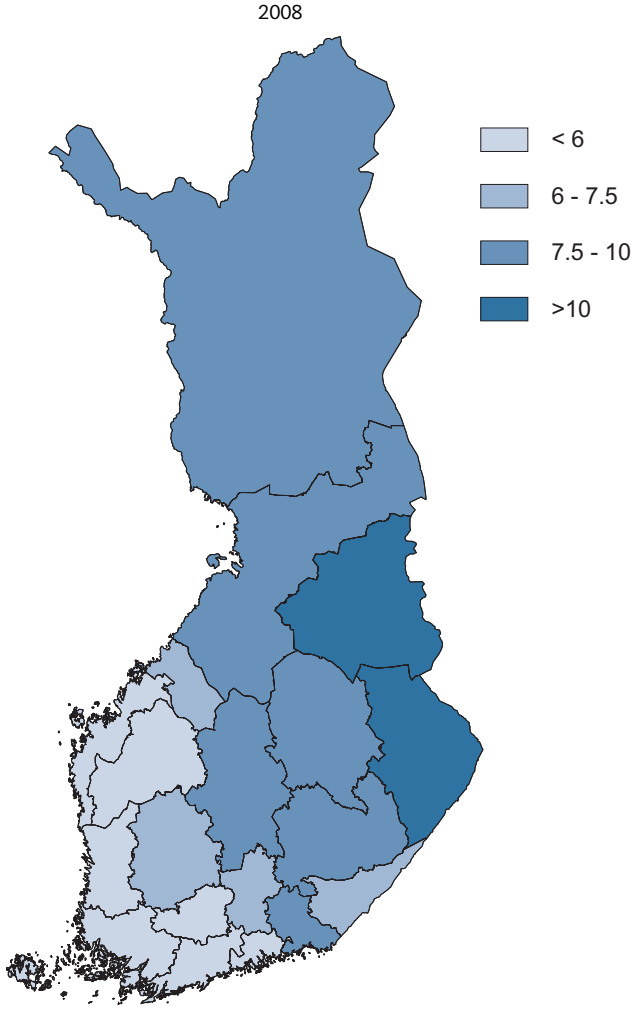


1. Coefficient of variation of (P50/P50) ratios of total income in the top five deciles and total income in the bottom five deciles across the 77 LAU1 regions.

Source: Statistics Finland.

StatLink http://dx.doi.org/10.1787/828430471256

Figure 4.6. **Finnish unemployment rates by region**



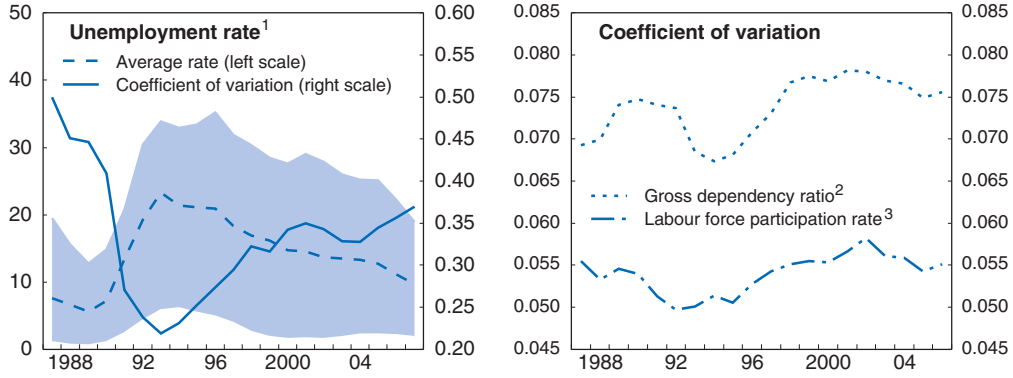
Source: OECD, *Regional Statistics Database*, February 2010.

StatLink http://dx.doi.org/10.1787/828466311403

Following the deep recession of the early 1990s, the aggregate and the extremes of the range of unemployment rates across regions started to decline in 1993 (Figure 4.7, left panel). However, the dispersion of regional unemployment rates did not decline relative to the falling average and, as a result, the coefficient of variation trended strongly upwards over this period (as does the Gini coefficient). Not only did the variance of the regions with respect to joblessness increase over this period, but so did the variance of participation rates and dependency ratios (Figure 4.7, right panel).

This disparity in labour market performance across regions is even more pronounced when looking at males. The gender disparities in labour market outcomes reflect significant structural shifts in activity within the regions since the early 1990s. For instance, between 1992 and 2007 total employment increased by 13%, but employment in forestry and related manufacturing declined by 17%, and employment in agriculture declined by a massive 46%. These two industries are traditionally associated with more peripheral regions and dominated by low-skilled male workers. In contrast, women tend to be employed in the rapidly growing municipal services sector (eight out of ten municipal employees are female).

Figure 4.7. **Regional labour market outcomes and dispersions**



1. The shaded area indicates the maximum and the minimum unemployment rates among Finnish LAU1 regions.
2. Defined as the sum of those aged under 15 years old, students and pensioners over the whole population.
3. Labour force aged 15-64 over the population of 15-64.

Source: Statistics Finland and OECD calculations.

StatLink http://dx.doi.org/10.1787/828517013636

Addressing disparities is complex calling for action on many fronts

Designing policies that address disposable income or regional inequality often involves balancing offsetting priorities and effects (for instance in terms of equity and efficiency) within tight budget constraints, especially in the current context of fiscal consolidation requirements. The complexity and causes of disparities call for a multifaceted approach including social, labour market, education, and tax and other fiscal reforms. These must be weighed against the intertemporal distributional concerns that the sustainability problem illustrates, which are particularly pertinent in the case of Finland. As the population ages and the regions struggle to adapt to ongoing structural change, the finances of both central and regional governments will come under increasing strain and their ability to continue to fund redistribution via income and other in-kind transfers will erode.

Finland has a long history of regional development programmes aimed at promoting equality and sustainability. In recent years this approach has gained a renewed impetus. In 2007 the government articulated its regional policy objectives in its Regional Development Act. These are: *i)* to strengthen national and international competitiveness of the regions; *ii)* to strengthen regional vitality and reduce regional disparities; and *iii)* to solve special regional challenges. Moreover, in August 2007 the functions of a number of ministries were combined into the new Ministry for the Economy and Employment which also took over the responsibilities of the Department for Development of Regions and Public Administration from the Ministry of the Interior, while the Regional and Local Administration Unit from the Ministry of the Interior was transferred to the Ministry of Finance. In January 2010 the government launched a Cohesion and Competiveness (CoCo) Programme which aims to build on individual regions' competitive advantages and strengths, thereby enhancing regional attractiveness to business and new residents. While these types of programmes might have cushioned the impact of structural change in the regions over the past two decades, disparities have nevertheless worsened, and given current fiscal pressures, room for extra spending on these measures is extremely limited.

At the same time, some further increase in income inequality may be inevitable. Increasing skill premiums may entail larger differences in wages. Constraints on public finances will limit amounts available for social transfers. These trends will put emphasis on policies that improve labour mobility and target transfers more efficiently.

Better targeting of social transfers

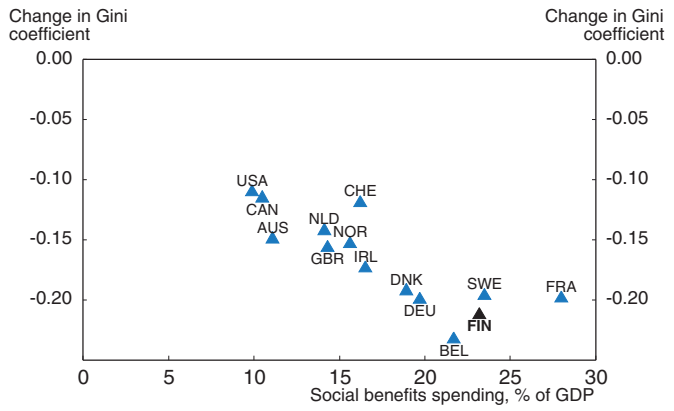
As in other Nordic countries, the role played by the public sector in Finland is central in tempering the uneven distribution in factor income. Finland and the other Nordic countries spend considerably more on both direct social benefits and other in-kind transfers such as public education and public health. Social benefit spending is boosted by the availability of long duration income-related unemployment benefits (500 days in the case of Finland; see Chapter 3). Relative transfers to smooth private (factor) income to achieve an equitable distribution of disposable income in Finland are among the highest in the OECD (Mahler and Jesuit, 2009). For instance, the gap between the Gini coefficients for private factor income and disposable income was 0.21 in 2004, compared to 0.19 in Sweden (in 2000) and Denmark (in 2004).[7] Over three quarters of redistribution in Finland is made through the transfer system (Mahler and Jesuit, 2009), which is in line with the other Nordics, but lower than in France and Switzerland. Comparing social benefits spending as a share of GDP against the consequent improvement in the Gini coefficient from moving from personal to disposable income shows the important role that unemployment benefits and pensions played in Finland in reducing income inequality following the 1990s recession (Figure 4.8). While increases in social transfers will be limited by the worsened fiscal outlook, even better targeting of the current system can have some impact in reducing inequalities.

To reduce income shifting among high earners, the DIT tax system should be reformed

Some of the dispersion in incomes can be reduced and equity increased by reducing potential for tax shifting in the DIT tax system. This would also help share the tax burden. A linearly progressive rate of capital taxation with rebates for low income earners could be one option. The provision for non-taxed shareholder dividends up to EUR 90 000 for closely

Figure 4.8. **Social benefits spending and redistributive effect**

2004 or latest available year



Source: Mahler, V. and D. Jesuit (2006), "Fiscal Redistribution in the Developed Countries: New Insights from the Luxembourg Income Study", *Socio-Economic Review* 4, *www.lisproject.org/publications/fiscalredistdata/fiscred.htm*.

StatLink http://dx.doi.org/10.1787/828517166251

held corporations is also a loophole that should be abolished. Moreover, the rate at which dividends that exceed that level are taxed is lenient and should be re-examined. These issues are likely being examined by a government working group currently formulating tax reform proposals.

Reinforcing labour market and education policies can reduce inequalities

The link between the income of parents and children is commendably weak in Finland and this in large part can be attributed to the strength of the pre-tertiary education system (OECD, 2010). Comprehensive schooling reforms were instrumental in lowering the correlation between father's income and that of his son (Pekkarinen *et al.*, 2009) and have also assisted in achieving low inter-school variation in test scores (OECD, 2006). This success has also been assisted by concerted efforts within schools to provide targeted remedial measures for those students who fall behind. This may be facilitated by among the highest teacher-to-student ratios in the OECD, particularly at the lower secondary level (OECD, 2009c). The low aggregate correlation between parent and child educational outcomes have resulted in high levels of intergenerational income mobility by OECD standards, with Finland ranking on a par with Norway and better than Sweden, Germany and France (D'Addio, 2007).

Nevertheless, intergenerational educational immobility remains an important issue in Finland particularly at the tertiary level, as highlighted by Statistics Finland census data on educational attainment across generations. For instance, in 2007 a 30-49 year old female is six times more likely to have obtained a higher tertiary qualification if her mother has a higher tertiary qualification as opposed to a basic level of education. The son-to-father higher tertiary attainment probability is even higher at close to seven times if the father also has a tertiary qualification compared to a basic level of education. Moreover, recent OECD research finds that in Finland, like in the United Kingdom and a number of southern European countries, the son of a father with a tertiary education enjoys a 20% wage premium compared to a son whose father does not have a tertiary qualification (OECD, 2010). This corresponds with the finding of high private internal returns to tertiary education in Finland relative to other OECD countries (OECD, 2006) and contrasts with the very small income

penalty for a son whose father has attained less than an upper secondary school education. Indeed, the low-educated parent penalty is so small in Finland that, even with the high tertiary-educated parent premium, the aggregate intergenerational elasticity is low by comparison to most other OECD countries (Causa and Johansson, 2009).

Inactivity and welfare dependency are strongly transmitted across generations, particularly for women. This seems to be especially so in Finland which is second only to the United Kingdom among European OECD countries in the degree to which welfare dependency is transmitted from mother to daughter (OECD, 2009a). Employment continues to be important in either lifting both individuals and families out of poverty or in reducing income disparities (OECD, 2009a). Poverty reduction by other means typically implies blunted work incentives. While certain measures aimed at increasing participation and employment might be detrimental for income equality (at least in the short term), particularly those that focus on financial incentives, other measures such as active labour market programmes and stricter gate keeping may have a considerably milder effect on equality (OECD, 2009a). Chapter 3 makes a number of recommendations regarding how the performance of regional employment offices might be improved.

Reducing skill mismatches and promoting regional mobility would also help improve regional equalities, particularly in factor income and labour market outcomes. As outlined in Chapter 3, more needs to be done to ensure that those without jobs are efficiently matched with existing vacancies. This also means that greater effort needs to be made to provide the appropriate skills to those workers who have become retrenched due to structural change and find that their existing skills are no longer suitable in the new industrial structure. In addition to more resources for this task, the right incentives also need to be put in place so that the unemployed more readily take up retraining opportunities, lift job search intensity and step up enforcement of relocation requirements.[8] The recent extension of the commute radius to 80km is a move in the right direction, but greater incentives and assistance could be provided for more distant moves where housing costs are frequently the greatest impediment.

The recommendation (Chapter 3) that wage outcomes be more closely related to productivity outcomes within firms has been resisted in some quarters on the basis that this may lead to a rapid divergence in wage outcomes and a consequent deterioration in equality. While this is true to some extent, there are several factors particular to Finland and the other Nordic countries that would mitigate this. We have already noted the important role that the transfer system plays in equalising disposable incomes in Finland. Moreover, educational outcomes in Finland are especially homogeneous, especially within generational cohorts, meaning that the distribution of productive abilities should be relatively even (Andersen *et al.*, 2007). Furthermore, in the long run, homogeneous wage outcomes across all sectors of the economy, without regard to relative productivity differences, are not sustainable, particularly in an economy that is becoming more and not less internationally open and more skill-intensive in production.

Regional inequalities can be reduced by improving municipal management

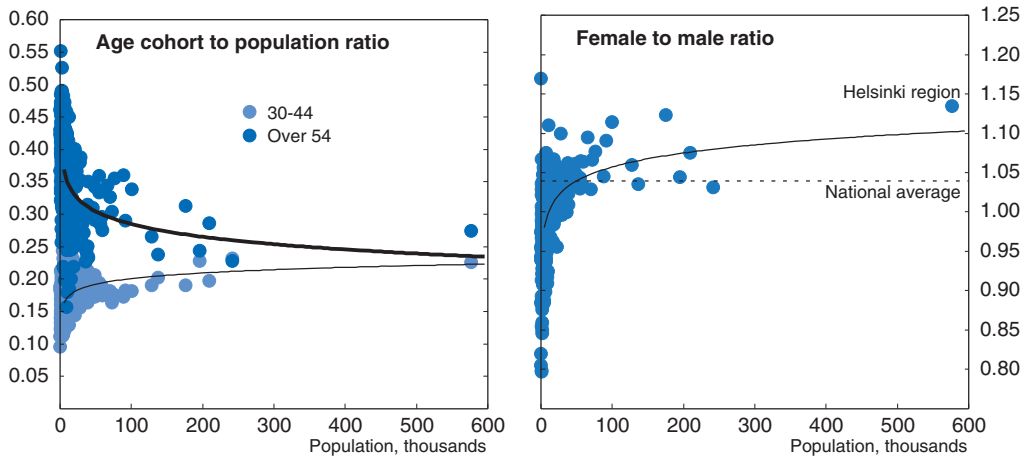
Smaller municipalities tend to have disproportionately large populations of lower income groups due to demographics disparities.[9,10] For instance, the 20-30 year old cohort is particularly absent from smaller municipalities. This might in part be because significant proportions attend tertiary institutions which are typically only found in the larger municipalities.[11] Nevertheless, the imbalance in the age distribution in small municipalities

remains when looking at the shares of prime-age and older cohorts (Figure 4.9).[12] As the population ages in coming years, dependency ratios are likely to climb even higher and strain municipal finances, especially in the smaller municipalities (see Chapter 2).[13]

A case for reducing the numbers of municipalities in Finland, along the lines of what has been done in Denmark, was also made in Chapter 2 of this *Survey*. Municipalities are an important feature of the Finnish system of government, particularly as Finland has among the largest proportion of population living in rural areas in the OECD at around 53% in 2005. But Finland also has one of the fastest rates of urbanisation in the OECD, with the decline in the rural population of 2.2 percentage points in the decade to 2005 being second only to Iceland (OECD, 2009b). This, combined with the growing regional inequalities and imbalances outlined above, suggests that the existing municipal framework is likely to come under increasing pressure going forward, particularly as structural change continues and demographic trends take hold.

The previous *Survey* recommended that more should be done to encourage the consolidation of municipalities, with a view to improving the efficiency of service delivery. The growing regional disparities highlighted in this chapter provide further motivation for greater efforts in promoting mergers, particularly aimed at achieving minimum sustainable population-sized units (perhaps 20 000 as in the case of the Danish reforms). These would help to achieve economies of scale and address concerns about the competence of municipal administration, as talent would be less diluted than is currently the case. Mergers of this sort would put local governments in a better position to tackle the rising inequalities that have been highlighted in this chapter by being able to pool resources and to put local governments as a whole on a more sustainable fiscal footing (Chapter 2). However, administrative mergers themselves are unlikely to be sufficient and need to be coupled with strong incentives for the enlarged entities to reap the benefits of the economies of scale and other efficiency improving measures. This would help to reduce costs and improve the quality of service provision, thereby improving the fiscal position of municipalities, as well as being in a better position to address inequalities.

Figure 4.9. **Demographics by municipality population size**



Source: Statistics Finland.

StatLink http://dx.doi.org/10.1787/828534377048

Box 4.3. **Summary of recommendations concerning rising inequality**

Distortions in the tax system are encouraging income shifting

- The opportunities offered by the dual tax system for high income earners to reclassify labour income as capital income challenge the sustainability of the existing dual tax system. Fundamental reforms of the system may be required as the continual patching up of loopholes is untenable in the long run. A linearly progressive rate of capital taxation with rebates for low income earners should be considered to address concerns about progressivity.
- Shareholder dividends up to EUR 90 000 are not taxed for closely held corporations. This disproportionately high limit should be reduced *e.g.* to correspond more directly to actual returns to capital. Moreover, the rate at which dividends exceeding that level are taxed is lenient and should be re-examined.
- Lowering income tax rates on high income earners would reduce incentives to shift income, improve work incentives and help to keep and attract skilled labour.

Labour market rigidities are hampering matching and exacerbating regional disparities

- The lack of interregional mobility remains an impediment to the efficient functioning of the national labour market and has contributed to growing interregional inequality. Existing schemes to promote mobility should be re-examined. Furthermore, enforcement of the requirement for unemployment benefit recipients to relocate should be stepped up.
- Wage compression should be deemphasised as a strategy for promoting income equality, as it does not assist in promoting sustainable job creation, particularly in an environment of globalisation and rapid technical change.
- Policies to promote labour market participation and employment should be pursued as these have been found to be the best strategy for tackling poverty. Moreover, higher levels of participation and employment increase the tax base and make transfer-based redistribution more affordable.

Municipalities will struggle to address rising inequalities unless efficiency is improved and financing addressed

- Improvements in the efficiency of service delivery by the municipalities are being hindered by the large number of small entities. A more ambitious programme of rationalisation – including wholesale mergers along the lines of what has happened in Denmark should be considered (see Chapter 2).

Notes

1. Sweden has also seen a similar pattern although it is considerably less pronounced than in Finland. The Stockholm region contributed around 40% of total real GDP growth between 1995 and 2005 while it comprised 21% of the total population of Sweden.
2. Denmark stands out as the one Nordic country to record only a marginal deterioration in disposable income inequality over the past two decades (Figure 4.1). This might be partially attributable to the "flexicurity" system that was introduced in the mid-1990s, which combines high unemployment benefit replacement rates with strict employment activation requirements. This has assisted in keeping Denmark's unemployment rate well below the Nordic average for much of the period since the mid 1990s.
3. According to OECD (2008), Finland ranked second after Sweden as having the most equal in income distribution among OECD countries in the mid-1980s, but by the mid-2000s. Finland had dropped to 7th.

4. According to the National Accounts, between 1993 and 2005 dividend income increased by a factor of almost ten (Statistics Finland).

5. The worsening can be partly due to the denominator, which is usually a fraction of median disposable income, outpacing increments in social benefits. However, neither nominal GDP nor nominal disposable income grew exceptionally fast in Finland by OECD standards over the decade to 2005 despite strong real GDP per capita growth. This is a reflection of the very modest inflation and nominal wage increases recorded through most of this period.

6. Riihelä (2009) shows that Gini coefficients over time within the 4 NUTS2 regions in Finland show a similar "U" shaped profile to the aggregate coefficient. The author also shows that average incomes across the regions tended to converge until the mid-1980s but have since remained static relative to one another.

7. Fiscal Redistribution Dataset. Assembled by David K. Jesuit and Vincent A. Mahler, *www.lisproject.org/publications/fiscalredistdata/fiscred.htm*.

8. Prior to the 1963 Act on Employment, reduced-wage public works employment was the only form of unemployment assistance and a policy of "total" inter-regional mobility was in force. After 1963 full wages were paid for subsidised employment and priority was given to finding employment in municipalities in which the unemployed resided. Also if the unemployed person was not able to be placed in a job, an unemployment benefit was paid by the government.

9. The relationship between municipality population size and unemployment rates is in fact an inverted "U". In 2006 the very smallest municipalities (ranging between 120 and 2 999 residents of which there are 89) had an average unemployment rate half a percentage point below the average of all municipalities. Conversely mid-sized municipalities (ranging between 3 000 and 9 999 residents of which there are 158) had an average unemployment rate of half a percentage points above the average while in larger municipalities the unemployment rate was also half a percentage point below the average. This is likely to be related to the larger share of the labour-intensive service sector in total value added in the smaller municipalities. The service sector share in the very smallest municipalities (120 to 999 residents) was almost six percentage points higher than the average while in mid-sized municipalities it was almost two percentage points lower. (Data from the Association of Finnish Local and Regional Authorities: *www.kunnat.net*).

10. Many of the very smallest municipalities are majority Swedish speaking. Around 10% of all Finnish municipalities are majority Swedish speaking but almost 60% of municipalities with a resident population of less than 1 000 are majority Swedish speaking. Finland has a disproportionate number of small municipalities, with the smallest half of all 348 municipalities (ranging from 120 to 14 000 inhabitants) only making up 10% of the country's total population. The average population of the 348 municipalities is just over 15 000 but the median is around 5 700.

11. The movements in the shares of other age cohorts across the municipalities hold even when adjusting for these differentials in the 20-30 year old cohort shares.

12. Those municipalities with small populations tend to have fewer prime-age residents and a greater proportion of retirees. Nationally in 2008, around 38% of the population was 55 years or older. However, for municipalities with less than 3 000 inhabitants (around one quarter of all municipalities) over 48% of the population was in that age cohort. Conversely, nationally 19% of the population is aged between 30 and 44 while for the small municipalities the figure is 15%. This point is further illustrated by the demographic dependency ratio (those aged below 20 and above 65 as a ratio of those aged between 21 and 64). In 2008 the national ratio was 0.66 but for municipalities with less than 3000 inhabitants the ratio was around 0.82.

13. Sweden has 290 counties with populations ranging from 2 500 to 810 000 and an average of 32 000 and median of 15 300. After the reforms of 2007, Denmark has 98 municipalities with populations ranging from 2 000 to 227 000 with an average of 56 000 and median of 43 000.

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Glossary

ALMPs	Active labour market policies
ATO	Australian tax office
BIS	Basic income support
CAPB	Cyclically-adjusted primary balance
DIT	Dual income tax
ECB	European Central Bank
EPL	Employment protection legislation
EMU	European Monetary Union
ETK	Finnish Centre for Pensions
FIN-FSA	Finnish Financial Supervisory Authority
GDP	Gross domestic product
HECS	Australia's higher education contribution scheme
HELP	Higher education loan programme
ICT	Information and communication technology
KELA	Social insurance institution
LAFOS	Labour force service centres
LMS	Labour market support
MEE	Ministry of Employment and the Economy
PES	Public Employment Service
R&D	Research and development
SATA	Social Security Reform Committee
SGP	Stability and Growth Pact
VAT	Value added tax

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