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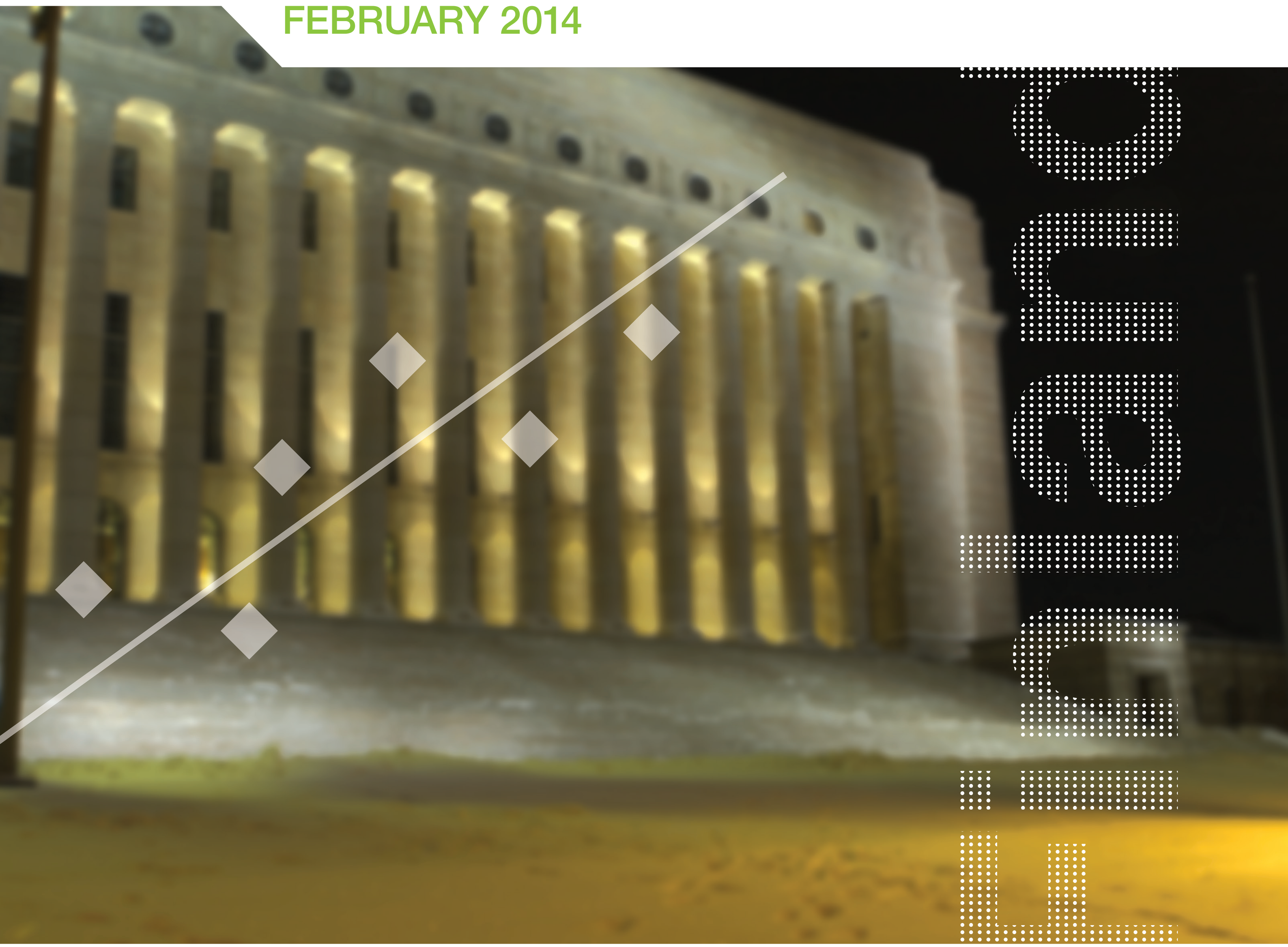

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OECD Economic Surveys: Finland 2014

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Table of contents

Thematic chapters

Boxes

Tables

Figures

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

The economic situation and policies of Finland were reviewed by the Committee on 16 January 2014. 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 30 January 2014.

The Secretariat's draft report was prepared for the Committee by Christophe André, Christine de la Maisonneuve and Clara García under the supervision of Vincent Koen.

The previous Survey of Finland was issued in February 2012.

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Basic statistics of Finland, 2012

(Numbers in parentheses refer to the OECD average)[a]

LAND, PEOPLE AND ELECTORAL CYCLE

Population (million)	5.4		Population density per km²	16.0	(34.3)
Under 15 (%)	16.4	(18.1)	Life expectancy (years, 2011)	80.6	(80.0)
Over 65 (%)	18.5	(15.3)	Men	77.3	(77.3)
Foreign-born (%, 2011)	4.9		Women	83.8	(82.8)
Latest 5-year average growth (%)	0.5	(0.5)	Last general election	April 2011	

ECONOMY

Gross domestic product (GDP)			Value added shares (%)		
In current prices (billion USD)	247.4		Primary sector	2.8	(2.5)
In current prices (billion EUR)	192.4		Industry including construction	26.0	(27.4)
Latest 5-year average real growth (%)	-0.7	(0.6)	Services	71.2	(69.9)
Per capita, PPP (thousand USD)	38.3	(37.2)			

GENERAL GOVERNMENT
Per cent of GDP

Expenditure	56.6	(42.6)	Gross financial debt	64.0	(102.4)
Revenue	54.4	(36.2)	Net financial debt	-55.4	(64.1)

EXTERNAL ACCOUNTS

Exchange rate (EUR per USD)	0.778		Main exports (% of total merchandise exports)		
PPP exchange rate (USA = 1)	0.929		Manufactured goods	29.6	
In per cent of GDP			Machinery and transport equipment	29.2	
Exports of goods and services	40.5	(53.8)	Chemicals and related products, n.e.s.	11.0	
Imports of goods and services	41.4	(50.4)	Main imports (% of total merchandise imports)		
Current account balance	-1.9	(-0.5)	Machinery and transport equipment	27.1	
Net international investment position	18.4		Mineral fuels, lubricants and related materials	22.0	
			Chemicals and related products, n.e.s.	11.7	

LABOUR MARKET, SKILLS AND INNOVATION

Employment rate (%) for 15-64 year-olds	69.4	(65.0)	Unemployment rates (%)		
Men	70.6	(73.1)	Total (age 15 and over)	7.7	(7.9)
Women	68.2	(57.0)	Youth (age 15-24)	18.8	(16.2)
Average hours worked per year	1,672	(1766)	Long-term unemployed (1 year and over)	1.6	(2.7)
Gross domestic expenditure on R&D (% of GDP, 2011)	3.8	(2.4)	Tertiary educational attainment 25-64 year-olds (%, 2011)	39.3	(31.5)

ENVIRONMENT

Total primary energy supply per capita (toe)	6.2	(4.2)	CO_2 emissions from fuel combustion per capita (tonnes, 2011)	10.3	(10.0)
Renewables (%)	29.1	(8.5)	Water abstractions per capita (1 000 m^3, 2006)	1.2	
Fine particulate matter concentration (urban, PM10, µg/m^3, 2010)	15.2	(20.1)	Municipal waste per capita (tonnes, 2011)	0.5	(0.5)

SOCIETY

Income inequality (Gini coefficient, 2009)	0.255	(0.305)	Education outcomes (PISA score, 2012)		
Relative poverty rate (%, 2009)	7.4	(10.7)	Reading	524	(496)
Public and private spending (% of GDP)			Mathematics	519	(494)
Health care (2011)	9.0	(9.5)	Science	545	(501)
Pensions (2009)	11.1	(8.7)	Share of women in parliament (%, November 2013)	42.5	(26.0)
Education (primary, secondary, post sec non tertiary, 2010)	4.1	(4.0)	Net official development assistance (% of GNI)	0.5	(0.4)

Better life index: www.oecdbetterlifeindex.org.

a) Where the OECD aggregate is not provided in the source database, an OECD average of latest available data is calculated where data exists for at least 27 member countries.

Source: Calculations based on data extracted from the databases of the following organisations: OECD, International Energy Agency, World Bank, International Monetary Fund and Inter-Parliamentary Union.

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Executive summary

- *Main findings*
- *Key recommendations*

Main findings

Strong growth, innovation and structural reforms in the decade preceding the global economic and financial crisis transformed Finland into one of the world's most competitive economies, ensuring a high level of well-being for its citizens. More recently, however, competitiveness has deteriorated and output has fallen, as electronics and forestry collapsed. The latest settlement between social partners for modest wage increases over the next two years will help. More broadly, economic revival requires building on impressive human capital, strong institutions and sound macroeconomic and financial management to strengthen growth and increase integration in global value chains.

The government has announced an ambitious package of structural reforms to: consolidate municipal finances; boost productivity growth in public services and continue providing them at an affordable cost as population ageing pushes up demand; extend working careers and raise labour supply to make up for a shrinking working-age population; reduce structural unemployment; and raise the economy's potential output. Meeting these goals is crucial to maintain high living standards and well-being.

Reforms to cope with ageing. Population is ageing more rapidly in Finland than in most OECD countries, exerting growing pressure on public finances, notably via pension and health care spending, and labour resources. Although employment of older workers is on the rise, the effective retirement age remains relatively low as many retire at the minimum age of 63 despite financial incentives to work longer, and different pathways are used to retire even earlier. While pension reform is needed, lengthening working lives also requires enhancing the employability of older people through training and reforming some labour market policies to boost overall employment.

Fiscal policy and structural reforms. Finland entered the global economic crisis with strong public finances and has avoided damaging pro-cyclical fiscal consolidation. Fiscal sustainability indicators, while different and surrounded by uncertainty, all suggest that further fiscal consolidation is necessary over the medium term. Most of it should come through structural reforms.

Local public finances and municipal reform. Finnish municipalities, which are small on average, provide a large share of public services, including education, health care and social services. Spending has increased steadily in recent years and some municipalities are struggling to align service provision with national standards. The government has launched a voluntary merger plan, whereby municipalities are to submit proposals by July 2014. At the current juncture, the outcome of the reform is still highly uncertain. International experience tends to support municipal consolidation, at least outside remote areas, even though political obstacles and transition costs can be significant. Local public finances could be further strengthened by modifying the tax mix and reinforcing fiscal rules.

Financial policy. The financial system, which avoided a credit crunch, has withstood global turbulence well. Nevertheless, beyond the ongoing global and European-wide efforts to strengthen the financial system, macro-prudential tools and cross-border cooperation in financial supervision need to be further developed to guard against future crises.

Innovation and green growth. Finland invests heavily in innovation. It has high energy taxation, which encourages efficient use of resources, but also still has some environmentally harmful subsidies. Innovation in clean technologies, which is strongly supported by government policies, is fostering green growth.

Key recommendations

Reforms to cope with ageing

- Increase the minimum pension age gradually, with some linking of both the retirement age and the benefits to life expectancy.
- End part-time pensions and the extended period of eligibility to unemployment benefits for older people. Access to disability pensions should be based on medical reasons only.
- Continue to promote lifelong training to help people stay in work as they age.
- Strengthen active labour market policies to improve the labour force participation of youth, women of childbearing age and the long-term unemployed.

Fiscal policy and structural reforms

- The rising costs of ageing and mounting public debt call for medium-term consolidation, mainly through structural reforms.
- Fiscal sustainability should be monitored closely and the fiscal stance adjusted accordingly, taking into account the cyclical situation and the medium- and long-term challenges.

Local public finances and municipal reform

- Continue to promote the merger of municipalities or scale back their responsibilities in functions where economies of scale and scope can be achieved.
- Implement the new fiscal framework for municipalities as planned. Better account for capital spending in municipalities' accounting to enhance deficit control and foster efficient allocation of public resources.
- Shift the mix of local tax receipts towards property taxes and away from the corporate income tax.

Financial policy

- Financial stability risks should be closely monitored. The macro-prudential tools available to the authorities could include caps on mortgage loan-to-value ratios and higher risk weights on mortgages (in line with EU capital requirements), to prevent potentially unsustainable developments in household debt.
- Examine whether additional capital buffers for systemically important financial institutions are warranted in light of the forthcoming asset quality review and stress tests. Continue to cooperate with other Nordic countries to put in place resolution mechanisms for large cross-border institutions, taking into account European-wide efforts to strengthen the financial system.

Innovation and green growth

- Continue to support innovation using a broad approach. Monitor the impact of direct public funding to ensure efficient resource allocation and prioritise support to activities generating positive externalities, such as basic research and education.
- Phase out environmentally harmful subsidies, taking into consideration wider socio-economic and competitiveness effects.

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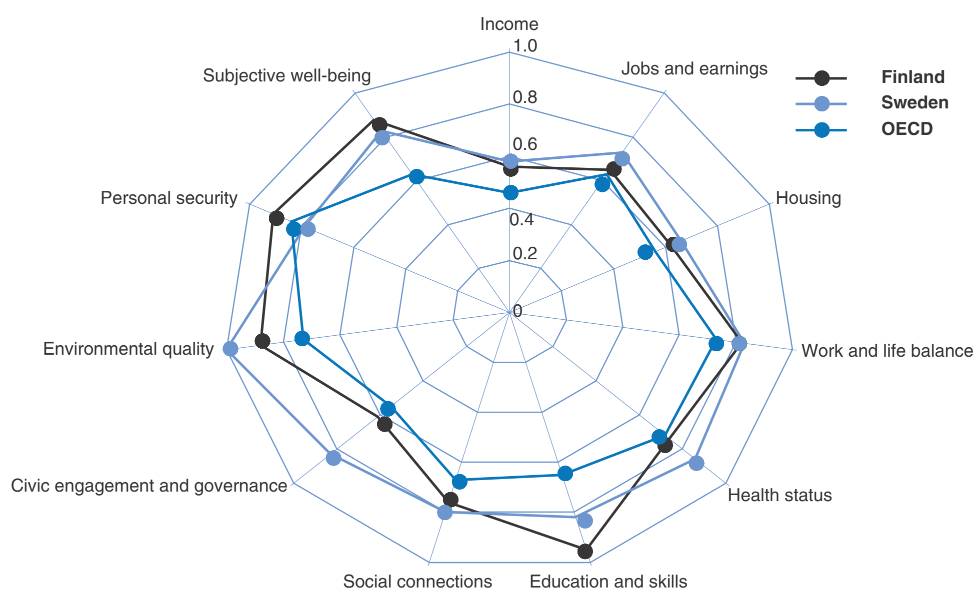
Assessment and recommendations

- *Activity is picking up slowly but uncertainty remains high*
- *The economy is undergoing deep restructuring*
- *The financial sector is solid but remaining vulnerabilities should be addressed*
- *Some medium-term consolidation is warranted*
- *Structural reforms to boost growth and ensure long-term fiscal sustainability*
- *The economic consequences of population ageing*
- *Enhancing public sector efficiency*

Finland enjoyed over a decade of strong output growth led by the high-tech sector before the 2008 global financial and economic crisis. It is one of the most competitive countries in the world and its residents enjoy a high level of well-being. Finland ranks seventh in the World Happiness Report 2013 (Helliwell et al., 2013), and performs better than the OECD average in all dimensions of the OECD Better Life Index (Figure 1). Income inequality is still among the lowest in the OECD. Social inclusiveness contributes to Finland's high level of subjective well-being, personal security, civic engagement, governance and social connections. Jobs and earnings are close to the OECD average, despite recent output weakness, and the work-life balance is good. Housing conditions are better than the OECD average, but households are accumulating substantial debt to finance their dwellings, which increases their vulnerability and that of the financial system to economic shocks. Environmental quality is very high and rich natural resources, notably forests, offer a promising potential for green growth. Education is excellent, even though Finland has fallen slightly in the latest Programme for International Student Assessment (PISA) rankings (OECD, 2013a). Public health care coverage is extensive, although health status is average.

Figure 1. **Well-being in Finland is relatively high**[1]



1. Each well-being dimension is measured by one to three indicators from the OECD Better Life indicator set. Normalised indicators are averaged with equal weights. Indicators are normalised to range between 1 (best) and 0 according to the following formula: (indicator value – minimum value)/(maximum value – minimum value).

Source: OECD, *How's Life? 2013, Measuring Well-being.*

StatLink http://dx.doi.org/10.1787/888932991375

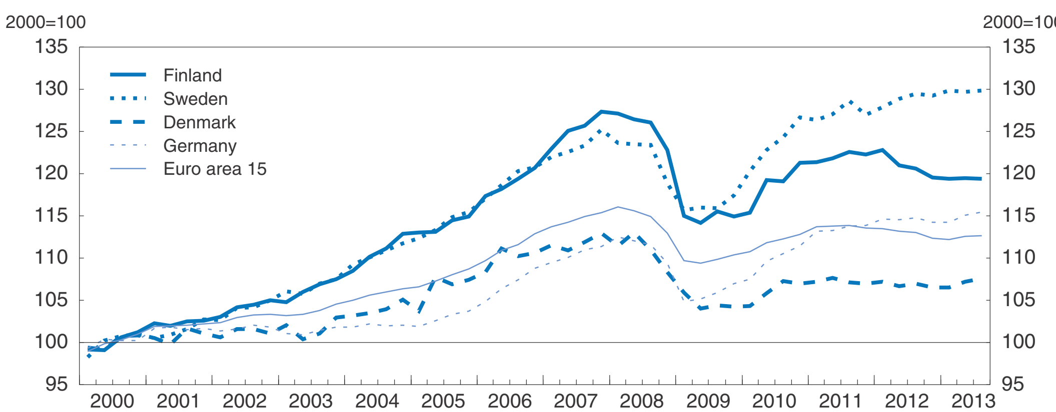
Nevertheless, government finances are facing pressures due to rising costs related to ageing and demand for health care services, and slower economic growth, largely reflecting structural factors such as deteriorating competitiveness and downsizing in the electronics and forestry sectors. Hence, pension and public sector reforms are needed to ensure long-term fiscal sustainability, while maintaining the quality of public services. The government has recently announced ambitious reforms to raise potential output and improve public finances, which are outlined below.

Activity is picking up slowly but uncertainty remains high

Finland had outperformed most comparable countries on GDP growth since 2000, but was hit particularly hard by the 2009 economic and financial crisis. It went through a double dip and output is still about 6% below its late 2007 peak (Figure 2). More recently, GDP has expanded weakly since the second quarter of 2013 and the recovery is expected to be slow (Table 1). Foreign demand remains subdued and the economy is undergoing deep restructuring. Weak household income growth and confidence weigh on private consumption and residential investment, while low capacity utilisation and uncertainty hold back business investment. The gradual improvement in the world economy will support the recovery, but strong growth will require innovation and gains in competitiveness to revive exports and investment.

Figure 2. **Output is still well below previous peaks**

Real GDP



Source: OECD Economic Outlook database.

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Unemployment, as measured in the internationally comparable labour force survey (LFS), has risen only modestly relative to the drop in output, and long-term unemployment has been contained (Figure 3, Panel A and B). Nevertheless, employment has fallen and registered unemployment is rising (Figure 3, Panel C). The divergence in unemployment trends between the data from the employment offices and those from the LFS suggests an increase in the number of discouraged workers, as the definition of active job search is more restrictive in the LFS. The rise in unemployment has been limited by relatively effective active labour market policies, although these could be improved further in terms of work incentives and earlier activation (OECD, 2012a and 2013c). A shift in the production structure from high-productivity manufacturing to lower-productivity services has also

Table 1. **Macroeconomic indicators and projections**
Annual percentage change, volume (2000) prices

	2010 Current prices (EUR billion)	2011	2012	2013	2014	2015
GDP	**179**	**2.8**	**-1.0**	**-1.3**	**1.1**	**1.9**
Private consumption	99	2.5	0.3	-0.6	0.6	1.4
Government consumption	44	0.5	0.5	-0.5	-0.2	0.7
Gross fixed capital formation	34	5.7	-1.0	-3.7	-1.4	2.6
Housing	12	5.0	-4.0	-0.9	0.6	2.3
Business	17	7.1	0.3	-5.9	-2.8	3.4
Government	4	2.6	1.7	-1.8	-1.3	0.0
Final domestic demand	177	2.6	0.1	-1.2	0.1	1.4
Stockbuilding[1]	-1	0.0	0.0	0.0	0.8	0.1
Total domestic demand	176	2.5	0.4	-1.1	0.8	1.5
Exports of goods and services	72	2.8	-0.2	0.7	3.8	4.8
Imports of goods and services	70	6.2	-0.7	-2.4	4.1	3.6
Net exports[1]	2	-1.3	0.2	1.3	-0.1	0.5
Other indicators (growth rates, unless specified)						
Gross domestic income	151	1.8	-1.5	-1.3	1.1	1.9
Potential GDP	. .	0.8	1.0	1.0	1.1	1.4
Output gap[2]	. .	0.1	-1.7	-3.6	-3.4	-2.9
Employment	. .	1.1	0.4	-0.8	-0.1	0.6
Unemployment rate[3]	. .	7.8	7.7	8.2	8.3	8.0
GDP deflator	. .	2.7	2.9	1.7	1.6	1.8
Harmonised index of consumer prices (HICP)	. .	3.3	3.2	2.2	2.2	1.8
Core HICP	. .	1.8	2.1	1.8	1.8	1.5
Household saving ratio, net[4]	. .	1.3	1.1	1.9	1.2	0.5
Trade balance[5]	. .	-0.8	-1.0	0.2	-0.3	0.2
Current account balance[5]	. .	-1.5	-1.8	-0.7	-1.0	-0.5
General government financial balance[5]	. .	-1.0	-2.2	-2.5	-2.3	-1.8
Underlying government net lending[2]		-0.9	-1.4	-0.8	-0.6	-0.4
Underlying government primary balance[2]	. .	-1.1	-1.5	-0.8	-0.6	-0.4
Gross government gross debt (Maastricht)[5]	. .	49.2	53.6	56.4	60.0	62.7
General government net debt[5]	. .	-54.2	-55.4	-52.5	-48.7	-45.1
Three-month money market rate, average	. .	1.4	0.6	0.2	0.1	0.3
Ten-year government bond yield, average	. .	3.0	1.9	1.9	2.3	2.8

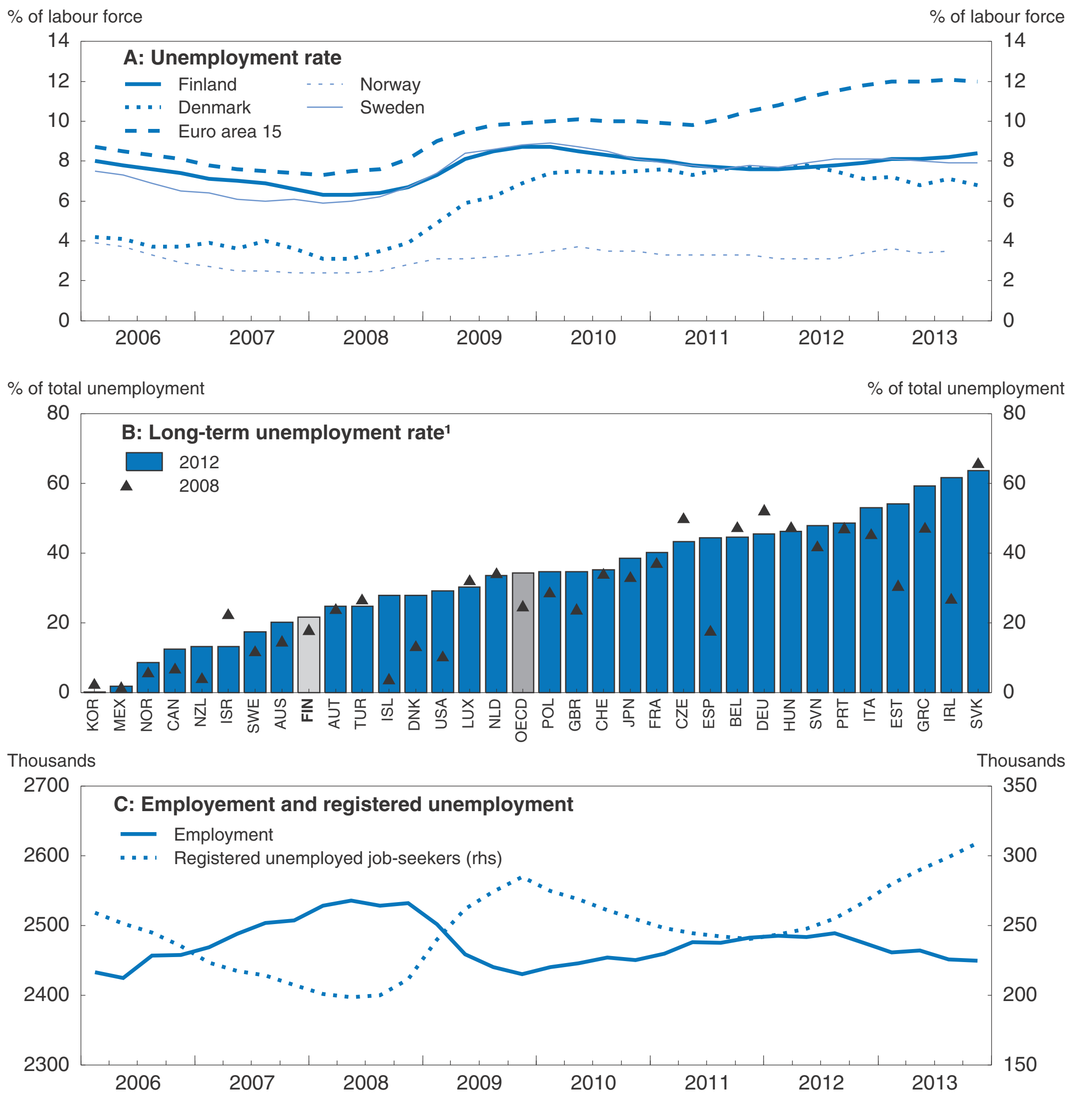
1. Contribution to changes in real GDP.
2. As a percentage of potential GDP.
3. As a percentage of labour force
4. As a percentage of household disposable income.
5. As a percentage of GDP.

Source: Update, based on the national accounts data as of end January 2014, of the projection presented in the *OECD Economic Outlook 94*, and Eurostat.

exacerbated losses in output relative to employment. Shrinking labour supply and the move towards lower-productivity sectors have combined with slower growth of the capital stock, due to low investment in recent years, to reduce potential output growth. This will slow and weaken the recovery.

The outlook is surrounded by huge external and domestic uncertainties. As a small open economy, Finland is vulnerable to faltering global demand, but also to a slowdown in particular in Russia or other Nordic countries. The euro area recovery is still hesitant and could be derailed by adverse developments in vulnerable countries and insufficient agreement between European Union (EU) member states on crisis resolution mechanisms (OECD, 2013d). While low interest rates are beneficial in the current context of weak

Figure 3. **The labour market has held up relatively well**



1. Duration of unemployment over one year. Data for the OECD refer to a weighted average.

Source: OECD Employment and Labour Market Statistics database, Statistics Finland, Ministry of Employment and the Economy and Eurostat.

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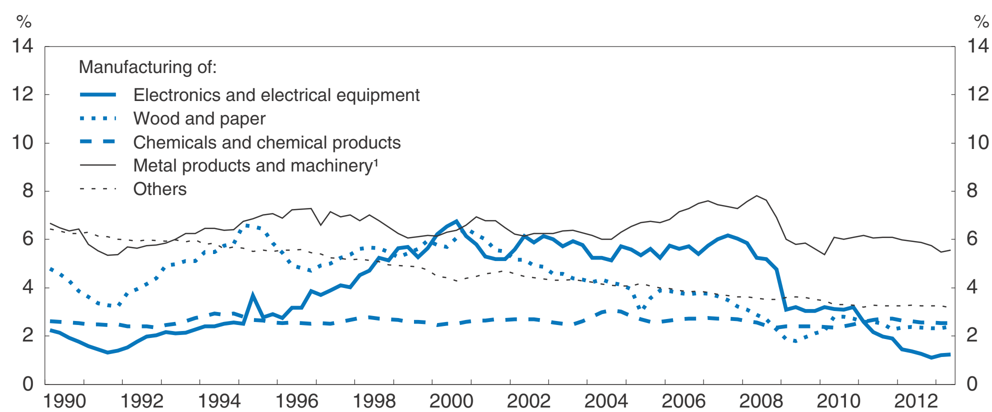
activity, they also entail significant risks. Lower interest income weakens banks' profitability and may induce them to take more risks, as they become more dependent on revenue from trading and investment. Borrowers may underestimate the burden of rising repayments once interest rates go up, build up excessive leverage and push up asset prices. Weak activity also increases credit risk, although bankruptcies and non-performing loans have so far remained limited. A highly skilled workforce and a favourable business environment suggest significant scope for a knowledge and innovation-led economic revival. However, if growth of new and young businesses turned out to be slower than anticipated, this would weigh on productivity and standards of living. Conversely, an improving export performance, as the economy restructures and cost competitiveness improves, could strengthen the recovery. A stronger than projected rebound in the global economy would also improve the prospects for the Finnish economy.

The economy is undergoing deep restructuring

Growing sectors have not compensated losses in electronics and forestry

The electronics sector has collapsed, falling from 6% of total value added in 2007 to little more than 1% recently, led by Nokia's tumble in the mobile phone market. The erosion of wood and paper production has been more gradual, but of almost similar magnitude (Figure 4). The chemical and metal sectors have been more resilient, but have been unable to make up for losses in electronics and forestry. Services have not compensated for losses in output and exports in manufacturing.

Figure 4. **The share of electronic and forest products in output has collapsed**



1. Excluding electronic and electrical products.
Source: Statistics Finland.

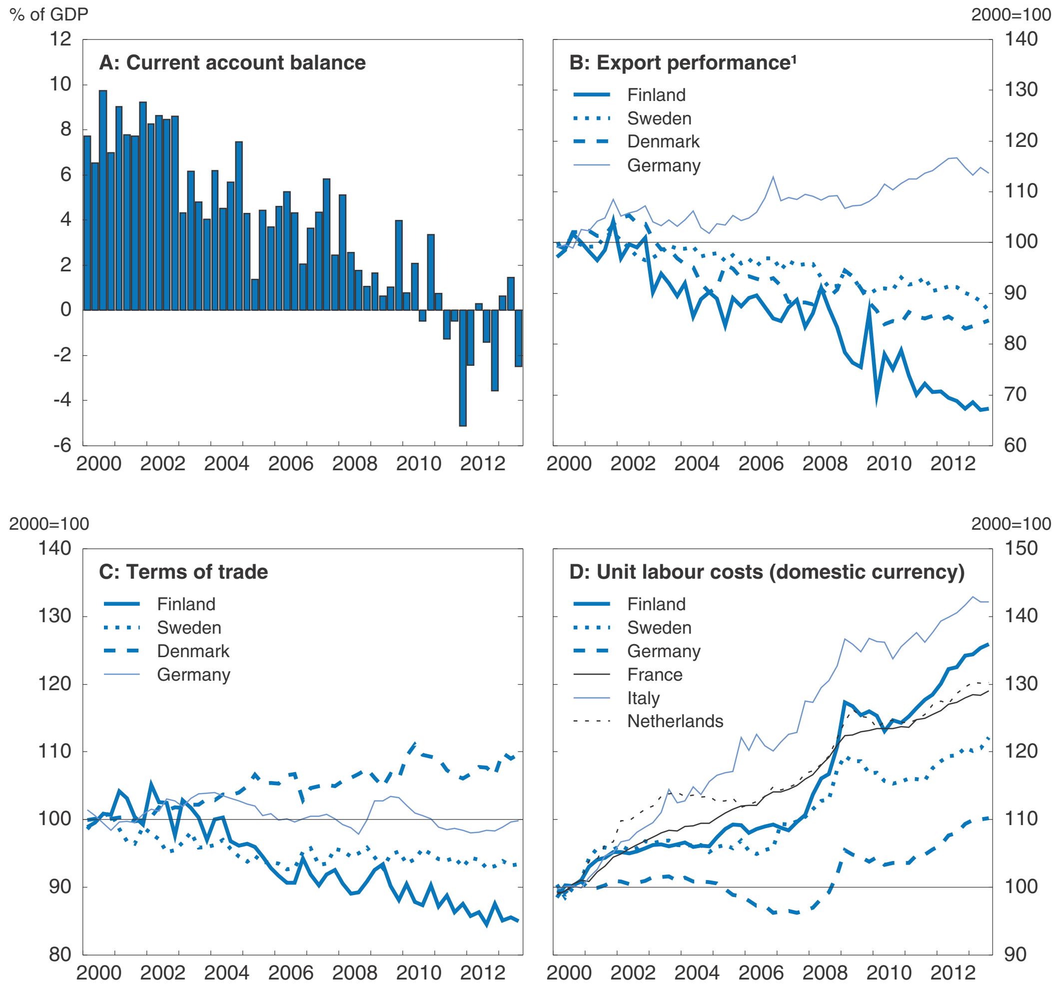
StatLink http://dx.doi.org/10.1787/888932991432

Finland's current account has fallen into the red after nearly two decades of surpluses (Figure 5, Panel A). The deterioration in Finland's export performance essentially results from losses in non-cost competitiveness, especially in electronics (Figure 5, panel B). Worsening terms of trade, as prices of electronic products fell, have also contributed to weakening the trade balance (Figure 5, panel C). Price competitiveness has also eroded, as unit labour costs have increased faster than in many other European countries since 2000 (Figure 5, panel D). However, the latest settlement between social partners for modest wage increases over the next two years will have a positive impact on cost-competitiveness, contributing to the recovery of exports.

The challenge for Finland is to continue to benefit from integration in global value chains

Production of goods and services has become increasingly fragmented into global value chains (GVCs) over the past decades (OECD, 2013e). Integration into GVCs offers huge opportunities to generate revenue from competitive advantage in specific areas. Finland benefitted from being well integrated into electronics GVCs from the late 1990s until recently. In 2009, the latest year for which data are available, nearly 15% of Finnish exports

Figure 5. **Competitiveness has eroded**



1. Ratio of exports to export markets (trade-weighted average of trading partners' imports). A decrease indicates a loss in export market shares.

Source: OECD Economic Outlook database.

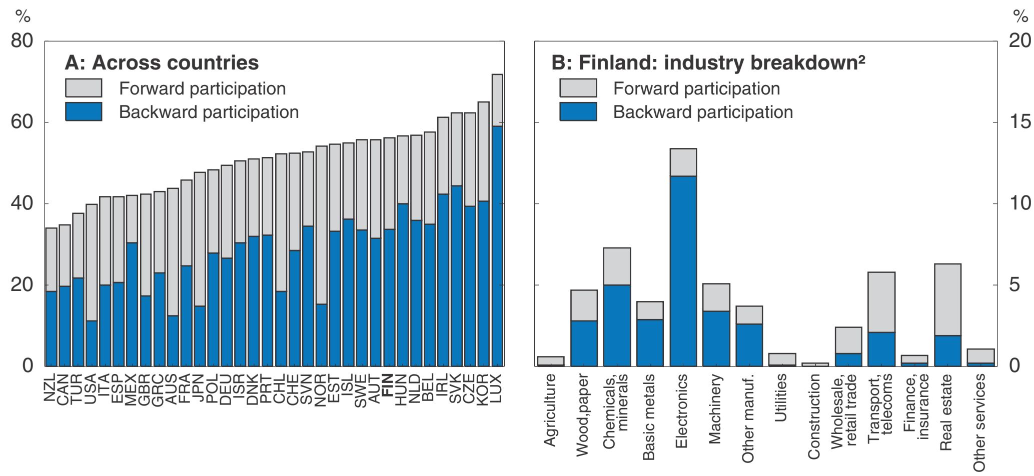
StatLink http://dx.doi.org/10.1787/888932991451

were linked to participation in electronics GVCs (Figure 6). However, as the electronics sector has shrunk since then, new opportunities for participation in GVCs need to be found to revive output growth and exports. While traditional sectors like chemicals and metals are already well integrated into GVCs, developments in new areas, such as electronic games, bio-technologies and bio-medicine and green technologies, are promising.

GVCs increase specialisation, which raises productivity globally. However, this can lead to increased output volatility and high adjustment costs, as demand shifts and activities relocate across countries. Policies have a crucial role in smoothing adjustments (OECD, 2013e). With strong social safety nets, an outstanding education system and well developed active labour market policies, Finland is well placed to capture the benefits from GVCs, while minimising the adverse effects. The government is revising legislation to strengthen competition in domestic markets for goods and services (Ministry of Finance, 2013). This should spur innovation, thereby raising opportunities for participation of Finnish firms in GVCs.

Figure 6. **Finland was well integrated in global value chains**[1]

As a percentage of gross exports, 2009



1. Backward participation shows the use of foreign intermediates in a country's exports and forward participation the use by other countries of a country's inputs in their exports.
2. As a percentage of total Finnish exports.

Source: OECD-WTO Trade in Value Added database.

StatLink http://dx.doi.org/10.1787/888932991470

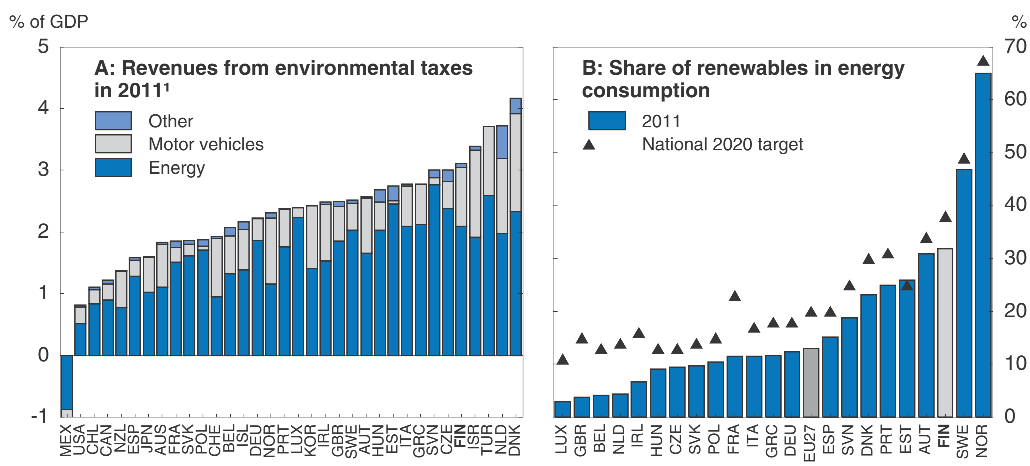
Innovation and green growth are being promoted but there is still scope for improvement

Finland spent about 3½ per cent of GDP on R&D in 2013, which is amongst the highest levels in the OECD. More than two-thirds is funded by the private sector, even though there has been a recent decline in the electronics sector's R&D spending. Finland ranks third in the World Economic Forum Global Competitiveness Index 2012-2013, behind Switzerland and Singapore and ahead of the other Nordic countries (Schwab, 2013). Nevertheless, there is still scope for growth-enhancing measures as outlined in the 2012 *OECD Economic Survey*, notwithstanding some progress over the past two years (see Annex). Areas for further action include streamlining R&D support, improving the efficiency of higher education through more performance-based allocation of resources, and boosting productivity by exposing sectors like health provision, network industries and retailing to more competition (OECD, 2012a).

The public sector contributes to funding innovation, mainly through the Finnish Funding Agency for Technology and Innovation (Tekes). Such project financing may be less effective in promoting innovation in green technologies than it has been in information and communication technologies, as growth areas may be more difficult to identify. Tekes' recent support for the climate and energy sectors seems to have had little impact so far on performance in terms of value added, although more time may be needed for a complete evaluation (National Audit Office, 2011). In addition, firms supported by government tend to remain dependent on such support. However, this could be mitigated by the planned increase in the share of loans relative to grants in Tekes financing (Ministry of Finance, 2013a). Careful project evaluation is also essential to ensure the efficient allocation of public funds. Developed venture capital markets reduce the need for public financing, which should be primarily targeted on activities generating positive externalities, such as basic research, education and upstream research where high uncertainties limit the availability of private financing. Vertical R&D support policies can orient the direction of innovation towards green growth, thereby facilitating knowledge spillovers and addressing environmental externalities. But there is a risk that necessarily narrow targeting excludes unforeseen areas of innovation. Hence, there is benefit in complementing vertical support by horizontal measures.

Finland, like other Nordic countries, has set climate change mitigation and green growth as strong priorities. The government is using a variety of demand and supply-side instruments to promote energy efficiency, which supplement EU legislation (Dreblow et al., 2013). In particular, energy taxes are based on energy content, CO_2 and particle emissions, following international best practice. They have been increased progressively and are high by OECD standards (Figure 7, Panel A). Feed-in tariffs for electricity produced from renewable energy were introduced in 2011. The share of renewable energy in overall energy production is about a third, one of the highest in the OECD, and Finland is likely to meet its ambitious target of a share of 38% for renewable energy by 2020 (Figure 7, panel B). The bio-fuel obligation will rise from the current 6% of transport fuels to 20% in 2020.

Figure 7. **Policies are promoting green growth**



1. Data for Australia and Poland refer to 2010. In Mexico, consumer prices on motor vehicle fuels are held more or less constant, in spite of large variations in world market prices. In years when world market prices are high, the excise tax on fuels turns into a subsidy, equalling 1% of GDP in 2011.

Source: Eurostat and OECD/EEA Database on Instruments used for Environmental Policy.

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A working group led by the Ministry of Finance has identified between EUR 2.7 and EUR 4.5 billion in production-linked subsidies which can heighten environmental pressures, mainly in energy, transport and agriculture (Hyyrynen, 2013; Ministry of Finance, 2013b). Such evaluation is very useful and should be followed by the phasing out of harmful subsidies where feasible, taking into consideration wider socio-economic and competitiveness effects. A constraint on cutting agricultural and energy subsidies is that they are influenced by EU policies, notably the common agricultural policy and the EU emission trading scheme, and must therefore wait for common action being agreed, although there is also scope for national action. The benefits of cuts in subsidies in the energy sector would be reinforced by coordination at the EU and global level.

While pricing environmental externalities through taxes or emission permits, along with adequate regulations, is a prerequisite for green growth, it is not sufficient. Most clean technologies are still in their infancy. The green technology sector is growing fast and applications with wide socio-economic impact build on Finland's comparative advantage in forestry and high-tech. For example, wood-based energy accounts for more than half of North Karelia's energy consumption. In the specific environment of this remote region, sustainable wood-based energy can compete with conventional sources in terms of costs and efficiency. Furthermore, renewables are contributing significantly to growth and employment in the region. Additional benefits include lower heating costs and improved energy security. Enhanced competitiveness in the forest industry and the manufacturing of forest machinery also generate opportunities for international expansion and integration into GVCs (OECD, 2012b).

As the national forest industry experiences structural difficulties resulting from a decline in the global paper market and increasing international competition, bio-energy is seen as a promising reconversion opportunity. As an illustration, a leading forest company is building a bio-refinery to produce wood-based bio-diesel on an industrial scale, which should be completed in 2014 and is not dependent on government grants. Second-generation bio-fuels do not compete with food production and are expected to have better energy yields and environmental balances than those of the first generation. They are likely to contribute significantly to allowing the transport sector to move towards more sustainable energy sources in the medium term, although major technical and economic challenges remain (Eisentraut, 2010).

Finland is a strong innovator in clean technologies, ranking fourth in the Cleantech Innovation index 2012 (Knowles et al., 2012). Nevertheless, its revealed advantage in environment-related technologies is around the OECD average, although with a strong relative position in environmental management, particularly of water resources and waste (OECD, 2012c). To accelerate the move towards green growth, the government has launched an ambitious programme to promote green innovation, in partnership with public and private stakeholders. Clean technologies offer strong opportunities to foster economic growth, boost exports and create jobs. The turnover of the Finnish cleantech sector is already approximately 25 billion – roughly equivalent to that of the forest industry – and the Cleantech programme targets EUR 50 billion by 2020. Finland is a leader in energy efficiency, clean industrial processes and bio-energy. More than 60% of Finnish Cleantech firms generate over half of their turnover abroad and Finland's share of the global clean technology market is about 1%, compared to a share of global GDP of 0.4%. The sector employs about 50 000 people and the objective is to create about as many new jobs by 2020.

Recommendations on innovation and green growth policies

Key recommendations

- Continue to support innovation using a broad approach. Monitor the impact of direct public funding to ensure efficient resource allocation and prioritise support to activities generating positive externalities, such as basic research and education.
- Phase out environmentally harmful subsidies, taking into consideration wider socio-economic and competitiveness effects.

Further recommendations

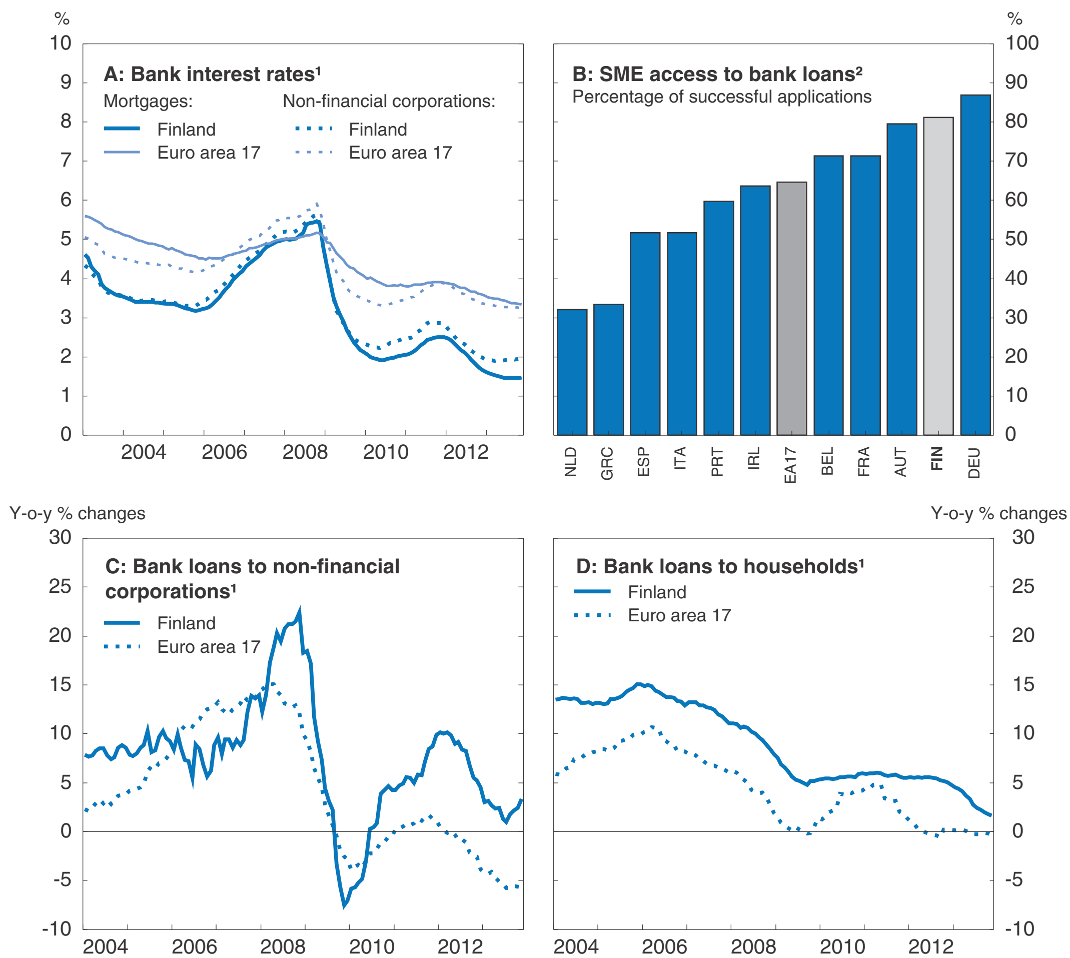
- Continue to use taxation to limit carbon emissions and other environmental externalities.

The financial sector is solid but remaining vulnerabilities should be addressed

The financial system has proved very resilient in the challenging environment of recent years and financing conditions are very supportive. Interest rates on corporate loans and mortgages are historically low (Figure 8, Panel A). Furthermore, although credit standards have tightened somewhat recently, access to bank loans for small and medium-sized enterprises is easier than in most other euro area countries (Figure 8, Panel B). Nevertheless, corporate credit growth remains subdued as weak investment and high uncertainty limit demand for loans and large firms have tended to replace bank credit with bond issuance for long-term financing (Figure 8, Panel C).

Growth in credit to households is now also subdued (Figure 8, Panel D). Nevertheless, household debt has increased rapidly over the past decade, although it is still fairly modest

Figure 8. **Financial conditions are supportive but credit growth is sluggish**



1. Refers to outstanding amounts from monetary and financial institutions.
2. Percentage of small and medium-sized enterprises that applied for bank loans over the previous six months and received all the financing they requested. Survey conducted from April to September 2013.

Source: European Central Bank.

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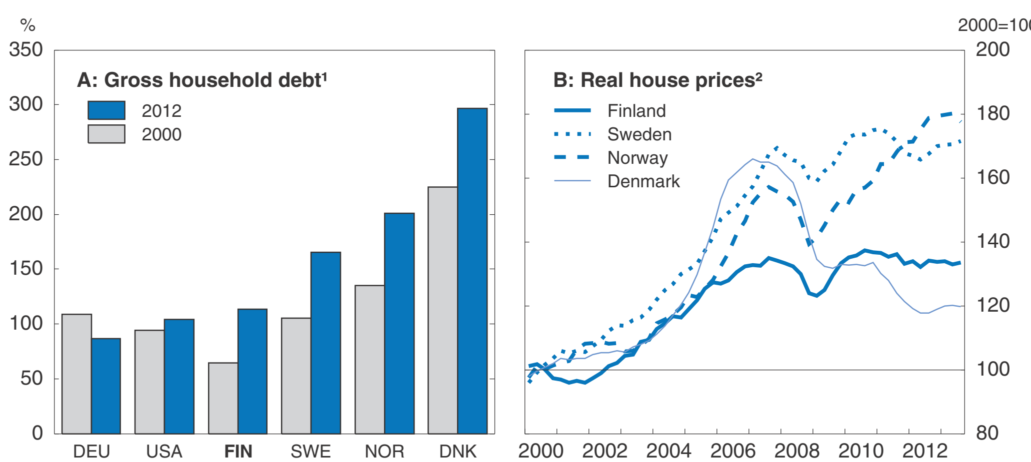
compared to other Nordics (Figure 9). Housing prices have increased markedly in the early 2000s, but they have been broadly flat since and do not seem to be out of line with underlying fundamentals (André and García, 2012). It is difficult to determine the risks associated with a specific level of debt, as they depend on a number of factors, in particular the volatility of the economy, the level and nature of assets, the sensitivity of debt servicing to interest rates and the distribution of debt across households. As a small open economy, Finland is vulnerable to external shocks. Finnish households do not have very high financial wealth, and first-time buyers tend to have little equity in their homes. In May 2012 more than half of first-time buyers had a loan-to-value ratio (LTV) in excess of 90% and more than 40% had a LTV over 100% (FIN-FSA, 2012). Most mortgages carry variable interest rates, exposing households to risks in the case of a sharp increase in interest rates. The government is reducing allowances for mortgage interest tax deduction, making borrowing less attractive. At present, the supervisory authority has the power only to lay down a recommendation on LTV caps on mortgage lending, but no juridical power to impose a binding LTV cap. While the current conditions of the housing market do not call for immediate action, the supervisory authorities should have the possibility to use macro-prudential tools, such as LTV limits if debt accumulation gathers pace (in line with recommendations from the EU Capital Requirement Directive IV, which entered into force in 2013). In that case, risk weights for mortgages in capital requirement calculations could also be increased, as in Norway and Sweden. In addition, underwriting practices and product development should be closely monitored to avoid excessive loosening of credit standards and proliferation of high-risk products, as happened in recent years with deferred-amortisation loans in Denmark (OECD, 2014).

Figure 9. **Gross household debt and house prices have trended up**



1. Total financial liabilities (excluding derivatives, shares and other equity) as a percentage of gross disposable income.
2. Deflated using the private consumption deflator.

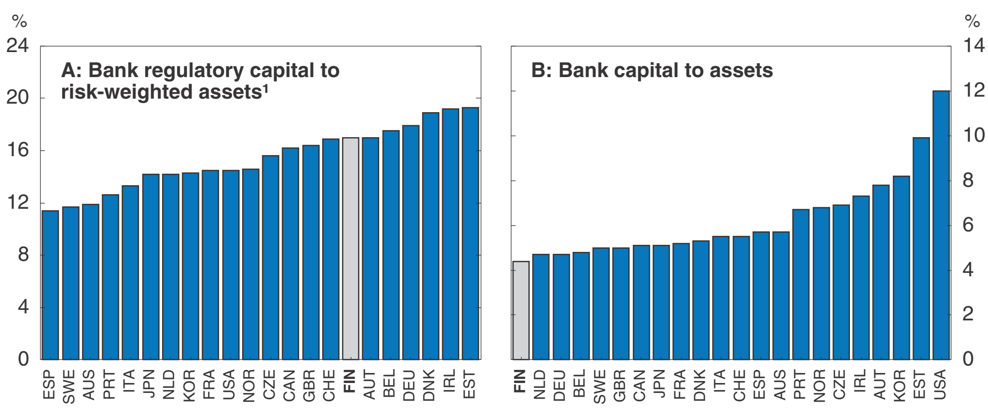
StatLink http://dx.doi.org/10.1787/888932991527

The banking sector, which is dominated by institutions from other Nordic countries, is fairly large, concentrated, interconnected and reliant on foreign wholesale funding. Total bank assets amount to around three times GDP. The top five banks hold a market share of about 80% and some banks are highly leveraged. OECD estimates of distance-to-default in 2011 point to moderate risks, but these can evolve rapidly (Blundell-Wignall and Roulet, 2013).

The dominant role of systemically-important financial institutions (SIFIs) in Finland calls for strict regulation and supervision, which has been in place since the crisis of the early 1990s and has allowed Finland to avoid major problems during the recent global financial turmoil. However, as financial and banking structures evolve, regulation and supervision need to adapt. Finnish banks' risk-weighted regulatory capital ratio is high (Figure 10, Panel A), but the overall bank capital to assets ratio is low compared to other OECD countries. This partly reflects internal arrangements within Nordic banking groups and particularly the position of Nordea, which has located its derivatives business in Finland (Bank of Finland, 2012 and 2013) (Figure 10, Panel B). Across OECD countries, high leverage is associated with high default risk (Blundell-Wignall and Roulet, 2013).

Figure 10. **Overall leverage is high**

2012



1. Data for Sweden refer to the four larger banking groups in 2009. Data for Norway refer to 2011, and do not include branches of foreign banks. Data for Austria, Czech Republic, Ireland, Italy and Switzerland refer to tier 1 capital only.

Source: IMF, *Financial Soundness Indicators*.

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Basel III capital and liquidity requirements and steps towards a European banking union will need to be complemented by measures at the national and regional level. The ECB has started a comprehensive assessment of large banks, which will consist of an asset quality review, a risk assessment and a stress test. It will be based on the EU Capital Requirements Directive, which allows requiring supplementary capital for SIFIs. Other Nordic countries plan to impose tighter capital norms than EU minimum requirements for SIFIs (Vauhkonen and Westman, 2013). Coordination between Nordic countries should be enhanced to avoid regulatory arbitrage (International Monetary Fund, 2013). Beyond the Single Resolution Mechanism proposed by the European Council, resolution mechanisms for SIFIs should also be put in place in cooperation between Nordic countries, making sure creditors bear part of the losses. Implicit government guarantees, which encourage excessive risk taking and put government finances at risk, can be reduced by credible resolution regimes (Schich and Kim, 2012).

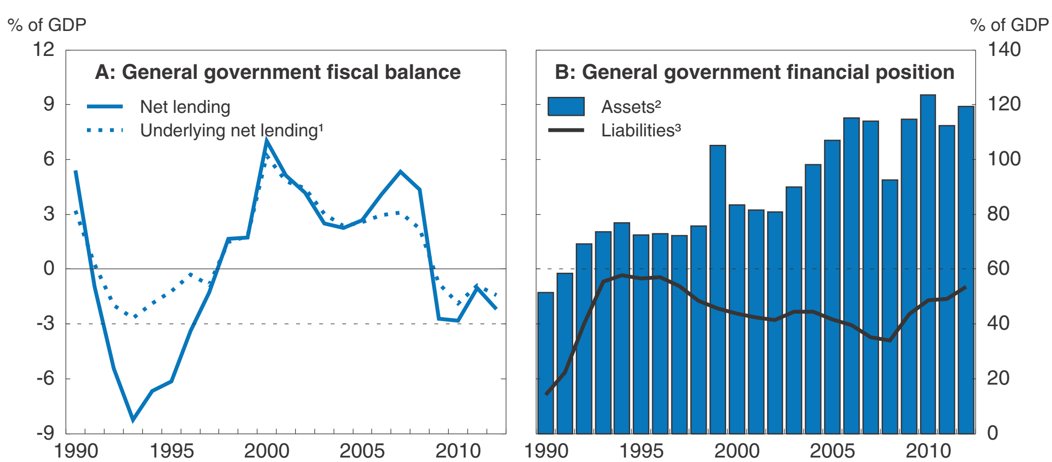
Recommendations on financial policy

- Financial stability risks should be closely monitored. The macro-prudential tools available to the authorities could include caps on mortgage loan-to-value ratios and higher risk weights on mortgages (in line with EU capital requirements), to prevent potentially unsustainable developments in household debt.
- Examine whether additional capital buffers for systemically important financial institutions are warranted in light of the forthcoming asset quality review and stress tests. Continue to cooperate with other Nordic countries to put in place resolution mechanisms for large cross-border institutions, taking into account European-wide efforts to strengthen the financial system.

Some medium-term consolidation is warranted

A strong fiscal position at the beginning of the slowdown allowed Finland to avoid damaging pro-cyclical fiscal consolidation (Figure 11, Panel A). However, gross government debt is rising towards 60% of GDP, as the protracted slump in activity delays the return to budget surpluses (Figure 11, Panel B). Even though government assets dwarf liabilities, largely as a result of pre-funding of pensions, the rise in gross debt needs to be halted.

Figure 11. **The fiscal position is deteriorating**



1. As a percentage of potential GDP.
2. Includes pre-funded pensions.
3. Maastricht definition.

Source: OECD Economic Outlook database.

StatLink http://dx.doi.org/10.1787/888932991565

The Ministry of Finance and the European Commission estimate the fiscal sustainability gap – the permanent fiscal consolidation needed to cover future obligations – at respectively 4.7% and 6% of GDP. The corresponding OECD estimate amounts to around 7% of GDP, out of which 5% stem from increasing pension and health care outlays (OECD, 2013b). The larger OECD estimate reflects higher pension and health care costs, based on different assumptions regarding a range of parameters such as population and productivity growth or increases in relative prices of health care services. Although fiscal sustainability indicators vary and are surrounded by uncertainty, they all suggest that further fiscal consolidation is necessary over the medium term. Most of it should come through structural reforms. Fiscal sustainability should be monitored closely and the fiscal stance adjusted accordingly, taking into account the cyclical situation and the medium- and long-term challenges.

Structural reforms to boost growth and ensure long-term fiscal sustainability

Restoring growth is essential to improving living standards and ensuring long-term fiscal sustainability. The government has announced ambitious reforms to raise potential output and improve public finances, although some specific measures still need to be spelled out (Government of Finland, 2013). Key priorities relate to pension and municipal reforms, which are discussed in depth in this *Survey*. The social partners have agreed to raise the effective retirement age by two years and negotiations on measures to achieve this goal are ongoing, with implementation scheduled for 2017. A comprehensive report evaluating the different options and their impact on public finances, employment and income distribution, published in November 2013, provides a solid basis for the negotiations (Finnish Centre for Pensions, 2013). The municipal reform to be implemented by 2017 offers opportunities for efficiency gains. The government aims to raise productivity growth in public service provision by 0.5% per year. Further measures aim at reducing structural unemployment and boosting potential output. The reform is very ambitious and there may be obstacles to its full implementation. Table 2 outlines the planned structural reforms and the impact the government expects over time on the fiscal sustainability gap. Both the sustainability gap estimate and the potential impact of reforms on growth and fiscal outcomes are inevitably surrounded by some uncertainty. The different reforms overlap to some extent and achieving the hoped-for efficiency gains in some areas may be contingent on successful reforms in others. For example, municipal reform, consolidation of municipal finances and social welfare and health care reform are strongly interrelated.

The government has also agreed on national tax increases and an intensification of the fight against tax evasion. On the other hand, the corporate tax rate will be lowered from 24.5% to 20% in 2014, following similar moves in Denmark and Sweden, although the impact of the cut will be partly offset by broadening the tax base and by higher dividend taxation. Even though short-term fiscal measures will help strengthen fiscal positions, the long-term sustainability challenge mainly results from projected increases in costs related to ageing and health spending, which should be addressed through structural reforms, in particular regarding pensions and public sector efficiency. The extension since 2011 of the fiscal policy monitoring and evaluation functions of the National Audit Office, which reports to Parliament, will strengthen budget control.

Table 2. **Estimated impact of structural reforms on the fiscal sustainability gap**

	Target	Impact on sustainability gap (percentage point of GDP)
Consolidation of municipal finances	€2 bn	-1.0
Savings through the reduction in municipalities' tasks and obligations		
Local tax increases and productivity gains		
Increasing productivity growth in public service provision	+0.5% / year	-1.4
Reform of social welfare and health care		
Reform of municipal structures		
Reform of public procurement		
Central government administration reform and development of electronic services		
Extending working careers and raising labour supply	+ 2 years	-1.4
Pension reform		
Labour market measures to raise labour force participation, in particular of older workers, young people, people with partial work ability, long-term unemployed and immigrants		
Reducing structural unemployment	-1 percentage point	-0.3
Changes to labour legislation to improve the functioning of the labour market		
Enhancing work incentives (via changes in housing policy in particular)		
Reinforcing the effectiveness of employment services		
Improving skills		
Raising the economy's potential output level	+1.5%	-0.6
Reducing obstacles to competition, streamlining business regulations and promoting investment		
Improving the functioning of commodity and housing markets		
Total		-4.7

Source: Government of Finland, Government Decision on Implementing the Structural Policy Programme, 29 November 2013.

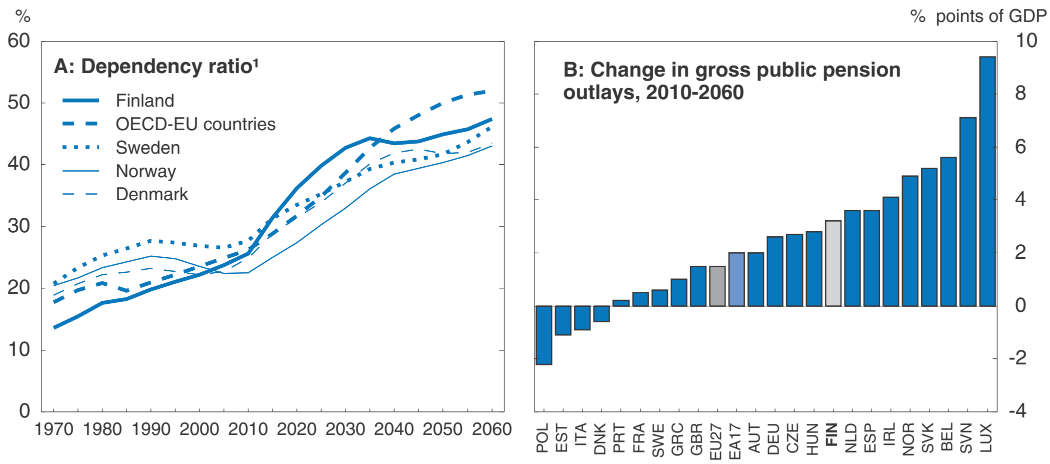
Recommendations on fiscal policy and structural reforms

- The rising costs of ageing and mounting public debt call for medium-term consolidation, mainly through structural reforms.
- Fiscal sustainability should be monitored closely and the fiscal stance adjusted accordingly, taking into account the cyclical situation and the medium- and long-term challenges.

The economic consequences of population ageing

Population is ageing more rapidly in Finland than in most OECD countries. The old-age dependency ratio has risen steadily over the past four decades and is projected to go up even faster between now and 2060. Compared with the other Nordic countries, Finland will experience an earlier and faster increase over the next two decades (Figure 12, Panel A). These demographic trends will put increasing pressure on public finances as well as on labour resources. But ageing should not only be seen as a burden, as it can also create opportunities for innovation and new markets and industries. As ageing is a global phenomenon, a competitive edge in goods and services in high demand among older people would create a strong potential for exports. Information and communications technologies, where Finland has a strong knowledge base, can help meet the key challenge of helping the elderly stay as autonomous as possible (OECD, 2012c).

Figure 12. **Old-age dependency and pension costs are growing rapidly**



1. Population aged 65 and over relative to population aged 15-64.
Source: Eurostat and European Commission, *The 2012 Ageing Report*.

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Population ageing will put pressure on pension and health spending

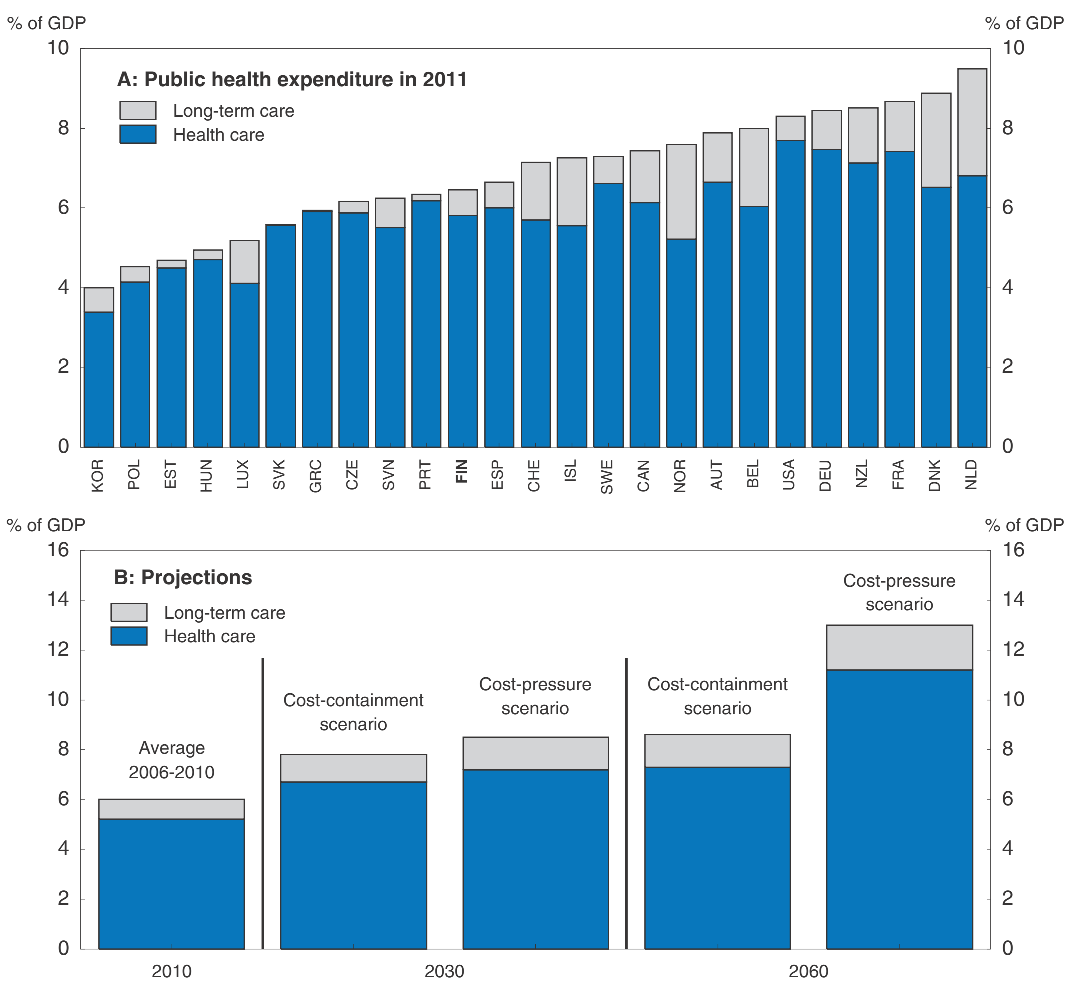
The Finnish pension system comprises three pillars. The first one is a non-contributory means-tested national pension complemented since 2011 by the guarantee pension to reduce old-age poverty. The second pillar is the compulsory earnings-related pension system. The system is financed by contributions paid by employers and employees and is based on insurance policies provided by different pension funds. The third pillar is individual private pension or life insurance schemes, but is not very developed, as wide coverage, relatively high replacement rates and the absence of a ceiling on contributions and benefits in the compulsory system make it unattractive. High costs of private pension insurances and changing tax subsidy policies may also have hampered the development of the third pillar.

The ratio of pension expenditure to GDP rose by around 3.5 percentage points between 1980 and 2009 to more than 9% of GDP, reflecting a rising old-age dependency ratio and the maturation of the earnings-related pension system. Going forward, the European Commission Economic Policy Committee's baseline scenario (European Commission, 2012) projects a further increase of 3 percentage points between 2010 and 2060, with a sharp increase before 2030 followed by relative stability between 2030 and 2060 (Figure 12, Panel B). The Finnish Center for Pensions projects an increase of 2 percentage points of GDP in total public pension outlays by 2030, half of which is reversed by 2060. These lower pension expenditure estimates mainly result from assumptions of higher population growth and a smoother path for wage increases.

Since the 2005 pension reform, the official retirement age ranges between 63 and 68 for the earnings-related pension scheme, with a possibility to delay retirement after 68. Nonetheless, most people draw their pension at age 63. Moreover, even though the average effective age of retirement has increased by nearly two years over the past decade, it is well below the official age for both men and women.

Public expenditure on health and long-term care remains relatively modest as a share of GDP (Figure 13, Panel A). However, it is expected to grow steadily over the next 50 years, even if policies act more strongly than in the past to rein in these outlays (Figure 13, Panel B) (De la Maisonneuve and Oliveira Martins, 2013). The larger number of dependent persons due to the increase in longevity will imply growing needs for long-term care and will contribute to the projected rise in total public health expenditure. Even though the Finnish health care system offers good quality treatments at a fairly moderate cost, its efficiency could be improved, in particular by reducing fragmentation and improving coordination, and strengthening incentives to achieve a better balance between primary and specialised care. Narrowing regional differences in the efficiency and quality of care should also be a priority (see the special chapter on health care in the 2012 *OECD Economic Survey of Finland* and Annex in the current *Survey*). Advanced information and communication technology (ICT) systems, including lifelong electronic patient records for all Finnish patients, are powerful tools for improving efficiency (Ministry of Social Affairs and Health, 2013).

Figure 13. **Health and long-term care expenditure are projected to rise sharply**[1]



1. Refers to expenditure excluding investment.

Source: OECD, Health expenditure and financing database, and De la Maisonneuve and Oliveira Martins (2013).

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Since the 1990s, policies have succeeded in substituting service housing (housing with special care facilities, often including 24-hour assistance) for institutional care for a growing number of elderly people. This is likely to generate substantial savings, while improving the quality of life of old people, and efforts in that direction should continue. The Ministry of Social Affairs and Health estimates that lowering further the share of over 75-year olds in long-term institutional care would reduce municipal health care costs by around EUR 300 million per year by 2017 (0.15% of GDP).

Ageing will also reduce labour supply and potential output growth

As the share of older workers, whose labour force participation is low, grows, the overall participation rate tends to decline. This has been the case for several years and is expected to continue for the next 50 years if no reform to increase the participation rate is implemented (Johansson et al., 2013). Labour force participation of people aged 55-64 has increased during the past decade, and is in fact higher for those aged 55-59 than for the total working age population. Nevertheless, participation in the 55-64 age group in Finland is still lower than in other Nordic countries. Shrinking labour supply will lead to lower output growth, even though higher productivity could compensate this effect to some extent.

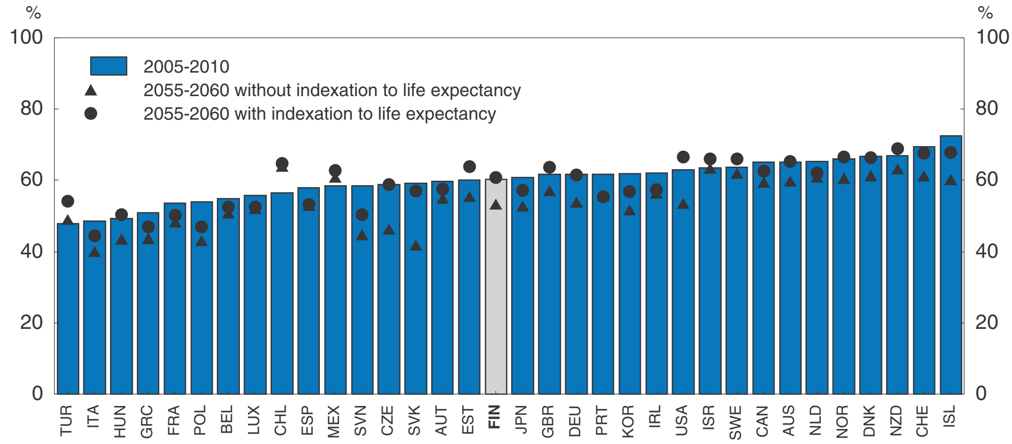
Pension benefit levels are linked to life expectancy via a coefficient which limits the impact of rising life expectancy on pension expenditure. As life expectancy increases, this coefficient reduces the amount of the monthly pension, which may induce individuals to work longer to avoid a cut in pension benefits. However, there is no guarantee that this will happen, as workers may prefer retiring at the minimum pension age.

Given the relatively low minimum pension age, it should be raised progressively. The pension age could be adjusted to maintain the ratio of retirement to working years constant as life expectancy increases. This could substantially raise labour force participation compared to a scenario without indexation (Figure 14). Furthermore, raising the minimum old-age retirement age forces people to work longer and thus to accumulate more entitlements, so limiting the risk of older people falling into relative poverty.

Since the 2005 reform, the unemployment pension has been abolished. Nevertheless, older people are still entitled to an extension of the period during which they receive the unemployment allowance. A person who has turned 61 and has received an unemployment allowance for less than 500 days is entitled to it until the start of the pension or until the age of 65. This arrangement is much less generous than the one in place before the 2005 reform, but this so-called "unemployment tunnel" is still an incentive for early retirement. Part-time pensions are heavily subsidised. While providing flexibility in working time to older workers is desirable and may postpone full retirement, the large subsidies may cut back working times significantly.

Raising the minimum retirement age by two years would lead to an increase in the effective retirement age by 8 to 10 months by 2025, but only if the unemployment tunnel and part-time pensions were abolished; otherwise, it would fail to raise the effective retirement age (Finnish Centre for Pensions, 2013). This underlines the need to abolish both the unemployment tunnel and part-time pensions. Another way to retire earlier is through access to disability benefits. Even though the share of new retirees being granted a disability pension has decreased, there is further room for improvement, as more than 20%

Figure 14. **Indexing the retirement age to life expectancy could stabilise labour force participation**[1]



1. Labour force participation rate of people aged 15 and over.

Source: Johansson et al. (2013).

StatLink http://dx.doi.org/10.1787/888932991622

of retiring people still go on disability pension. Access to disability pensions should be based on medical reasons only (Braconier, 2010).

Reducing relatively high implicit taxes on continued work would encourage older people to continue working. If working an additional year yields an increase in the present value of the future stream of pension payments which is lower than foregone pensions and contributions paid during that year, there is an implicit marginal tax on continued work (Duval, 2003). This tax is, for instance, around 60% at age 65 (see Chapter 1).

Lengthening working lives cannot be achieved without reforming some parts of the labour market. Indeed, older workers face a range of work disincentives and barriers to employment. Employers are often reluctant to hire older workers or retain them in their jobs. Moreover older workers are frequently discouraged from staying at work because of poor working conditions (Eurofound, 2012). Finland has put in place different programmes that help employers to manage the "greying" of their labour force, through age-management training.

The employability of workers could also be enhanced through lifelong training. Finland's adult population proficiency in literacy, numeracy and problem solving is among the highest in the 22 countries participating in the OECD Survey of Adult Skills (PIAAC). Nevertheless, the gap between younger and older age groups is wide, reflecting mainly spectacular progress in education over the past decades (OECD, 2013f). Hence, there seems to be scope to enhance skills in older generations. In addition to helping workers adapt to new tasks and technology, training can help people in arduous jobs shift to less exacting work after a certain age. As well, working conditions (e.g. working time, workplaces) should be adapted for older workers.

Strengthening other groups' labour market participation

Labour force utilisation should also be enhanced for other segments of the labour market and overall disincentives should be reduced. The labour tax wedge should be reduced and the efficiency of the tax structure improved by cutting taxes on labour in favour of indirect taxes (OECD, 2013g). Active labour market policies should be strengthened in order to increase the participation of youth, childbearing age women and long-term unemployed (OECD, 2012a). Working lives could be lengthened by shortening the transition period from school to work (OECD, 2010a). Recent measures to shorten the period during which students are eligible to receive financial support (from September 2014) and to tackle youth unemployment should help raise the youth employment rate. The labour force participation of women of childbearing age should be encouraged, as its low level reduces career prospects and pay. The recent proposal to split the child home care leave evenly between the two parents should contribute to this objective. More accommodative immigration policies, in particular towards young people who have studied in Finland, would also help cope with labour market shortages.

Recommendations on pension, health and labour market reforms

Key recommendations

- Increase the minimum pension age gradually, with some linking of both the retirement age and the benefits to life expectancy.
- End part-time pensions and the extended period of eligibility to unemployment benefits for older people. Access to disability pensions should be based on medical reasons only.
- Continue to promote lifelong training to help people stay in work as they age.
- Strengthen active labour market policies to improve the labour force participation of youth, women of childbearing age and the long-term unemployed.

Further recommendations

- Reduce fragmentation of health services and improve coordination and incentives to achieve a better balance between primary and specialised care (for more details, see the special chapter on health care in the 2012 *OECD Economic Survey of Finland*).
- Age discrimination should continue to be tackled, notably via information campaigns.

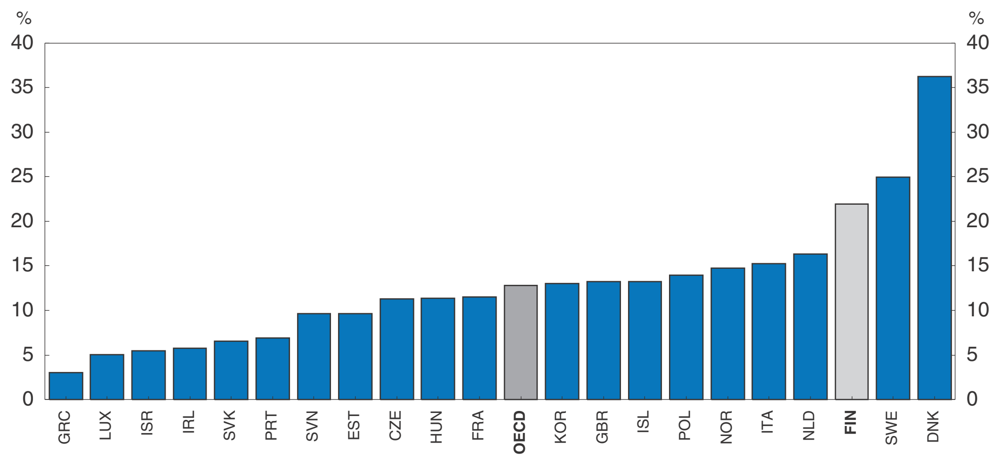
Enhancing public sector efficiency

Structural reforms to enhance government sector efficiency are essential to ensure the sustainability of high-quality public services in the face of ageing, slower output growth and shrinking labour resources. The Productivity Programme has scaled back central government employment but will need to better link staff reductions to innovations in organisation, management and regulation (OECD, 2010b and 2010c). Developing further the use of ICT offers opportunities to improve cost efficiency and effectiveness of public services. Key objectives in that respect are to reduce the fragmentation of electronic information systems and to expand ICT use at the municipal level (Government of Finland, 2013). As municipalities account for two thirds of government consumption, enhancing their efficiency through mergers and other measures will be extremely important for containing public spending.

Municipalities are small and have broad responsibilities

Self-government is a core value, enshrined in the Constitution of Finland, and translates into a high degree of decentralisation and a large share of local government spending in GDP (Figure 15). Municipalities have extensive responsibilities, including most of education and health care. Furthermore, municipal duties have been extended over the years. The government has now identified a wide range of local government tasks and obligations that could be reduced, which would save about 0.5% of GDP (Government of Finland, 2013). Finland's municipalities, with an average population of about 17 000, are quite large in a European perspective, but Danish and Swedish municipalities, which also have wide responsibilities, have on average over 50 000 and 30 000 inhabitants respectively. Half of Finnish municipalities have fewer than 6 000 inhabitants and only 16% more than 20 000 (Figure 16, Panel A).

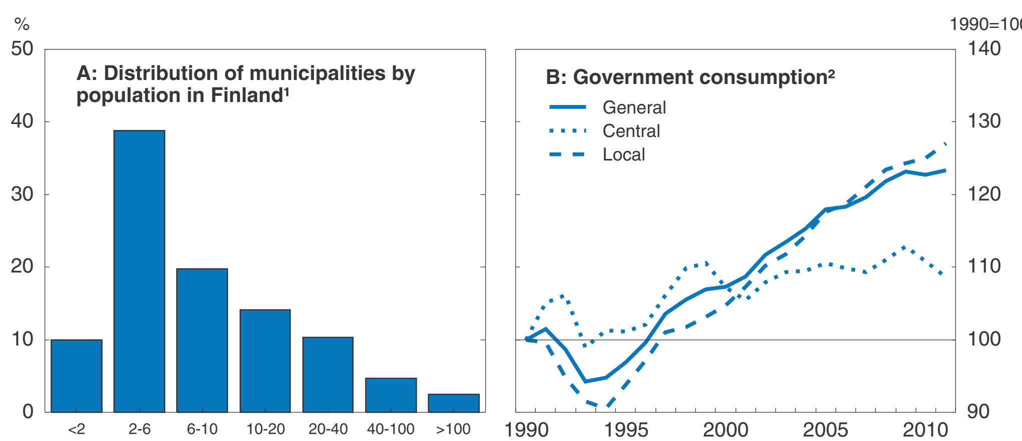
Figure 15. **Local government expenditure is high as a share of GDP**[1]



1. In 2011. Includes unitary countries only. Data for the OECD refer to an unweighted average.
Source: OECD Fiscal Decentralisation database.

StatLink http://dx.doi.org/10.1787/888932991641

Figure 16. **Fragmentation makes it difficult to rein in spending**



1. In thousands of inhabitants.
2. In real terms.
Source: Statistics Finland and OECD calculations.

StatLink http://dx.doi.org/10.1787/888932991660

While a significant number of voluntary mergers, supported by central government, have taken place since 1990, bringing the number of municipalities from 460 to 320, most municipalities prefer to cooperate to produce specific services on a larger scale, rather than merge. However, enhancing cooperation may not be sufficient to meet the challenges associated with population ageing and eroding tax bases (Moisio et al., 2010).

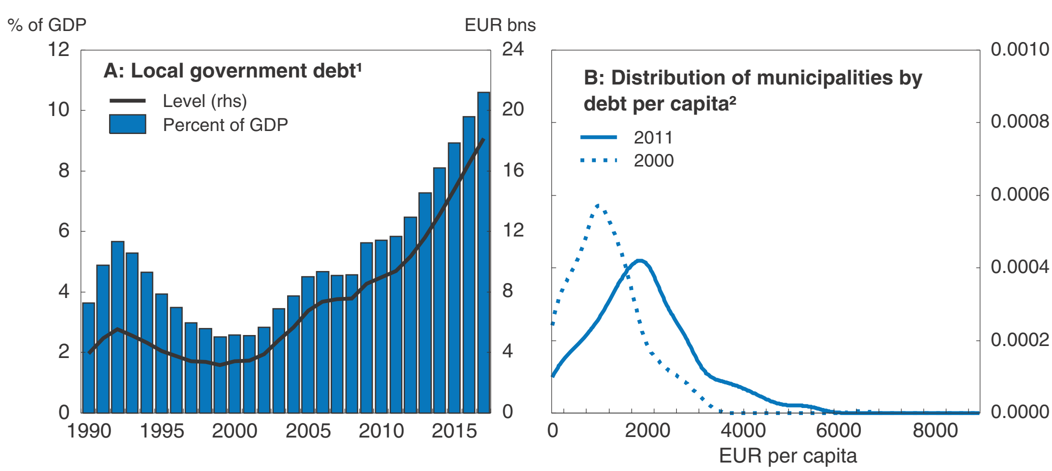
Local government consumption has outpaced that of central government since the early 2000s (Figure 16, Panel B). Ageing, technology and people's expectations are likely to continue pushing up health care and social expenses. Hence, efficiency gains are necessary to ensure the sustainability of municipal finances, while preserving the quality of public services. The fragmentation of the supply of public services generates cost inefficiencies, but also inequity in access to services, as small municipalities often struggle to align service provision with national standards, notably because of shortages in qualified personnel.

Local government debt is drifting up, with widening differences across municipalities

Local government debt has been increasing steadily since the beginning of the 2000s, from less than 3% of GDP to about 7% in 2013. According to Ministry of Finance projections, it will reach nearly 11% of GDP by 2017 (Figure 17, panel A). Although this is still small, both in relation to central government debt and in international perspective, the growth in debt calls for caution. As debt rises, municipalities are becoming more vulnerable to increases in interest rates from currently exceptionally low levels. Furthermore, inability to control increases in sub-national debt can trigger adverse reactions from financial markets and raise the cost of borrowing, both for municipalities and central government.

Debt varies widely across municipalities, reflecting both differences in population needs, operating environments and efficiency. The distribution of municipal debt has widened over the past decade, even before the global economic and financial crisis (Figure 17, panel B). Some municipalities suffered large drops in revenue recently, notably

Figure 17. **Municipal debt is rising and unevenly distributed**



1. Maastricht definition. Data for 2012 are preliminary, and from 2013 are projections. The series in levels is adjusted using the GDP deflator.
2. Kernel density. Municipal debt deflated by the government consumption price index.

Source: Ministry of Finance, OECD database on sub-national finances (Directorate for Public Governance and Territorial Development), and OECD calculations.

StatLink http://dx.doi.org/10.1787/888932991679

as a result of falls in corporate profits and plant closures that eroded tax revenue. Expenditure per capita has also increased unevenly, especially in health care and social services. As some municipalities are relying increasingly on central government transfers, planned cuts in grants by more than 10% at the 2015 horizon will increase pressure to rein in spending or raise taxes.

Strengthening the fiscal framework

Municipalities receive significant corporate income tax (CIT) revenues, which are ill-suited to fund local budgets owing to their volatility. CIT accounted on average for about 3% of total municipal revenues in 2010, but about 8% of local tax receipts, with this proportion exceeding 20% in some municipalities. Furthermore, high tax receipts, which may be temporary, tend to translate into permanent increases in spending, threatening fiscal sustainability. Property taxes would be a better revenue source, as they generate more stable revenue and impose limited distortions on resource allocation. However, they account for only 1.1% of GDP, compared to an OECD average of 1.8%.

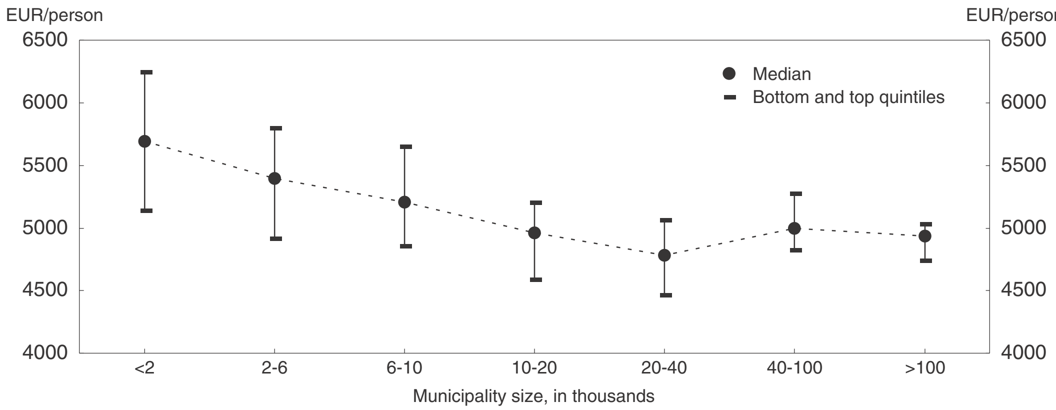
Finland has relatively weak fiscal rules at the local government level. The current budget needs to be balanced over a four-year period. So far, there have been no expenditure ceilings or limits on municipal borrowing or debt. Better taking into account capital spending in municipalities' accounting would enhance deficit control and foster efficient allocation of public resources. Financial reporting by municipalities follows standards which are close to those of private accounting. Nevertheless, efforts to produce and disseminate local government accounts consistent with those of central government should continue (Fredriksen, 2013). In the context of the implementation of the EU fiscal compact, the government developed a new steering system for local government finances, to be implemented from 2015. Its aim is to ensure that in the future municipalities' responsibilities match the available funding. If they are given new responsibilities, either existing ones are to be cut or more funding is to be provided. Moreover, an amendment to the Local Government Act is under preparation. One proposal in that context is that from 2015 municipalities and joint municipal boards will have to offset any deficit within a period of four years, with no leeway to postpone offsetting.

The reform of municipalities has the potential to generate efficiency gains

The government has committed to implementing a comprehensive nationwide reform of municipalities to enhance productivity and effectiveness in the delivery of public services. Municipal councils have an obligation to provide reports and proposals for mergers by July 2014, to be implemented between 2015 and 2017.

Some international studies have found evidence of a U-shaped relationship between the size of municipalities and the overall cost of public services per capita. Municipalities with less than 20 000 to 25 000 and with more than 250 000 inhabitants appear less efficient than those within that range (McKinlay Douglas Limited, 2006; Holzer et al., 2009). In Finland, costs appear to be lowest in the 20 000 to 40 000 inhabitants range (Figure 18). Although numerous factors may affect cost differences across municipalities – including the age and socio-economic structure of the population, morbidity, financial resources and the quality of public services – there seems to be a strong case in favour of merging municipalities with population below 20 000, at least outside remote areas where special arrangements may be needed. International evidence suggests that necessary strategic planning in metropolitan areas of the size of the Helsinki region may be more easily achieved through enhanced cooperation than merger (McKinlay Douglas Limited, 2006; OECD, 2003).

Figure 18. **Municipal costs are lowest at about twenty thousand inhabitants**
Expenditure per person by municipality size, 2011



Source: OECD questionnaire (Directorate for Public Governance and Territorial Development) and OECD calculations.
StatLink http://dx.doi.org/10.1787/888932991698

Municipalities too small to produce services efficiently may purchase them from other producers, either public or private. Economies of scale are concentrated in specialised and capital-intensive tasks, which can be outsourced. A purchaser-provider split can improve efficiency, enhance user choice and encourage innovation. It should be encouraged where the population base and the nature and complexity of services allow meaningful competition and possibilities to expand the use of vouchers for buying services should be explored. Competition should be promoted through enhanced benchmarking and by levelling the playing field between the private sector and public providers, as the latter often benefit from advantages in terms of access to markets, tax treatment and implicit guarantees. An essential step in that direction was taken with the law on the corporatisation, by end-2015, of activities carried out in competitive market environments.

Reaping efficiency gains through mergers will require substantial reorganisation of public services. A significant obstacle to reorganisation is the protection of public jobs for five years following a merger. It is important to be careful not to undermine public support for mergers or public employees' motivation. Nevertheless, more flexible arrangements than strict job protection for five years could perhaps be devised, building on Finland's broad social safety nets and effective active labour market policies to engineer a smooth reallocation of labour.

As regards future reform of the administrative structure of social and health care services, a working group set up by the Ministry of Social Affairs and Health proposes a minimum of 20 000 inhabitants for municipalities to retain control over primary health care and of 50 000 to organise specialised care. Adapting the scope of responsibilities of municipalities to their financial and technical capabilities in other areas could be considered.

The government is also considering imposing mergers in the 10 or so main urban centres outside the Helsinki Metropolitan Area if municipalities fail to come up with sufficiently ambitious consolidation plans. These areas, where population density is relatively high, have the highest potential for efficiency gains through a reduction of administrative fragmentation. Building robust municipalities in the main urban centres would also help achieve the regional development targets of strengthening the competitiveness and vitality of regions and promoting well-being and environmental sustainability (Ministry of Employment and the Economy, 2012).

Recommendations on local public finances and municipal reform

Key recommendations

- Continue to promote the merger of municipalities or scale back their responsibilities in functions where economies of scale and scope can be achieved.
- Implement the new fiscal framework for municipalities as planned. Better account for capital spending in municipalities' accounting to enhance deficit control and foster efficient allocation of public resources.
- Shift the mix of local tax receipts towards property taxes and away from the corporate income tax.

Further recommendations

- Facilitate user choice where the population base and the nature and complexity of services allow meaningful competition. Explore the possibilities to expand the use of vouchers for buying services. Level the playing field between public and private providers by scaling back the advantages of public suppliers in terms of access to markets, tax breaks and implicit guarantees.
- Benchmarking of public service providers should guide user choice and promote best practice.
- Continue to improve the coverage, timeliness and dissemination of local government accounts consistent with the standards used for the central government.

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ANNEX

Progress in structural reform

This annex summarises recommendations made in previous Surveys and actions taken since the OECD Economic Survey on Finland published in February 2012.

This annex presents under each theme:

- Past recommendations
  - ❖ ***Actions taken and current assessment***

Fiscal framework

- Strengthen the fiscal framework by adopting a medium-term fiscal target for the general government balance (while allowing automatic stabilisers to work) that is consistent with a debt target. Contain spending growth, especially in municipalities, preferably by expanding the expenditure ceiling to cover a larger share of general government spending.
  - ❖ ***A new steering system for local government finances will be introduced with the aim of safeguarding the sustainability of local government finances, which will be comparable to the present central government spending limits procedure. The new system will ensure that municipalities' tasks and obligations are consistent with balanced local government budgets.***

Health care reform

Efficiency and quality of care

- Ensure that the merger process leads to the establishment of municipalities that are large enough to ensure efficient provision of health care and social services. Ensure that mergers result in efficiency-enhancing re-organisation of services.
  - ❖ ***The number of municipalities dropped from 336 at year-end 2011 to 320 currently. The municipal reform programme should lead to further consolidation from 2015 onwards. The health care reform aims to consolidate the organising structure of social and health care services.***
- Rationalise the organisation of health services to achieve a better balance between primary and specialised care.
  - ❖ ***The proposed reform aims to integrate responsibility for primary and specialised care, which will make for a more practical division of labour between the two.***

Incentives for a better balance between primary and specialised care

- Introduce a mix of capitation and fee-for-service payment in health teams' remunerations to encourage activity in primary care.
  - ❖ ***Municipalities have considerable autonomy in how they remunerate public health care staff. This allows them to develop remuneration practices suitable to local conditions.***
- Encourage the effective use of diagnosis-related groups (DRGs) in hospitals by adopting national guidelines and encourage developing DRGs for primary care.
  - ❖ ***The first national guidelines for specialised care DRGs were published at the end of 2012. The development of primary care DRGs should be ready for municipal use in 2014.***

User choice

- Drawing on existing experiences in some municipalities, a purchaser-provider split (PPS) should be adopted in areas where the population base and the level of complexity of treatment allow meaningful competition.
  - ***Municipalities have considerable autonomy in how they provide the required health services and the use of PPS is expanding.***
- Competition on prices should be permitted wherever the level of complexity and the density of population allows, accompanied by appropriate benchmarking of health care providers, possibly requested from the National Institute for Health and Welfare (THL).
  - ***Negotiations on prices have been part of discussions on partnerships between municipalities and private providers. The expansion of DRG use and patient choice between public providers aim to enhance quality of care in the public sector.***

Information flows

- Complete the nationwide patient record, which is essential to improve co-ordination of care.
  - ***Electronic prescriptions should be in use by both public and private organisations by April 2014. Patient records should be archived by public organisations from September 2014 and from September 2015 in private organisations.***
- Continue to develop electronic tools to promote evidence-based medicine and health provider benchmarking.
  - ***Care practices are developed by Current Care Guidelines; THL compiles benchmarking statistics on provider performance. The increased electronic storage of information can be used to further develop care practices.***

Prevention and promotion of healthy lifestyles

- Further dissemination of information on health risks but also on the benefits from a healthy diet, including through mass media, should be considered and prevention of disease in high-risk groups could be reinforced.
  - ***Taxes on alcohol and sugar-rich food products will be raised. The health care reform aims to ensure adequate resources for primary care and prevention.***

Non-institutional long-term care

- Continue to encourage the development of home care to limit dependence on institutional care and explore possibilities to expand the use of vouchers for buying services needed to support independent living at home.
  - ***The government has pledged in its November 2013 reform package to accelerate the transition from institutional care to service housing.***

Availability of an adequate health workforce

- Adapt admission targets for medical education to anticipated needs, continue to upgrade the tasks of qualified nurses and explore ways to encourage older medical practitioners to defer their retirement.
  - ***The November 2013 reform package contains measures to relax qualification requirements in the health sector. Admission levels to tertiary education will be temporarily increased, though the division by field is still undefined.***

Labour market reform

- Adjust active labour market policies so that activation takes place earlier.
  - ❖ ***From 2014, activation will be offered within three months from the start of unemployment. The so-called youth guarantee, which offers everyone under the age of 25, as well as recent graduates under the age of 30, a job or training, a study place, or a place in rehabilitation within three months after becoming unemployed, took effect at the beginning of 2013.***
- Adjust the temporary lay-off scheme so that the employer bears some of the costs of the programme.
  - ❖ ***No action taken.***
- Lower high replacement rates in the unemployment insurance and related benefit systems to improve work incentives. Work incentives for second earners in families with small children should also be improved.
  - ❖ ***No action has been taken to lower replacement rates in unemployment insurance. However, the earned income tax credit has been increased to boost incentives to work. Also, a protected portion in the unemployment benefit has been introduced coming into effect in 2014.***
  - ❖ ***To support mothers' labour market participation, a new flexible child care allowance for parents with children under the age of three has been introduced, whose aim is to make part-time work more attractive for those currently at home taking care of children, increase women's employment, and make it easier to combine work and family.***
  - ❖ ***Half of the home care allowance period, i.e. about 12.5 months, will be for the father only. If the father decides not to use his right to the allowance, these 12.5 months are lost.***
- Taper unemployment benefits over time as is currently done in many other OECD countries.
  - ❖ ***No action taken.***
- 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 (rehabilitation requirements already extensive, but no major changes in recent years).***
- Abolish the unemployment "tunnel" to retirement.
  - ❖ ***The age limit for the right to a continued unemployment allowance will be increased by one year for those born in or after 1957.***
- 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.
  - ❖ ***The Public Employment Service and its management were reformed in early 2013. The 74 local Employment and Economic Development offices were merged into 15 regional offices, allowing better coordination. Efficiency is also pursued by multichannel services provision where an increasing share of the customer services is provided on the internet and a nationwide telephone service.***
- Consider nationalising unemployment insurance.
  - ❖ ***No action taken.***

Productivity enhancing reforms

Entrepreneurship, innovation and R&D

- Maintain a strong government support role in basic R&D and education. Academic performance should be improved by distributing research grants according to performance. Administrative rules for student financing should be tightened to shorten university study times.
  - ***The national target set by the Government in Europe 2020 Strategy is maintaining R&D spending at a minimum of 4% of GDP.***
  - ***The university funding model was revised at the start of 2013 and that of universities of applied sciences will be revised at the start of 2014. The number of completed qualifications and study progress will affect funding more than before. The reform will accelerate the completion of studies (along with tighter indicative completion times) and the transition to working life, boost the quality and internationalisation of teaching and research, and strengthen the specialisation of higher education institutions.***
  - ***The level of financial aid to higher education students will be raised cost-neutrally as the period of entitlement to financial aid is shortened.***
- Lower business subsidies and shrink the number of business supporting institutions. Lower or terminate government funding in areas (like venture capital) where markets nowadays provide equal or better services.
  - ***The structure of the business subsidies will be reviewed as part of the structural programme next year. No other major changes.***
- Consider whether a R&D tax credit would be a more efficient instrument for supporting private sector R&D.
  - ***A time-limited trial on R&D tax credit is ongoing.***
- Align capital taxation across organisational forms.
  - ***The proposal to cut the corporate income tax rate and to change dividend taxation at the start of 2014 is expected to narrow the differences in tax treatment of income that different kinds of business forms distribute to their owners.***

Competition and deregulation

- Pursue more structural reforms within network industries and open up government dominated sectors to private provision, e.g. in health, in order to increase productivity and provide stronger incentives for private sector R&D in those sectors.
  - ***The structural reform of the health sector is at the planning stage.***
- Follow up the 2011 Competition Act by ensuring that the competition authority has sufficient resources to fulfill its extended mandate.
  - ***Resources have been increased.***
- Loosen zoning and planning restrictions on retail development to encourage competition and increase store-level scale economies.
  - ***No major action taken.***

Public sector efficiency

- Pursue further municipal mergers to increase efficiency and achieve economies of scale in basic service provision.
  - ❖ ***The Municipal Structure Act took effect in July 2013. By end-November 2013, the municipalities were obliged to report with which municipality or municipalities they would explore municipal merger opportunities. Government can decide on a merger of a municipality in economic crisis also against the municipality's will. Extra financial support of EUR 150/inhabitant will be provided for the new merged municipality where a crisis municipality is included (up to a maximum of EUR 1 million).***
  - ❖ ***A supplement to the Local Government Structure Act has been prepared to safeguard the compact urban structure of the main metropolitan areas and the efficient arrangement of services. Government intervention would be restricted to situations in which the goals of the Local Government Structure Act cannot be implemented voluntarily. A Government bill will be submitted in spring 2014 and the legislation is foreseen to come into force in summer 2014. The Government will decide on possible mergers of municipalities such that they can come into force from the start of 2017.***
- Develop benchmarking further to enhance municipal-level productivity.
  - ❖ ***The Ministry of Finance has set up a programme and a coordination group to enhance municipal-level productivity and effectiveness together with the municipal sector and labor-market organisations. Sharing of best practices across municipal and sectoral borders is promoted. A table of indicators has been created to help evaluate the quality and effectiveness of municipal services. A data bank on municipal productivity has been opened on the Internet.***
  - ❖ ***Transparency and comparability of the costs of public services will be promoted by introducing in the local government sector a common model for the accounting and comparison of production and costs.***

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.
  - ❖ ***Taxation of labour has been decreased moderately. At the start of 2013 the EITC was increased and it will be increased further at the start of 2014. The EITC is targeted mainly to low and middle income groups.***
- Raise property tax revenues by setting property assessment values (for tax purposes) equal to 100% of market valuations and by raising property tax rates.
  - ❖ ***Government has proposed to raise property taxes in 2014 by increasing the assessment values for both land and buildings. Also the tax rates for unbuilt land will be increased in 2014 to encourage sales of land and building of dwellings.***
  - ❖ ***Assessment values are to be adjusted via a reduction in the maximum amount of age-discount for dwellings and an increase in the assessment values for buildings and cadastral values for land. These changes will bring property assessment values closer to market prices.***
  - ❖ ***The proposed change of the property tax rate on land increases the tax for unbuilt land in the metropolitan area of Helsinki and the surrounding municipalities.***

- 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 municipalities get around one third of the corporate income tax revenue. The property tax is a local tax, and the increase in the assessment values in 2014 will boost tax revenue by about EUR 100 million (see the previous point).***
- Consider ways to further broaden the corporate tax base and lower the rate.
  - ❖ ***At the start of 2013 some temporary tax incentives for companies and investors were introduced to boost growth and investments. However, the temporary tax incentives will be shortened when the corporate income tax rate drops from 24.5% to 20% at the start of 2014. The tax package including these proposals has yet to be approved by Parliament.***
  - ❖ ***The deductibility of interest expenses on intra-group loans in business taxation is restricted from 2014 and onwards to curb tax planning and safeguard the corporate income tax base.***
- Raise the revenue efficiency of the VAT by eliminating reduced VAT rates.
  - ❖ ***The structure of the VAT rates has been kept intact since the previous survey though all VAT rates were increased by one percentage point at the start of 2013.***

Thematic chapters

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Chapter 1

The economic consequences of ageing

Finland's population is set to age rapidly in the coming decades. This will put pressure on public finances, while shrinking labour resources. Nonetheless, solutions exist to alleviate those pressures. Adjusting the pension age in line with the rise in life expectancy would reduce pension costs and increase older workers' employment, provided it is accompanied by the removal of the pathways to early retirement. In order to allow people to work longer, labour market flexibility should be enhanced and lifelong training promoted further. Active labour market policies should be strengthened so as to increase the labour force participation of youth, childbearing age women and the long-term unemployed. Finally, ageing should not only be seen as a burden as it can also create opportunities for innovation and new markets and industries. Information and communications technologies, where Finland has a strong knowledge base, can help the elderly stay as autonomous as possible, which would contain long-term care costs and improve well-being.

Finland's population is set to age rapidly over the coming two decades, even more so than in other Nordic countries, the European Union (EU) and the OECD. The growing share of older people will put pressure on public finances. Absent further reform, the sustainability of the pension system would be jeopardised, as public expenditure on pensions is expected to increase considerably until 2060. Pressure on public finances will also arise from health and long-term care expenditure, which is also on course to increase markedly over the same period. Regarding long-term care, the increasing number of dependent people will require more carers. Ageing will also reduce labour supply, leading to potential labour shortages.

Nonetheless, solutions exist to address those issues. Rising life expectancy calls for longer working lives. The minimum retirement age should be indexed to longevity. This would alleviate pressure on the pension system and at the same time offset, at least partly, the labour shortages arising from population ageing. The pathways to early retirement should be reduced or abolished and measures to help older workers stay at work should be implemented. While financial incentives for early retirement need to be reduced, the employability of older workers should be enhanced and employers should be encouraged to hire and retain them. Employers often have negative perceptions towards older workers, related for instance to their supposed obsolete technological skills or lower productivity. At the same time, older employees often find that their working conditions are not good enough to keep on working after the minimum retirement age. Those issues should be tackled by providing lifelong training, reducing employment protection legislation, developing flexible working arrangements and reducing high implicit tax rates.

Ageing also creates new business opportunities, as it modifies the demand structure. As ageing is a global phenomenon, a competitive edge in age-related consumption growth areas would create a strong potential for exports. Information and communications technologies, where Finland has a strong knowledge base, can contribute to meeting the key challenge of helping the elderly stay as autonomous as possible.

The first section of this chapter looks at the pressure population ageing will put on public finances and the labour market. The second section suggests pension and health system reforms to adapt to ageing. The third section then proposes labour market adjustments to enhance employment of older workers. The fourth section discusses ways to increase labour force participation in other groups. The final section outlines growth opportunities offered by ageing.

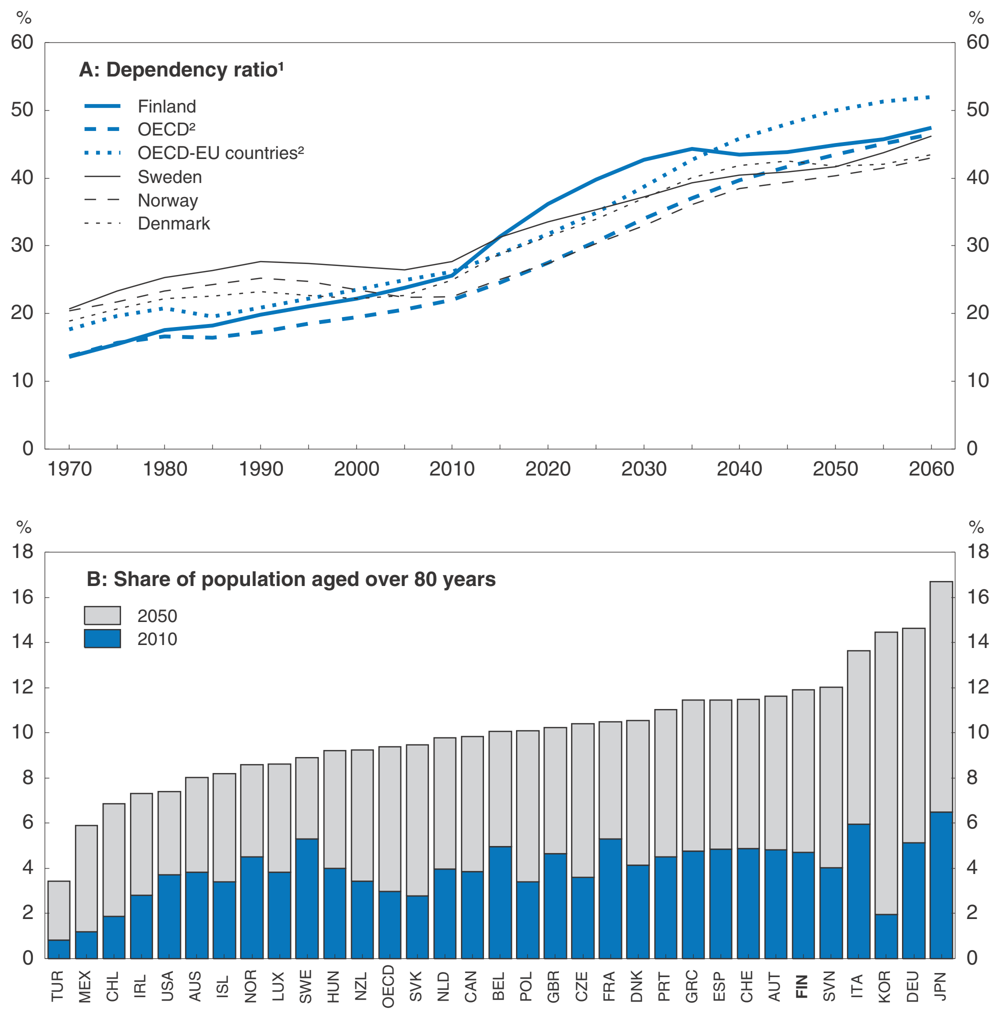
A rapidly ageing population will put increasing pressure on public finances and labour resources

A rapidly ageing population

As in most OECD countries, the population is ageing rapidly in Finland, as a consequence of lower birth rates and higher longevity. The old-age dependency ratio, defined as the share of the population aged 65 and over relative to the population aged

15-64, has risen steadily from less than 15% in 1970, to 25% in 2010, and it is projected to exceed 45% by 2060 (Figure 1.1, Panel A). Even more strikingly, the share of people aged over 80 in the total population will increase from less than 5% in 2010 to around 12% in 2050, when it will be among the highest in the OECD and larger than in other Nordic countries (Figure 1.1, panel B).

Figure 1.1. **An ageing population**



1. Population aged 65 and over relative to population aged 15-64.
2. Weighted average.

Source: Eurostat, United Nations Population Division, *World Population Prospects: The 2013 Revision*, and OECD *Help wanted? Providing and paying for long-term care.*

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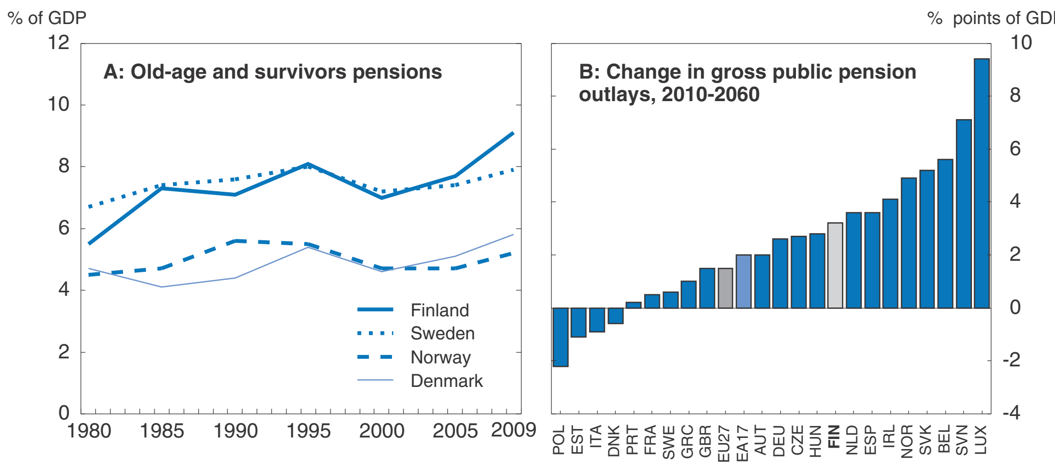
Pension expenditure is projected to increase considerably

As a consequence of population ageing, pressure on the pension system will increase. The evolution of old-age and survivor pension expenditure differs across Nordic countries (Figure 1.2, Panel A). In Finland, this spending, starting from a rather moderate share of GDP, rose by around 3.5 percentage points between 1980 and 2009, reflecting a strong increase in the old-age dependency ratio. By contrast, the increase was around one percentage point of GDP in Denmark, Norway and Sweden, partly due to much lower demographic pressure. Moreover, Denmark and Sweden implemented pension reforms earlier than Finland.

Figure 1.2. **Old-age dependency and pension costs are growing rapidly**



Source: OECD Social Expenditure Database and European Commission, *The 2012 Ageing Report*.

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Going forward, the European Commission Economic Policy Committee's (EPC) baseline scenario (European Commission, 2012a) projects an increase in total public pension expenditure of more than 3 percentage points between 2010 and 2060, with a sharp rise before 2030 followed by relative stability between 2030 and 2060. This increase is higher than in Denmark, Sweden and the EU27 average, though less than in Norway (Figure 1.2, Panel B). While disability and survivor pension expenditure is expected to decrease as a share of GDP, old-age pension outlays are set to rise by about 4 percentage points.

The Finnish Center for Pensions expenditure projections are lower than the EPC's: total public pension outlays as a share of GDP are projected to increase by nearly 2 percentage points between 2012 and 2030 and then to decline by 1.2 percentage points to slightly less than 14% of GDP by 2060. The difference mainly reflects higher assumed population growth, resulting from lower mortality and higher immigration, and a smoother wage path in the Finnish Centre for Pensions scenario.

The Finnish pension system has been reformed successfully to bear these rising costs in the short run

The pension system, which was reformed in 2005, comprises three pillars (Box 1.1). The first one is a non-contributory national pension based on residence in Finland or other EU countries. It is means-tested, financed from general taxation and paid by the central government. As the national pension is below the poverty line, it has been complemented since 2011 by the guarantee pension for people without or with only a small earnings-related pension. The importance of the national pension has decreased over time as the earnings-related pension system matured. On average across all ages, it accounts for 10% of pension income, with the remaining 90% coming from earnings-related pensions (Barr, 2012).

Box 1.1. **The characteristics of the Finnish pension system**

The Finnish pension system comprises three pillars. The main one is the compulsory earnings-related pension system. It is complemented by a non-contributory national pension and individual private pension or life insurance schemes.

The earnings-related pension system covers all employed persons: employees, entrepreneurs (business owners) and self-employed. It provides old-age pensions, disability pensions and family pensions to widows and orphans. The pension rights are transferable. Since 2005, the pensions are calculated over the lifetime salary.

The maximum replacement rate with a constant salary is 71.5% at age 63 and 89.5% at age 68. The average replacement rate of new pensions is 60%, while the average replacement rate of all pensions is 50%. Since 2005, pension rights accrue at an annual rate of 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 average pension insurance contribution is 22-23% of the salary, with 17% from employers and 5% from employees at ages 18-52 and 6% at age 53 and above. Moreover employers need to contribute to a disability scheme. To determine the disability contribution component, large companies are divided into contribution categories based on the number of disability pension incidences in the company two years earlier. There are 11 contribution categories depending on the size of the disability risk. Each category contains a different experience-rated contribution. Disability contribution rates range between 0.09% and 4.95%.

Past earnings are revalued at a rate reflecting price increases for 20% and earnings growth for 80%. Earnings-related pensions in payment are increased each year in line with the earnings-related pension index, which is a weighted average of price change (80%) and wage change (20%).

In 2005, Finland introduced a life expectancy coefficient to adjust starting pension benefits. It serves to limit the impact of rising life expectancy on pension expenditure. As life expectancy increases, this coefficient will reduce the amount of the monthly pension. However, it will not reduce the total amount that a pensioner will receive during retirement, provided he lives to the age corresponding to the increased life expectancy. The level of comparison is life expectancy in 2009, for which the life expectancy coefficient was set at a value of one. It applied to people born in 1947 who retired in 2009. It decreases thereafter to reach 0.98 for people born in 1951 retiring in 2013.

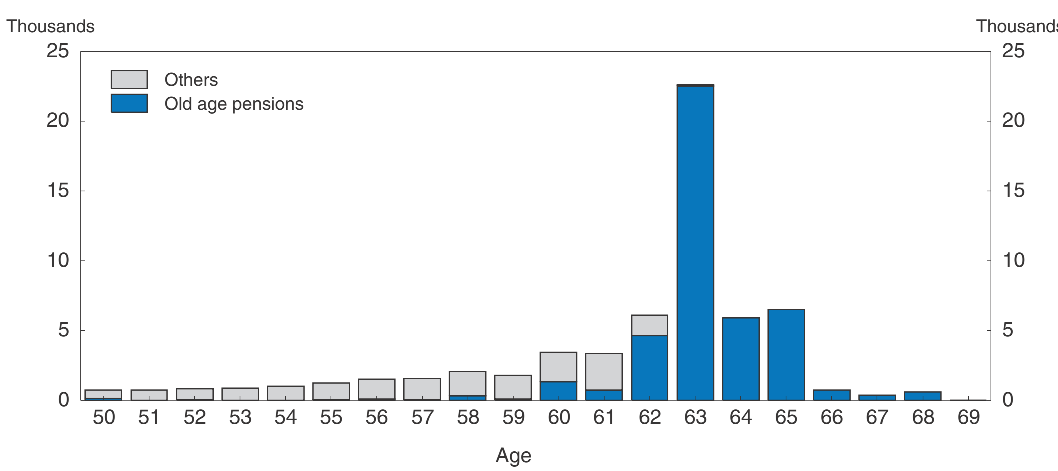
The second pillar, referring to compulsory earnings-related pensions, is a defined-benefit system financed by contributions paid by employers and employees, and is based on insurance policies provided by different pension funds. It is about one-quarter funded. The characteristics of the system are negotiated between the social partners and co-ordinated by the Finnish Centre for Pensions under the supervision of the Ministry of Social Affairs and Health and the Financial Supervisory Authority. Private and public employees are covered by different funds. Seven companies manage 95% of private sector pensions. Varma and Ilmarinen dominate the market, with over 70% of pension insurance companies' assets as of end-2011. Keva, an independent corporation governed by public law, covers public employees.

The pension funds can be firm-specific or group-specific. Total pension assets amounted to 155 billion euros as of end-March 2013, with the public sector funds representing 55 billion and the private sector 100 billion. Finnish pension funds now represent around 80% of GDP compared to less than 50% in 2001. This far exceeds the unweighted OECD average of 34% (in 2010). As Finnish private-sector pensions have been partly funded since 1962 – when the system came into force and well before many other European countries where such buffer funds were only established in the 1990s – the Finnish funds' accrued assets are higher. Pension assets must be invested profitably and securely by law. At the end of 2012, the largest proportion of assets (38%) was invested in shares while 36% were invested in bonds, 11% in other interest-bearing instruments, 11% in real estate and 4.5% in hedge funds.

The third pillar relates to the individual private pension or life insurance schemes and is not as important as in most OECD countries. In 2010, the mandatory earnings-related pension comprised 86% of pension wealth, 4.4% of total contributions were for voluntary earnings-related pensions, and only 2.7% were for voluntary individual pensions (Barr, 2012). As there is no ceiling on the contributions and benefits of the compulsory system and as the earnings-related pension system provides wide coverage and good replacement ratios, there is very little incentive to participate in third pillar schemes. Moreover, high private pension insurance costs and changing tax subsidy policies may have hampered the development of the third pillar.

Since the 2005 reform, the official retirement age ranges between 63 and 68 for the second-pillar scheme. Figure 1.3 shows the age distribution of the individuals when they start drawing these pensions. There is a large spike in retirements at age 63, as most people draw their pension as soon as they can notwithstanding the increased accrual rate after 63. The average effective age of retirement is even lower. Even if it has increased by nearly two years over the past decade, it is still below the official age, at 61.8 for men and 61.9 for women (Figure 1.4). The gap between the official and effective retirement age – taking 65 as the Finnish official retirement age, as it is the age at which the national and guarantee pension can be accessed – is among the widest in the OECD, far larger than in other Nordic countries. Nonetheless, four out of five Finns consider that working past the official retirement age should be allowed, and the same proportion would find it attractive to combine a part-time job with a partial pension instead of full retirement. This is higher

Figure 1.3. **New retirees by age group in 2011**



Source: Finnish Centre for Pensions.

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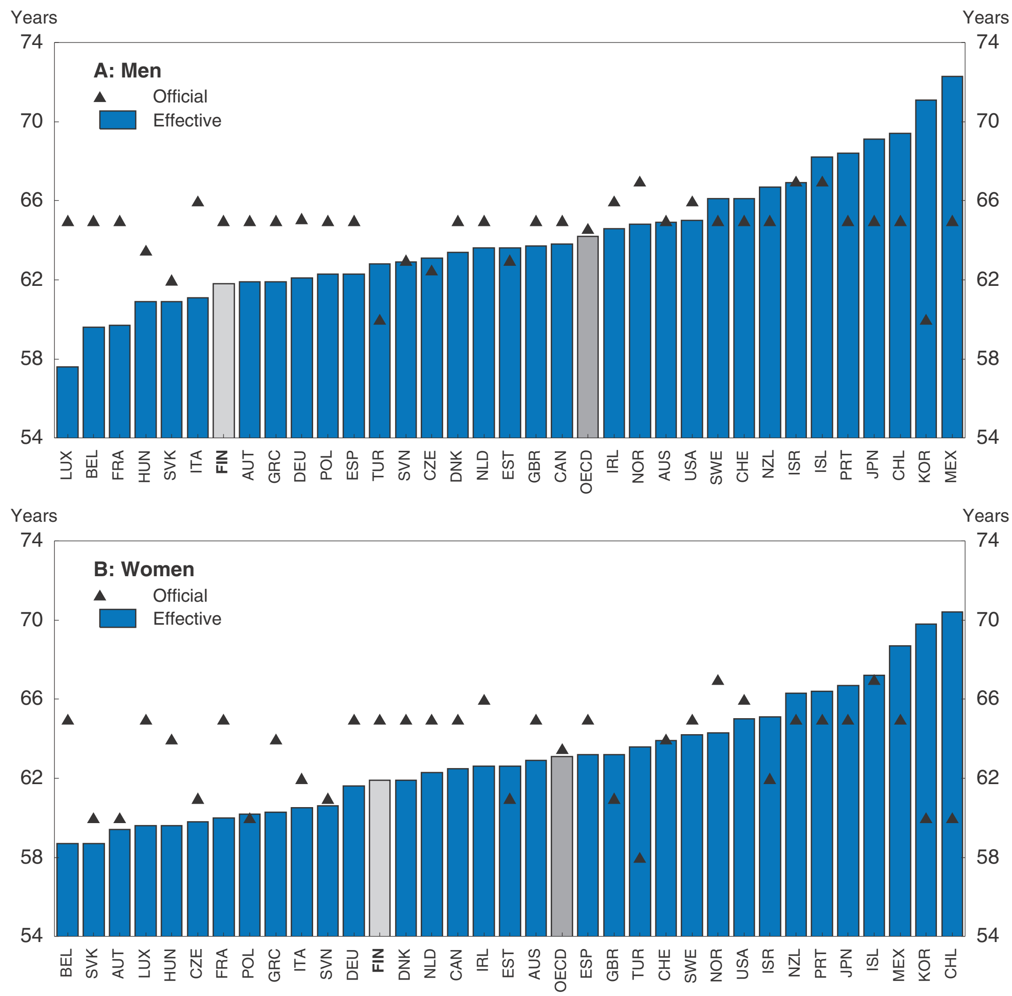
Figure 1.4. **Average effective age of labour-market exit and normal pensionable age**[1]



1. The effective retirement age shown is for the five year period 2007-12; the pensionable age shown is for 2012.
Source: OECD (2013a), *Pensions at a Glance*.

StatLink http://dx.doi.org/10.1787/888932991774

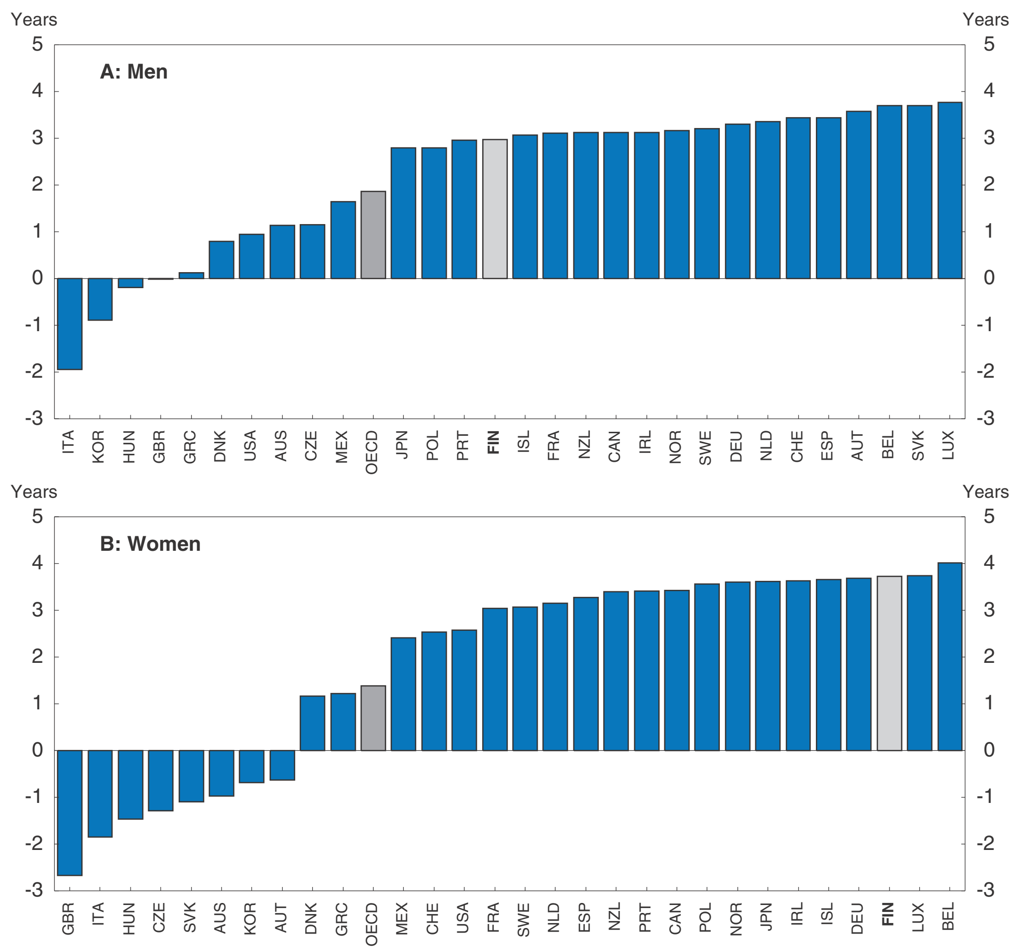
than the EU average, which is at around two thirds. Even if financial incentives play an important role in the decision to retire, retirement choices are also driven by non-financial determinants related to individual background (e.g. health status, type of job, household situation), limited rationality, or socio-cultural and institutional factors (Van Erp et al., 2013).

But increasing life expectancy will put the pension system under unsustainable pressure

Life expectancy increased significantly during the past decades, while the effective retirement age remained unchanged or has fallen in most OECD countries. Hence, the share of lifetime spent in retirement is increasing. Based on the life expectancy projections carried out by the United Nations Population Division and the pension age as planned under the current legislation, the OECD computes the expected retirement duration (OECD, 2011). Although no increase in the Finnish pension age has yet been legislated, the pension age is set at 65 until 2050. While, on average across OECD countries, the expected retirement duration at normal pensionable age is projected to increase by 1.9 (1.4) years for men (women) between 2010 and 2050, its increase for Finland is projected to amount to 3 (3.7) years (Figure 1.5).

Figure 1.5. **Projected change in expected retirement duration at normal pensionable age**[1]

Between 2010 and 2050



1. For Finland, the normal pensionable age is set at 65.

Source: OECD (2011), *Pensions at a Glance*.

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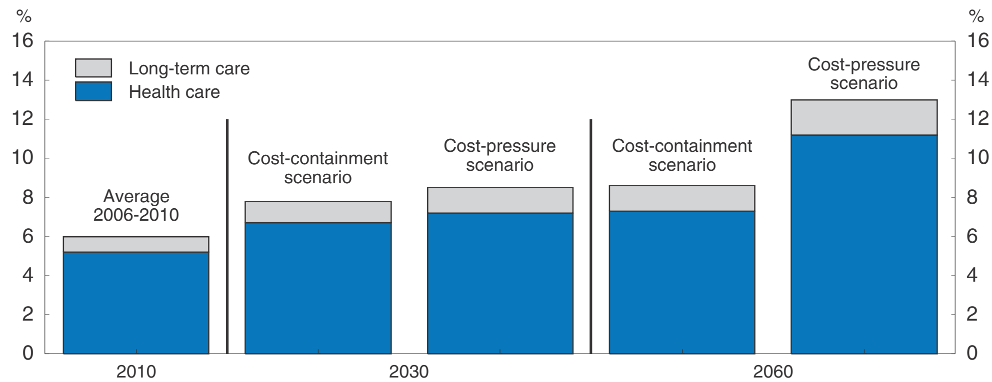
Pressure will also arise from health and long-term care

Public spending on health and long-term care (LTC) has increased significantly over the past decade as a share of GDP, as in other Nordic countries. Since 1970, it has risen by nearly 3 percentage points to more than 6% in 2010. Looking forward, the OECD projects that over the next 50 years it will increase by more than 2.5 percentage points to 8.6%, even if policies act more strongly than in the past to rein in health and long-term care expenditures (Figure 1.6) (De la Maisonneuve and Oliveira Martins, 2013). In the absence of such policies, the expenditure ratio could more than double to reach 13% of GDP in 2060. Public health-care expenditure will be pushed up by both population ageing and non-demographic factors, such as increasing relative prices of health services and cost-increasing technological progress, with the latter factors taking the lion's share.

Figure 1.6. **Projected public health and long-term care expenditure**

As a percentage of GDP



Source: De la Maisonneuve and Oliveira Martins (2013).

StatLink http://dx.doi.org/10.1787/888932991812

While demography is not the main driver of health care spending growth, it will induce a significant change in the structure of spending over time. In 2010, around 55% of health care expenditures were directed to people under 65 years old. It is projected that by 2060 more than 60% of expenditures will be directed to people aged over 65, reflecting an increase from 17% to 27% of their share in the population. This reflects demographic effects only, as non-demographic effects are assumed to affect all age groups in the same proportion. Inter-generational equity may thus be jeopardised at the expense of younger generations.

Growing needs for formal long-term care will contribute to the projected rise in total public health expenditure. This is largely due to the increase in longevity, as limitations in activities of daily life become increasingly common among people over 75 years old. In Finland, dementia is becoming more prevalent with the growth of the very old population (80 or more) and it is an increasingly common cause of death. The number of deaths caused by dementia more than doubled in two decades and represented around 20% of the total deaths of the elderly by 2011 (Statistics Finland, 2009; Forma et al., 2011). In the future, the increase in need for LTC is likely to be mitigated by healthy ageing (i.e. the translation of longevity gains into equivalent additional years without limitations in activities of daily life) through lifelong health prevention initiatives. However, three non-demographic factors are projected to push up LTC expenditure: increases in the relative price of LTC, rising incomes and changes in demand for publicly-financed LTC (which is likely to increase as informal care provided by the family declines with the increased labour force participation of older people, in particular women).

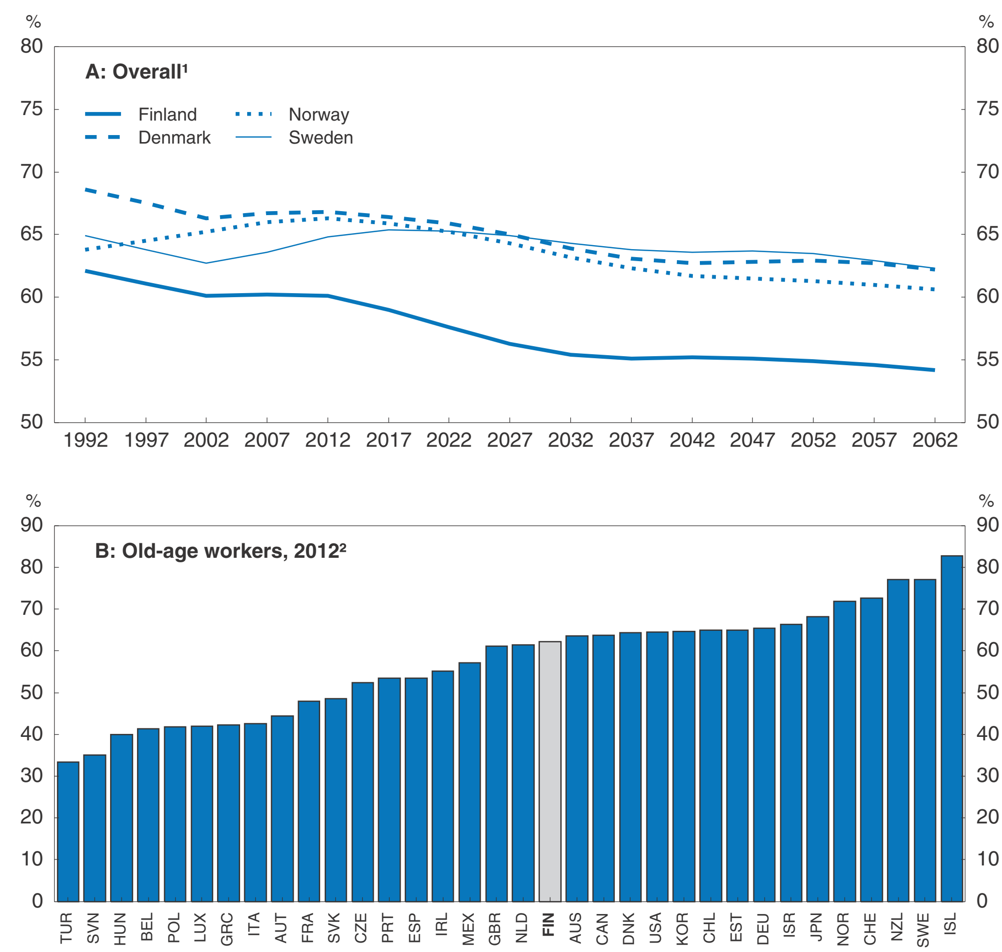
Rising relative prices due to rising unit labour costs of LTC services, which suffer from an inherent low potential for productivity gains, will be the major driver of expenditure. In the absence of cost-containment policies, the ratio of public LTC expenditure to GDP, starting from 0.8% of GDP in 2010, is projected to increase by one percentage point by 2060.

If cost-containment policies were implemented, the public LTC spending ratio would still increase by 0.5 percentage points between 2010 and 2060. Since the 1990s, policies have succeeded in substituting service housing (housing with special care facilities, often including 24-hour assistance) for institutional care for a growing number of elderly people (OECD, 2012b). As institutional care is very expensive, the move towards service housing is likely to generate substantial savings, while improving the quality of life of old people. In addition, the National Memory Programme 2012-2020 aims at enhancing prevention, reducing stigma attached to memory disorders, enabling early diagnosis, improving treatments and developing research (Ministry of Social Affairs and Health, 2013a). This should both enhance well-being and reduce social welfare and health care costs.

Ageing will also reduce labour supply

Ageing will also put pressure on the labour market. With a growing share of older workers in the labour force whose participation rate is rather low, the overall participation rate tends to decline. This has been the case for several years and is expected to continue for the next 50 years if no reform to increase participation is implemented (Figure 1.7,

Figure 1.7. **Labour force participation rate**



1. People aged 15 and over.
2. People aged 55-64.

Source: Johansson et al. (2013) and OECD, *Labour Force Statistics*. StatLink http://dx.doi.org/10.1787/888932991831

Panel A). The problem is much larger in Finland than in other Nordic countries. Starting at around 62% in the 1990s, the labour force participation rate of people aged 15 and over is projected to decline by over 8 percentage points to 54% by 2060. Labour force participation of people aged 55-64 has increased during the past decade and is in fact higher for those aged 55-59 than for the total working age population. Nevertheless, participation in the 55-64 age group, at just over 60%, is still lower than in Denmark, Norway and Sweden (Figure 1.7, Panel B).

The link between ageing and productivity is unclear

Empirical evidence on the link between productivity and age is mixed. The *OECD Survey of Adult Skills* (PIAAC) finds that while Finland's adult population proficiency in literacy, numeracy and problem solving is among the highest in the 22 OECD countries participating in the *Survey*, the gap between younger and older age groups is wide. It should, however, narrow over time, as it mainly reflects spectacular progress in education over the past decades (OECD, 2013b). Surveys suggest that some physical and mental abilities decline from around the age of 50 (Skirbekk, 2003). In contrast, some verbal abilities and communicative skills remain more or less unchanged. Moreover, older workers can rely on their professional experience to adapt and compensate for declining abilities (OECD, 2006a).

A related, and potentially even more important, matter is the evolution of productivity relative to wages. If labour costs rise more steeply with age than productivity, firms will not want to retain or hire older workers (D'Addio et al., 2010). Mahlberg et al. (2013), using data for Austria, find no evidence that older workers are overpaid relative to their productivity. Likewise, Van Ours and Stoeldraijer (2010) find little evidence of an age related pay-productivity gap in the Netherlands. In contrast, Crépon and Aubert (2003) for France and Hellerstein and Neumark (2004) for the United States find that the decline in productivity after the age of 55 does not go along with a decline in relative wages. In Finland, OECD data show no evidence that wages exceed productivity for older workers (D'Addio et al., 2010).

At the macroeconomic level, scarcity of labour could push up wages, which would be an incentive to substitute capital for labour. Capital deepening would raise productivity. Nevertheless, it is unlikely that this effect would be sufficient to compensate for lower labour input in production. Hence, ageing should have a negative impact on growth (Box 1.2).

Box 1.2. **Impact of ageing on growth and saving**

Demographic trends, including ageing, shape the future path of labour and human capital and, in turn, GDP per capita (Johansson et al., 2013, and Bloom et al., 2011). Indeed, *ceteris paribus*, ageing will diminish labour supply and thus GDP growth. Age may also affect human capital: where older cohorts are less educated than younger ones, an older population will have, on aggregate, a lower level of education.

Using a Cobb-Douglas production function, the OECD projects long-term GDP as well as its determinants, namely physical capital, technical progress, human capital per worker and employment. Finland's potential GDP is projected to grow at an annual rate of 1.5% in 2012-17, 2.1% in 2018-30 and 1.4% in 2031-60 (OECD, 2013c). While total factor productivity is the main driver, human capital is the second largest one. The baseline scenario assumes that over time each age-cohort has a constant level of human capital, corresponding to the level of schooling obtained at age 25-29. Reflecting past trends, educational attainment of the 25-29 age group is assumed to continue to gradually improve until reaching 18 years of schooling in 2100.

Box 1.2. **Impact of ageing on growth and saving** *(cont.)*

Ageing may also have an impact on saving, which could affect investment and thereby productivity, innovation and ultimately income per capita. In fact, the old-age dependency ratio is one of the main determinants of saving (Kerdrain et al. 2010). This is consistent with the standard life-cycle hypothesis under which older people tend to have a lower propensity to save than people of working age (Modigliani and Ando, 1963). OECD projections show that Finland will experience a stronger increase in its dependency ratio and a larger decrease in its saving ratio than Sweden and Denmark (Table 1.1). Finland being a small open economy, the impact of lower saving on investment may be limited, as in such an economy interest rates are determined at the global level and are not affected by domestic saving (Sheiner et al., 2007). Nevertheless, reliance on foreign capital would increase, which could entail some risks, especially when financial markets are volatile.

Table 1.1. **Projections of old-age dependency ratios and saving**

	Finland	Sweden	Denmark	Finland	Sweden	Denmark
	Old-age dependency ratio, in %			Total gross saving, in % of GDP		
2005-10	24.8	27.0	23.8	23.6	26.8	23.7
2025-30	42.1	36.8	35.3	17.9	24.9	22.5
2055-60	45.9	45.5	41.9	16.2	22.0	21.6
Difference 2005-60	21.1	18.4	18.1	-7.4	-4.8	-2.1

Source: OECD (2013c).

Solutions exist to adapt the pension and health systems to ageing

Ageing will put pressure on public finances and labour supply. As regards public finances, reforms should be implemented to ensure the sustainability and adequacy of the pension and health systems. These reforms should go along with labour market adjustments to ensure that older workers can keep working.

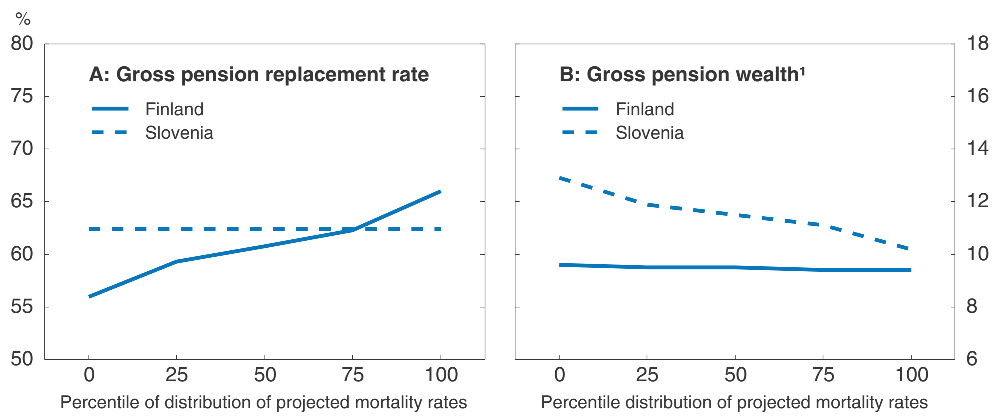
Lengthening working lives seems to be the most consensual solution

As regards pensions, the question is about the share of the adjustment which should fall on the current contributors and retirees relative to future retirees. An intuitive approach is to achieve a long-term actuarial equilibrium, where the stream of expected future contributions and other revenues over a suitably long horizon (50-75 years) is enough to pay for projected benefits over that period. In countries like Finland, where large assets have been accumulated in pension funds, these need to be included in the calculation. To correct situations of actuarial disequilibrium, three parameters can be adjusted: pension eligibility ages; benefit levels; and contribution rates (OECD, 2012a).

As noted above, Finland chose in 2005 to index pension benefit levels to longevity via a life expectancy coefficient. In order to gauge the impact of such a reform, two measures of pension entitlements are useful. The first is the pension replacement rate which is the annual value of the benefit relative to individual earnings when working. The second is pension wealth, which is the present value of the lifetime flow of pension benefits (see OECD, 2011 for details on how these indicators are calculated). In a pure defined-benefit system, the same level of benefits is provided regardless of the evolution of life expectancy. This means that replacement rates are constant whereas pension wealth rises with life expectancy. For instance, a longer retirement duration implies higher lifetime benefits. Figure 1.8 shows the evolution of these two measures between 2010 and 2050 under different mortality scenarios for Finland and Slovenia, which both have public defined-benefit schemes. The two countries display different patterns as Finland has already introduced indexation of benefits to longevity, but Slovenia has not. As a pure defined-benefit system, Slovenia displays a constant replacement rate and higher pension wealth in lower mortality scenarios, where longevity increases. By contrast, Finland's replacement rate is reduced when longevity increases, and pension wealth is roughly constant.

Figure 1.8. **Pension entitlements under different life expectancy scenarios**

Man with average earnings



1. Pension wealth measures the total value of the lifetime flow of retirement incomes. It is expressed as a multiple of gross annual individual earnings.

Source: OECD (2011), *Pensions at a Glance*.

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The life expectancy coefficient has been in place since 2010 and adjusts the level of pension benefits according to the future evolution of life expectancy (Box 1.1): the higher life expectancy, the lower the benefits. An obvious way to avoid a cut in pension benefits for an individual is to retire later. Working longer has three obvious advantages for public finances: it provides additional contributions, the benefit will be paid for a shorter period and higher employment will raise output, lowering the deficit. However, there is uncertainty regarding the extra working time needed to offset the decrease in pension levels and provide a constant replacement rate over time, as the future evolution of life expectancy is uncertain. The OECD calculated the pension age delivering an unchanged replacement rate in 2050 based on different assumptions regarding the evolution of mortality (OECD, 2012a). For Finland, starting from 65, the pension age is assumed to increase by 0.7 year in the high-mortality scenario, 2.3 years in the median-mortality scenario and up to 3.8 years in the low-mortality one, to almost 69 years (Table 1.2).

The retirement age should be indexed to longevity

As regards the life expectancy coefficient, there is no mechanism in place to ensure that people will compensate for the decrease in benefits by working longer. The life expectancy coefficient has only been in use for a few years and so far the associated adjustment has been small, hence its impact on retirement behaviour remains hard to quantify (Finnish Centre for Pensions, 2013). In half of OECD countries, the official

Table 1.2. **Pension ages needed to equalise benefits in 2010 and 2050 under different mortality scenarios**

Man on average earnings, selected countries

	Current normal pension age	Pension age delivering equal replacement rate in 2050		
		Low mortality	Median mortality	High mortality
Chile	65	68.8	66.2	65.7
Estonia	63	64.2	63.7	63.3
Finland	**65**[1]	**68.8**	**67.3**	**65.7**
Italy	65	69.1	67.3	65.8
Mexico	65	68.7	66.2	65.7
Norway	67	70.9	69.6	67.7
Poland	65	68.7	67.7	65.7
Portugal	65	67.3	66.4	65.4
Slovak Republic	62	63.6	63.1	62.4
Sweden	65	68.8	67.4	65.7

1. National and guarantee pension can be accessed at 65. The earnings-related pension age is 63 to 68.
Source: OECD Pensions Outlook, 2012.

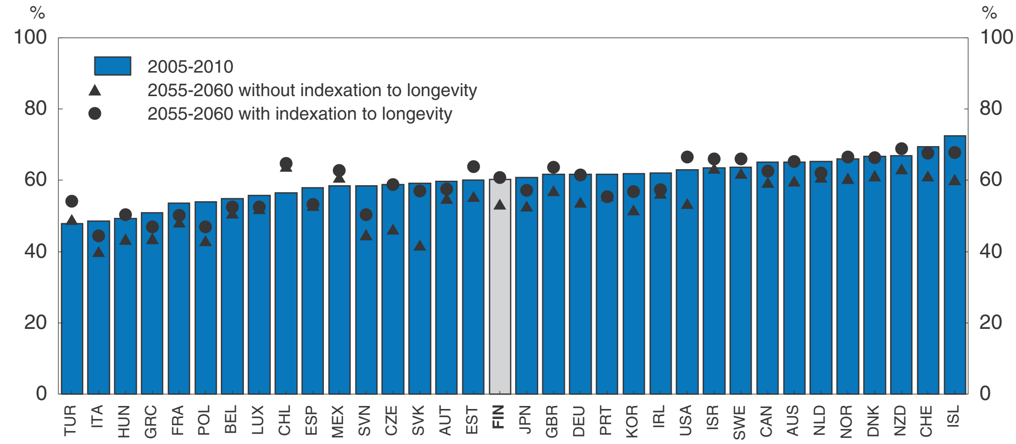
retirement age for men is 65 (14 countries for women). Eight countries have an official age of 67 for men (seven for women). Finland allows people to retire on an old-age pension between 63 and 68 and currently experiences a sharp peak in retirements at age 63. The minimum retirement age should be indexed to life expectancy to increase the effective retirement age. This recommendation is in line with the European Commission prescription. It will be more or less equivalent to raising the retirement age to 67 as in other EU (except France) and Nordic (except Sweden) countries by 2030, but automatic indexation will allow increasing the retirement age more smoothly. The upper retirement age limit should also be increased or abolished.

An alternative to indexing the retirement age only to life expectancy is to jointly adjust the retirement age and the level of pensions according to life expectancy gains. Adjusting these parameters has different consequences. While raising the minimum old-age retirement age forces people to work longer, adjusting the levels of benefits leads to lower pensions as benefits fall because people live longer. Indeed, benefits could decline by 15-20% for those drawing their pension in 2050 compared to 2010 (OECD, 2012a). The ensuing potential fiscal gains may be offset by additional expenditure on safety-net benefits.

Even though around half of OECD countries plan to increase their retirement age by 2030, only a few have linked the pension age to life expectancy. Denmark has indexed the retirement age to life expectancy after an initial increase to 67. From 2015, a five-year review of life expectancy will be carried out and the retirement age will be increased accordingly, but only after approval from the Danish Parliament. Greece and Italy have recently introduced reforms which allow indexation of the retirement age to life expectancy. France has introduced a kind of automatic adjustment, as the system aims at maintaining the ratio between the duration of activity and the expected duration of retirement constant.

Indexing the retirement age to life expectancy would boost labour force participation to the extent it raises the effective retirement age. In the context of the OECD long-term growth project, labour force participation projections were computed under unchanged policies as well as under the assumption of an indexation of the retirement age to longevity (Johansson et al., 2013). Under the second scenario, projected labour force participation is calculated so that "active life" remains constant as a share of life expectancy (Figure 1.9).

Figure 1.9. **Indexing the retirement age to life expectancy could stabilise labour force participation**[1]



1. People aged 15 and over.
Source: Johansson et al. (2013).

StatLink http://dx.doi.org/10.1787/888932991622

For all OECD countries, indexing the age of retirement to longevity implies a higher overall participation rate in 2060 but the size of the gap between the two scenarios differs across countries. In Finland, starting from around 60%, the overall labour force participation rate is projected to decline to around 53% in 2060 in the first scenario, whereas it is projected to stay constant in the second one. This is one of the widest gaps between the two scenarios in OECD countries and the largest among the Nordic countries. Indexation to life expectancy is therefore called for as soon as possible in Finland.

The modalities of indexation of the pension age, notably the ratio between the length of retirement and active life, should be decided by the government and the social partners. Although there are several ways to link the pension age to life expectancy, keeping active life constant as a share of life expectancy is the most widely accepted. Increasing the retirement age one for one with life expectancy gains would be a viable alternative only if each extra year in life expectancy translated into an additional year in good health.

However, life expectancy differs across occupational groups. Myrskylä et al. (2013) show that men's (women's) life expectancy in Finland at age 50 in 2007 was 31.5 (35.8) years for upper-level non-manual workers, while it was only 26.6 (32.9) years for manual workers. Moreover, since 1989, life expectancy has increased by 4 (3.4) years for men (women) upper-level non-manual workers, while it has only increased by 3.4 (2.9) for manual men (women). These trends are also observed in other countries. In the United Kingdom, men's life expectancy at age 65 is 2.6 years higher for the "Managerial and Professional" category than for "Routine and Manual" workers. This may need to be borne in mind during the negotiations on the modalities of indexation.

Nevertheless, policies should primarily focus on reducing health status disparities. Smaller reductions in mortality from cardiovascular diseases and – to a lesser extent – alcohol-related diseases, accidents and suicides in lower socio-economic groups have driven up inequalities. These trends are shared by other European countries but health inequalities seem to be particularly high in Finland, in contrast with income and education inequalities, which are among the lowest in the OECD (OECD, 2010 and 2012b). Efforts to reduce health inequalities have produced insufficient results so far. Prevention of risky behaviour and promotion of healthy lifestyles are part of broadly defined health policies. The merger of municipalities and the concomitant reform of the health system should also help reduce socio-economic health disparities (Chapter 2) and, as a consequence, reduce differences in future life expectancy.

The pathways to early retirement should be reduced or abolished

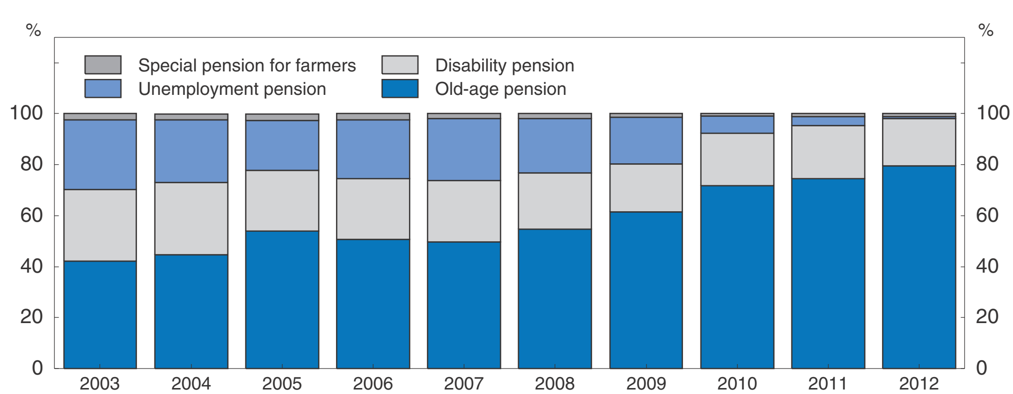
Since the 2005 reform, progress has been achieved in reducing early retirement. The unemployment pension has been abolished (Figure 1.10), but older people are still entitled to an extension of the period during which they receive the unemployment allowance. Under the Unemployment Security Act, a person who has turned 61 and has received an unemployment allowance for less than 500 days is entitled to the unemployment allowance until the start of the pension or until the age of 65. This arrangement is much less generous than the one in place before the 2005 reform, which allowed a person on the average wage to retire at 55 with an initial replacement rate of about 60% (OECD, 2006b). Even so, this entitlement to unemployment benefits, the so-called "unemployment tunnel", still encourages older workers to give up active job search.

This scheme and part-time pensions, which are heavily subsidised, are impediments to longer working lives. Part-time pensions can be granted if an individual transfers from full-time work to part-time work and doesn't receive any other pension based on his work history. According to a report from the Prime Minister's Office (2011), raising the minimum retirement age by two years and abolishing the unemployment tunnel and part-time pensions would imply an increase in the effective retirement age of 8.4 months in 2025. Assessing a similar reform, Määttänen (2013) finds an increase of 10 months. On the other hand, if the retirement age is raised without abolishing the pathways to early retirement, working lives are not lengthened, as people use these pathways instead of working longer. This suggests that both the unemployment tunnel and part-time pensions should be abolished.

Access to disability benefits offers another pathway to early retirement. Since the 2005 reform, while the individual early retirement pension has been abolished, there is a possibility to get a disability pension under less strict criteria from the age of 60. While the share of claim rejections has increased and the share of new retirees being granted a disability pension has

Figure 1.10. **New retirees aged 50 and above by type of pension**

As a share of total pensions, excluding part-time pensions



Source: Finnish Centre for Pensions.

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decreased by nearly 10 percentage points, still more than 20% of new retirees leave the labour force on a disability pension. In terms of expenditure, the share of disability pensions in total pensions fell from more than 18% in 2003 to about 13% in 2011. Access to disability pensions should be based on medical reasons only. Shifting the initial medical evaluation away from patients' physicians towards insurance teams would help achieve greater consistency and increase focus on medical conditions (Braconier, 2010).

Lengthening working life could also be achieved at the beginning of the career

Finnish students tend to enter the labour market relatively late. Indeed, the transition from school to work is one of the longest among Nordic countries. In Finland, around 16% of youth aged 20-24 are neither in education or training nor in employment, as against 14% in Sweden, 12% in Denmark and 9% in Norway. As regards the 25-29 year-olds, this share is even higher, amounting to nearly 17%. Reducing delays in graduation and shortening the transition period from school to work would allow people to contribute longer to the pension system (OECD, 2010). The Government has announced measures such as shortening the period during which students are eligible to receive financial support from September 2014, a reformed selection process for higher education and a reform of the home-care allowance (Government of Finland, 2013). Revising public sector hiring requirements, so that a Bachelor's degree would be sufficient for certain positions, would also allow some youth to enter the labour market earlier. Moreover, measures should be taken to reduce the youth unemployment rate (see below). Incentives should also be enhanced to encourage young inactive people to enter the labour market.

Other means to adjust the Finnish pensions system are not optimal

Another way to adjust the pension system would be by increasing the income of pension funds, *via* higher contribution rates. But contributions in Finland are already high by international standards and the wedge between the labour costs borne by the employer and the corresponding net take-home pay of the employee is high, reducing employment incentives (see below). Alternatively past earnings could be revalued in the calculation of future benefits. In most OECD countries, past earnings are raised in line with economy-wide wage growth for the purpose of benefit calculation. In Finland, the system indexes a worker's past earnings for 20% to prices and 80% to earnings, which is generally less costly. A further move towards a less generous revaluation procedure may jeopardise the adequacy of the system, by lowering benefit levels excessively. Finally the pension system can be improved by adjusting the growth of benefits received by current pensioners. They are now indexed for 20% to wages and 80% to prices, while, before the 2005 reform, the weights were 50% for both wages and prices. This evolution is in line with other OECD countries which have reformed their system towards less generosity in order to reduce costs. Moreover, these weights are appropriate to avoid an erratic response to inflation and, while sharing risks between workers and pensioners, expose the latter to less risk than the former (Barr, 2012).

The Finnish government has already started negotiations with the social partners about further reforms to be implemented in 2017. A target is to raise the effective retirement age to 62.4 by 2025, but the means to reach this goal have not been specified. According to the latest long-term projections, under current rules, the effective retirement age is expected to reach 61.5 in 2015. In March 2012, the social partners agreed on two immediate amendments: an increase in the minimum part-time retirement age to 61 and to raise the age limit for eligibility to extended unemployment benefits from 60 to 61 for persons born in 1957 or later.

The health system also needs to adapt to cope with ageing

Even though the Finnish health care system offers good quality treatment at a fairly moderate cost, its efficiency could be improved, in particular by reducing fragmentation and improving coordination, and strengthening incentives to achieve a better balance between primary and specialised care. Narrowing regional differences in the efficiency and quality of care should also be a priority (see the special chapter on health care in the 2012 *OECD Economic Survey of Finland* and the Annex in the Assessment and recommendations of this *Survey*). Information and communication technologies are powerful tools to improve the efficiency and quality of health care. Finland is one of the leading countries in the development of e-health, along with Denmark, and considerable progress has been made in standardising data over recent years, resulting in particular in the creation of lifelong electronic patient records for all Finnish patients. Such an information system has huge potential in terms of enhancing the integration of health and social care, improving care pathways and managing chronic diseases, which remains to be fully exploited (Ministry of Social Affairs and Health, 2013b). Municipal mergers and the associated reorganisation of health care services will help achieve significant efficiency gains (Chapter 2). Enhancing the efficiency of the health system will help cope with the burden of ageing and will improve equity in access to health care. This should improve the health status of many individuals, raising labour supply as those in good health are more productive, less often on sick leave and enjoy better opportunities to build up human capital. The chances that they retire early are reduced, and as older people remain in good health for longer it reduces the burden of care on their relatives, who are more likely to take up a job.

Long-term care should be provided in the most cost-effective way. The ongoing shift from institutional care towards service housing should lower costs and improve the quality of life of old people. The Ministry of Social Affairs and Health estimates that lowering further the number of over 75-year olds in long-term institutional care would reduce municipal health care costs by around EUR 300 million per year by 2017 (0.15% of GDP). Helping people to stay as autonomous as possible will contribute to maintaining or even improving the level of well-being elderly Finns enjoy today (Box 1.3).

Box 1.3. **Older Finns' well-being exceeds that of the overall population in many respects**

As shown in the Assessment and Recommendations, Finland performs well in international comparison in all dimensions of well-being. Nonetheless, life satisfaction has slightly declined between 1981-84 and 2005-08 (World Values Survey, Gallup World Poll). During the same period, self-assessed health has worsened, while it has improved in the OECD as a whole (OECD, 2012b). These results relate to the Finnish population as a whole. In the context of an ageing society, it is useful to look at age-specific results. Recent literature argues there is evidence that well-being is U-shaped through the life cycle (Blanchflower and Oswald, 2007).

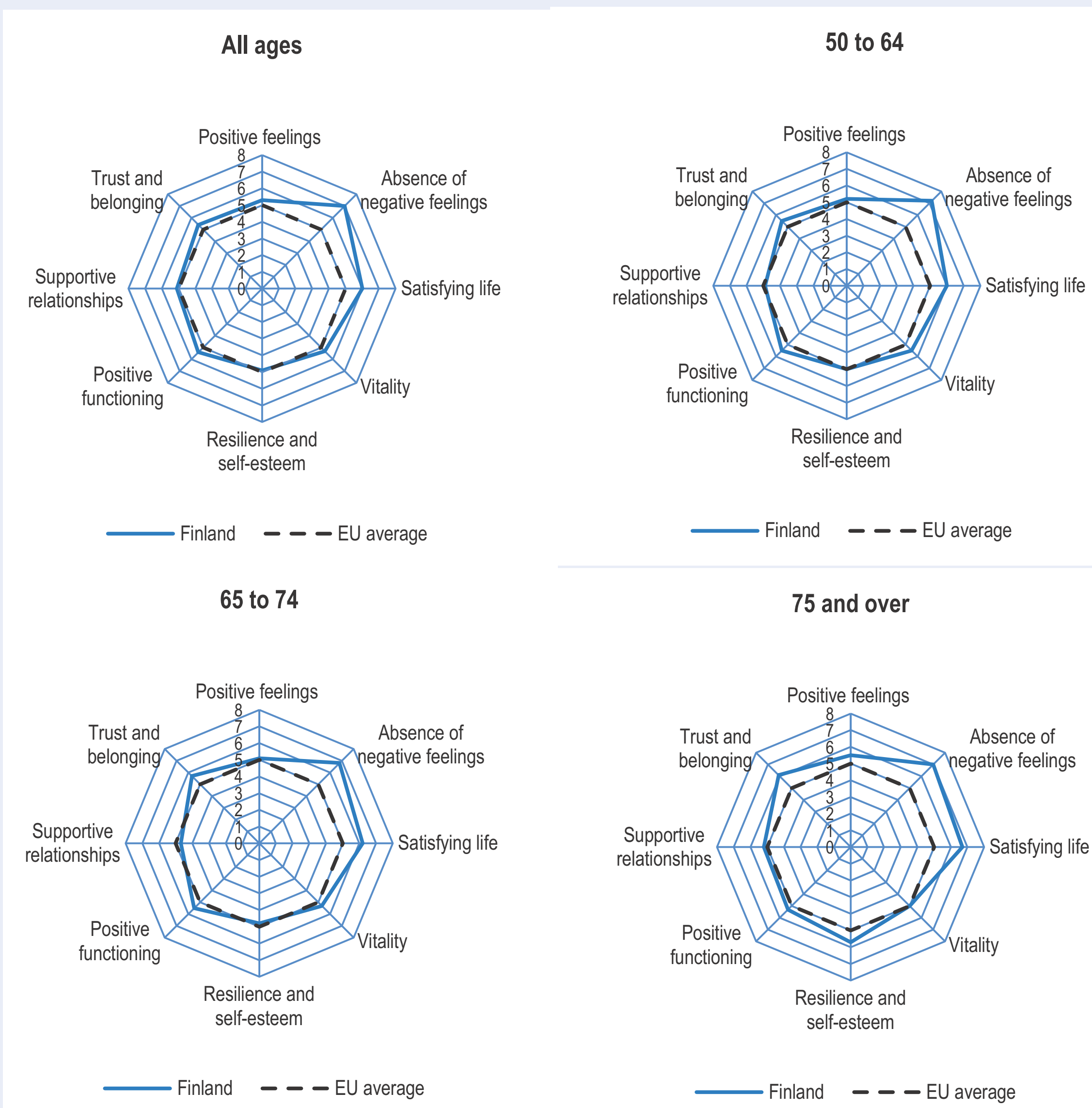
The well-being of older people in Finland compares favourably to EU countries, according to a recent study that provides a broad view of the well-being of older people (HelpAge International, 2013). In addition, the New Economics Foundation (NEF) computes some age-specific well-being indicators, which can be classified into personal and social. The former include positive feelings; absence of negative feelings; satisfying life; vitality, resilience and self-esteem; and positive functioning. The latter comprise supportive relationships; and trust and belonging.

Box 1.3. **Older Finns' well-being exceeds that of the overall population in many respects** *(cont.)*

According to the NEF survey, for the population as a whole, Finland performs slightly better for the personal indicator (ranking 5th out of 23 EU countries) than for the social one (9th out of 23). Finland scores close to the EU average for almost all components of well-being, and substantially above average for absence of negative feelings and satisfying life. This profile broadly applies to all ages. Interestingly, people aged 75 and over perform relatively better on satisfying life, resilience and self-esteem, and trust and belonging than the average of the population and the EU average (Figure 1.11).

Figure 1.11. **Well-being profile for different age groups**[1]

2007



1. Indicators are normalised to range between 10 (best) and 0.

Source: The New Economics Foundation, *National Accounts of Well-being*.

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Measures should be implemented to help older workers stay at work or be hired

The strong skills of Finnish workers highlighted in the PIAAC survey should ease the transition to longer working lives (OECD, 2013b). Nonetheless, lengthening working lives cannot be achieved without reforming some parts of the labour market. Indeed, even if there are some financial incentives to work longer (e.g. an increased accrual rate after 63), they may not be sufficient to keep people at work. Older workers face a range of work disincentives and barriers to employment which need to be removed. Employers are often reluctant to hire or retain them. Moreover, older workers are frequently discouraged from staying in work owing to poor working conditions.

In 2004, the OECD published a survey that took stock of employment policies implemented to address ageing (OECD, 2004). Recommendations were provided to enhance the employability of older workers. They covered three main areas: strengthening financial incentives to continue working, tackling employment barriers on the side of employers and improving the employability of older workers. A follow-up of this survey for Finland published in mid-2012 assesses progress in these areas since 2004 (Table 1.3). This shows that further improvement is needed in many areas.

Table 1.3. **Ageing and employment policies in Finland**

OECD's recommendations to Finland in 2004	Action taken by mid-2012
A. Strengthening financial incentives to carry on working	
Review the proposal to extend the duration of unemployment benefits	+
Tighten job search requirements for receiving unemployment benefits	+
Review the proposed easing of eligibility rules for receiving disability benefits	/
Abolish the subsidy of part-time pensions	+
B. Tackling employment barriers on the side of employers	
Remove the age-related component of social security contributions and review the system of experience-rating	+
Continue to promote age management training and information campaigns	++
Review the implementation of anti-age discrimination legislation	+
C. Improving the employability of older workers	
Encourage upgrading of education levels and participation in lifelong learning	+
Arrange for working time to leave room for training	+
Establish quantitative goals for future government programmes	/

Notes:
/ = no (relevant) action has been taken; + = some action has been taken, but more could be done; ++ = substantial action has been taken.
Source: OECD (2004), Ageing and Employment Policies: Finland and answers to the follow-up questionnaire from Finland, (*www.oecd.org/els/emp/Older%20Workers%20Finland-MOD.pdf*).

Reducing financial incentives to retire

Reducing relatively high implicit taxes on continued work would encourage older people to continue working. If working an additional year yields increases the present value of the future stream of pension payments less than foregone pensions and contributions paid during that year, there is an implicit marginal tax on continued work (Duval, 2003). Implicit taxes on continued work are still higher in Finland than in other Nordic countries, contributing to low employment rates among older workers. Moreover, in contrast to the other Nordic countries, these implicit taxes have increased since 2007 (OECD, 2013d). During the window of retirement, namely between the age of 63 and 67, the implicit tax on further work increases (Braconier, 2010) (Figure 1.12).

Figure 1.12. **Implicit tax on further work**[1]

1. Implicit gross tax on working one additional year for an individual at 60%, 100% and 140% of the average wage instead of taking out an old-age pension.

Source: Braconier (2010).

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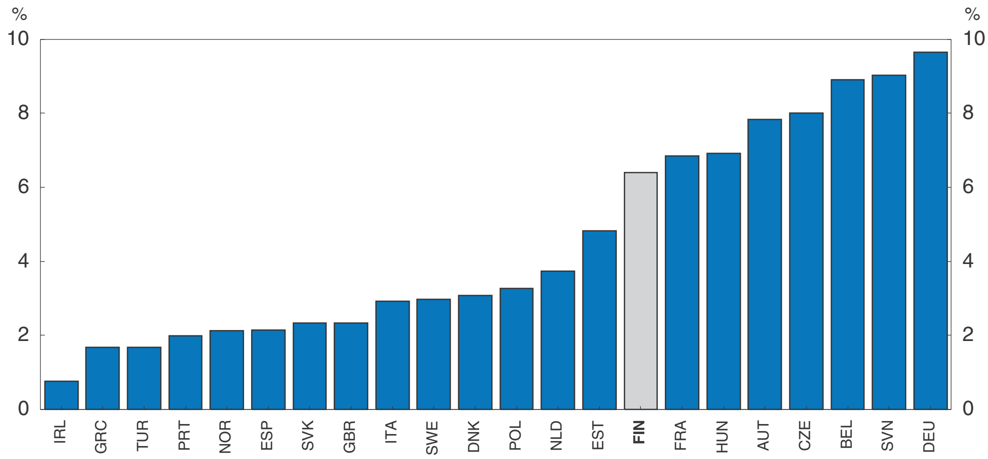
Encouraging the hiring of older workers

Increasing older workers' employment rate depends as much on employer as on employee behaviour. In almost all OECD countries, surveys suggest (at least perceived) age discrimination on the part of employers. Around two thirds of Finns believe that negative perceptions by employers towards older people are an important factor for stopping work – around 10 percentage points above other Nordic countries. Around 60% believe that a job applicant aged over 55 is at a disadvantage. Around 7% of workers older than 55 have faced age discrimination in the workplace, more than in other Nordic countries (Figure 1.13). Older workers are perceived as having low technological skills and lacking openness to new ideas. However, they are generally seen as more reliable and productive, and as better decision-makers and problem-solvers than their younger counterparts (European Commission, 2012b).

In addition to anti-discrimination legislation based on international human rights agreements, Finland has put in place programmes to help employers manage the "greying" of their labour force: The Veto Programme (2003-07) implemented by the Ministry of Social Affairs and Health (MSAH), the Finnish Workplace Development Programme *TYKES* (2004-09), the Finnish Development Strategy of Working Life (2012) and a Forum for Well-being at Work (2008-11) put in place by the MSAH and which is being developed further in 2011-15 under a new strategy, *Socially Sustainable Finland 2020*. These programmes aim at promoting age management to extend and improve working lives. Even if some progress has been accomplished regarding age discrimination, the implementation of the legislation still needs to be monitored.

Strict employment protection legislation (EPL) has two opposite impacts on hiring and firing older workers. On the one hand, it may help to keep people at work because it increases the cost of dismissals. On the other hand, it raises the cost of hiring and as a consequence may reduce the number of recruitments. Even if the net impact is not clear, some surveys have found that strict EPL tends to depress hiring and retention rates of older workers (Daniel and Siebert, 2004 and OECD, 2006).

Figure 1.13. **Age discrimination at work**[1]



1. Percentage of workers over 55 years old who report having been subject to age discrimination at work.
Source: European Working Conditions Survey, 2010.

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The employability of workers should also be enhanced through lifelong training. As a result of the ongoing evolution of technology and the continuing shift from manufacturing to services, job requirements are evolving rapidly. This means that workers increasingly need to acquire new skills and upgrade existing ones, for which access to lifelong training is crucial. This would help workers adapt to new tasks and technology and can help them shift from arduous jobs to less exacting work after a certain age.

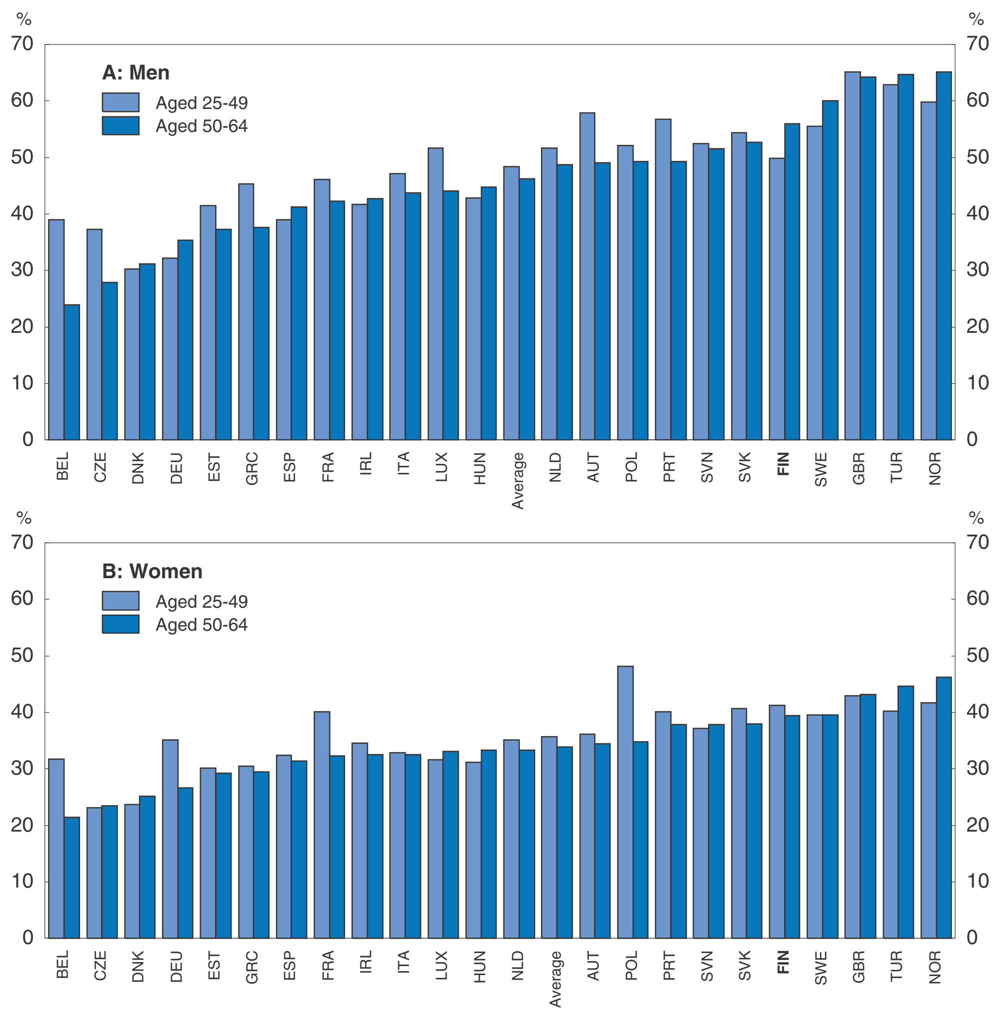
According to PIAAC, more than 1.7 million Finnish adults participate in adult education each year and a growing number participate in further vocational education and apprenticeship training (Ministry of Education and Culture, 2010). Moreover, for each level of literacy proficiency, the proportion of adults participating in training is higher in Finland than in the average of countries for which data are available. Nonetheless, as in other countries, adults with low literacy levels participate less than those with higher levels. Thus, efforts are needed to develop training for people with lower literacy levels, who are often also those who have not completed upper secondary education. Conflict with the work schedule is cited as the main obstacle to participation in training by 17% of the respondents aged 55 to 64 in the EU Adult Education Survey, somewhat more than in other Nordic countries (11% in Sweden and Norway) (Eurostat, 2011). Accordingly, training during working hours should be promoted.

In 2003-09, the *Noste* Programme was implemented to raise the level of education among adult and older workers. Among the working age population, around 7.3% of people were involved regularly in vocational education and training and 5.6% obtained some qualification. The objective of 10% involvement was not attained and it is therefore important that such a programme can continue to be active in order to help keep older people at work. Apart from the *Noste* Programme, education and training of the unemployed have also been enhanced by supporting self-motivated training from 2010 onwards. The reform combines different categories of financial support to the unemployed during education and training, allowing them to choose more freely the sort of training they wish to attend (OECD, 2012d).

Lowering barriers from employee's side

Improving the financial incentives to stay at work is not enough to keep people in the workforce. Their working conditions (e.g. working time, workplaces) should also be adapted. Indeed, poor working conditions may lead people to retire as soon as they reach the minimum pension age. According to the European Working Conditions Survey 2010, more than 55% of Finnish men aged 50-64 are exposed to unpleasant working conditions, 10 percentage points above the (unweighted) average of countries for which data are available. The share is around 40% for women of the same age, slightly below average (Figure 1.14). Even if such surveys give only a partial view of overall working conditions, they nevertheless stress the importance of improving the working environment of older workers.

Figure 1.14. **Unpleasant working conditions by age and gender**[1]



1. Workers were classified as experiencing unpleasant working conditions if they reported that for between around half to all of the time they were exposed in their main job to at least one of the following: vibrations from hand tools or machinery; noise so loud that you would have to raise your voice to talk to people; high temperatures which make you perspire even when not working; low temperatures whether indoors or outdoors; breathing in smoke, fumes, power or dust; breathing in vapours such as solvents and thinners; handling or being in skin contact with chemical products or substances; tobacco smoke from other people; handling or being in direct contact with materials which can be infectious.

Source: European Working Conditions Survey, 2010.

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In the same survey, between 25 and 30% of people aged 50-64 considered that their work affects their health. In particular, mental health at work is an increasing problem in most OECD countries. In Finland, mental disorders and particularly depression, have accounted for an increasing share of disability pensions since the mid-1990s and are now the leading cause of disability benefit claims. The number of people retiring due to depression almost doubled after the mid-1990s, in part reflecting changes in the living, working and psychosocial environment. However, during the past four years, depression-related work disability has been declining, mainly thanks to cooperation between different actors and the dissemination of best practices (Honkonen et al., 2012). Nevertheless, the economic cost of depression-related disability remains high (OECD, 2014).

The government, recognising the overlap between mental illness and incapacity for work, has run the Masto project (2007-11) to prevent depression and depression-related work disability by tackling mental health problems at an early stage (OECD, 2014). The main themes included in the project were the promotion of well-being at work, various activities to prevent depression, early recognition and treatment, and the rehabilitation and return to work of people recovering from depression. The Masto project also included a nationwide tour that helped to reach managers and occupational safety and health personnel and provided information on the manifestation of depression and its impact on working lives.

More generally, lifelong health prevention can improve employability. It is widely available to the working population and especially people aged 45 and over. Through the so-called "age bus stop" in the occupational health centres in some municipalities, a full medical screening is provided free of charge. This allows the early recognition of diseases that are not conspicuous due to obvious symptoms. While such services used to be available only to employees, some projects started to provide occupational health services to the unemployed in order to maintain their employability and lower the cost of bringing them back into employment (von Werder and Thum, 2013).

Flexibility in the workplace would facilitate labour market attachment. Around a third of workers aged over 50 would prefer working fewer hours, in line with the EU average. The incidence of part-time work among people aged 55-64 is slightly lower than the OECD average. For men it is 4 percentage points higher than the OECD average, while for women it is 10 percentage points lower. Even if Finland registers the highest proportion of companies providing flexible-time arrangements in the European Union, such arrangements still seem insufficient for older people.

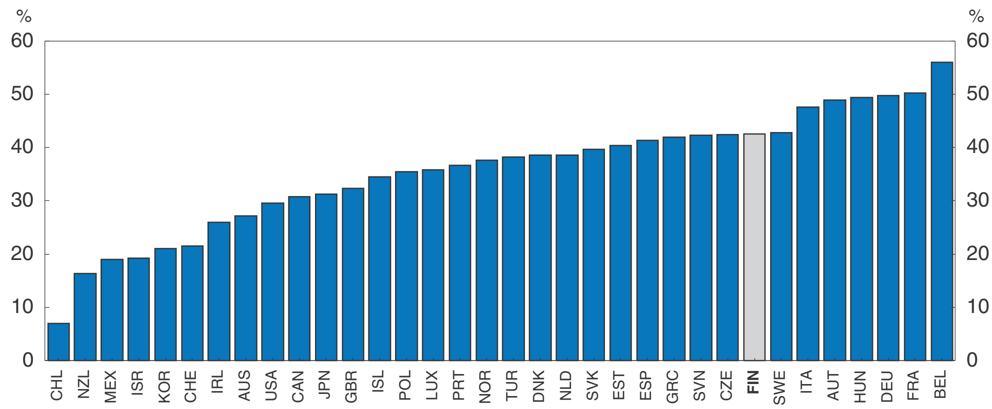
Increasing labour force participation among other groups

A high tax wedge on labour hinders labour participation

Labour force utilisation should also be enhanced for other segments of the labour market and overall disincentives reduced. The Finnish tax wedge is high by OECD standards, higher than in Denmark and Norway and around the same level as in Sweden (Figure 1.15). The labour tax wedge should be reduced and the efficiency of the tax structure improved. The revenue loss due to lowering labour taxation could be offset with higher indirect taxes.

Figure 1.15. **Tax wedge in 2012**[1]

As a percentage of labour costs



1. Single individual without children at the income level of the average worker.

Source: OECD, *Taxing Wages 2013*.

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Youth, childbearing age women and long-term unemployed participation rates should be enhanced

Active labour market policies should be strengthened as insufficient activation of unemployed workers and high unemployment benefits are holding back employment. As from 2013, youth and recent graduates under the age of 30 unemployed for more than three months are guaranteed a tailored response from the employment offices. The responsibility of employment services is being shifted to municipalities after 12 months of unemployment, with individual follow-up and monitoring, in some pilots. Active labour market policies should continue to adjust so that activation takes place earlier and replacement rates should be reduced and tapered off throughout the unemployment spell (OECD, 2010).

Labour force participation of women in childbearing age should be encouraged as its low level has negative consequences on career prospects and pay. The Finnish family policy model provides ample support to parents with young children through paid parental-leave, home care leave and subsidised pre-school until children go to primary school at age seven. This has contributed to a female employment rate of 67.5% in 2011, well above the OECD average of 56.5%. However, at 20% the gender pay gap is above the 16% OECD average (OECD, 2012e). The OECD Gender Initiative showed that periods of leave beyond two years reduce female employment and increase the gender pay gap, and the recent proposal to split the home care leave between the two parents evenly should therefore contribute to increase the employment rate of childbearing age women.

Long-term unemployment should also be tackled in order to increase the overall employment rate. In contrast with the OECD average and the other Nordic countries, Finnish long-term unemployment has decreased in the past decade. Nonetheless at more than 20% of total unemployment in 2012 for people aged 15 and above, it is still higher than in Norway and Sweden. This is true especially for prime-age and older workers. Higher levels of qualification facilitate integration into the labour market and increase the productivity of workers. The government plans to increase the compulsory school leaving age from 16 to 17. This should improve the employability of youth and thereby reduce the duration of unemployment spells, provided education programmes fit student and labour market requirements. Furthermore, the Government has announced measures to reduce structural unemployment, such as strengthening employment services, developing a new electronic monitoring system for employment plans, bringing in earlier activation, tightening job-search requirements, enhancing work incentives through adjustments to the welfare system and making vocational training more flexible (Government of Finland, 2013).

More accommodative immigration policies would help cope with labour market shortages

Besides the lifting of residents' labour force participation, immigration could provide additional resources. While net immigration has increased recently, it is still relatively low by international standards especially compared with the other Nordic countries. Moreover, the share of foreign-born workers in recruitment has been low since 2008. This leaves room to encourage immigration for employment reasons and to implement more accommodative policies.

Finland has already launched several programmes to promote immigration and enhance integration, notably the *Future of Migration 2020 Strategy*. This comprehensive programme aims at anticipating the volume and nature of immigration required by Finland, and its impact on Finnish society. It has a number of key objectives: managing the labour market; ensuring equal rights for all employees; improving employment opportunities for people from an immigrant background; pursuing a more successful integration policy; a faster processing of asylum applications; and fighting discrimination. The preparation, co-ordinated by the Ministry of the Interior, involves a wide range of stakeholders, including municipalities, labour market organisations, the church and immigrant groups. Integration is also included in the *Future of Migration 2020 Strategy* which aims, among other things, at making integration policies more effective, increasing immigrants' employment rates and intensifying anti-discrimination efforts. Furthermore, a specific Integration Act entered into force in Finland in September 2011 followed by the adoption, in June 2012, of the Government Integration Programme for 2012-15. All these programmes should enhance the participation of migrants in the Finnish economy. Immigration policies should also avoid discouraging foreign students from staying to work in Finland.

While, as seen above, ageing will create pressure on the supply side of the labour market, it will also create new expectations on the demand side. Indeed, with the growing number of older people in the population, the demand for carers will increase. There are several ways to tackle shortages in the social care sector, particularly for long-term care (e.g. by recruiting LTC workers from underrepresented or inactive populations, for instance retired elderly people, unemployed populations, volunteers, or groups traditionally underrepresented in the LTC workforce such as men) (Fujisawa and Colombo, 2009). Finland is one of the countries reporting LTC workforce shortages alongside Spain, Austria, Canada and Italy. Current immigration policies should adapt to better respond to the growing demand for LTC labour.

Ageing also creates new opportunities

Ageing should not be seen only as a burden, as it can also create new opportunities. Innovation for an ageing society offers the prospect of new market opportunities and new growth industries (OECD, 2012c). As mentioned above, Finland has experienced an increase in the prevalence of dementia as the very old population increased. Such trends will require innovation to help the elderly stay as healthy, autonomous and active as possible. Indeed it will be important to harness the potential of information and communications technologies to develop new products and services to enhance the elderly's autonomy and keep them active in social, economic and cultural life. Technology already helps slow down the evolution of dependency. It participates in the prevention of pathologies by providing drugs or vaccines and in the restoration of physiological status after a health shock (e.g. prostheses and implants).

Moreover, information and communication technologies can facilitate social communication (via phone, internet, etc.), improve safety and make the home environment easier to manage. Since the 1990s, the proportion of older people in institutional care has declined steadily, in favour of service housing (OECD, 2012b). Technology is essential in this evolution, which can generate well-being gains for the elderly and substantial savings, as institutional care is very expensive. Finnish firms have developed tele-care devices, which connect people in need of care to social services. For example, an intelligent watch sends an alarm if it detects a significant fall in its user's activity. Home tele-health allows remote monitoring of health parameters, such as blood glucose levels. Smart homes include many systems which enable independent life for older people (European Commission, 2010). Finland is marketing these services abroad and developing them further in international cooperation. For example, the Sendai-Finland Wellbeing Center is a joint venture promoted by Japanese and Finnish public institutions, which combines care and research and development (Fujita and Hill, 2011). It brings Finnish LTC organisation and technology to Japan. Furthermore, it is at the heart of a health, well-being and LTC cluster, where private companies and universities from both countries are involved in developing innovative technologies to improve the well-being of an ageing population. Such cooperation offers great opportunities for Finnish companies to expand in a high-growth market.

Recommendations on pension, health and labour market reforms

Key recommendations

- Increase the minimum pension age gradually and link the pension age and benefits, in combination, to life expectancy.
- End part-time pensions and the extended period of eligibility to unemployment benefits for older people. Access to disability pensions should be based on medical reasons only.
- Continue to promote lifelong training to help people stay in work as they age.
- Strengthen active labour market policies to improve the labour force participation of youth, women of childbearing age and the long-term unemployed.

Further recommendations

- Reduce fragmentation of health services and improve coordination and incentives to achieve a better balance between primary and specialised care (for more details, see the special chapter on health care in the 2012 *OECD Economic Survey of Finland*).
- Age discrimination should continue to be tackled, notably via information campaigns.

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Chapter 2

Local public finances and municipal reform

Finnish municipalities enjoy ample fiscal autonomy and provide or arrange the provision of a large share of public services. In recent years, their spending and debt has been increasing steadily, especially because of population ageing and increases in the cost of health care and social services. Furthermore, small municipalities are often struggling to align service provision with national standards. The government has launched a reform to create more efficient municipalities through voluntary mergers. Both international experience and costs per capita across Finnish municipalities suggest an optimal size for municipalities of over 20 000 inhabitants, at least outside remote areas. As mergers are to be voluntary, the outcome of the reform remains uncertain. If merger plans prove insufficient to achieve efficient public service provision, the government could impose mergers on smaller municipalities, especially around the main urban areas. Responsibilities of smaller municipalities could be scaled back in all functions where economies of scale and scope can be achieved. Policies also need to be flexible enough to allow restructuring of services after mergers. Partnerships between public or private entities to provide services could be developed further in some areas. Finally, the tax structure and fiscal rules should be enhanced to ensure long-term fiscal sustainability.

Finland has relatively strong public finances and is one of the few euro area countries which did not breach the Maastricht deficit ceiling of 3% of GDP in recent years, despite fiscal stimulus in 2009-10. Sound fiscal policy allows funding quality public services. Education is consistently ranked among the best in the OECD, the health care system offers universal coverage for a wide range of high quality services, and the country enjoys good infrastructures and an extensive social safety net.

As the level of taxation is one of the highest in the OECD, the scope for increasing tax revenue is limited. While central government spending has been held in check in recent years, spending by municipalities has risen considerably. This reflects to some extent the nature of municipal spending, half of which relates to health care and social services, where demand is strong and costs are difficult to control. Municipalities are small on average, their responsibilities are vast and the possibilities for economies of scale and scope are limited. Furthermore, as population ageing pushes up demand for services and internal migration towards cities erodes the tax base of rural municipalities and reduces labour resources, small municipalities are increasingly struggling to deliver high-quality services at affordable cost.

The government has launched a number of reforms that have important implications for the functioning and financing of the local government sector (Box 2.1). Municipal councils have an obligation to provide merger proposals by July 2014. Consolidation could be imposed at a later stage in some areas if the government considers municipal mergers plans as insufficient. Initial reactions suggest that the number of mergers may not be sufficient to create the robust municipalities the government was hoping for. If so, mergers could be imposed on municipalities failing to reach critical size, as was done in Denmark. Alternatively, adjusting the tasks devolved to smaller municipalities to better align them with financial and organisational capacities could be considered, even though the provision of major services often has already been widely outsourced. Enlarging municipal and other joint service providers could be of greater benefit. A step in the latter direction has in fact been taken with the working group of civil servants established by the Ministry of Social Affairs and Health, which sets minimum inhabitant numbers for municipalities to retain control over health care and social service provision. New ways of delivering public services, including enhanced cooperation between municipalities and commissioning of services from external providers could also reconcile small size with efficient provision of high-quality services.

While insufficient scale is an obstacle to efficient provision of services in some areas, size in itself does not guarantee efficiency. Past municipal mergers in Finland seem to have resulted in limited productivity gains and international evidence on the efficiency impact of mergers is mixed. It is therefore necessary to ensure that the merged municipalities take advantage of potential productivity gains through reorganisation. There are, however, some trade-offs between efficiency gains and political economy issues. In particular, the commitment to protect municipal jobs during five years after mergers may be necessary to

Box 2.1. **Ongoing reforms affecting local government**

The government is pushing forward a number of reforms that will impact the local government sector. This box provides an overview of the most important ones.

Voluntary mergers

Finland has a long history of voluntary mergers, which already reduced the number of municipalities from 560 in 1945 to 416 in 2005. In that year, the government launched a project to restructure local government and services with a view to reinforce the capacity of municipalities to deliver services, through mergers and enhanced cooperation. Since then, significant municipal consolidation has taken place, reducing the number of municipalities to 320, and inter-municipal cooperation for providing services has increased. Nevertheless, only modest results in terms of improvement in service provision seem to have been achieved (Moisio et al., 2010; Kröger, 2011). The government elected in 2011 launched a more ambitious reform to restructure municipalities and services, building on economically robust municipalities, which would enable improvements in administrative structures, productivity and effectiveness (Prime Minister's Office, 2011). Municipalities will submit mergers plans by July 2014, but it is unlikely that the number of mergers proposed will match initial expectations.

Plan to impose mergers around the main urban areas

As the government estimates benefits of mergers to be highest around main regional centres, it plans to propose a bill to parliament, which would allow forcing municipalities in about 10 urban areas to merge with the relevant regional centre.

Metropolitan council of Helsinki

The government aims at improving cooperation in the Helsinki metropolitan area to enhance services, land use, transport and communications networks, and business opportunities (Prime Minister's Office, 2011). The current plan aims at establishing an elected metropolitan council with fairly strong decision-making powers.

Social and health care reform

Plans are being devised to reduce fragmentation, improve user choice and further promote prevention. A working group set up by the Ministry of Social Affairs and Health proposes a minimum of 20 000 inhabitants for municipalities to retain control over primary health care and of 50 000 to organise specialised care.

Steering system for local government

A new steering system for local government finances will be put in place, with the aim of ensuring that in the future municipalities' responsibilities match the available funding. If municipalities are given new responsibilities, either existing ones are to be cut or more funding is to be provided.

Fiscal rules for municipalities

Fiscal rules will be tightened. Municipalities are currently required to balance their budget over a four-year period. However, enforcement rules are not very stringent, as correction may be spread out over several years. Going forward, such postponement of consolidation will no longer be allowed. This could lead to more municipal mergers through the compulsory adjustment procedure.

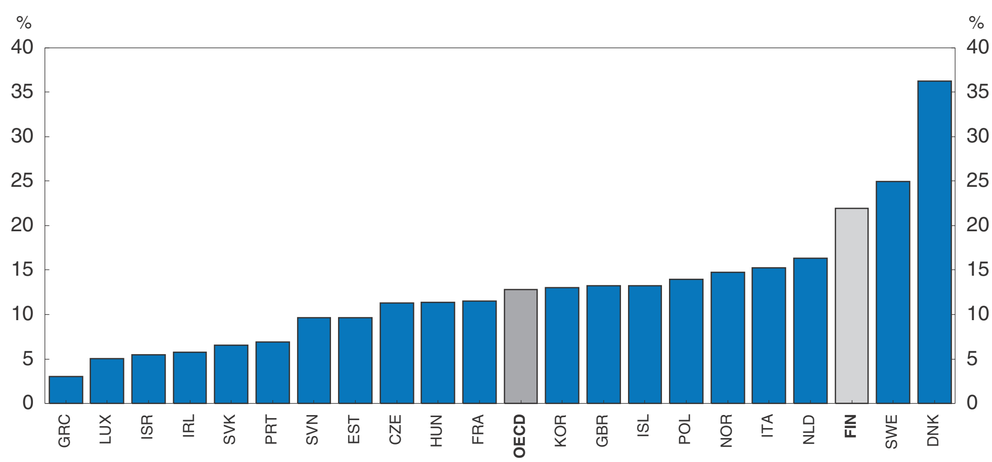
ensure support for mergers, but could delay the necessary restructuring of services. Transition costs also need to be taken into account to ensure a smooth adjustment process.

This chapter is organised as follows: the first section briefly describes the organisation of the Finnish government sector; the second documents developments in municipal finances since the mid-1990s and looks at challenges to ensuring equal access to public services across the country; the third examines how the fiscal framework could be strengthened; and the final section assesses the difficulties and opportunities offered by municipal mergers in the light of international experience.

Finland is one of the most decentralised OECD countries

Self-government is a core value, enshrined in the Constitution of Finland and translates into a high degree of decentralisation. The latter is evidenced by the large share of local government in public spending (Figure 2.1). This is an imperfect indicator of the autonomy of local governments, however, as national mandates and constraints on local authorities vary widely across countries. Nevertheless, institutional indicators of decentralisation constructed by the OECD for the two main areas of public service provision, education and health care, confirm the high degree of local autonomy in Finland.

Figure 2.1. **Local government expenditure is high as a share of GDP**[1]



1. In 2011. Includes unitary countries only. Data for the OECD refer to an unweighted average.
Source: OECD Fiscal Decentralisation database.

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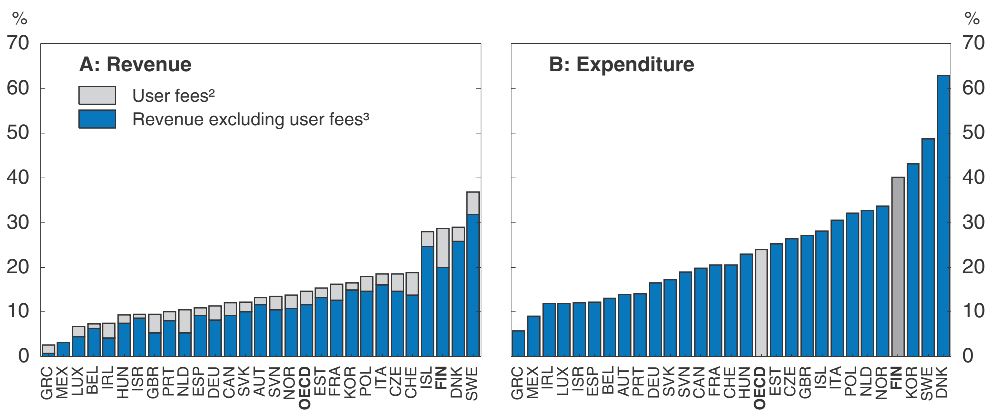
The share of local government in public revenue and spending is high

Nordic countries – except Norway – stand out for having by far the largest share of government revenue collected by local authorities in the OECD. As Finland is a unitary country, the focus is on local government, rather than sub-national government, which also includes intermediate levels, especially in federal states (e.g. states or provinces). The local government share of revenue exceeds a third in Sweden and is close to 30% in Denmark, Finland and Iceland (Figure 2.2, panel A). The OECD average is less than 15% and the first non-Nordic country in the ranking, Switzerland, has a share of less than 20%. Moreover, Finnish local authorities receive a substantial amount of user fees, representing more than 8% of general government revenue and more than a fourth of local government income. The high share of user fees in OECD comparison partly reflects the wide range of services provided by Finnish municipalities. The largest part of user fees relates to utility charges and public transport, with modest fees charged on public health care, while basic education is free (Moisio et al., 2010). User fees provide both revenue and incentives to use resources efficiently, even though these advantages have to be balanced against equity in access to services.

The share of local authorities is even higher in government spending than in revenue in Nordic countries (Figure 2.2, panel B). The share of local authorities in public spending exceeds 60% in Denmark and is close to 50% in Sweden. It is about 40% in Finland and 30% in Iceland and Norway. The OECD average is about 24% and Korea is the only non-Nordic unitary country with a share of local expenditure close to that of Finland.

Figure 2.2. **Local government revenue and spending in 2011**[1]

As a share of total public revenue and spending



1. Data for Canada, Korea and Mexico refer to 2010. Data for the OECD refer to an unweighted average.
2. Individual payments to public service providers, including collective and private co-payments through insurance schemes, in return for services provided.
3. Excludes grants and subsidies.

Source: OECD Fiscal Decentralisation Database.

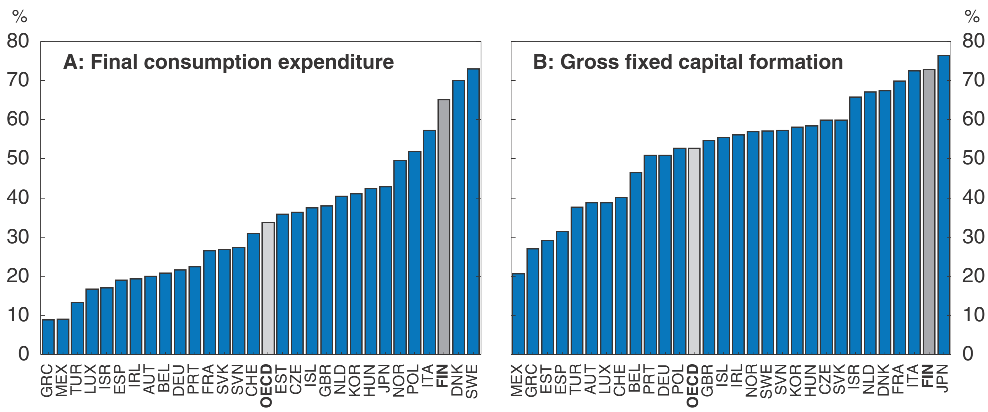
StatLink http://dx.doi.org/10.1787/888932991983

The share of local authorities in public final consumption, which reflects more closely the supply of public services, is even higher than their share in overall revenue or spending. About two thirds of public final consumption in Finland takes place at the local level. This is similar to other Nordic countries. Sweden and Denmark are the only two OECD countries where the local share of public consumption is higher than in Finland (Figure 2.3, panel A).

Local authorities also account for over 70% of public investment, the second highest share in OECD unitary countries after Japan (Figure 2.3, panel B). Although the high share of local authorities in public investment in Nordic countries stands out less prominently than for consumption, more than half of public investment is undertaken by local authorities in all Nordics. Finnish municipalities are major investors in education, social services, health care, infrastructure and energy projects. Whereas in many countries fiscal consolidation has led to deep cuts in sub-national public investment, Finnish municipalities have so far been able to sustain high levels of investment (OECD, forthcoming).

Figure 2.3. **Local government consumption and investment**[1]

As a share of total public consumption and investment



1. In 2011. Data for the OECD refer to an unweighted average.

Source: OECD General Government Accounts.

StatLink http://dx.doi.org/10.1787/888932992002

Education and health care are highly decentralised

The sub-national share of government expenditure is often used as a measure of sub-national authorities' spending power, but could be misleading where local government spending decisions are strongly influenced by upper-level government regulation (Blöchliger, 2013). Indicators reflecting institutional arrangements may provide a more accurate picture of sub-national autonomy than spending shares, although they are inevitably more subjective. While no overall institutional indicator is currently available for the whole government sector, some have been constructed by the OECD for primary and secondary education and health care. The institutional indicators are based on the level of decision-making for the main functions in the sector and the consistency of responsibility assignment across levels of government (for details, see Gonand et al., 2007 on education and Paris et al., 2010 on health). Both for education and health care, the degree of decentralisation in Finland is among the highest in the OECD (Figure 2.4). These indicators may even underestimate the responsibilities of the Finnish municipalities relative to other countries, as in some of the latter many tasks are decentralised at state or regional rather than local level. Education is highly decentralised in all Nordic countries, though slightly less so in Norway than others. Regarding health care, Finland is more decentralised than other Nordics. Furthermore, most health care responsibilities in Denmark, Norway and Sweden are devolved to regions or counties rather than municipalities.

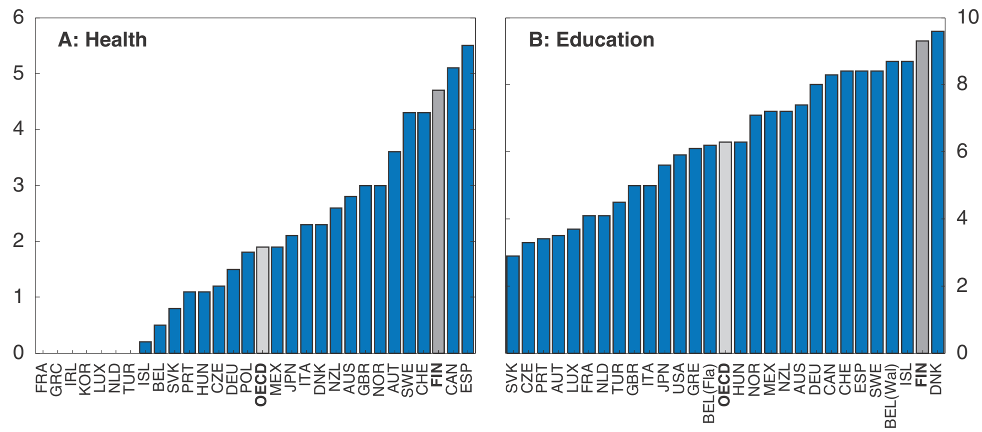
Municipalities have wide responsibilities

The Finnish government sector is essentially organised around only two tiers, central and municipal (Box 2.2). In the absence of a regional level of government, as exists in different forms in other Nordic countries, a wide range of responsibilities is devolved to the 320 municipalities,* notably in the areas of education, health and social services and local infrastructure. In particular, municipalities are responsible for providing their residents with:

- Comprehensive and upper secondary schooling, vocational education and training and other education and cultural services.

* Of which 16 in the autonomous region of Åland that is not involved in the municipal reform plans.

Figure 2.4. **Decentralisation in health and education**[1]



1. Index scale, with a higher value indicating higher decentralisation. A "0" score implies that most key decisions are taken at the central government level. Data for the OECD refer to an unweighted average.

Source: OECD *Survey on Health Systems Characteristics 2008-2009*; Sutherland, D. and R. Price (2007), *OECD Economics Department Working Paper*, No. 558.

StatLink http://dx.doi.org/10.1787/888932992021

- Preventive, basic and specialised health care, dental care and healthy living environment promotion.
- Social services for old and disabled people and childcare.
- Town and land-use planning, water and energy supply, waste management, infrastructure maintenance, environmental protection and fire and rescue services.

Municipal responsibilities have been extended over the years. The government has now identified a wide range of local government tasks and obligations that could be reduced, which would save about 0.5% of GDP. They relate in particular to emergency services, medical archives, education, elderly care and transport (Government of Finland, 2013).

Box 2.2. **The role of the municipal sector in Finland**

Finnish government is organised around only two elected tiers, central and municipal, in contrast with other Nordic countries, which have intermediate levels, such as regions or counties. This structure results in the devolution of a large number of tasks to municipalities. This box outlines the organisation of public administration in Finland, with a focus on the role of municipalities.

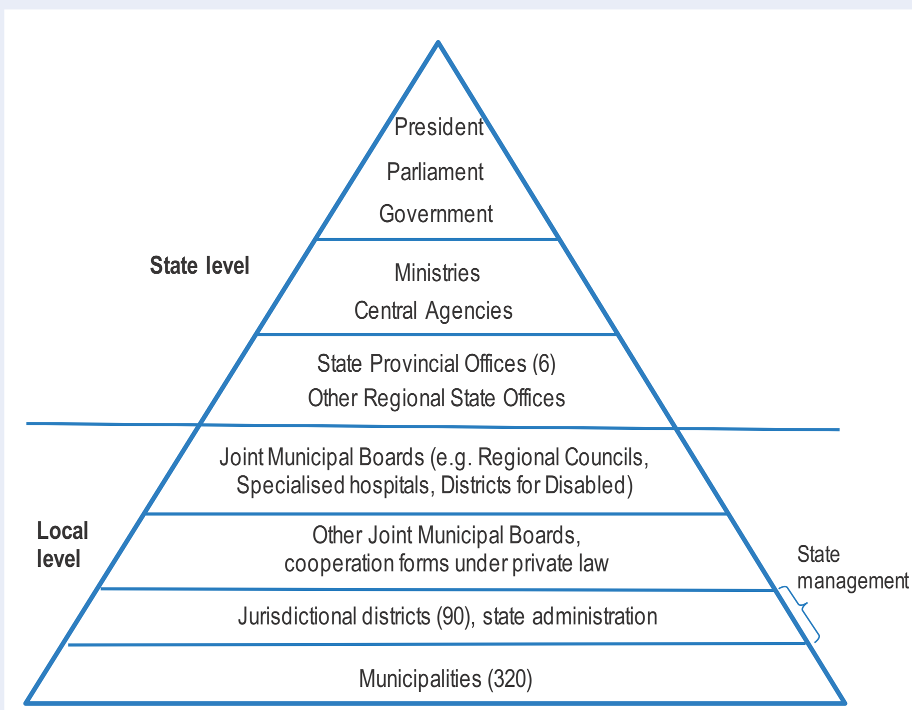
Municipal institutions include municipalities, but also joint municipal boards (Figure 2.5). Joint municipal boards administer joint authorities set up by municipalities to perform specific tasks on a permanent basis. There are currently 184 joint authorities, most of them dealing with health care and education. Joint authorities have no taxing power and are managed by municipality representatives and financed by the member municipalities, mostly based on the use of services by their residents. Joint structures can operate on a local basis – e.g. health care centres – or on a regional scale – e.g. specialised and University hospitals. Joint authorities are mostly created voluntarily by municipalities, but membership is compulsory for specialised (and University) hospital districts, joint authorities for social welfare of the disabled and regional councils, which are assemblies of municipal representatives responsible for regional development, planning and management of structural funds. All municipalities also own companies providing services (for example water, energy or housing, waste management), separately or jointly.

Box 2.2. **The role of the municipal sector in Finland** *(cont.)*

Local state administration includes jurisdictional districts for general and specialised administrative tasks, including police and registry. Local state administration also includes employment service centres and tax offices and courts.

Central government comprises government and ministries, but also a wide range of central offices and agencies, which provide in particular expertise, policy guidance and supervision. At the regional level, the central government is represented by regional state administration. It has been reorganised in 2010, with the creation of new administrative bodies. Regional State Administrative Agencies (AVIs) are responsible for steering and supervising implementation of national policies regarding basic rights and legal protection, access to basic public services, environmental protection and sustainability, public safety and occupational safety and health. Centres for Economic Development, Transport and the Environment (ELY) are in charge of creating the preconditions for promoting trade and industry, well-functioning and safe traffic, a good living environment and sustainable development. There are also other regional offices, for example for defence or tax administration.

Figure 2.5. **Public administration in Finland**

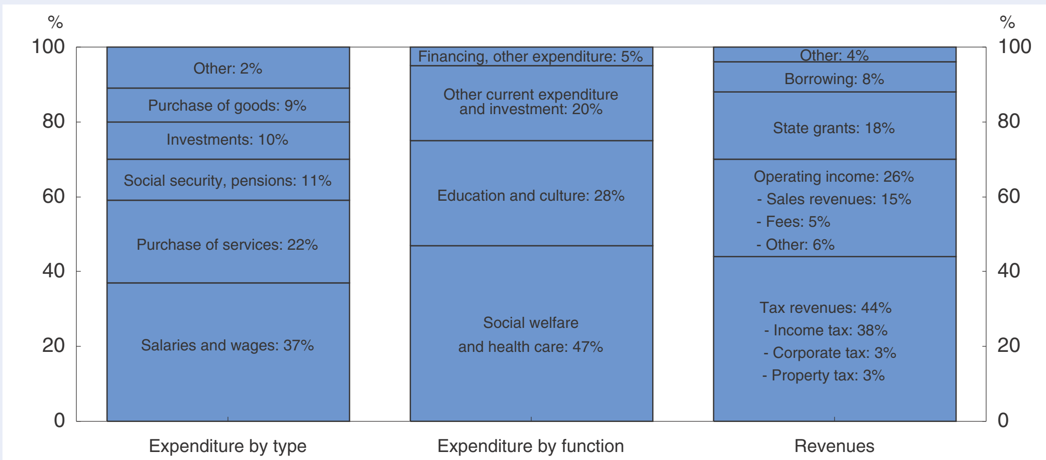


Source: Ministry of Finance.

The municipal sector accounts for about two-thirds of public consumption and more than a fifth of the total number of employees in the country. Its main sources of revenue are taxes, state grants and sales of goods and services. The main spending items are compensation of employees, purchases of goods and services and investments. About half of total expenditure relates to social welfare and health care and a fourth to education (Figure 2.6).

Box 2.2. **The role of the municipal sector in Finland** *(cont.)*

Figure 2.6. **Municipal sector expenditures and revenues**[1]



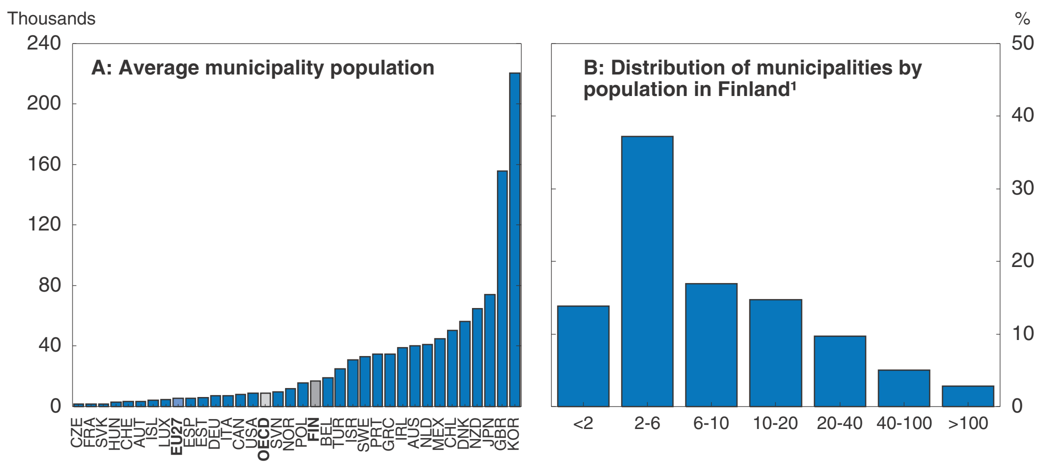
1. Estimate for 2013.
Source: Finnish Local and Regional Authorities (Kuntaliitto).

While many of these duties are generally municipal responsibilities across OECD countries, the most complex ones are usually assigned to higher levels of government. This is especially the case for specialised health care, where administration at the municipal level is unusual. There are both advantages and drawbacks to decentralisation. On the one hand, decentralised systems are likely to better respond to local needs and preferences, as local authorities are more directly accountable to local residents than are higher levels of government. Competition between municipalities to attract mobile individuals and firms creates incentives for providing an attractive mix of tax and services. Local administration may also show greater flexibility and allows a wider range of innovation and experimentation than more centralised management. Blöchliger et al. (2013) find that across OECD countries decentralisation, as measured by revenue or spending shares, is positively associated with GDP per capita levels, educational outcomes as measured by international student assessments (PISA) and a higher share of physical and especially human capital investment in general government spending. On the other hand, decentralisation can generate inequalities in the quality of public services provided in different jurisdictions and excessive fragmentation in the delivery of services, likely to generate coordination problems and diseconomies of scale and scope. This is especially the case when a wide range of responsibilities is devolved to small entities, which may lack both expertise to organise, plan or purchase complex services efficiently and bargaining power in negotiations with providers of outsourced services. Externalities may arise when public goods and services are used by residents outside municipal boundaries. Local authorities may also face conflicts of interest, when they are producers of services employing large numbers of local staff.

Municipalities tend to be small relative to the extent of their responsibilities

Finland's 320 municipalities have an average population of about 17 000, which is not especially small compared to other continental Europe countries. Most Southern and Eastern Europe countries, Austria, France and Germany have on average smaller municipalities than Finland (Figure 2.7, panel A). But these countries also devolve fewer tasks to municipalities (Fox and Gurley, 2006).

Figure 2.7. **Municipality population in 2012**



1. In thousands of inhabitants. Data for the OECD refer to an unweighted average.

Source: OECD *Key Figures on Subnational Governments in OECD countries – 2012 data* (2013); Statistics Finland and OECD calculations.

StatLink http://dx.doi.org/10.1787/888932992040

Municipalities play a greater role in Nordic countries, and more so in Finland in the absence of powerful regional institutions. Compared to other Nordic countries, Finnish municipalities are significantly larger than in Iceland and Norway, but much smaller than in Denmark and Sweden. Before the 2007 reform, the average population of Danish municipalities was already around 20 000 and it now well exceeds 50 000. The last significant phase of municipal consolidation in Sweden ended in the mid-1970s, by which time the average population was close to 30 000. The nationwide average hides large differences across Finnish municipalities, whose size ranges from a few hundred to about 600 000 inhabitants. The median size is around 6 000. Nearly 40% of municipalities have between 2 000 and 6 000 inhabitants. Only 16% have a population over 20 000 (Figure 2.7, panel B).

Municipal cooperation to provide some services jointly is well developed in Finland. For example, some small municipalities share a health centre (there were 162 health centres for 336 municipalities in 2011). Specialised health care is handled by hospital districts, which are managed and financed by joint municipal boards (federations of municipalities). While health care accounts for three-quarters of total joint-authority expenditure, municipal cooperation is also important in other areas, including education, waste management and water supply. Cooperation takes different forms, allowing flexible responses to local needs. Examples include joint authorities set up by municipalities to perform specific tasks on a permanent basis (e.g. hospital districts, health centres, districts for vocational education); the "host municipality model", where a municipality manages some functions for a group of municipalities; and contractual cooperation, frequent in utility services and education. Municipal cooperation solves many scale and externality problems and is generally working quite well in Finland. Nevertheless, enhancing cooperation is unlikely to be sufficient to meet the challenges associated with population ageing and eroding tax bases in many municipalities (Moisio et al., 2010). Cooperation also seems associated with a lack of transparency and accountability in decision making, which progressively shifts from elected representatives to professionals (Moisio, 2012).

Transfers from central government to municipalities are used to ensure, as far as possible, equity in access to social services, health care and education, as well as in taxation across the country. The Finnish cost and revenue equalisation scheme is one of the largest in the OECD as a share of government expenditure and GDP (Blöchliger et al., 2007). Since 1993, municipalities receive non-earmarked block grants, leaving them ample autonomy in spending decisions, even if limited by national standards and regulations. The transfer amounts are set to meet estimated population needs and equalise revenue. The weight of cost factors in the determination of transfers is about 90%, which contrasts with Sweden and Denmark, where revenue equalisation is dominant (Blöchliger et al., 2007). This may make the Finnish system more difficult to administer and theoretically more prone to manipulation although there is no evidence to that effect (Moisio et al., 2010). Population needs are estimated using a range of criteria for each type of spending. Some criteria aim at compensating for higher service costs due to the size, age structure, density of population and isolation of a municipality. Some apply to several service sectors. Others are specific to one sector, for example morbidity in health and unemployment in social services. Additional grants go to the bilingual municipalities, the archipelago area and Sami regions. All grants are now administered by the Ministry of Finance, except for those related to upper secondary schooling and vocational education.

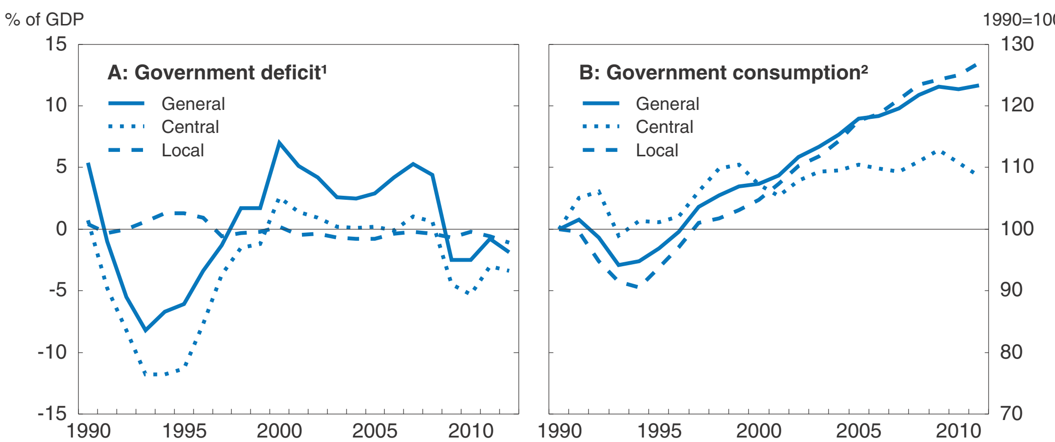
An equalisation system redistributes tax revenue, via state transfers across Finnish municipalities, according to their tax-raising potential. The potential tax revenue is computed by applying the country average tax rates to the municipal tax bases. Municipalities with a potential tax revenue per capita below 91.86% of the national average receive the difference in the form of added transfers from the state. The municipalities with a potential tax revenue above that threshold see their calculated state transfers reduced by 37% of the tax revenue in excess of the threshold. Currently 61 of the 304 municipalities outside the autonomous region of Åland are above the threshold. While municipalities below the threshold would not benefit from an increase in tax revenue, which would be offset by lower grants, those above the threshold retain 63% of any additional revenue collection. Such asymmetry may reduce incentives for weaker municipalities to develop their activity and tax base, leading to widening regional differences (Blöchliger and Pinero Campos, 2011).

Local finances are deteriorating and public services becoming increasingly uneven

The aggregate local government deficit and debt are rising

Central government currently accounts for the largest part of the general government deficit, as its revenue and spending are most sensitive to the business cycle. Nevertheless the contribution of local government is also significant (Figure 2.8, panel A). Moreover, the local contribution is of a more structural nature. While a strong economic recovery would reduce the central government deficit significantly, the impact on municipalities would be much more limited, especially as ageing and other factors are likely to continue pushing up health care and social expenses (see Chapter 1). Local government consumption has outpaced that of central government since the early 2000s (Figure 2.8, panel B). Despite increases in tax revenues and central government transfers over the period, the local government sector has run a deficit of ½ per cent of GDP on average. The deficit has increased significantly since 2010. According to the Ministry of Finance, the deficit is expected to remain around 1% of GDP in the coming years, as a result of cuts in central government grants and continued pressure on spending.

Figure 2.8. **Trends in government finances**



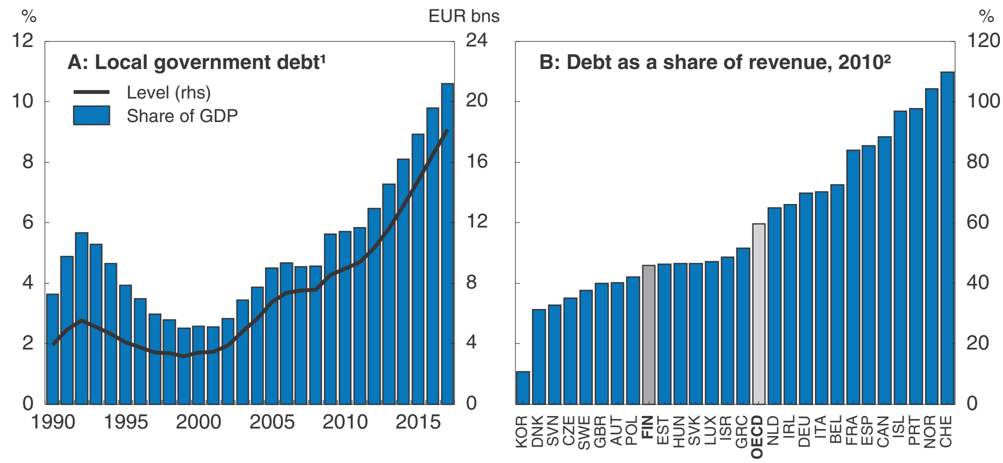
1. Data for 2011 and 2012 are preliminary.
2. In real terms.
Source: Statistics Finland.

StatLink http://dx.doi.org/10.1787/888932992059

Deteriorating fiscal positions are pushing municipalities to raise local taxes or to increase borrowing. About a third of municipalities have hiked their local income tax rate in 2013. While there may be some scope to increase local taxes further, especially the least distortive ones on property, the overall level of taxation in Finland is already high by OECD standards, suggesting that tackling deficits mainly by raising taxes may become increasingly difficult. In addition, higher tax increases in municipalities operating in a challenging environment than in more prosperous ones may further widen regional economic differences. Hence, maintaining high-quality public services will require structural reforms.

Local government debt has increased steadily since the beginning of the 2000s, from less than 3% of GDP in 2000 to about 7% in 2013. According to Ministry of Finance projections, it will reach nearly 11% by 2017 (Figure 2.9, panel A). This remains relatively modest, both in relation to central government debt and in international perspective. Local government debt accounts for a fairly modest share of local revenue (Figure 2.9, panel B). Nevertheless, the rapid growth in debt calls for caution over medium to long-term sustainability, even if part of the projected increases is related to cuts in central government grants. As debt rises, municipalities are becoming more vulnerable to

Figure 2.9. **Local government debt**



1. Maastricht definition. Data for 2012 are preliminary, and from 2013 are projections. The series in levels is adjusted using the GDP deflator.
2. Data for the OECD refer to an unweighted average.

Source: Statistics Finland and OECD fiscal decentralisation database.

StatLink http://dx.doi.org/10.1787/888932992078

increases in interest rates from currently exceptionally low levels. Furthermore, inability to control increases in sub-national debt can trigger adverse reactions from financial markets and raise the cost of borrowing, both for municipalities and central government.

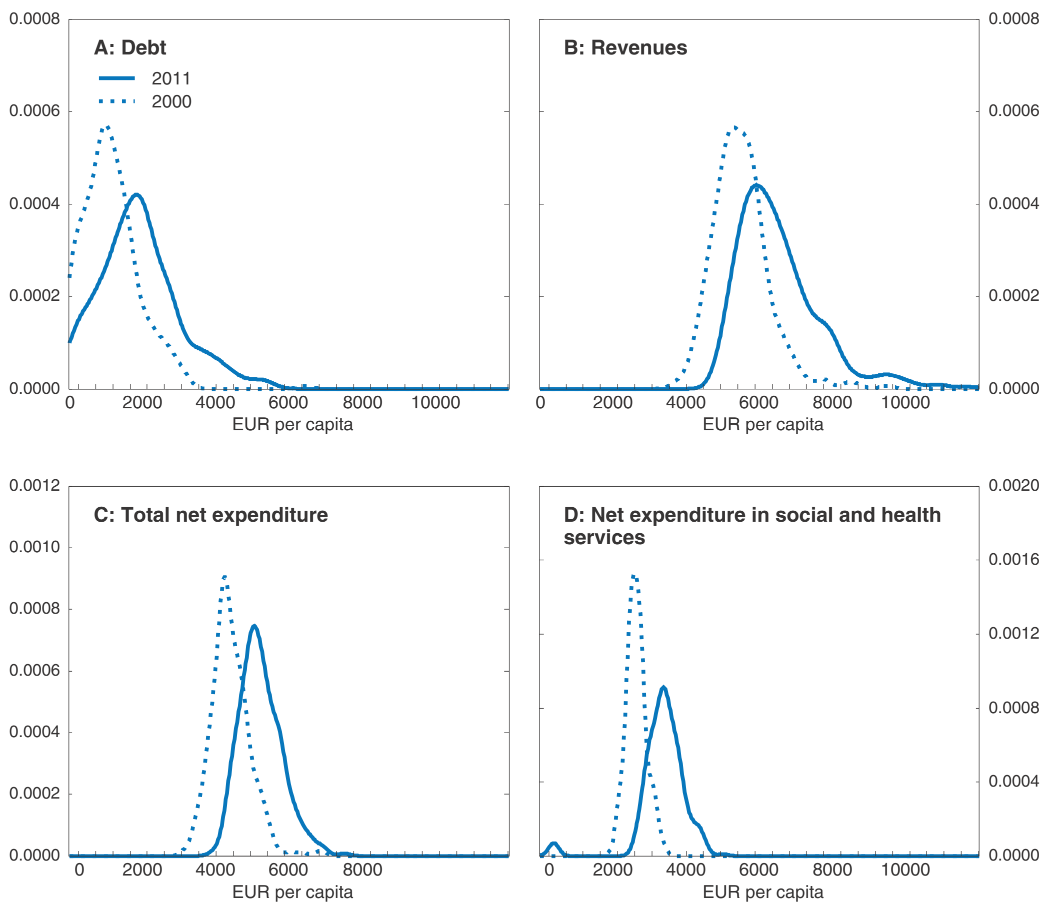
Differences in the financial situation of municipalities are widening

Aggregated local government data hide divergent fiscal fortunes across municipalities, reflecting both diversity in population needs and operating environment and differences in efficiency (Moisio, 2002). The distribution of municipal debt has widened over the past decade, even before the global economic and financial crisis (Figure 2.10, panel A). Differences in revenue per capita across municipalities have increased (Figure 2.10, panel B). Some municipalities suffered large drops in revenue, notably as a result of falls in corporate profits and plant closures eroding tax revenue (Box 2.3). Differences in net expenditure per capita of municipalities have also increased markedly, especially for health care and social services (Figure 2.10, panel C and D). Municipal expenditure per capita in remote areas is higher than elsewhere, as in other countries with low density areas (Kitchen and Slack, 2006). Average expenditure in the 20% of municipalities with the lowest population density is 17% above the average in the remaining 80%.

A large share of municipal debt (currently about 80%) is financed through Municipal Finance (MuniFin), a fully publicly-owned provider of financial services to local governments. MuniFin debt is guaranteed by the Municipal Guarantee Board, which includes most Finnish municipalities. It enjoys a triple-A rating and has benefitted from Finland's safe haven status in recent years. A potential drawback of the joint liability of municipalities and the associated low credit risk is a lack of discrimination between borrowers. However, this is not specific to Finland, as market discipline on sub-national public authorities is almost absent outside the United States and Canada (Moisio, 2012). MuniFin has conservative risk management policies, in particular allowing no foreign currency risk and restricting the use of derivatives to hedging, which proved wise in the recent financial turmoil.

Figure 2.10. **Local government finances**[1]

Distribution of municipalities[2]



1. Deflated by the government consumption price index.
2. Kernel density.

Source: OECD database on sub-national finances (Directorate for Public Governance and Territorial Development), and OECD calculations.

StatLink http://dx.doi.org/10.1787/888932992097

Some municipalities have been relying increasingly on central government transfers, with the distribution of transfers from central government to municipalities widening significantly. Cuts in central government grants by more than 10% at the 2015 horizon will put further pressure on municipalities to rein in spending or raise taxes. Over the medium to long term, ensuring the sustainability of municipal finances while preserving the quality of public services will inevitably require efficiency gains. Municipal consolidation and reorganisation of public services should play a major role in generating such gains.

Ensuring equal access to services across the country is challenging

In addition to the wide variation in the cost of providing public services across municipalities, there is increasing concern that some municipalities are struggling to provide adequate services. While providing public services is mainly a municipal

Box 2.3. **The municipality of Salo: adjusting to the closure of the Nokia plant**

Salo is a city of about 55 000 inhabitants in south-west Finland. The current municipality is the result of the merger on 1 January 2009 of the core of Salo with nine surrounding municipalities. Salo used to house a key Nokia mobile phone production site, which employed more than 5 000 workers at its peak, but manufacturing stopped in 2012. Nokia retained a research unit in Salo, with about 1 200 workers, which is now being taken over by Microsoft. The fall in Nokia's profits caused a sharp drop in the municipality's corporate tax revenue, which fell from nearly EUR 60 million in 2010 (about 28% of total tax revenue) to less than EUR 9 million in 2012. Downsizing at Nokia and eventually the plant's closure resulted in a sharp rise in the unemployment rate, which jumped from less than 6% in mid-2008 to more than 14% in early 2013. The municipality of Salo, with support from the State, is actively implementing strategies to deal with this challenging situation.

The 2009 merger has improved Salo's ability to deal with the current situation, as one large municipality is more flexible to reorganise in response to shocks than ten smaller ones with numerous cooperation agreements, and a bigger municipality has greater influence at the provincial and national level. As usual following mergers, operating expenses rose sharply in 2010, reflecting in particular harmonisation of salaries to the highest levels, but decelerated in 2011 and 2012, before falling slightly in 2013. While the merger improves resource allocation, duplication still remains, especially because employment protection for five years following the merger delayed reorganisation. The expiry of the employment guarantee in early 2014 will facilitate the reshuffling of municipal services. This will require care to preserve the quality of essential public services. In addition, support will be needed to help employees made redundant to find new jobs (e.g. job-search assistance, training).

The Ministry of Employment and the Economy granted Salo the status of "rapid structural change area" from September 2009 to end-2013. The status gives access to financing, including European Union funds, for interventions in various fields, including labour market programmes and support for entrepreneurship. However, to be effective, support will need to go beyond 2013. The Municipality of Salo is cooperating with Nokia and the government to help laid-off workers find new jobs, in particular through job-search assistance, education and training and support for start-ups. Actions are taken to maintain working ability and prevent social exclusion. Reemployment of laid-off workers is challenging, as many are production workers, for which there is less demand than for white-collar employees. A wide range of measures similar to those taken in Salo to support laid-off workers seem to have facilitated reemployment after the closure of a plant of the manufacturer of electronics and telecommunication equipment Perlos in North Karelia in 2007, although better labour market conditions than now were also helpful (Jolkkonen et al., 2012).

The Salo Business Service Center, owned by the City of Salo, offers business services to small and medium enterprises (SMEs), support for international expansion and advice for start-ups. It also promotes the city as a place to invest, benefitting from a skilled workforce, excellent logistic connections and a business-friendly environment. While overcoming the impact of the closure of the Nokia plant will take time, an extensive network of SMEs holds promises for Salo's future, as business expands in innovative industries such as eco-effective lighting, marine industry, solar energy and healthcare technologies.

responsibility, there is a strong commitment by central government to ensure equal access to services across the country through financial transfers and national standards and regulation. Although municipalities retain large autonomy in organising services, more than three quarters of local government expenditure relates to tasks mandated by central government. The principle of equal access to services also enjoys wide public support. Nevertheless, there is tension between self-governance and equal provision of services. Municipalities often complain that national standards are imposing an excessive financial burden on them. Moisio et al. (2010) argue that "the burden of tasks of the municipalities should no longer be increased" and that it is perhaps time to start a political discussion on the distribution of tasks between local authorities, central government and the private sector. The government is taking steps to avoid overstretching local finances through excessive demands, unmatched by adequate funding (Box 2.1).

Complaints about inadequate public services in some municipalities, notably in elderly care, rose in the 2000s, prompting the government to strengthen central control on local social care provision. A project to restructure local government and services (PARAS) was launched in 2005 to reinforce the capacity of municipalities to deliver services, through mergers and enhanced cooperation. Although the project has led to significant municipal consolidation and enhanced cooperation, it seems to have achieved only modest results in terms of improvement in service provision (Kröger, 2011). The economic downturn has further eroded financial resources available to finance public services, while population ageing is increasing demand. Hence, further reform is warranted to ensure efficient provision of services across the country.

Health care is an area where providing services according to national standards is more and more difficult for some municipalities, as increasing specialisation and technological developments push up fixed costs and shortages of qualified personnel complicate recruitment. As an illustration, the overall shortage of doctors in municipal health centres was estimated at 6% in 2011, but reached 22% in the worst affected region (Finnish Medical Association, 2011). Shortages of health personnel result in inequality in access to health care, as employees can use occupational health care and private consultations are available to those who can afford large co-payments. Waiting times are still a major problem in local health care services, even though they have been reduced in recent years (Vuorenkoski et al., 2008). Inequality in access to health care is high by OECD standards and likely contributes to disparities in health status (OECD, 2012).

The fiscal framework could be strengthened

A solid fiscal framework is essential to ensure efficiency and fiscal discipline at all levels of government. Factors likely to influence local and general government fiscal outcomes include the degree of tax autonomy enjoyed by local authorities, the type of taxes levied by different levels of government, the design of intra-government transfers and the strictness of central government control over local spending.

Finnish municipalities enjoy extensive fiscal autonomy. They may freely set the level of the municipal income tax rate (a flat rate) and can set the property tax rate within a range defined by central government. Municipalities have broad discretion over spending decisions, even though national standards and regulations restrict local choice. The current budget needs to be balanced over a four-year period. There are no expenditure ceilings. There are also no limits on municipal borrowing or debt levels, which is unusual in the OECD, with the few exceptions including Austria and Norway (Sutherland et al., 2005). According to an OECD indicator of tax autonomy, which summarises information on rules and regulations applying to local taxation, Finland ranks third among OECD countries for tax autonomy of local authorities, behind Sweden and Denmark and on a par with Iceland (Blöchliger and Pinero Campos, 2011). Fiscal autonomy can have both advantages and drawbacks, depending on the institutional settings, the design of rules and how they are implemented. It can favour responsiveness to local preferences, flexibility, allocative efficiency and ability to cope with economic shocks. However, extensive collection of taxes by local authorities results in the inclusion of volatile items in local tax bases, with risks of pro-cyclicality in fiscal policy and negative effects on service provision and fiscal sustainability. Fiscal autonomy may also create inequalities and foster negative tax competition.

The tax mix could be improved

The tax mix has important implications for the efficiency and stability of the fiscal system. The main source of local tax revenue is the municipal income tax, which represents nearly 40% of total municipal income (Figure 2.6). Municipalities also raise property taxes and receive a share of corporate income taxes. The theoretical literature on fiscal federalism posits that local taxation should be "benefit taxation", where benefits to residents derived from public services match the taxes they pay (Tiebout, 1956). The extensive provision by municipalities of welfare services, which are redistributive in nature, prevents the full application of this principle in Finland. User fees can be collected for goods and services consumed individually. For public goods, which are consumed collectively, few taxes come close to a "benefit tax". Hence, a large local government sector imposes recourse to other types of taxes. Furthermore, "benefit taxation" is hampered by spillovers – i.e. use of public goods and services produced by other municipalities than the one where taxes are paid – which are excluded by assumption in the mainstream literature. Nevertheless, shifting the tax mix more towards property taxes and away from volatile corporate income tax could improve the efficiency and stability of the fiscal system.

Property taxes are the closest to "benefit taxes" (Borge and Rattsø, 2012). They tend to distort resource allocation less than other taxes and hence damp growth less (Arnold et al., 2011). In addition, recurrent residential property taxes, if closely reflecting property values, could reduce housing market volatility (Muellbauer, 2006). As it touches largely immovable tax bases, reliance on property taxes also reduces opportunities for harmful tax competition, especially as taxes tend to be capitalised in property prices (Blöchliger and Pinero Campos, 2011). Property taxes account for a modest share of total tax revenue across OECD countries. Nevertheless, they make up a sizeable share of local taxes in countries like Canada, France, the United States or the United Kingdom. In Nordic countries, property taxes account for a small share of total local revenue – less than 3% in Finland. As a share of GDP, they stand at 1.1%, as against an OECD average of 1.8%, suggesting that there is room for increasing their weight in local taxation. Furthermore, high-income municipalities which benefit most from corporate tax revenue tend to set low property tax rates. Central government has been encouraging greater reliance on property taxes. In 2010, the range within which local governments may set property tax rates was increased from 0.5%-1% to 0.6%-1.35%. A revision to bring real estate valuations closer to market values in 2014 should increase tax income by 100 million euros (Ministry of Finance, 2013).

Directing part of corporate income tax revenue to municipalities may encourage them to create an attractive business environment in order to develop their tax base. Competition between municipalities to attract firms may lead to better public services. However, corporate taxes are very volatile, making them ill-suited to fund public services, even though they on average account for only 3% of municipal revenue and flexible fiscal rules and ability to borrow attenuate this problem. Higher revenue almost inevitably tends to push up public spending and the temporary nature of some receipts is often underestimated. A sharp fall in corporate tax receipts may force municipalities to cut spending drastically, especially as it is most likely to be accompanied by lower receipts from personal income taxes and higher spending on social services, as the earnings base contracts and unemployment rises. Municipalities facing the closure of large plants are particularly vulnerable (Box 2.3). Another motivation for reducing dependence on corporate taxes is that these are likely to continue being eroded by international tax competition, as illustrated by the cut in the corporate tax rate from 24.5% to 20% in 2014 following similar moves in Denmark and Sweden. Finnish municipalities are strongly resisting any attempt to remove corporate taxes from their tax base, as they are concerned losses would not be compensated by higher state grants (Moisio et al., 2010). Nevertheless, attempts to reduce the share of corporate taxes in local revenue in favour of more stable property taxes should be pursued.

Tighter fiscal rules could be considered

Devolving a wide range of spending decisions to local authorities, while ensuring a high degree of equality in taxation and service provision across jurisdictions, may result in excessive spending due to the "common pool problem" (Ter-Minassian, 2007). Redistribution implies that part of local expenditure is funded by a national pool. This may lead to underestimating public services costs at the local level, as only part of these costs are matched by taxes, and thereby create moral hazard (Moisio, 2012). Expectations of central government bailout in case of trouble may also reduce prudence. Provision of essential public services by local authorities raises the probability of bailout (Ter-Minassian, 2007). In Finland, municipalities facing economic duress may receive discretionary grants from central government. Discretionary grants amount to EUR 20 million per year, roughly 0.02% of annual state current transfers to municipalities. Discretionary state grants, however, are accompanied by stringent adjustment programmes, imposing tax increases, sale of municipal property, cuts in personnel, postponement of investments or reorganisation of service provision. Between 2006 and 2011, 36 municipalities entered such a programme, which in 17 cases was associated with voluntary merger.

A stronger fiscal framework could further mitigate common pool and moral hazard problems, in particular through the design of intra-government transfers and fiscal rules. In the context of the implementation of the EU fiscal compact, the government decided in spring 2013 to establish a civil service working group to develop the Basic Public Services Programme procedure, with the aim of enhancing the macroeconomic steering of local government. This working group examines in particular the possibility to limit the central government's ability to increase municipal responsibilities and expenditures without also allocating full financing. Blöchliger et al. (2007) suggest that redistribution between municipalities (horizontal transfers) is less likely to generate budget problems than transfers from central government to municipalities (vertical transfers). As noted above, the Finnish transfer system is both large and tilted towards vertical transfers. The grant system has been criticised as too complex, opaque and based on formulas using inadequate indicators of needs (Moisio et al., 2010). Reform of the system is currently under preparation, with the objective of simplifying criteria and calculations, improving transparency and ensuring neutrality in merger cases. Municipal consolidation will also reduce the need for redistribution through grants, as municipalities will become more homogenous.

Fiscal rules may mitigate moral hazard and ensure fiscal sustainability. However, they may also have negative side effects, such as weakening local fiscal responsibility, lowering allocative efficiency and reducing flexibility to adjust to the economic cycle and temporary shocks. The OECD Fiscal Federalism Network has developed an indicator of sub-central government fiscal rules, which takes into account these various dimensions. Table 2.1 shows how Finland compares with other unitary countries with strong local government, including other Nordics. On the composite indicator, Finland scores below Norway, but above Denmark and Sweden. Finnish fiscal rules appear particularly weak at ensuring debt sustainability. They are also quite weak at restraining public spending, although less so than in Norway and Sweden. On the other hand, they strongly support allocative efficiency and provide high flexibility to cope with shocks. Setting an expenditure ceiling could improve expenditure control and debt sustainability, with limited negative side effects on ability to cope with shocks and allocative efficiency. Broadening the budget balance rule by including the capital account in the target would enhance deficit control and foster efficient allocation of public resources, as the current exclusion of capital outlays from the budget target may lead to investments with low social return (Fredriksen, 2013). A set of *Principles on Effective Public Investment* is to be adopted by the OECD Council in early 2014, which will provide further guidance on coordinating investment decisions between levels of government, strengthening capacity for public investment and ensuring proper framework conditions at all levels of government (OECD, 2013).

Table 2.1. **Sub-central government fiscal rules indicator in selected countries**[1]

2011

	Composite indicator	Sub-indices			
		Restraining the size of the public sector	Supporting allocative efficiency	Ensuring debt sustainability	Coping with shocks
Korea	5.9	2.5	8.0	5.8	2.0
Norway	5.6	2.6	7.8	7.8	3.0
Czech Republic	5.4	3.6	9.4	3.5	5.0
Finland	**5.2**	**3.1**	**7.8**	**3.6**	**6.3**
Denmark	4.8	3.5	4.5	7.4	3.6
Poland	4.3	3.2	6.6	6.8	1.8
Sweden	4.3	2.4	6.7	4.0	4.2
Estonia	4.1	2.5	4.4	7.5	2.0

1. Values are normalised to range between 0 and 10, with a higher value indicating more stringent rules.
Source: Fredriksen, K. (2013), *OECD Economics Department Working Paper,* No. 1071.

The extension since 2011 of the fiscal policy monitoring and evaluation functions of the National Audit Office, which reports to Parliament, strengthened the provision of independent assessments of general government finances. Financial reporting by municipalities follows standards which are close to those of private accounting. Accounts of private law entities (companies, associations, cooperatives and foundations) controlled by a municipality are consolidated in its financial statement. Nevertheless, efforts to produce and disseminate local government accounts consistent with those of central government should continue (Fredriksen, 2013). Statistics Finland is already working on improving timeliness, developing quarterly statistics on municipal finances and better recording implicit liabilities. Monitoring the quality and efficiency of public services is essential. Benchmarking of providers of public services could be developed further to encourage best practice (OECD, 2012). While improving the fiscal framework may help contain expenditure, more fundamental challenges need to be addressed to ensure efficient delivery of high-quality public services.

The reform of municipalities has the potential to generate efficiency gains in public services

The government is promoting an ambitious reform

The government which took office in June 2011 has committed to implementing a comprehensive nationwide reform of municipalities to enhance productivity and effectiveness in the delivery of public services. Mergers will initially be voluntary. Municipal councils are currently discussing merger plans and have an obligation to provide reports and proposals by July 2014, for mergers to be implemented between 2015 and 2017. The government is considering imposing mergers in the 10 or so main urban centres outside the Helsinki Metropolitan Area if municipalities fail to come up with sufficiently ambitious consolidation plans.

Evidence from OECD countries points to potential benefits of merging small municipalities

Municipal consolidation has taken place in many OECD countries in the past (Box 2.4). Although important differences in the structure of government and responsibilities devolved to municipalities across countries need to be kept in mind, the literature analysing the impact of mergers provides some useful lessons.

There is international evidence of a U-shaped relationship between size and overall cost of public services per capita. Municipalities with less than 20 000 to 25 000 inhabitants or with more than 250 000 appear less efficient than those within that range (McKinlay Douglas Limited, 2006; Holzer et al., 2009). Small municipalities tend to suffer from diseconomies of scale, although these tend to be confined to specific areas, in particular specialised and capital-intensive services. Beyond a certain point, larger municipalities tend to become less efficient, presumably because they are more complex to administer. In Finland, some 84% of municipalities have less than 20 000 inhabitants, so there is ample room for municipal consolidation. Furthermore, as explained below, the optimal size of municipalities varies across functions and the wide range of responsibilities devolved to municipalities in Finland may call for larger entities than in countries where municipal duties are more restricted.

A U-shaped relationship between the size of municipalities and the cost of public services *per capita* is also observed in Finland. Costs appear to be lowest in the 20 000 to

Box 2.4. **Municipal mergers in OECD countries**

Municipal mergers have taken place in many OECD countries, driven by various objectives, including improving coordination within a metropolitan area, enhancing strategic planning, promoting development and achieving economies of scale and efficiency gains in administration and provision of public services. Early cases include the United States (notably Philadelphia and New York), Japan and Portugal, back in the second half of the 19th century. Large-scale consolidation, generally compulsory and often reducing the number of municipalities by more than half, took place from the 1950s to the 1970s in Austria, Belgium, Canada, Denmark, Germany, Japan, the Netherlands, Norway, Sweden and the United Kingdom. Amalgamation was also achieved in the 1989 New Zealand local government reform and in Australia since the early 1990s, on a compulsory or voluntary basis depending on states. Few municipal mergers occurred over the past 50 years in the United States, where cooperation through special purpose entities has been privileged and consolidation mainly concerned school districts (Fox and Gurley, 2006).

Mergers of municipalities within the Toronto and Montreal metropolitan areas were imposed by the provincial government of Ontario in 1998 and Quebec in 2002 despite strong local opposition, but seem to have achieved neither significant cost savings nor improvements in regional coordination (Slack and Bird, 2012; Smith, 2007). In Montreal, following local referendums, 15 of the 27 merged municipalities regained independence in 2006. The cooperation approach followed by British Columbia seems to have been more successful than amalgamation strategies followed by other provinces at creating flexible and efficient public management structures (McLean et al., 2006).

Eastern European countries have followed diverging paths after returning to democracy. The Czech Republic, Estonia, Hungary and Poland have favoured the cooperation approach, while Latvia and Lithuania have embarked on large scale consolidation, with mixed results.

Luxembourg launched a project in 2008 to reduce the number of municipalities from 116 to 71 by 2017 and there was a cut to 106 in January 2012. In Greece, the “Kallikratis reform” reduced the number of municipalities from 1 033 to 325 in 2010. The “Capodistrias plan” had already reduced the number of Greek municipalities from 5 825 to 1 033 in 1997. Reforms are underway in other countries, including Ireland and the Netherlands.

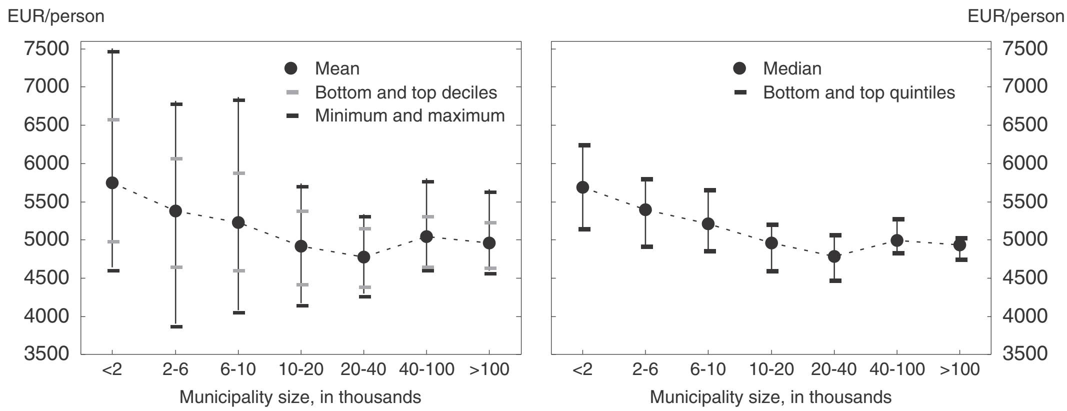
Successive waves of mergers have reduced drastically the number of municipalities in Nordic countries. The number of municipalities in Sweden was brought down from about 2 500 to around 1 000 in 1952 and to 278 in 1974. A few subsequent splits raised their number to 290. The number of Norwegian municipalities was cut from about 750 to around 450 in the early 1960s and 428 in 2013. Denmark went from more than a thousand municipalities in the 1960s to about 275 in 1970 and to 98 in 2007. The number of municipalities in Iceland, where mergers are mainly voluntary, shrank from 229 in 1950 to 170 in 1995, 124 in 2000 and 74 in 2013. In Finland, although there has been no large amalgamation plan, voluntary mergers reduced the number of municipalities from 560 in 1945 to 460 in 1990 and 320 today (Borge and Rattsø, 2012).

40 000 inhabitants range, consistent with findings from the international literature. For municipalities with less than 10 000 inhabitants, the dispersion of spending per capita is wide (Figure 2.11, panel A). Using median instead of average spending avoids giving too much weight to outliers and yields a similar U-shaped curve (Figure 2.11, panel B). Intervals between the first and fifth quintiles – which remove the 20% of municipalities with highest

and lowest spending per capita – clearly confirm the U-shaped relation between size and costs per capita. This empirical evidence argues strongly in favour of merging municipalities to reach a population of at least 20 000, at least outside remote areas.

Figure 2.11. **Cost of public services by municipality size**

2011



Source: OECD questionnaire (Directorate for Public Governance and Territorial Development) and OECD calculations.

StatLink *http://dx.doi.org/10.1787/888932992116*

Building robust municipalities in the main urban centres would also help achieve the regional development targets of strengthening regions' competitiveness and vitality and promoting well-being and environmental sustainability. At the same time, the role of regional centres as innovation hubs contributing to Finland's competitiveness in the global economy would be strengthened. Public service coordination and efficiency would also be enhanced by reducing fragmentation, especially in areas with potential for economies of scale and scope such as health care and social services. Further areas which would benefit from regional centre steering include education, employment, land-use planning and environmental policies (Ministry of Employment and the Economy, 2012).

In sparsely populated areas, scope for economies of scale is limited. About a fifth of Finland's population lives in rural regions, notably in the north. This is one of the highest shares in the OECD, similar to Denmark and Sweden, although less than Norway (OECD, 2011). Some services, like primary education or basic health care, need to be provided at a reasonable distance from where people live, limiting possibilities of concentration. Even though there might be some trade-off between distance to services and efficiency, as economies of scale in such labour-intensive activities are limited, efficiency gains would likely be offset by transport costs. In more capital-intensive services, such as water supply, economies of scale are larger in production. However, in remote areas, gains in production costs resulting from concentration would be more than offset by higher distribution costs (Fox and Gurley, 2006). Building financially robust municipalities is difficult, as tax bases in remote areas tend to be narrow and isolation increases the cost of providing services. Irrespective of institutional arrangements, remote areas will need to rely heavily on central government subsidies. Whether such subsidies are justified depends on political, strategic and cultural, rather than economic, considerations. In some cases, special arrangements for providing services in remote areas may be appropriate.

Finnish municipalities with more than 40 000 inhabitants incur higher costs per capita than those in the 20 000-40 000 range. Even though this is consistent with the international pattern of a U-shaped relationship, the threshold where costs start rising is low by international standards. This may be surprising, as the wide range of tasks devolved to Finnish municipalities, notably specialised health care and social services should push the optimal size up. However, the threshold above which there might be diseconomies of scale is more uncertain than the lower threshold for efficiency and may be more country specific. For example, whereas the international literature points to a threshold of around 250 000 inhabitants, diseconomies of scale seem to appear above about 115 000 in Japan (Mabuchi, 2001). Furthermore, there were only 25 municipalities with a population of over 40 000 in Finland in early 2013, too small a sample to safely draw general conclusions.

Large metropolitan areas, such as the Helsinki region, require strategic planning, which may be best achieved within a single municipality. Sizeable spillovers, as residents use services across the whole metropolitan area rather than those exclusively funded by their municipality, also justify a single government unit. However, municipalities forming a metropolitan area can be very diverse, warranting some local autonomy to meet residents' preferences. Moreover, as noted above, diseconomies of scale tend to appear beyond a certain population size. The experience of mergers of big international cities is mixed. Brisbane has amalgamated a number of entities to create a successful city of 900 000 inhabitants, about half the population of the metropolitan area (McKinlay Douglas Limited, 2006). But mergers imposed by provinces have failed to achieve their objectives in Toronto and Montreal, even leading to subsequent "de-mergers" in the latter case (Box 2.4). Hence, in metropolitan areas, enhanced cooperation structures may be more appealing than mergers, especially where popular support for the latter is insufficient (OECD, 2003).

The optimal size of municipalities is most often assessed in the literature on the basis of the overall cost of public services *per capita*. This is, however, a very crude measure of efficiency as numerous reasons may explain differences in spending across municipalities of similar size, including the age and socio-economic structure of the population, density, remoteness, morbidity, financial resources, the quality of public services and the efficiency with which they are delivered. Municipal mergers often aim at increasing the quality of services as much as at reducing costs. However, efficiency improvements are more difficult to measure than costs, explaining at least in part the focus of studies on the latter. Under-provision of complex services, due to technical difficulties or inability to recruit enough qualified personnel may result in lower costs. In smaller cities, expectations of citizens regarding public services may be lower than in bigger ones, leading to lower spending. Insofar as public services are funded through local taxes or user fees, the willingness of residents to pay for services also influences spending. Hence, estimates of optimal size need to be taken with caution. Perhaps more importantly, the optimal size varies with the functions undertaken by local governments.

The optimal size of municipalities varies across functions

As noted, the U-shaped relationship between size and cost of public services per capita observed at the aggregate level suggests that there is an optimal size for municipalities. However, the optimal size varies across services. More specialised and capital-intensive functions generally imply greater optimal size. According to the international literature, nearly 80% of municipal tasks are not subject to economies of scale beyond a population of 10 000 to 20 000 (McKinlay Douglas Limited, 2006; Holzer et al., 2009).

However, most Finnish municipalities have a population well below the thresholds where economies of scale in the less complex and capital-intensive functions are considered to be exhausted. For more specialised tasks (e.g. specialised social services) and capital-intensive functions (e.g. utility systems or public works), economies of scale may arise well beyond a population of 20 000. A particular area seldom mentioned in the literature, as it is rarely devolved to municipalities, is specialised health care, where international evidence suggests the optimal catchment area would be around 200 000 (OECD, 2012).

Public services can be delivered in different ways

The issue of the optimal size of a municipality cannot be dissociated from the question of how public services are provided. The relations between scale and efficiency in different types of services suggest that responsibility for more specialised and capital-intensive tasks raises the optimal size of municipalities. This is certainly the case if municipalities produce the services they deliver to their residents by themselves. However, services may also be purchased from other producers, either public or private. Purchasing services instead of producing them may reconcile small municipalities with scale efficiency. It may help preserve local accountability and responsiveness, while allowing the production of each type of service on an optimal scale. Public service provision can be separated from production in several ways. Cooperation between municipalities, which is extensive in Finland, is one of them. Public goods and services may also be contracted out through tendering, outsourcing or public-private partnerships.

Cooperation is essential in allowing small Finnish municipalities to deliver the wide range of public services for which they are responsible. The central government, while encouraging voluntary municipal mergers, had until the recent municipal reform proposal consistently presented municipal cooperation as an alternative to mergers for achieving economies of scale and reinforcing the capacity to provide public services. In particular, the project to restructure local government and services (PARAS), launched by the government in 2005, set minimum population targets for a number of activities (e.g. 20 000 for primary health care, 50 000 for vocational basic education), but left it to municipalities to decide whether these targets should be met through mergers or enhanced cooperation. Municipalities in the Helsinki metropolitan area were required to set up cooperation plans for land use, housing, transportation and services used across municipal boundaries. Cooperation allows economies of scale, but coordination problems across services under the responsibility of different administrative entities may arise. For example, coordination between primary health care managed by municipalities and specialised care run by hospital districts is imperfect (Moisio et al., 2010). Coordination problems have also been reported in other countries, such as Canada and New Zealand (Aulich et al., 2011). Furthermore, special purpose entities are prone to capture by special interests (Slack and Bird, 2012).

In many OECD countries, both federal and unitary, a large number of public services are organised by an intermediate level between central government and municipalities (e.g. state, province, region or county), with elected representatives and taxing power. Services managed by the intermediate tier are essentially those which benefit from economies of scale, generate spillovers, involve redistribution and are required to meet the same standards across the jurisdiction (Kitchen and Slack, 2006). Intermediate level governments may have an advantage over municipalities in providing public services, notably because they operate on a larger scale and facilitate cooperation and strategic planning. However, they may be less accountable to citizens and more prone to capture by special interest groups. A supplementary tier of administration may also result in less consistent allocation of responsibilities across levels of government, with possible overlaps creating duplication and coordination problems. Finland has experimented with a regional government in the Kainuu region between 2005 and 2012. While the experience may have brought some benefits in service provision, cost savings are uncertain and the experience was stopped, as one municipality refused to carry on (Box 2.5).

Box 2.5. **The Kainuu regional experiment**

A regional government experiment was carried out in Kainuu, a sparsely populated region in Eastern Finland, from 2005 to 2012. About 60% of municipal activities, as measured by costs, were transferred to the regional level, including basic health care, social care (except nursery) and secondary education. Municipalities contributed approximately 60% of their income to the regional administration. The aims were to improve the availability and quality of services, to raise efficiency and to promote regional development. The experiment would also bring some lessons regarding the opportunity of developing an intermediate tier of government across the country.

A study by the Ministry of Finance (Ministry of Finance, 2010) suggests that the experiment might have saved as much as 70 million euros during its first four years. This compares to total spending on health and social services in the region of about 250 million euros in 2009. However, such evaluations need to be taken with caution, if only because the costs that would have been incurred by municipalities in the absence of the experiment are unknown. The study by the Ministry of Finance compared variations in costs in Kainuu to the national average. However, Hämäläinen and Moisio (2012) show that even before the experiment, the evolution of costs in Kainuu and at the national level were very different. To isolate the impact of the experiment, the authors construct a synthetic control region whose differences in cost developments with Kainuu before the experiment were minimal. Using this methodology, they find savings of only about 35 million euros. Furthermore, there are uncertainties about the accuracy of cost data. When data from the Kainuu Regional Council are replaced by data from Statistics Finland, savings become insignificant. Hence, there are serious doubts about the cost savings achieved in Kainuu.

However, the experiment may have brought other benefits, such as improvements in service availability and quality. While the overall results of the experiment are still unclear, the municipalities involved decided at the end of 2011 not to carry on after 2012. The decision was the result of the opposition of only one of the eight municipalities, illustrating the political economy difficulties associated with municipal cooperation.

A municipality may purchase services from other public entities or the private sector. A purchaser-provider split introduces market mechanisms in the provision of public services. Municipalities retain the autonomy to make decisions on the supply of services to their residents, within the limits imposed by national regulations. However, services are commissioned to separate providers. A purchaser-provider split may lead to higher efficiency by avoiding conflicts of interest arising when municipalities are both suppliers and producers of public services which employ a large local workforce. For example, some estimates suggest that Finnish municipalities would be willing to accept hospital costs 20% higher to avoid closing a local hospital (OECD, 2012). Competition between providers may enhance user choice, promote innovation and lower costs where local authorities can commission services from several providers. A split between purchaser and provider is more frequent in utilities than in social services. Nevertheless, one third of Finnish municipalities reported using some kind of purchaser-provider split in health care and social services in 2009 (Tynkkynen et al., 2013). The May 2011 Health Care Act expands user choice in the municipal sector, opening further opportunities for empowering patients and increasing competition between service providers.

However, in a small country like Finland, competition is likely to be limited, although further deregulation of the European Union service market could provide new opportunities in the future. Where competition is weak, contracting out services is unlikely to generate significant cost savings. A number of small Finnish municipalities have commissioned health services from private providers, but this seems to have resulted in higher costs than own provision, reflecting underdeveloped markets and a lack of bargaining power of small municipalities (Mikkola, 2009; Tynkkynen et al., 2013). Some large municipalities like Tampere seem to have been more successful in creating competition and innovation through commissioning private health care providers. Further difficulties with external commissioning include potential lack of contracting expertise in

Table 2.2. **Share of public services provided by private providers**

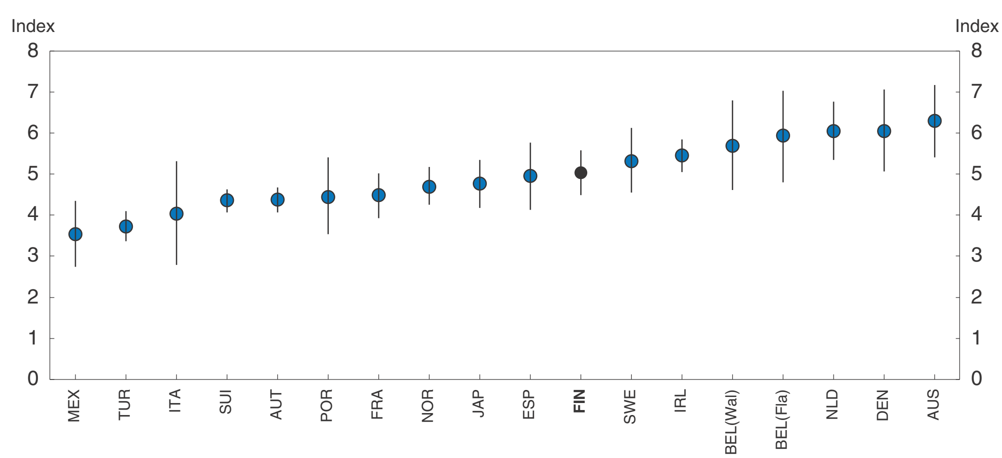
	Primary education	Lower secondary	Total vocational education	Hospitals	Public transport	Nursing homes	Childcare institutions	Waste collection	Average
Australia	28.7	35.4	2.9	64.0	98.0	91.0	66.2	95.0	60.1
Austria	4.5	7.8	30.6		0.0		26.6		13.9
Belgium	54.7	56.6	52.4				53.5		54.3
Czech Republic	1.1	1.8	32.1				1.4		9.1
Denmark	11.7	23.4	0.9	2.0	85.0	79.0		67.0	38.4
Finland	**1.2**	**4.1**	**29.6**	**4.0**	**80.0**	**12.0**	**8.1**	**100.0**	**29.9**
France	14.7	21.4	28.0	15.0			12.7		18.4
Germany	2.9	7.3	36.1				58.8		26.3
Greece	7.5	5.4	0.0				3.4		4.1
Hungary	5.9	6.7	39.6				4.4		14.1
Iceland	1.1	0.8	39.5				7.7		12.3
Ireland	1.0	0.0	7.2	13.0		66.0	46.5	55.0	27.0
Italy	6.9	3.5	14.8	14.0	5.0		28.4		12.1
Japan	0.9	6.2	91.2				65.7		41.0
Korea	1.3	19.8	85.0				77.1		45.8
Luxembourg	6.9	19.9	0.0				6.3		8.3
Mexico	8.1	12.6	3.7				10.6		8.8
Netherlands	68.9	75.9	0.0	100.0			69.7	42.0	59.4
New Zealand	11.9	16.0	26.2				43.8		24.5
Norway	1.9	2.3	35.8		62.0	7.0	41.0	13.0	23.3
Poland	1.4	2.1	20.8				6.6		7.7
Portugal	10.2	11.5	50.0	5.0		15.0	47.4		23.2
Slovak Republic	4.5	5.3	12.7				0.7		5.8
Spain	32.0	32.4	22.5	16.0	11.5	22.3	35.1	0.0	21.5
Sweden	5.6	6.3	34.9		73.0	14.0	14.1		24.7
Switzerland	3.8	7.1	70.0	22.0		33.0	6.8		23.8
Turkey	1.5	0.0	2.0				3.9		1.9
United Kingdom	5.0	6.4	100.0				8.5		30.0
United States	10.3	8.8	14.6				40.1		18.5
Unweighted average	10.9	14.0	30.5	25.5	51.8	37.7	28.4	53.1	

Source: Blöchliger, H. (2008), *OECD Economics Department Working Paper*, No. 626.

municipalities and challenging quality control. Even so, separating provision from production is worth exploring on a case-by-case basis. Vouchers are increasingly used by municipalities in areas such as elderly care, with apparent success (Kähkönen and Volk, 2008; Moisio et al., 2010). Although vouchers are not suitable for all kinds of services, there seems to be scope to extend their use further, provided stringent evaluation of services ensures that cost reductions are not achieved at the expense of quality.

Finland, like other OECD countries, uses private provision more in technical public services, such as utilities or transport, than in social services, like education or health care (Blöchliger, 2008). On average, about 30% of public services are delivered by the private sector (Table 2.2). This is much lower than in Australia, Belgium, the Netherlands and even Denmark, but comparable to Norway and Sweden. Waste collection, most public transport and a significant share of tertiary vocational education are provided by the private sector. A synthetic OECD indicator, which captures dimensions such as contracting out, user choice, competition and user fees, shows significant use of market mechanisms in public service provision in Finland, although notably less than in Australia, Denmark and the Netherlands and slightly less than in Sweden (Figure 2.12). Public suppliers often enjoy advantages in terms of access to markets, as some services which could potentially be supplied by the private sector are not open to competitive bidding. In addition, public entities benefit from tax exemptions and implicit guarantees which lower their financing costs. Moving towards a level playing field between public and private providers would enhance competition and support innovation.

Figure 2.12. **Use of market mechanisms in public service provision**[1]



1. Values are normalised to range between 0 and 10, with a higher value representing more efficient market arrangements in public service provision. The vertical bars denote confidence intervals.

Source: Blöchliger, H. (2008), *OECD Economics Department Working Paper*, No. 626.

StatLink http://dx.doi.org/10.1787/888932992135

Larger municipalities would make for greater equity in access to services

The fragmentation of the provision of public services generates cost inefficiencies, but also inequity in access to services, as small municipalities are often struggling to align service provision with national standards. Residents of economically robust municipalities normally enjoy more even access to services. Within an urban area, mergers will redistribute resources from places with high potential resources to places with limited tax bases. Spillovers within agglomerations justify such redistribution, which also reduces reliance on central government grants. Given the difficulty in capturing local needs through a simple grant formula, this may improve allocation of resources and supply of services. In areas like health care, where municipalities are exposed to exceptional costs, municipal consolidation will improve risk pooling, although the optimal level of pooling would probably be national (OECD, 2012).

Reorganisation of services to achieve efficiency gains

Economically robust municipalities created through mergers will have the opportunity to improve public services and reap efficiency gains. But it will require substantial reorganisation of public services. The evidence on efficiency gains from recent mergers is mixed (Moisio et al., 2010). Nevertheless, such results need to be taken with caution, as they may be driven by the specific characteristics of municipalities which decided to merge. For example, weaker municipalities may have more incentives to merge than stronger ones, but mergers between weak municipalities may result in limited efficiency gains. Some municipalities have merged after a long period of cooperation and most potential efficiency gains may have been achieved through reorganisation of services prior to the merger. Efficiency gains may also have been hindered by limited reorganisation of services, especially as a transition period of five years, during which public employment is protected, is likely to have delayed restructuring.

There is uncertainty as to whether the voluntary merger process will result in an economically robust municipal sector. Negative initial public reactions to a government proposal to reduce the number of municipalities to about 70 suggest that achieving a critical size may be difficult in many cases. One option would be to impose mergers on municipalities with a population below a certain threshold, as was done recently in Denmark. If this is not possible for political reasons, scaling back responsibilities of smaller municipalities in functions where economies of scale and scope can be achieved could be contemplated. The proposal by the new working group established by the Ministry of Social Affairs and Health sets a minimum of 20 000 inhabitants for municipalities to retain control over primary health care and of 50 000 to organise specialised care. This would both induce rationalisation in health care provision and improve coordination between primary and specialised care. Adapting the scope of responsibilities of municipalities to their financial and technical capabilities could also be considered in other areas where economies of scale and scope can be achieved. This would encourage mergers and reduce risks of continued inefficiencies and under-provision of services.

Transition costs can be significant

Transition costs following mergers can be substantial. Hence, when assessing the opportunity of merging municipalities, the potential long-term gains have to be weighed against expected transition costs. The international experience on mergers suggests that transition costs are generally underestimated when merger plans are devised (Aulich et al., 2011). After a merger, it may take time for the new municipality to reach its optimal structure. In particular, rapid adjustment of the number of employees to an optimal level may be hampered by agreements to protect public employment. This is particularly relevant for Finland, where jobs are protected for five years following a merger. The age structure of the Finnish workforce may ease the transition, as many employees are set to retire in the coming years. However, the professional profile of retiring employees will not fully match job reduction requirements. More flexible arrangements than strict job protection for five years could perhaps be devised. It is necessary to be careful not to undermine public support for mergers and public employees' motivation to endorse change and improve processes, which would have adverse effects on productivity (De Vries and Sobis, 2013). However, it may be possible to build on Finland's broad social safety nets and effective active labour market policies to engineer a smooth reallocation of labour, in the way it is being done in the case of site closures by private firms. While this would generate costs in the form of severance pay, other benefits, or spending on active labour market policy programmes, it would facilitate the reorganisation of public services, free human resources for the private sector, and enhance the career prospects of public sector workers whose jobs would in any case be at risk after the transition period.

Mergers generally imply equalisation of wages across the merged entities. Since individual pay cuts are unlikely, wages tend to align on the highest levels. Similarly, services provided may converge to the highest standards, which may be desirable and indeed is one of the objectives of the reform, but also induces catch-up costs. Reshaping administrative services will often require investments in information technology systems, which can be costly, especially if municipalities use very different systems before the merger. Nevertheless, developing further the use of information and communication technologies (ICT) offers opportunities to improve cost efficiency and effectiveness of public services. Accordingly, reducing the fragmentation of electronic systems and expanding ICT use at the municipal level are key objectives of the government's structural reform programme (Government of Finland, 2013). Investments may also be necessary to ensure the compatibility of infrastructure networks (Fox and Gurley, 2006). Such costs may be minimal when municipalities have been cooperating closely prior to the merger, but may be significant otherwise. Finally, merging organisations with different cultures is often difficult, as is well known in the corporate world.

Beyond their role in the overall cost-benefit analysis of mergers, transition costs are important to evaluate, because they are likely to influence the merger process itself. High transition costs borne by municipalities may discourage voluntary mergers. Merger grants will transfer part of the burden to the central government, although they are unlikely to cover transition costs fully. The reform awards grants ranging from EUR 2 million for a merger of two municipalities with combined population below 20 000 to EUR 10 million for a merger of at least six municipalities with combined population above 80 000. High transition costs are likely to dissuade strong municipalities from merging with weaker ones. While in the long term, a larger municipality may prove more prosperous as a result of economies of scale and agglomeration effects, in the short term mergers may look excessively costly because bringing down costs in weaker parts of the new municipalities takes time. Another potential obstacle is existing financial liabilities. The reform of the grant and equalisation system which accompanied the 2007 Danish municipal reform ensured that the latter did not increase overall costs for municipalities (Blöchliger and Vammalle, 2012). This seems to be a prerequisite for success in a voluntary merger process.

Municipal consolidation requires overcoming difficult political obstacles

Municipal mergers can generate economies of scale and scope, improve the quality of public services and raise efficiency. However, they often face strong opposition from local residents and their representatives, as they are seen as weakening local democracy and accountability and threatening public jobs. Mergers often entail redistribution from more to less affluent municipalities, which can be a further cause of resistance to amalgamation. In many countries, central governments have pushed for voluntary mergers, but forced mergers took place in a number of places. The cost of imposing compulsory mergers could be significant. Self-government is highly valued by citizens. Political voice and governance has been identified as an important determinant of well-being (Stiglitz et al., 2009). Furthermore, the benefits of mergers largely depend on the willingness and ability of municipalities to reorganise services and innovate, and hence may be lost in the event of local resistance. The evidence on performance following voluntary and forced mergers is limited. As mentioned earlier, the merger of municipalities within the Toronto and Montreal metropolitan areas, imposed by provincial governments in spite of strong local opposition, are widely seen as failures and were even followed by "de-mergers" in Montreal (Box 2.4). However, such experiences in large cities may not be very relevant for Finland, except perhaps for the Helsinki metropolitan area. A study on the 1952 Swedish municipal reform finds that municipalities formed voluntarily experienced higher growth than those formed on a compulsory basis, after controlling for other factors (Hanes and Wikström, 2010). While this suggests that voluntary mergers are preferable to forced ones, it should not rule out the latter when no agreement can be reached.

In some cases, imposing mergers is the only way to achieve rapid consolidation. Mergers have been imposed by several Australian states since the 1990s, with apparently limited impact on local democracy, partly because local councils simultaneously took measures to enhance communication with citizens and ensure community engagement. It is sometimes argued that an advantage of compulsory mergers is that they may lead to more rational structures, while voluntary mergers would be determined by agreement possibilities (Aulich et al., 2011). The argument may carry some weight, particularly in the case where strong municipalities are reluctant to merge with weaker ones. The 2007 Danish local government reform gave municipalities strong incentives to enter into voluntary mergers, as those which did not reach the population target could be forced to merge by parliament. Municipalities were also entrusted with new responsibilities transferred from abolished counties. Although municipalities could avoid mergers under certain conditions, this involved renouncing new responsibilities and being forced to enter compulsory agreements to purchase services from neighbouring municipalities. The reform achieved greater consolidation than anticipated. It is often argued that imposing municipal mergers may be difficult in Finland, given its strong tradition of self-government. However, Denmark also has a strong tradition of local democracy and the 2007 reform followed two failed attempts at municipal consolidation (Blöchliger and Vammalle, 2012). Strong leadership from the government and careful design of the reform allowed overcoming obstacles.

The outcome of the municipal reform process in Finland is still uncertain. If large-scale mergers cannot be achieved rapidly, there is a risk that endless debate on administrative structures obscures the final objective of ensuring the provision of high-quality public services in the most efficient way. In that case, municipalities lacking critical size could be encouraged to purchase services for their residents from other public entities or from the private sector, rather than producing them by themselves. Such arrangements do not entail any loss of local choice, as municipalities still decide about the quantity and quality of services provided. Efficient provision of public services is compatible with different administrative structures, but responsibilities and delivery mechanisms need to be adjusted accordingly.

Recommendations on local public finances and municipal reform

Key recommendations

- Continue to promote the merger of municipalities or scale back their responsibilities in functions where economies of scale and scope can be achieved.
- Implement the new fiscal framework for municipalities as planned. Better account for capital spending in municipalities' accounting to enhance deficit control and foster efficient allocation of public resources.
- Shift the mix of local tax receipts towards property taxes and away from the corporate income tax.

Further recommendations

- Facilitate user choice where the population base and the nature and complexity of services allow meaningful competition. Explore the possibilities to expand the use of vouchers for buying services. Level the playing field between public and private providers by scaling back the advantages of public suppliers in terms of access to markets, tax breaks and implicit guarantees.
- Benchmarking of public service providers should guide user choice and promote best practice.
- Continue to improve the coverage, timeliness and dissemination of local government accounts consistent with the standards used for the central government.

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Colombia, January 2013
Czech Republic, November 2011
Denmark, January 2014
Estonia, October 2012
Euro area, March 2012
European Union, March 2012
Finland, February 2014
France, March 2013
Germany, February 2012
Greece, November 2013
Hungary, January 2014
Iceland, June 2013
India, June 2011
Indonesia, September 2012
Ireland, September 2013
Israel, December 2013
Italy, May 2013
Japan, April 2013
Korea, April 2012
Luxembourg, December 2012
Mexico, May 2013
Netherlands, June 2012
New Zealand, June 2013
Norway, February 2012
Poland, March 2012
Portugal, July 2012
Russian Federation, January 2014
Slovak Republic, December 2012
Slovenia, April 2013
South Africa, March 2013
Spain, November 2012
Sweden, December 2012
Switzerland, November 2013
Turkey, July 2012
United Kingdom, February 2013
United States, June 2012

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