

Economic Survey of Finland, 2004

Summary

The transformation of the Finnish economy over the last decade represents one of the few examples of the “new economy” taking hold in Europe. Output and productivity growth over the second half of the 1990s was among the highest in the OECD, and the recovery from the global downturn has been much stronger than for the euro area as a whole. However, imminent population ageing threatens to expose weaknesses in the labour market. Demographic developments, which over past decades have been broadly neutral, could reduce the growth rate of GDP per capita by $\frac{1}{4}$ of a percentage point per annum over the remainder of this decade and by almost 1 percentage point over the next decade. This, combined with the likelihood of smaller productivity gains in the information and communication technology (ICT) sector, a continuation of falling ICT prices as well as the mediocre performance in the sheltered sectors, threatens the future growth of living standards. Within a decade, and in the absence of further policy changes, these developments together could imply that Finland not only loses its top performer status but could face a protracted period of slow growth, as illustrated in the following scenario:

What are the key challenges?

What is the short- and medium-term outlook?

How can competition be strengthened?

Will the government’s employment objectives be achieved?

Is the fiscal position sufficiently strong to cope with ageing?

How should municipal finances be reformed?

How can pressures on public spending be contained?

Summing-up

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Where to contact us?

This Policy Brief presents the assessment and recommendations of the 2004 OECD Economic Survey of Finland. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee’s discussions, and issued under the responsibility of the Committee.

Contribution to annual average growth rate of GDP/capita

	1995-2000	2000-05	2005-10	2010-20
Productivity growth	2.5	1.7	1.8	1.8
Demographics	0.0	0.0	-0.2	-0.9
Employment rate	1.8	0.3	-0.3	0.1
GDP per capita	4.4	2.1	1.3	1.0

In order to avoid such a scenario a number of key challenges need to be addressed to sustain the strong growth performance over the coming decades:

- **Growth needs to be enhanced and broadened by boosting competition and labour market flexibility.** Priority should be given to reducing state ownership, lowering support for agriculture and further reforms in utilities, transport and the retail sectors, as well as a further strengthening of the competition framework. Greater flexibility in implementing central wage agreements would also help.
- **Wide-reaching reforms are needed to achieve the government's ambitious employment rate target.** This could offset up to four-fifths of the expected cumulative decline in living standards resulting from ageing over the next two decades. But this is unlikely to happen without wide-reaching reforms, many of which do not currently appear on the government's reform agenda. Foremost among these are the further curtailment of various early retirement schemes, over and above what is due to be implemented in 2005. Consideration should also be given to tapering the generosity of unemployment benefits with duration. Reductions in taxes on labour are also important and should be focussed at the lower end of the wage distribution, while recognising that there

is also a strong case for subsequent reductions at the upper end.

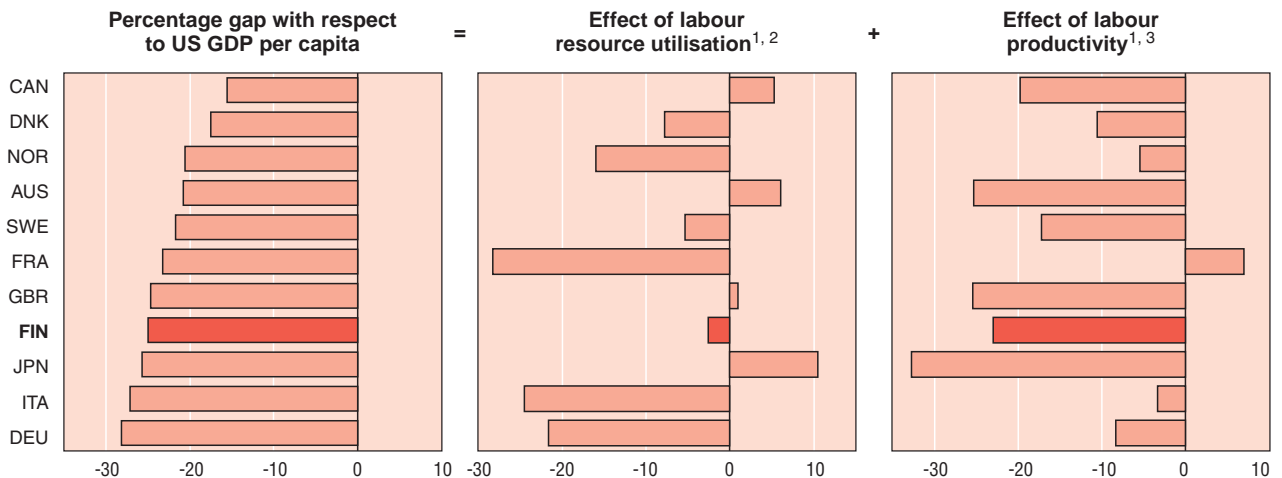
- **Public finances need to be improved and room for labour tax cuts created by tight spending control.** Further pension reform is needed in order to improve government finances in the face of the ageing shock. The reform to be introduced in 2005 will help in this respect, but is not sufficient. As a minimum requirement, central government and municipalities should avoid fiscal deficits, while the pension funds continue to accumulate assets. Maintaining these balances, while reducing the high taxation of labour, will require more efficient service provision, better fiscal coordination with municipalities and meeting some of the future growth in service demand via private funding.

A broad package of measures along these lines, which would both achieve the 75 per cent employment target and boost productivity growth, could double the expected increase in GDP per capita between now and the end of the next decade, relative to the scenario shown above. ■

What are the key challenges?

Over the past decade, the growth performance of the Finnish economy has been among the most

The sources of differences in income 2002, in 2000 PPP terms



1. Percentage gap with respect to the US level.

2. Labour resource utilisation is measured as total number of hours worked divided by working-age population.

3. Labour productivity is measured as GDP per hour worked.

Source: OECD.

impressive in the OECD, underpinned by both strong productivity and employment gains. However, the standard of living as measured by gross domestic product (GDP) per capita is still only close to the median OECD country. Moreover, the contribution of the information and communication technology (ICT) sector to future growth is unlikely to be as great as in the second half of the 1990s, and ageing will occur sooner and more rapidly than elsewhere. Within a decade these developments threaten to usher in a period of stagnation in living standards.

A number of key challenges need to be addressed to sustain the strong growth performance and to further close the income gap with the best performing OECD countries.

Growth potential. Outside the dynamic export-oriented ICT sector the performance of many parts of the economy, particularly those sheltered from international trade, has been poor. Moreover, those sectors with the highest growth potential, such as the

knowledge-intensive services, are relatively small despite the high level of skills and educational attainment of the labour force. Various policy initiatives to boost product market competition and labour market flexibility are needed to enhance growth prospects as well as ensuring that they are more broadly based.

Employment. The major economic policy target of the government is to add 100 000 jobs by 2007 (pushing the employment rate to about 70 per cent) and to reach a 75 per cent employment rate over the medium term. Achieving the latter would offset up to four-fifths of the expected negative impact of ageing on living standards over the next two decades. By raising potential output and tax revenues it would also mitigate the fiscal pressures resulting from ageing.

Public finances. To prepare for the fiscal implications of ageing, further pension reform is needed, though this is currently not on the policy agenda, as a reform of the system will be implemented from 2005. Absent further reform, the projected rise in pension and

health-related spending means that a sizeable general government surplus would be necessary to avoid future tax increases. Further pension reform, structural measures to boost employment and more efficient public spending are therefore necessary to create room for lowering the high taxation of labour. ■

What is the short- and medium-term outlook?

Partly stimulated by an expansionary fiscal stance, Finland has recovered more quickly from the global downturn than most euro area countries, and higher growth is likely to persist through 2005. Specifically, growth has averaged 2 per cent per annum in 2002 and 2003 and output is expected to rise by 2½ per cent in 2004 and 4 per cent in 2005, propelled by strong foreign trade and further tax cuts. As a result, cyclical slack could already be absorbed in 2005. Nevertheless, the unemployment rate could still remain above 8 per cent, close to the structural unemployment rate. The medium-term outlook is much bleaker. Demographic developments, which over past decades have been broadly neutral, could reduce the growth rate of GDP per capita by ¼ of a percentage point per annum over the remainder of this decade and by almost 1 percentage point over the next decade. Moreover, the growth contribution from ICT production is likely to diminish. Both together could imply GDP per capita growth of only 1 per cent over the next decade, highlighting the need to press ahead with reforms that will strengthen future growth potential.

One means of boosting future productivity growth, as labour becomes relatively scarce due to ageing, is to raise the capital-labour ratio. However, this ratio has fallen since the early 1990s. The low overall level of business investment may also explain why Finland only has a mediocre ranking among OECD countries in terms of investment in ICT, despite being a world leader in ICT production. The government will be introducing a major reform of capital income and corporate taxation which aims at increasing investment. ■

How can competition be strengthened?

Enhancing competition is another important area where policy can raise productivity and growth potential. The competition policy framework was overhauled in 1988 and the competition law was recently brought into full conformity with the prohibition-based system of European Union (EU) competition law. However, there are areas, where the framework could be strengthened further:

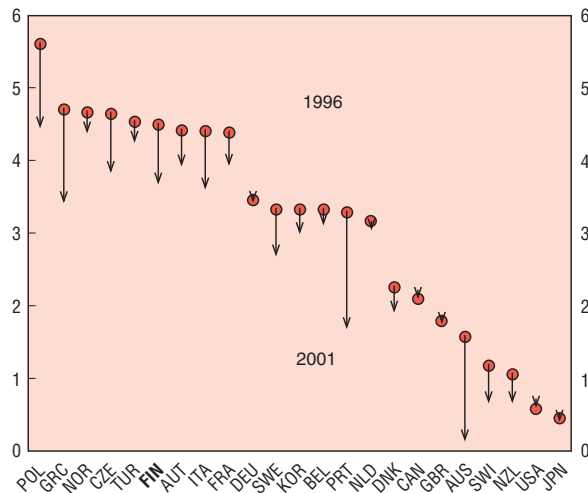
The Finnish Competition Authority should direct more of its resources towards addressing cartels and other restraints. Moreover, the Market Court should be freed from minor public procurement disputes by establishing a public procurement authority and introducing a minimum jurisdictional threshold.

The *de facto* independence of the Competition Authority should be recognised formally.

Sanctions need to be substantial and credible to secure deterrence. Moreover, individual liability should be considered. Both measures would contribute to increase the effectiveness of the new leniency programme.

In publicly-owned companies competitive activities should be separated from activities governed by policy objectives that are non-competitive. The playing field *vis-à-vis* private companies should be levelled by abolishing the tax advantages of some non-incorporated public enterprises. To remove the conflict between the state's regulatory role and its ownership interests, publicly-owned companies should be concentrated in a ministry without regulatory oversight. However, the preferred solution would be an extensive privatisation programme.

While competition is robust in exposed sectors, several indicators point to relatively weak competition in a number of sheltered sectors. Conversely, the rapid efficiency gains in the telecommunication and electricity sectors following their early liberalisation, as well as the marked effect on food prices of the recent entry of a couple of foreign-owned chains into food retailing, provide examples of the potential gains from increased competition. To boost competition, additional measures should be introduced:

Relative size of the public enterprise sector¹

1. Index 0-6 scale from lowest to highest share of public enterprises, index based on the extent of state ownership and (gross) proceeds from privatisations.

Source: OECD.

The role of sector regulators should be enhanced. Although more elements of *ex ante* regulation are being implemented, such regulatory oversight of liberalised network industries should be strengthened further to support the introduction of competition and to prevent companies from exploiting their local monopoly power. Non-discriminatory third party access charges need to be applied more effectively and formal separation of vertically-integrated companies pursued. Regulatory capture, and over regulation should be prevented and as competition becomes viable in these sectors, the regulatory approach can be replaced by the application of general competition principles.

Efforts to promote competition in network industries would be helped by a more rigorous evaluation and competition-neutral financing of universal service obligations. Moreover, the reform process should be accelerated in the railway and postal sectors and the license system should be reviewed in the latter sector to ease entry. Competition in domestic air transportation should be promoted by setting individual airport

charges to reflect the true cost of each individual airport and by introducing a market based system for slot allocation.

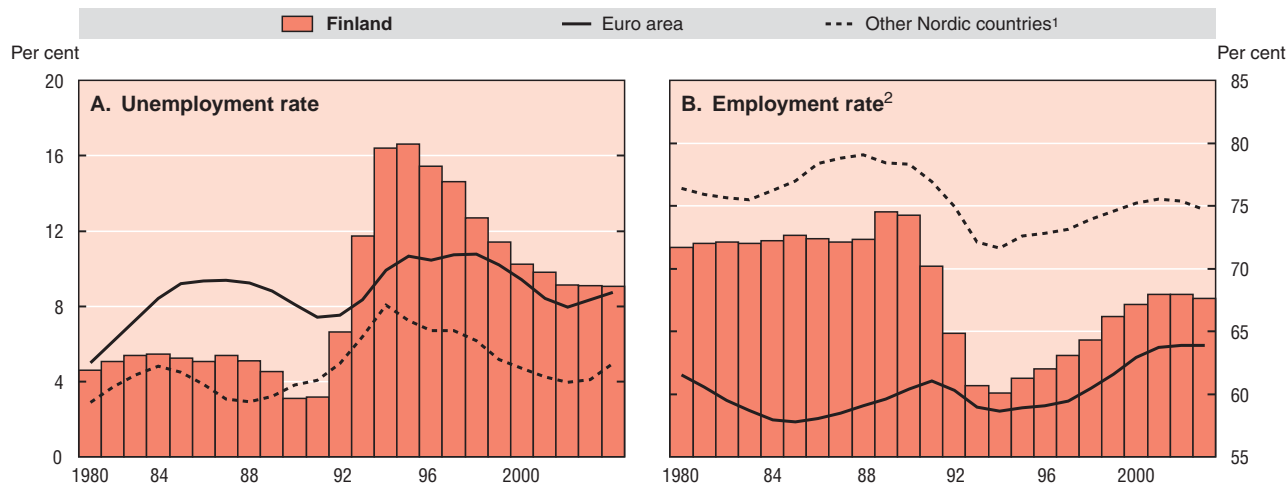
Regulation of retail distribution should be relaxed; shop opening and zoning laws should be reviewed to facilitate entry.

National agricultural subsidies are large and come on top of those provided by the Common Agricultural Policy. They should be brought down. Phasing them out could be accompanied with income support, if deemed necessary. ■

Will the government's employment objectives be achieved?

The long-term objective of reaching a 75 per cent employment rate, from below 68 per cent currently, will only be realised with the help of a broad package of labour market reforms. The government's approach focuses mainly on cuts in labour taxation and improvements and expansion of active labour market policies (ALMPs). The government has emphasised that future tax cuts are contingent on a low central wage agreement, which would lead to fiscal savings, particularly on the public sector wage bill. Nevertheless, the authorities would need to remain vigilant that fiscal policy remains on track, particularly in the period beyond that covered by the wage agreement. Moreover, a low wage settlement has yet to be secured, and in its absence further tax cuts, unless accompanied by lower spending, are likely to compromise fiscal objectives and may eventually end up being reversed. On the basis of current evaluations, it is unlikely that any expansion in ALMPs in isolation will have much effect on aggregate labour market outcomes. However, the government's emphasis on ALMPs is welcome to the extent that it is conceived as part of a "mutual obligations" approach whereby effective re-employment services and benefits are provided to job-seekers, which in turn have to look actively for a job. The intention is to make participation in active measures mandatory for continued receipt of labour market support (the basic means-tested unemployment benefit) after some period of unemployment, although details of how this will operate have yet to be decided.

Aggregate labour market indicators



1. Denmark, Iceland, Norway and Sweden.

2. Total employment as a per cent of working-age population (aged 16-64).

Source: OECD, *OECD Economic Outlook*, No. 75, June 2004.

Comparison with other OECD countries suggests that the greatest potential for raising the employment rate is at either end of the age spectrum. Recent improvements in the employment rate of older workers and the introduction of a wide-ranging pension reform next year are encouraging. However without additional reforms, future improvements in the participation rate of older workers may do little more than contain the effect of ageing on aggregate participation rates. This would imply that little progress will be made towards achieving the government's employment targets.

The wide-ranging pension reforms coming into force next year will help to raise the participation of older workers by providing very high accrual rates between the ages of 63 and 68. This in itself will reduce the attractiveness of the early retirement options. Nevertheless, it is still a matter of concern that some pathways to early retirement remain open, particularly through disability and unemployment benefit schemes. This could blunt the increased incentives to work longer that are provided by the reformed old age pension system. A priority for reform should be the

further curtailment of early retirement pathways. At a minimum this should involve an end to the preferential treatment of the older unemployed. They are able to remain continuously on benefit with little obligation to either look for a job or participate in active measures. The planned relaxation of medical assessments required to receive disability benefit should not be implemented, and instead more of those currently claiming disability benefits might be helped into work with active measures.

In addition, demand-side barriers to the retention and hiring of older workers should be tackled, including the removal of the age-related component of social security contributions, and further emphasis placed on lifelong learning to ensure that skills are upgraded throughout a career.

The low employment rate of younger workers also partly reflects the long time taken to complete education and begin work. Another focus for policy is therefore to reduce the average age at which young people begin to work, through lowering the average age of beginning and completing studies. Various initiatives,

including greater possibilities for a 3-year rather than 5-year degree and speeding up the transition from school to tertiary education, are being introduced. But replacing grants with fees and loans in tertiary education, as recommended by a recent Employment Task Force, should also be considered.

Raising the employment rate will also require that job mismatch problems are addressed. One reason for job mismatch is wage compression due to the prevalence of centralised wage agreements. It is further aggravated by high replacement rates and high average and marginal rates of labour taxation. The effect is most apparent in the scarcity of jobs for the low skilled in the service sector and high unemployment among the unskilled (see top chart on page 11). Current measures to tackle this problem include the tax deductibility for domestic help. In addition, tax cuts in recent years have included an extension of the earned income tax allowance which disproportionately benefited low-paid workers. To maximise the gains to employment any further tax cuts should focus on reducing employers' social security contributions for the low paid, as is already planned for 2006. However, there is also a case for reducing high marginal tax rates further up the earnings distribution. The highly progressive tax system may discourage work effort, particularly from the highly skilled, make it more difficult to attract and retain such workers, and also inhibit growth in some of the more highly-paying dynamic service sectors.

A direct way of tackling job mismatch problems is to introduce greater flexibility into the system of centralised wage determination, perhaps along the lines in other Nordic countries, where firm level negotiations typically determine how the central wage agreement is implemented. In this respect, agreement on a low central norm in the wage negotiations, which begin this autumn to determine the basis for wages over the following two years, would provide more scope to introduce productivity- or profit-related differentials. The negotiations should also take into account that output prices may rise by around 1 per cent per annum less than consumer prices, and that aggregate productivity developments are likely to be more modest than in the past. At the very least, future

central wage agreements should avoid specifying minimum absolute changes in wages, which lead to larger percentage changes in the costs of low-paid workers. In addition younger workers should be exempt from the wage floors which are often specified in sectoral wage agreements, in some cases at a high level in international comparison.

Plans to introduce a cut-off period for the passive receipt of the unemployment benefit which is available to those not eligible for the earnings-related benefit (currently claimed by more than half of the unemployed) may help to reduce the reservation wage for low-skilled work. But there is also scope for tapering the earnings-related unemployment benefit with duration of the unemployment spell to intensify job search. At present, replacement rates for this benefit are among the highest in the OECD. ■

Is the fiscal position sufficiently strong to cope with ageing?

In comparison with other OECD countries the fiscal position of general government appears very strong, both in terms of the surplus (2 per cent of GDP in 2003) and net asset position (34 per cent of GDP in 2003). However, such a comparison is potentially misleading in at least two respects. First, Finland faces rapid ageing earlier than other OECD countries. Second, pension funds are included in the general government account (essentially because contributions are mandatory). They account for the net asset and surplus position, whereas central government and municipalities combined were in slight deficit (plus $\frac{1}{4}$ and minus $\frac{1}{2}$ per cent of GDP, respectively) in 2003 with a combined deficit of 1 per cent of GDP projected for 2004 and 2005 (see bottom chart on page 11). A major reform of the pension system will be introduced from next year with a number of innovative features – including sharply rising accrual rates after the age of 63 and a life expectancy adjustment – which will improve both incentives to work longer and fiscal sustainability. Nevertheless, the net assets of the pension funds are insufficient to cope with rising future pension costs, despite the recent reform of the pension system. Absent further reform, contribution

rates are still expected to rise by 5 percentage points over the next three decades. To ensure fiscal sustainability, a combined central government and municipal surplus of about 1 per cent of GDP would then be needed for the remainder of this decade in order to keep the tax-to-GDP ratio constant, even with some improvement in the employment rate.

Although the present pension reform has not yet been implemented, thinking about further pension reform should start soon. In addition, the curtailing of early retirement options, discussed above, would further enhance the incentives to work longer from the impending pension reform.

Further reform options could improve the financial viability of the pension system with little or no adverse impact on incentives to work. For example, the accrual of pension rights during non-work periods (for example during study leave) as well as the higher accrual rates that can be earned by a worker in the early fifties have little economic rationale, and removing them would halve the required increase in future contribution rates.

Central government and municipal fiscal deficits which cannot be explained by the economic cycle should be avoided. With the future demographic increase in health-related spending, the government's fiscal objective should be considered a minimum requirement, even if further pension reform is undertaken. It stipulates balancing the central government finances by 2007 under normal circumstances of economic growth. However, a cyclically-adjusted central government deficit of more than ½ per cent of GDP is projected for 2005 indicating that further structural reform or spending restraint is required, and all the more so if additional tax cuts are to be implemented.

As the memory of the crisis in the early 1990s wanes, the demand for still more and better welfare services is growing and puts pressure on central government and municipalities' finances. Recent targets to limit government spending have been frequently over-shot, public employment is growing by more than 1 per cent per annum, while the share of public consumption in potential GDP has started to increase. These developments threaten to derail the government's

fiscal strategy by undermining the room for further tax cuts that are needed to improve incentives to work and invest in Finland. With a recovery underway, there is no need for a fiscal stimulus and further tax cuts should be matched by spending restraint. A major challenge will be to raise public sector efficiency.

The cost effectiveness of public spending should be raised, and over the medium term, with many retiring from the public sector, this may be the only way of improving – or even maintaining – services, as it will be difficult to recruit a sufficient number of professionals in the face of a shrinking workforce. The government's initiatives aiming to simplify administration, make better use of information technology and increase exposure to competition are thus welcome.

Providing better incentives for public service providers to be more efficient is a way forward. In health care, for example, more activity-based funding could help reduce the exceptionally long waiting times. Also, involving a wider range of private sector providers via contracting out and voucher arrangements would promote innovation. The share of private providers is very low compared with other countries. ■

How should municipal finances be reformed?

Insufficient efforts to raise efficiency and new service obligations imposed by government and parliament have led municipalities to raise their income tax rates recently. Indeed, the autonomy of municipalities to set income tax rates could prove to be the Achilles heel of the fiscal framework with municipal income tax hikes neutralising the central government cuts.

To avoid such tensions, the menu of taxes which municipalities control should be changed. In addition, the municipal share of corporate tax revenues should be decreased or eliminated in order to reduce the effect of cyclical fluctuations which tend to ratchet up municipal spending. At the same time, and as a counterpart, the upper limit on real estate and land taxes, which are currently low by international standards, should be removed.

Public and private service providers:¹ an international comparison



1. Based on the number of users in each type of institution. Private institutions include both non-profit institutions and private firms.
 2. Includes pre-primary education and organised centre-based programmes designed to foster learning and emotional and social development in children from 3 years to compulsory school age.
 Source: OECD.

To prevent an upward drift in service spending, the automatic upward adjustment of state grants in response to municipal cost increases should be abolished, and conditions for *ad hoc* support to individual municipalities should be tightened considerably. Benchmarking of municipal service efficiency can be developed much further. In this respect, Norway provides an example which might be followed, by

making a much wider range of comparative performance indicators available publicly. More transparency would help to alert citizens and municipal boards when local service efficiency is below average, in which case any expansion of service provision should be funded by first exhausting the potential for productivity improvements and reductions in unit costs before increasing tax rates. ■

How can pressures on public spending be contained?

Currently a broad range of welfare services is funded by the state, ranging from the essential, such as emergency medical care, to more peripheral, such as home help for the elderly and childcare. Over the longer term as demand for such services grows, particularly from the elderly in areas that are related to health care, it is important that the government considers what are the core welfare services for which it will continue to provide public funding and equal access. For other less-essential welfare services it will be important to allow part of the growth in demand to be met by private spending, otherwise longer-term fiscal sustainability will be compromised.

User fees as a share of municipalities' total health and social spending have fallen over the last decade, so the government's intention to ensure that in future they are updated in line with cost developments is to be welcomed. Beyond that, charging for ageing-related services should be re-organised to better allow users to pay for care and practical help, beyond what is regarded as necessary. Financial instruments should be better developed to help the elderly finance co-payments. Private health insurance could also play a greater role for supplementary services

Public spending should be reconsidered in areas where the underlying policy objectives could be achieved with less demand on public finances. Public spending on tertiary education is among the highest in the OECD, and more resources could be provided by graduates who benefit from high wages. Introducing graduate contributions while lowering top income tax rates would make it easier to attract highly-skilled foreigners. Also, public spending is heavily skewed towards transfers compared with other countries, and

some of the most expensive elements, such as early retirement schemes and child home care benefits should be reconsidered to make room for increasing service demands. ■

Summing-up

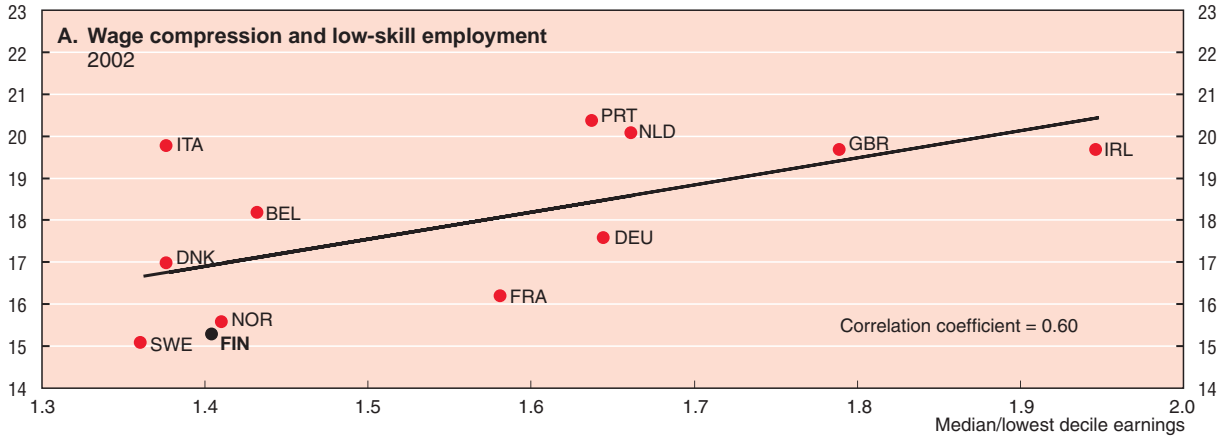
This Survey argues that the benefits from reforms are likely to be large. Reaching the government's medium-term employment rate target, for instance, would offset up to four-fifths of the future impact of ageing on living standards, while static benefits from raising competition alone could amount to more than 3 per cent of GDP with additional dynamic improvements to growth likely, but difficult to quantify. As ageing is due to set in so rapidly and full reform effects may not be felt for several years, early action is needed. Finnish policy making is characterised by a desire to reach consensus with the social partners on reforms. This clearly has advantages in educating everybody about the need for reform and in carefully weighing the trade-offs involved. On the other hand, attempting to reach consensus can also lead to slow progress with necessary reforms and the government's current policy agenda appears too limited. Wide-ranging and deep reforms are needed to cope with the implications of ageing, while preserving the basic principles of the welfare state. ■

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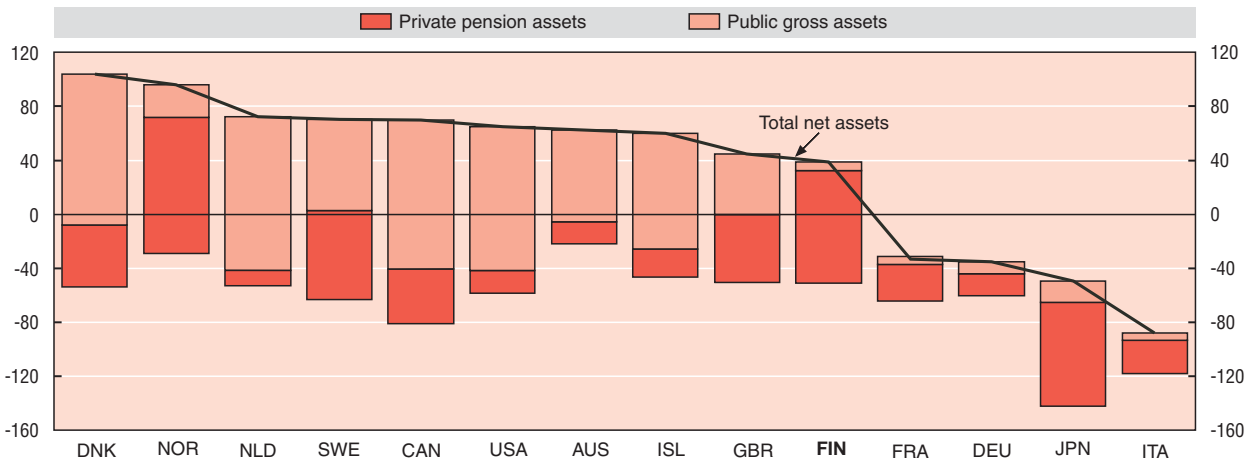
Wage compression leads to a shortage of low-skilled jobs

Low-skill service employment¹



1. Low-skill services are defined as the wholesale and retail trade, hotels and restaurants sector and are expressed as a percentage of total employment. Source: OECD, Earnings database and Labour Force database.

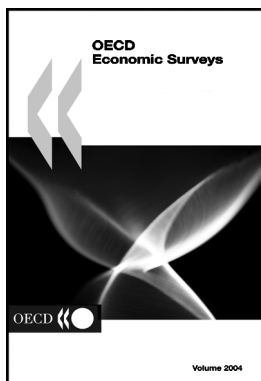
Government and private pension assets¹
2001 in per cent of GDP



1. Combined assets of general government and private tax-favoured retirement schemes. Source: OECD.

For further reading

- **Online:** In addition to the material included in this Policy Brief, some key charts and excerpts from the Survey can be accessed at www.oecd.org/eco/surveys/finland.
- **OECD Economic Surveys:** *Economic Surveys* review the economies of member countries and, from time to time, selected non-members. Approximately 18 Surveys are published each year. They are available individually or by subscription. For more information, consult the Periodicals section of the OECD online Bookshop at www.oecd.org/bookshop.



- **Additional Information:** More information about the work of the OECD Economics Department, including information about other publications, data products and Working Papers available for downloading, can be found on the Department's Web site at www.oecd.org/eco.
- **Economic Outlook No. 75**, June 2004. More information about this publication can be found on the OECD's Web site at www.oecd.org/eco/Economic_Outlook.

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