



## Economic Survey of Finland, 2008

**How can the benefits of globalisation be maximised?**

**Is the fiscal outlook adequate to cope with the ageing challenge?**

**What can be done to make the tax system and public spending more effective?**

**How can wages be made more flexible and employment raised?**

**How can the higher education system be improved?**

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### Summary

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

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

- **Ensuring long-term fiscal sustainability:** Further adjustments to the pension system are needed, and the government should ensure that its intention to achieve a general government structural surplus of 3½ per cent of GDP is met.

*This Policy Brief presents the assessment and recommendations of the 2008 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.*

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

### How can the benefits of globalisation be maximised?

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

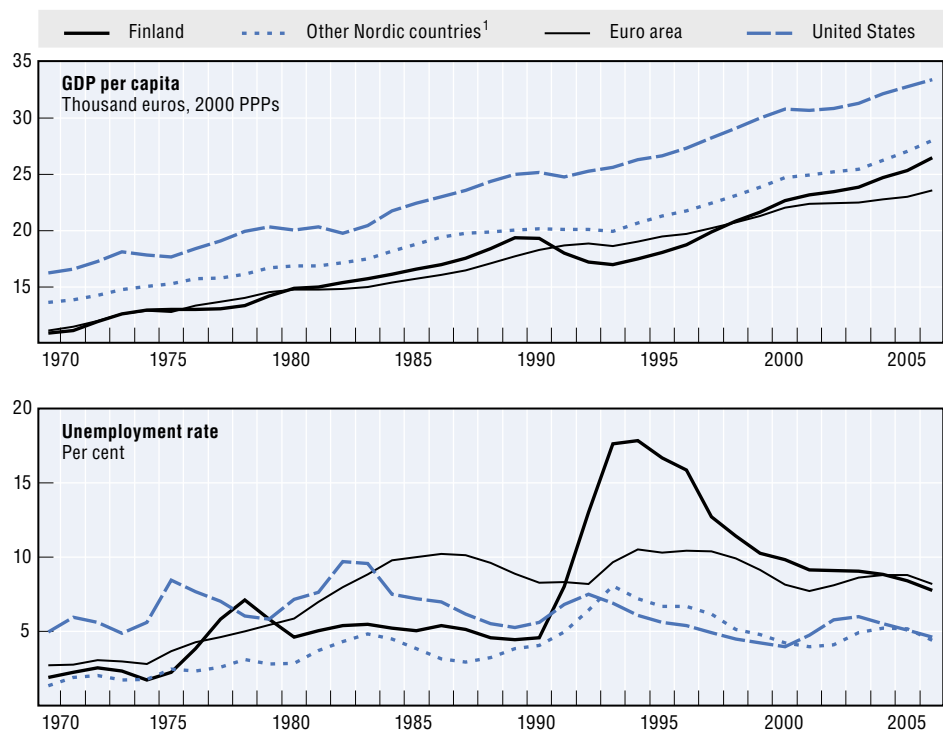
The low-tech segment of industry, however, remains sizeable. Intensifying international competition, offshoring, excess capacity due to weakening demand in Europe and high input costs have contributed to a number of plant closures in the pulp and paper industry, and even in the successful telecommunications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

The use of collective mechanisms for risk sharing – a key feature of the Nordic model – has made it easier for Finnish citizens to embrace both globalisation and competition. The tax burden is above the OECD average, although within the group of Nordic countries, Finland has a relatively low overall tax burden and social expenditure, and public spending is lower than in many other European countries. Even so, the tax and

welfare systems have generally ensured that the winners from structural transformation have shared their gains to some extent with the losers. Moreover, the composition of public spending has tended to support high employment levels, such as through the provision of affordable child care and early education. Nevertheless, income inequalities have been rising, and unemployed households remain vulnerable. Unemployment remains high and therefore the tax and welfare systems should be reviewed in order to see whether the trade-off between the incentives to work and income support is appropriate. The challenge for Finland is to modify the existing system so that it better encourages efficiency and sharpens labour market incentives, without losing the benefits of redistribution and social support. Given the ageing population and the need to lift employment rates, it is also worrying that many graduates do not enter the labour market until their late 20s. Taxation of labour is currently too high, particularly given the increased mobility of jobs and people that globalisation implies. In this context, the sustainability of the welfare system will require significantly higher employment, more efficient taxation and more cost-effective public spending.

Economic growth was above 4% in 2006 and 2007, contributing to a further catching up in GDP per capita towards the slightly higher average

Figure 1.  
KEY ECONOMIC INDICATORS



1. Weighted average of Denmark, Iceland, mainland (in case of the GDP) Norway and Sweden. Source: OECD, OECD Economic Outlook and National Accounts databases.

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

### Is the fiscal outlook adequate to cope with the ageing challenge?

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

### What can be done to make the tax system and public spending more effective?

Globalisation creates a tension between the need to spend on social safety nets and the need to maintain tax revenue from mobile factors. In response to the increasing mobility of capital, there has been a trend decline in corporate tax rates across the OECD along with a broadening of the tax base. In Finland, the dual income tax (DIT) system has also permitted a much lower tax rate on capital income, while labour income is still taxed more heavily. The DIT system has increased the efficiency of

capital investments. Nevertheless, the DIT system creates incentives for individuals to reclassify labour as capital income, and the procedures put in place to limit this have increased the complexity of the tax system, while still permitting some groups of workers to reclassify their income relatively easily. Reclassification incentives could be reduced by lowering the average tax rate on upper income earners. Finland should also *monitor the success of the Norwegian shareholder equity system with a view to adopting a similar scheme – if it is judged to be successful – to reduce income-shifting incentives*. The 2005 tax reform cut the corporate tax rate slightly to 26%. This brought the Finnish rate below the EU15 average. However, the average statutory tax rate in the new member states was about 19% in 2006 and planned changes will bring it down another percentage point. The latest cut in the corporate rate was not accompanied by any base broadening measures. *There is probably still room to broaden the corporate tax base and lower the rate.*

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

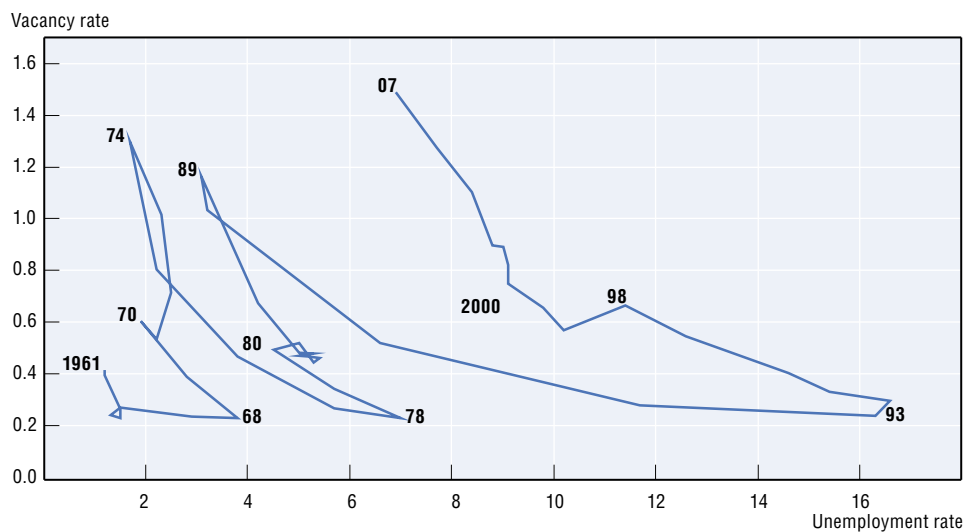
Social services, which are mainly delivered by the municipalities, account for almost 20% of total economy value added, making it the second most important sector after manufacturing. But productivity has declined, posing fiscal sustainability concerns and the risk of labour shortages in key social services as the population ages. A significant number of municipal mergers are under way which may improve efficiency in the long term, although the number of municipalities (about 350 even after the mergers) will remain far too high. *To raise productivity a sharper distinction should be drawn between core and non-core services with municipal*

resources being increasingly focussed on the former. The private sector should be encouraged to play a larger role in the provision of social services – particularly support services that are not considered core outputs. This will require more active encouragement of competition between public and private providers of services. *The central government should ensure that the framework conditions in which municipalities operate guarantee a level playing field between private and public providers. This may require changes to public procurement legislation and the introduction of policies to encourage the incorporation of all municipally-owned activities that constitute economic activities.* There is also considerable scope for the central and municipal governments to *promote municipal-level productivity gains, such as by developing more sophisticated benchmarking exercises and other measures to facilitate the sharing of best practice municipal management.* ■

**How can wages be made more flexible and employment raised?**

Finland has enjoyed a period of strong labour market performance in recent years, with robust employment growth and steadily declining unemployment. However, further progress in dealing with the ongoing restructuring associated with globalisation requires decisive reforms in the labour market. Raising wage flexibility should be a priority. *Finland’s wage negotiation framework still needs reform to ensure that outcomes more closely reflect labour market conditions for each skill level and occupation. Future rounds should continue to be negotiated at a decentralised level and the process of determining a greater proportion of wage increases at the firm level should continue. At the same time, some degree of co-ordination might*

**Figure 2.**  
**BEVERIDGE CURVE**



Source: OECD, Main Economic Indicators – online database.

be required to ensure that wage developments as a whole are compatible with overall productivity growth and the ECB's inflation target. Opting out of collective agreements should be made easier, and the government should canvass the costs and benefits of eliminating the current practice of extending by legislation virtually all collective agreements to all firms. Finland is increasingly facing skill shortages and the time to fill job vacancies is lengthening, particularly in buoyant regions of the country. This is coupled with high unemployment rates in other regions, suggesting a need for higher inter-regional labour mobility. The legal requirements for geographic (and occupational) mobility of the unemployed should be more strictly enforced and real sanctions applied. In addition, subsidies directed at assisting inter-regional mobility should be rebalanced. Those that are found to be the most effective should be increased while others (such as the second residence subsidy) should be abolished.

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

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

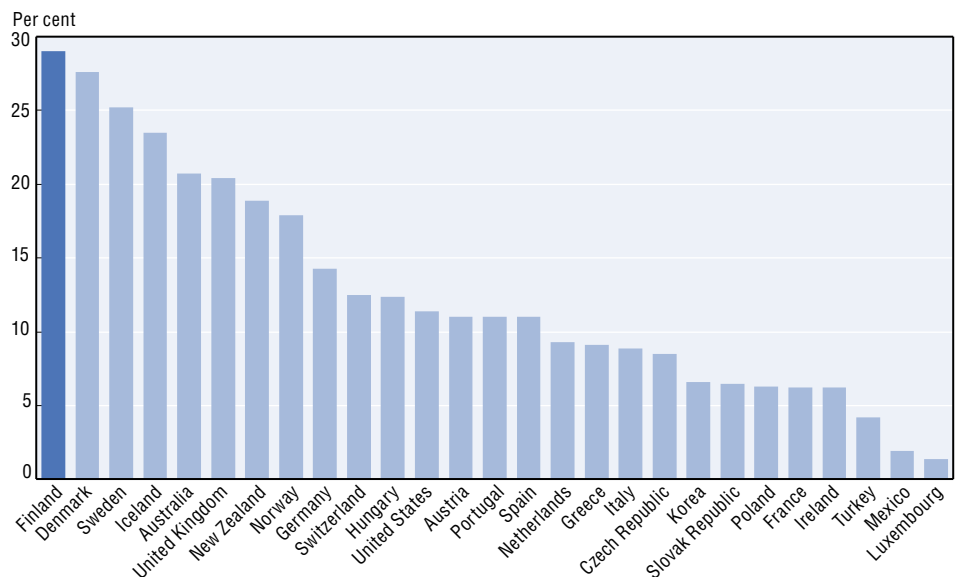
### How can the higher education system be improved?

While Finland is excellent at providing the population with basic skills, there are problems in the later stages of the education system. The transition from secondary to tertiary education is a particular problem, as it can take many years. Due to this "matriculation backlog", only a minority of students is admitted to their preferred field of study immediately after completing secondary studies. Most require several

attempts before gaining a study place. This is a considerable source of inefficiency and contributes to the high age of tertiary graduates. To reduce inefficiencies in the allocation of study places, tertiary institutions should be encouraged to assess applications by relying more on the matriculation exam results. To eliminate the matriculation backlog, additional starting places could be temporarily allocated to areas of greatest demand, although not to the full extent of the backlog. In the long term, the centrally-planned system of starting places should be relaxed by allowing the educational institutions to determine the number of starting places, with financing following the student. Allowing demand to play a larger role in the determination of starting places would also support a more regionally balanced division of starting places, taking better into account the preferences of the students and needs of the labour market. To ensure that prospective students are making informed choices, students should be provided with more information on employment prospects and the wages of graduates.

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

**Figure 3.**  
**ENROLMENT RATES**  
**OF 27 YEAR-OLDS**  
 Full-time and part-time students in public and private institutions, 2005<sup>1</sup>



1. As a percentage of the population in the same age group.  
 Source: OECD (2008), Education database.

improved incentives for them to select their courses of study based on labour market potential; higher expectations by students and greater responsiveness of institutions to students' preferences.

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

### Can more immigrants be attracted to areas with skill shortages?

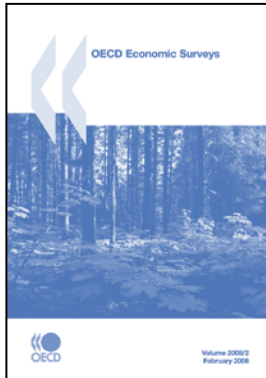
While immigration has traditionally been low – particularly work-related immigration – a growing number of Finnish firms are facing skill shortages and are looking to recruit labour abroad. However, there remain a number of obstacles to attracting skilled migrants to Finland, particularly now that many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

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**Economic Outlook No. 83**, June 2008.

More information about this publication can be found on the OECD's website at [www.oecd.org/eco/Economic\\_Outlook](http://www.oecd.org/eco/Economic_Outlook).

**Economic Policy Reforms: Going for Growth**, 2008 edition.

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