



## Economic Survey of Finland, 2010

**Why was Finland's recession so deep and how could wage outcomes spur recovery?**

**How large is the fiscal sustainability gap?**

**Which fiscal institutions would support needed consolidation?**

**Which policies could contain fast-rising spending and raise efficiency in municipalities?**

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### Summary

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

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

*This Policy Brief presents the assessment and recommendations of the 2010 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.*

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

**Increasing inequalities challenge Finland’s social model and may be aggravated by the crisis.** Although income inequality remains low by OECD standards, it has increased substantially in recent years in spite of decreasing unemployment until recently. The incomes of high earners have increased disproportionately since the early 1990s. Several factors have contributed to this development, among which some elements of the dual tax system. This tax regime should be reviewed. Rising inequality also has a regional component, with wealth and opportunities being increasingly concentrated in the Helsinki region along with economic activity. Measures to improve regional mobility would help to address the uneven performance of regional labour markets. ■

## Why was Finland's recession so deep and how could wage outcomes spur recovery?

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

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

Relative wage flexibility in Finland has been low, partly reflecting a long-standing centralised wage bargaining system. In the 2007/08 round, wage negotiations were decentralised to the industry level to increase wage flexibility. The overall outcome was unsatisfactory however. While the resulting high wage outcomes were in part due to a booming economy, they may also reflect the inability of the less centralised industry-level wage framework to rein in excessive wage increases beyond those justified by economic conditions. Progress on increasing local wage flexibility has also been slow. If the ongoing negotiations, under a broadly similar framework, are unable to achieve reasonable aggregate wage outcomes and improved local wage flexibility, particularly in light of the current dire economic situation, the negotiating framework may need to be reassessed. *Moving back to a centralised bargaining system with government income policies should not be considered. Instead more co-ordination among and between employers and unions may be needed.* Such co-ordination should, however, be limited to achieving reasonable overall wage outcomes and ensuring international competitiveness, and it should not in any way hinder progress towards greater local wage flexibility.

While co-ordination in wage negotiations is largely in the hands of employers and unions, the government should insist on other avenues being taken

to increase wage flexibility. These can include reforms aimed at lowering the currently high replacement rates for the unemployed and generous early retirement schemes (see below). Given that union members only pay a fraction of the total costs of the unemployment insurance, incentives to curtail wage increases that create excessive unemployment are low. *The government and the social partners should therefore consider implementing mechanisms that strengthen these incentives, for example, through experience ratings.*

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

### How large is the fiscal sustainability gap?

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

Although the overall size of the fiscal stimulus implemented in Finland during the crisis is similar to the OECD average, it is distinguished by its mainly permanent nature. A significant part of the stimulus consists of permanent tax cuts announced in the 2007 government programme, which were timed on cyclical grounds and implemented in 2009. Only one third of the stimulus was of a one-off nature or for a limited period. The government has so far only announced some consolidation measures and the exit strategy is still to be formulated. The open-ended fiscal stimulus contributes to pre-existing, significant long-term fiscal challenges. Even before the recession, unfavourable demographics implied an unsustainable fiscal position in the long run. The subsequent losses to potential output and the fiscal stimulus have contributed to a further deterioration. The so-called sustainability gap, which shows the permanent fiscal consolidation needed to cover future fiscal obligations, is estimated to have risen to almost 8% of GDP. ■

### Which fiscal institutions would support needed consolidation?

To restore sustainability Finland will need to show the same fiscal resolve as it did following the 1990s crisis. *While it would be premature to start fiscal consolidation now, the government should urgently develop, communicate and be ready to implement a sustainability plan. Such a plan should mainly rely on significant increases in the length of working lives and lower government expenditures, but higher*

taxes are also likely to be needed. Due to compounding, the hurdle will increase significantly for every year without consolidation and will add to the burdens of future generations. Consolidation should start once the recovery firms.

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

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

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

The size of the sustainability gap means that tax increases probably will be needed to rectify the fiscal position. On a general level, the government should endeavour to broaden tax bases and raise beneficial taxes, while holding off from raising them on corporations or labour. The recent cut of the value-added tax (VAT) on foodstuffs, which will be broadened to include restaurants, is a step in the wrong direction as it lowers efficiency in the VAT system. The announced increase in the overall VAT rate for 2010 should eventually be accompanied by a full harmonisation of the VAT at this higher level. This needs to be accompanied by targeted compensation for low income earners.

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

tax increases should be implemented gradually and may need to be accompanied by changes in the transfer system to municipalities.

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

### Which policies could contain fast-rising spending and raise efficiency in municipalities?

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

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

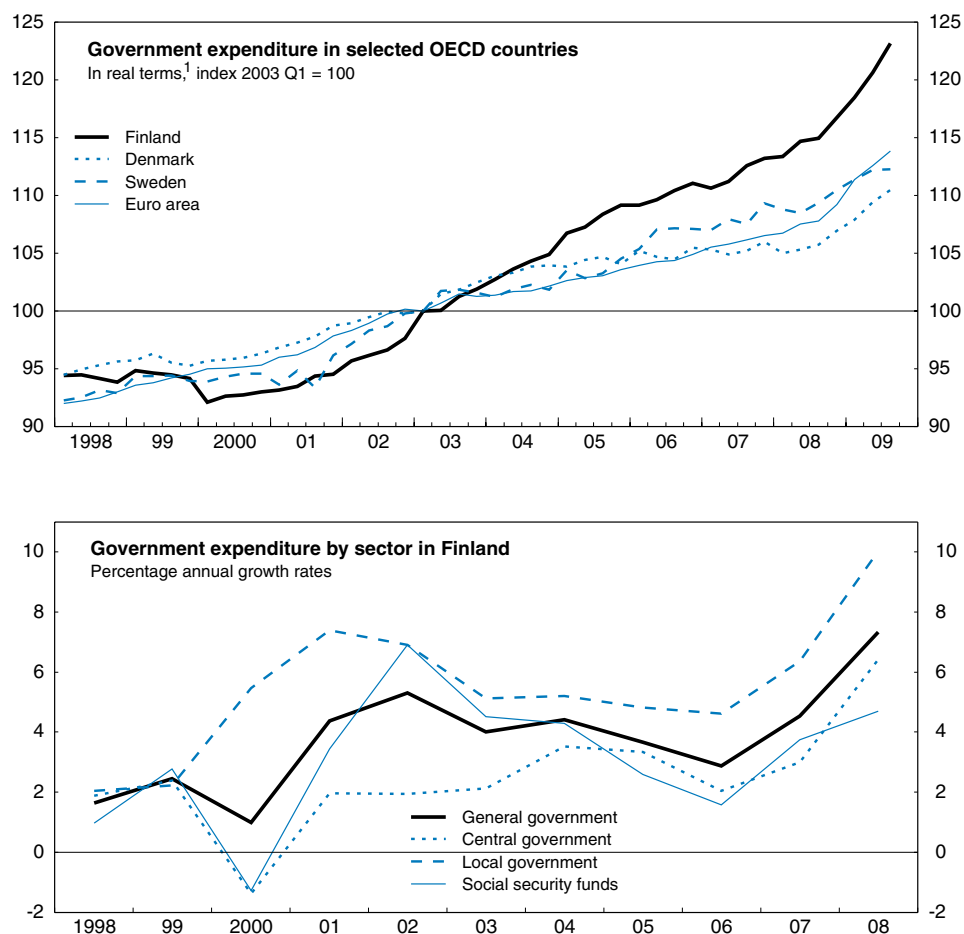
Productivity in local government-provided services fell by more than 10% between 2000 and 2008 on the back of strongly growing municipal expenditures. The decentralised fiscal structure and the soft budget constraints faced by local governments have contributed to this development. The increasing inefficiencies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

Programmes to increase efficiency in local governments include incentives for mergers, for investment in information technology and the establishment of minimum population-base requirements for school and healthcare districts.

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

To improve efficiency in municipal service provision, the strategy for mergers needs to be accompanied by rationalisation in local governance to reap plant-level economies of scale in health care, education and childcare. While

**Figure 1.**  
**EXPENDITURES HAVE BEEN INCREASING RAPIDLY**



1. Deflated by the private consumption deflator.

Source: Statistics Finland and OECD Economic Outlook 86 Database.

relying on competition to improve efficiency in service provision in small municipalities may be difficult due to the thinness of the market, there is clearly more scope for competition in larger municipalities. Finding cost-efficient and yet equitable ways of providing municipal services will be a challenge, and the government needs to continue to support research on and knowledge-dissemination of best practices among them. ■

### How can labour market and social policies contribute to higher employment?

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

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

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

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

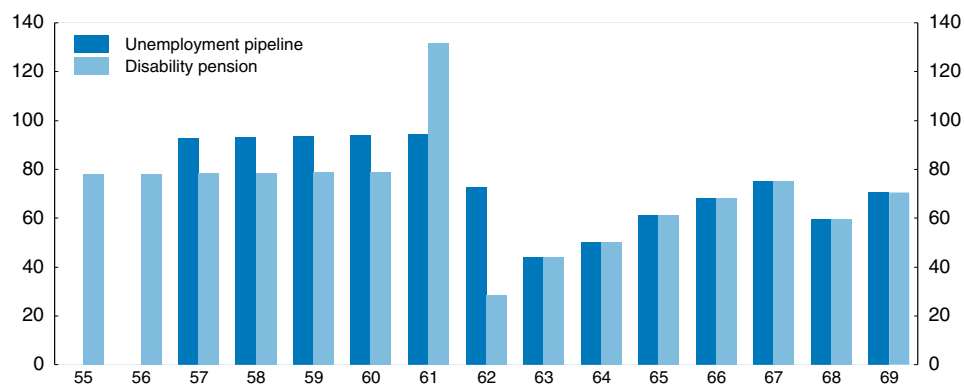
Earnings-related unemployment benefits are provided by funds associated with unions, but mainly paid for by employers and the central government. The separation of financing and benefit provision may lead to a too lenient treatment of members in relation to existing rules and higher administrative costs.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

Entry into various early retirement schemes should be restricted to minimise the long-term consequences of the recession for labour supply and fiscal sustainability. The past practice of alleviating temporary labour market imbalances by providing ample and generous exit opportunities for older workers has proved to be costly over time. Despite recent improvement, participation rates of older workers in Finland are relatively low in the Nordic context. With unemployment mounting, the pressures on the disability pension system, the “unemployment pipeline” and early exit into regular retirement are increasing. *The success so far with partial reforms of the unemployment pipeline should be followed up with its full scale abolition. Entry into the disability pension should only be allowed on medical grounds under tighter assessment procedures. The focus on rehabilitation has so far yielded little in terms of outflow from disability, and sheltered employment may be a better way forward. Lower replacement rates in the disability pension should be considered to reduce incentives for early exit from the labour market.* ■

**Is pension reform critical to long-term fiscal sustainability?**

To accommodate the challenges from ageing, Finland should take a multi-faceted approach. Over the next two decades, old-age dependency will increase faster in Finland than in almost any other OECD country. Pre-funding should be enhanced so that the accumulation of net assets, before dependency ratios become too high, mitigates the pressure to raise taxes later. To deal with increasing longevity, working lives need to be extended. In the Finnish pension system introduced in 2005, benefits will be adjusted downwards in line with improving longevity. Although this adjustment clearly reinforces the robustness of the system, further reforms

**Figure 2.**  
**IMPLICIT TAX ON WORK ON EARLY RETIREMENT PATHS<sup>1</sup>**



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

Source: OECD calculations.

are needed to ensure that sustainable public finances can be achieved without crippling tax increases.

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

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

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

### How can Finland mitigate rising income inequality?

Along with GDP, income distribution is an important indicator of well-being. While inequality of disposable income in Finland remains among the lowest in the OECD, it has increased in recent years despite a substantial decline in unemployment rates since the 1990s recession. Like in most other OECD

countries this reflects technical change, rising globalisation and shifting demographics. In Finland strong realised capital gains and income shifting promoted by the dual tax system have also been important factors. *Loopholes in the dual tax system therefore need to be addressed.*

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

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**OECD Economic Outlook No. 86**, November 2009.

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**, 2010 edition.

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