

Economic Survey of Finland, 2006

What are the main challenges?

What is the short-term macroeconomic outlook?

How should fiscal policy respond to imminent ageing pressures?

Will the new pension reform succeed?

How can the disabled be helped into work?

What other measures can be taken to improve labour market performance?

Is the current state of the housing market a cause for concern?

How can housing policy be improved?

For further information

For further reading

Where to contact us?

Summary

Growth performance has been among the best in the OECD, underpinned by a strong innovation performance and high educational attainment.

The unemployment rate, currently at 8%, has dropped below the euro area average, employment rates, particularly among the old workers, have been increasing rapidly, inflation is among the lowest in the OECD and the government surplus sizeable.

Yet, there is considerable scope for further improvement as GDP per capita is still only close to the OECD median.

This largely reflects a subdued productivity performance in the sheltered sectors, including in the provision of public services, as well as unused labour resources, especially of young and older workers.

With population ageing imminent and pronounced, both growth prospects and fiscal sustainability could be undermined. Against this background, policymakers will need to address the following challenges:

- **Ensuring the sustainability of public finances.** This will require: i) the maintenance of a sizeable fiscal surplus over the remainder of this decade; ii) the phasing out of early retirement schemes; and iii) efficiency gains in public services, greater use of fees in their provision and more supply of such services by the private sector, for which there is scope while respecting equity objectives. The medium-term goal must be to reduce the high tax wedges on labour further, despite the spending pressures from ageing.

- **Raising employment.** Lowering taxation, especially on labour, is one way to raise labour supply and achieve the government's ambitious medium-term employment target. But more is needed.

The tax-benefit system leads to unemployment and poverty traps and active labour market policy should be better focused on the most vulnerable groups.

Moreover, the central wage agreements, while serving the country well in terms of restraining wage inflation, have compressed the earnings distribution, which reduces demand for the low-skilled. Strong employment creation recently makes it likely that the short-term employment target of creating 100 000 jobs over this electoral period might be achieved.

Nevertheless, further reform needs to be undertaken to achieve the more ambitious long-term objective of a 75% employment rate.

- **Boosting productivity and enhancing resilience.** The considerable productivity boost from information and communication technology (ICT) products is likely to wane, and more emphasis should be put on utilising ICT elsewhere in the economy, particularly in both private and public services.

Measures to raise competition in the service sectors, including in the public sector are needed.

The housing market has been very volatile in the past, though current house prices seem to be closely aligned with fundamentals.

But house price inflation has picked up and credit demand is strong. Now is an opportune time to introduce reforms to curb future risks stemming from the housing market.

Labour market mobility would be enhanced and public money saved by reducing the support to social housing, the extent of which currently goes beyond that required to satisfy equity objectives.

A comprehensive reform package is needed to meet these challenges and ensure a continuing strong growth performance. ■

What are the main challenges?

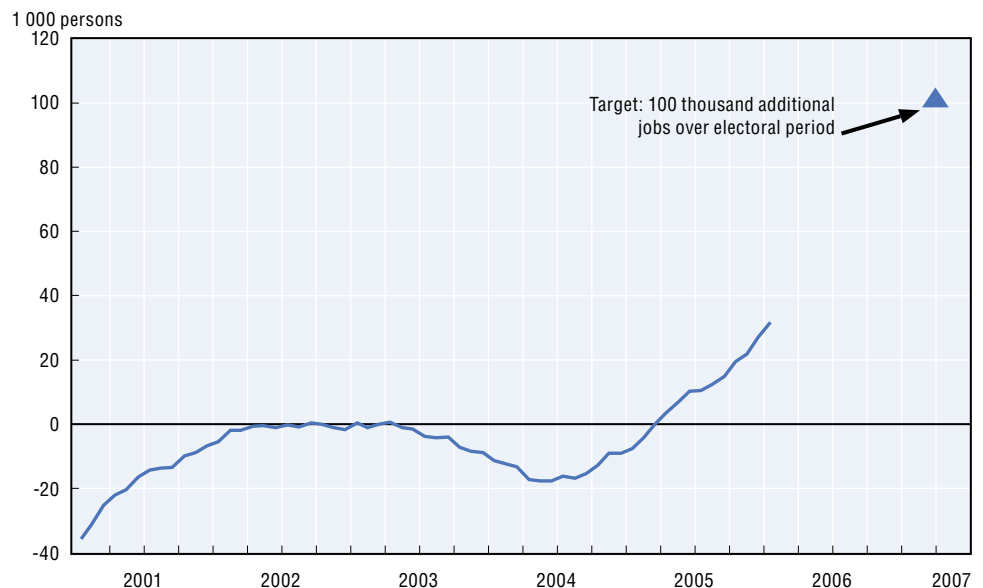
Growth over the past decade has been among the strongest in the OECD. Finland also ranks highly as regards innovation performance and educational attainment, both of which are key drivers of productivity.

However, there has been a marked weakening in growth performance since the turn of the millennium; the contribution from the ICT sector to aggregate productivity has been much smaller and increases in the employment rate have been meagre, though the employment rate among the old has been increasing rapidly from a low level.

Moreover, income growth could fall further because over the next 25 years population ageing is among the most rapid in the OECD; the number of employed workers for each welfare benefit recipient, including those on unemployment benefit and all forms of pensions, could drop from 1.7 currently to about 1.0 by 2030, if current age-specific employment and benefit recipiency rates are maintained.

The main challenges facing policy-makers are to sustain the growth in living standards by boosting productivity, especially in the sheltered sector and in public services, by realising the government’s ambitious employment targets as well as by ensuring fiscal sustainability and reducing future pressures on taxation, especially those on labour. ■

Figure 1.
RECENT PROGRESS
TOWARDS THE
EMPLOYMENT TARGET
 Change in employment¹
 relative to March 2003²



1. Employment is measured as the average over previous 12 months to eliminate seasonal effects.
 2. The last general election was in March 2003 and the election period is a maximum of 4 years.

Source: Statistics Finland.

What is the short-term macroeconomic outlook?

Growth in 2006 is likely to exceed 3%, which according to OECD estimates will take output clearly above potential for the first time since the global downturn in 2000.

The growth figure for this year partly reflects a bounce-back from the coincidence of a labour dispute in the paper industry and a temporary lull in the electronics industry in the first half of 2005, although with output growth picking up strongly in the second half growth in 2005 was still 2%.

Employment growth picked up surprisingly strongly through 2005, raising the possibility that if it continues at this rate the government might meet its objective of raising employment by 100 000 over the electoral period.

Inflation as measured by the harmonised consumer price index (CPI) is currently about 1%, the lowest in the euro area and mostly accounted for by higher energy prices. Rises in non oil import prices, especially for intermediate goods, as well as demand pressures, are likely to push up inflation somewhat; however, the central wage agreement which runs to mid-2007 will ensure that any pick up will not feed into higher wage inflation and so keep price inflation below 2%. ■

How should fiscal policy respond to imminent ageing pressures?

The general government surplus was around 2½ per cent of GDP in 2005. It is easily the largest in the euro area, although this is entirely accounted for by the pension funds, whereas the combined central government and municipalities financial balances are roughly in balance.

The combined balance of central government and the municipalities should remain in surplus on a cyclically-adjusted basis for the rest of this decade.

This would imply a general government surplus of 3-3½ per cent of GDP. Maintaining such a large general government surplus, while desirable to prepare for the fiscal pressure from imminent population ageing, will be difficult given the government's promise of tax cuts on earned income and strong spending pressures at the municipal level.

With the recovery firming, there is no need for additional fiscal stimulus from a macroeconomic perspective, and further tax cuts on labour should be matched by spending restraint or revenue-neutral changes to the structure of taxation. Moreover, given past actions, the room for tax cuts seems exhausted.

With rapid ageing, it is essential to re-balance public and private provision to cope with rising service demand.

If not managed well, current spending pressures may force municipalities to continue raising their income taxes thereby neutralising the income tax cuts by the central government.

Cost-efficiency of health care and social services is of strategic importance due to the prospective increase in the demand for them.

There is scope to raise the efficiency of health care provision, which is largely a municipal competence, as evidenced by the wide variation in the cost of hospital services.

The government has launched an ambitious programme for reforming the structure of local government with the aim of increasing the cost efficiency of municipal services. It is important that this programme is carried out vigorously.

Reducing or eliminating the municipal share of corporate tax revenues would also improve the overall control of aggregate public finances by reducing cyclical fluctuations in municipal revenues which have tended to ratchet up municipal spending.

Introducing tertiary education fees for all students while developing the loan system (perhaps with income-contingent repayments) would not only be more equitable but also more efficient.

Higher tuition fees would make students' demands for education attentive to the quality and subjects being offered, with subsequent effects on their supply. ■

Will the new pension reform succeed?

A major achievement has been the introduction of a wide-ranging pension reform from the beginning of 2005. It comprised a complex package of measures that achieved a broad degree of national consensus.

The government is relying on this reform to make a major contribution to raising the length of working lives by two-three years through improved incentives to work longer, especially from higher accrual rates for older workers (63-67) and the abolition of the cap on the maximum pension.

While the reform package includes many innovative features, notably linking pensions to changing life expectancy, it also includes a number of features which unnecessarily add to future pension costs.

Thus, while the reform will improve the financial sustainability of the pension system, contribution rates for the private sector – which are already very high by international standards – were still estimated to have to rise by 6 percentage points by 2030.

Recent measures to increase the return on the pension funds are likely to alleviate this pressure by 1 to 2 percentage points. But more is needed.

There is understandably little appetite to revisit this issue again so soon after a major reform, although implementing many of the changes more quickly rather than phasing them in gradually could lower pension costs.

In addition, some elements of the reform – in particular the accumulation of pension rights during non-work periods (*e.g.* during study) and the higher rate of accumulation from age 53 – only partly compensated by a higher contribution rate by employees in this age group – are costly and serve little economic purpose. They should be reconsidered.

The area which should be considered most urgently to ensure that the old-age pension reform is a success in encouraging longer working lives is alternative pathways to early retirement.

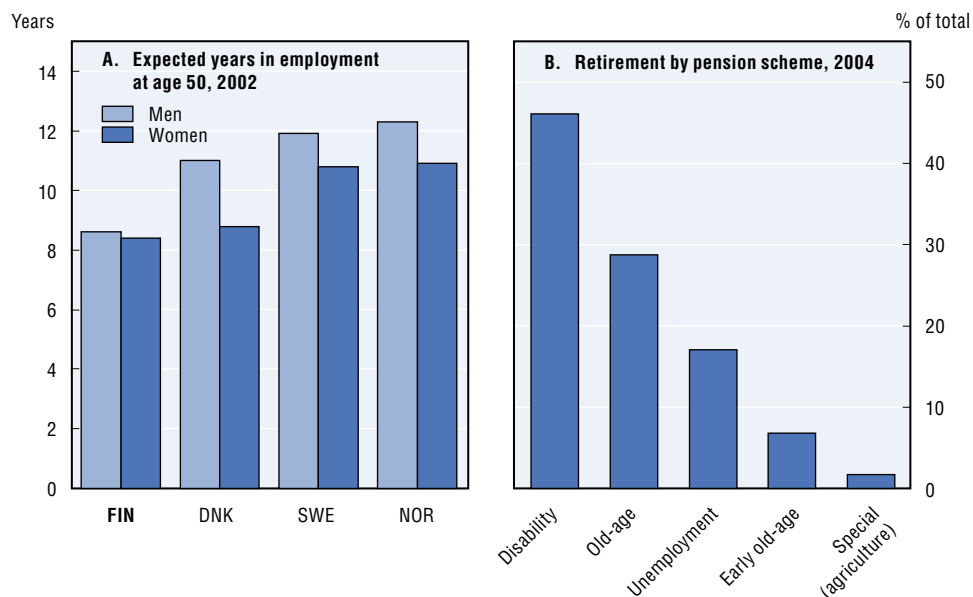
Currently nearly 7 out of 10 new retirees retire early on some form of unemployment or disability benefits. Cross-country evidence suggests that, if these pathways to early retirement remain, they will blunt the increased incentives to work longer that are provided by the old-age pension reform.

Indeed, Finnish experience over the past decade when the increase in the employment rate of older workers has been among the most rapid of any OECD country, demonstrates the importance of limiting pathways to early retirement.

The current reform package includes a postponement of the age at which the unemployment pathway (or so-called “unemployment pipeline”) can be used from 55 to 57, but the objective should be much more ambitious: the unemployment and disability benefits should be re-focused on their original purpose.

The unemployment pipeline has been moved from the pension system to the unemployment insurance. Normal activation principles should apply or even better, the scheme should be phased out. ■

Figure 2.
EXPECTED YEARS
IN EMPLOYMENT AND
RETIREMENT BY PENSION
SCHEME



Source: Hytti, H. and I. Nio (2006), “The Finnish Employment and Income Security Models in a Nordic Comparison”, *Social Security and Health Research Working Papers*, The Social Insurance Institution, Finland (forthcoming); Eurostat; Finnish Centre for Pensions, *Statistical Yearbook of Pensioners in Finland – 2004*.

How can the disabled be helped into work?

The proportion of the population who are inactive and on disability benefits is among the highest in the OECD with nearly half of all new retirees retiring on a disability pension.

While abolishing the previous “individual early retirement pension”, the reform still allows for “social factors” (as opposed to just medical conditions) to play a stronger role after the age of 60 when assessing eligibility for a disability pension.

Concerns about this change are increased by evidence from the 1990s of switching between unemployment and disability pathways to early retirement as the relative ease of using one pathway changed.

Eligibility for a disability pension should be evaluated entirely on medical grounds, and should be assessed in the first instance by an independent physician rather than one of the applicant’s choosing.

Once on a disability pension there is little likelihood of regaining employment. While the activation rate among the disabled unemployed is just below that for all unemployed, the number of disabled that are classified as “jobseekers” and are thus considered for active labour market support measures is a small proportion of those on a disability pension.

This is despite the fact that a large proportion of those retiring on a disability pension have less serious conditions (like back pain and less serious mental health problems).

This might, with appropriate medical treatment, mean not only that work is possible but also that work might contribute to an improvement in their medical condition.

The large and growing proportion of those retiring on a disability pension for reasons of mental health raises wider issues of well-being as the number of deaths attributed to mental health conditions (including suicide) is proportionately much higher than in any other OECD country.

It also appears that those with mental health conditions make surprisingly little use of available treatments, although these are generally considered effective, free and not in short supply.

In these circumstances there may be considerable gains from both an economic and wider well-being perspective, in activating those on disability benefits by adopting a similar approach to the successful pilot programme in the United Kingdom.

Under the UK’s *Pathways to Work* scheme, participation in work-focused interviews and training or activities to help the person better manage their health condition is mandatory for all except the most severely disabled. In addition a back-to-work credit is paid for those taking up employment. ■

What other measures can be taken to improve labour market performance?

There is considerable scope to raise the employment rate of young people. One important policy response, which is recognised by the government, is speeding up the transition from studies to work by reducing study times (which are among the longest in the OECD), simplifying admission procedures to universities which contribute to delaying entry into higher education, as well as by making the 3-year bachelors degree a more attractive study alternative.

There may also be a role for strengthening links between education and the labour market through increasing the possibilities for work experience embodied in the curriculum. Centralised collective agreements have probably resulted in aggregate wage moderation, but this has been at the cost of reducing relative wage flexibility.

Wage compression, especially at the lower end, is strong because of high minimum wage floors. Consequently, employment in low-skill industries is weak and unemployment is particularly high among the unskilled. Regional wage flexibility is also low despite wide and increasing disparities in employment performance across regions.

The government has traditionally been involved in centralised wage negotiations, often making tax cuts contingent on the outcome. While the merits of such involvement is unclear the government should use any leverage (as through tax cuts) to promote greater wage flexibility in future central agreements.

This could be achieved by making more use of the so-called “union allowance”, whereby employers and unions have greater flexibility in allocating a portion of the centrally-agreed wage increase at the local level.

Also the use of opt-out clauses allowing for local wage agreements with lower wages than the central agreement if employers and employees agree should be made easier.

To raise employment of younger and low-skilled workers, minimum wages, determined by collective wage agreements, could be better differentiated by age and skills.

Future central wage agreements should avoid building in clauses allowing for supplementary wage increases contingent on CPI inflation surpassing a threshold in such a way that they would imply a risk of magnifying the consequences of an adverse supply shock, such as an oil price shock.

After declining for some years the number of long-term unemployed started rising again in 2004 and has continued rising during most of 2005. The government’s goal is to raise the activation rate of active labour market programmes (ALMPs) to 30% by the end of 2007, from 23% currently, which would imply an increase by around 35 000 participants.

While there is scope for improving the mix of ALMPs in favour of those that are most effective by providing more wage subsidies in the private and less in the public sector, it is not clear on the basis of current evaluations that an expansion will have a significant effect on regular employment.

ALMPs should also be better targeted on older workers. The recent and planned expansion of the public employment service (PES) offices is to be welcomed if it leads to greater emphasis on job search support, counselling advice and obligations to participate in programmes after a period of job search.

The performance of PESs should be monitored in these respects. A particular weakness of current ALMPs is the low coverage of older workers despite the government's goal that older workers who became unemployed during or after 2000 should be encouraged to take up regular employment through training and rehabilitation measures.

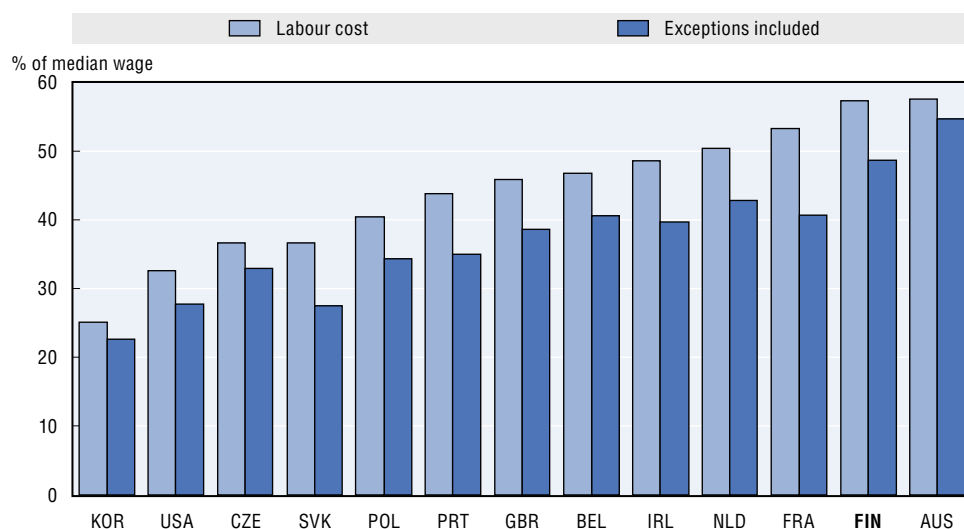
Also the activation of persons on disability schemes should be raised. In addition marginal effective tax rates when moving from unemployment to employment are high in international comparison.

They should be reduced by tapering unemployment benefits at longer durations which are currently among the most generous in the OECD, unless obligations to participate in ALMPs are more strictly enforced. ■

Is the current state of the housing market a cause for concern?

Although there is no sign of imminent macroeconomic instability stemming from the housing market, the Finnish housing market has historically been amongst the most volatile in the OECD. While the level of household debt is currently low in international comparison, it has been growing rapidly in recent years, and mortgages are overwhelmingly financed at short variable rates, so that household disposable income is vulnerable to changes in interest rates.

Figure 3.
MINIMUM LABOUR COST OF YOUNGER WORKERS AND APPRENTICES,¹ 2004



1. The cost of labour is the sum of the wage level and the corresponding social security contribution paid by employers for a single worker. The minimum cost for younger workers includes exceptions by age or by contract.

Source: OECD, Minimum Wage and Taxing Wages databases.

The government currently operates a mortgage loan guarantee scheme, which in 2004 covered one quarter of all new mortgage loans. Consideration should be given to phase out or better target this scheme in such a way that it will not undermine the risk awareness of home buyers.

While the restricted deductibility of mortgage interest expenses is intended to facilitate access to home ownership, the effect is probably capitalised in higher house prices and it may also add to housing market volatility.

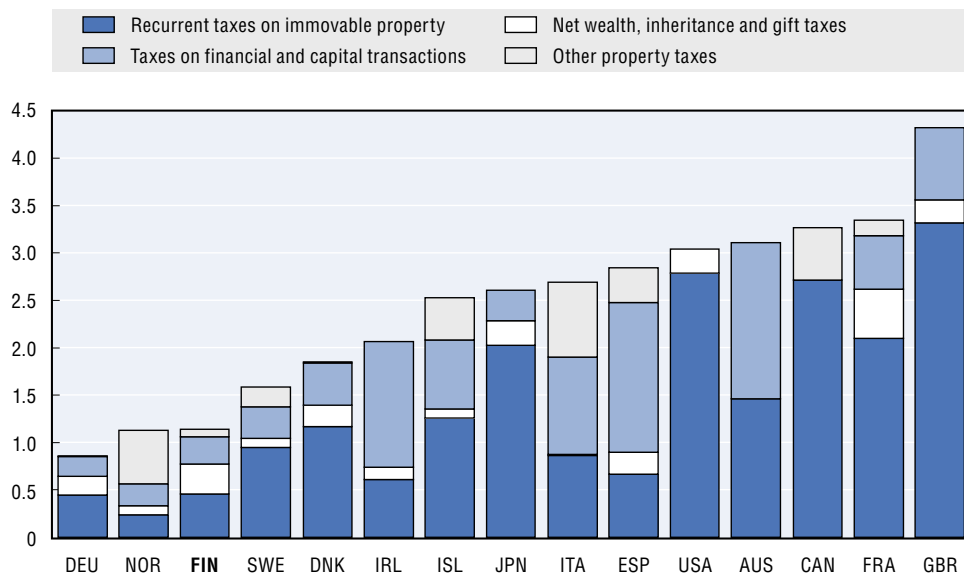
Furthermore, as the imputed rental income and capital gains from home ownership are not taxed, while property taxes are relatively low, the deductibility of mortgage interest expenses favours home ownership over other forms of investment.

The government should therefore take advantage of the currently low level of interest rates to begin scaling back mortgage interest deductibility, possibly in the context of a more comprehensive reform of housing policies and taxation. ■

How can housing policy be improved?

The shortage of building land in the fast-growing regions may partly reflect municipalities' disincentives to provide land for new housing, since municipalities are responsible for financing the expensive infrastructure and services in urban areas required to support population growth. One way to encourage municipalities to provide more building land is to promote the use of the property tax as a source of tax revenue and to extend the tax base to undeveloped land, which is currently not taxed.

Figure 4.
PROPERTY TAXES ARE LOW
As a percentage of GDP, 2004¹



1. 2003 for Australia.

Source: OECD, Revenue Statistics, 1965-2004, 2005 ed.

This would require further easing the limits imposed on municipal property tax rates. This might have the further advantage of shifting the burden of taxation away from labour towards property which is currently at a low level by international standards.

In order to further enhance the incentives of municipalities, property tax revenues could be exempted from the fiscal equalisation scheme.

The incentives could also be promoted by allowing municipalities to tax the increase in the value of building land provided for housing or by making more effective use of the options for the municipalities to use their preferential right to buy land and to charge building developers for the costs of new infrastructure.

Another factor restricting the supply of new housing is lengthy and bureaucratic planning procedures. In particular, there are multiple possibilities to appeal over the decisions concerning building permits and local plans.

The applicants and third parties have the right to challenge the decisions in both the regional and supreme administrative court and the average length of proceedings is relatively long.

The multiple possibilities to appeal over the decisions concerning building permits and local plans should be constrained without hampering the due process of planning.

Nearly three-quarters of Finland's population is eligible for social housing programmes and even relatively high income earners live in government subsidised housing.

Limiting the eligibility to social housing would save money, with probably little implication for social objectives, while stimulating the private rental sector.

The housing allowance system should also be reformed. The magnitude of the allowance should be linked to the average rent in the region, rather than the actual rent paid, which would reduce the cost of the scheme and allow households to choose the quality and price of the housing. ■

For further information

For further information regarding this *Policy Brief* please contact:

M. David Turner: tel.: +33 1 45 24 87 15 (david.turner@oecd.org),

Ms. Åsa Johansson: tel.: +33 1 45 24 87 80 (asa.johansson@oecd.org),

Ms. Laura Vartia: tel.: +33 1 45 24 94 72 (laura.vartia@oecd.org).

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Where to contact us?

OECD HEADQUARTERS

2, rue André-Pascal
75775 PARIS Cedex 16
Tel.: (33) 01 45 24 81 67
Fax: (33) 01 45 24 19 50
E-mail: sales@oecd.org
Internet: www.oecd.org

GERMANY

OECD Berlin Centre
Schumannstrasse 10
D-10117 BERLIN
Tel.: (49-30) 288 8353
Fax: (49-30) 288 83545
E-mail:
berlin.contact@oecd.org
Internet:
www.oecd.org/deutschland

JAPAN

OECD Tokyo Centre
Nippon Press Center Bldg
2-2-1 Uchisaiwaicho,
Chiyoda-ku
TOKYO 100-0011
Tel.: (81-3) 5532 0021
Fax: (81-3) 5532 0035
E-mail: center@oecdtokyo.org
Internet: www.oecdtokyo.org

MEXICO

OECD Mexico Centre
Av. Presidente Mazaryk 526
Colonia: Polanco
C.P. 11560 MEXICO, D.F.
Tel.: (00.52.55) 9138 6233
Fax: (00.52.55) 5280 0480
E-mail:
mexico.contact@oecd.org
Internet:
www.ocdemexico.org.mx

UNITED STATES

OECD Washington Center
2001 L Street N.W., Suite 650
WASHINGTON DC. 20036-4922
Tel.: (1-202) 785 6323
Fax: (1-202) 785 0350
E-mail:
washington.contact@oecd.org
Internet: www.oecdwash.org
Toll free: (1-800) 456 6323

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