This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.
Summary

- Main findings
- Key recommendations
Main findings

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

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

Reforms to cope with ageing

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

Fiscal policy and structural reforms

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

Local public finances and municipal reform

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

Financial policy

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

Innovation and green growth

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

Reforms to cope with ageing

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

Fiscal policy and structural reforms

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

Local public finances and municipal reform

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

Financial policy

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

Innovation and green growth

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

- Activity is picking up slowly but uncertainty remains high
- The economy is undergoing deep restructuring
- The financial sector is solid but remaining vulnerabilities should be addressed
- Some medium-term consolidation is warranted
- Structural reforms to boost growth and ensure long-term fiscal sustainability
- The economic consequences of population ageing
- Enhancing public sector efficiency
Finland enjoyed over a decade of strong output growth led by the high-tech sector before the 2008 global financial and economic crisis. It is one of the most competitive countries in the world and its residents enjoy a high level of well-being. Finland ranks seventh in the World Happiness Report 2013 (Helliwell et al., 2013), and performs better than the OECD average in all dimensions of the OECD Better Life Index (Figure 1). Income inequality is still among the lowest in the OECD. Social inclusiveness contributes to Finland’s high level of subjective well-being, personal security, civic engagement, governance and social connections. Jobs and earnings are close to the OECD average, despite recent output weakness, and the work-life balance is good. Housing conditions are better than the OECD average, but households are accumulating substantial debt to finance their dwellings, which increases their vulnerability and that of the financial system to economic shocks. Environmental quality is very high and rich natural resources, notably forests, offer a promising potential for green growth. Education is excellent, even though Finland has fallen slightly in the latest Programme for International Student Assessment (PISA) rankings (OECD, 2013a). Public health care coverage is extensive, although health status is average.

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

Figure 1. Well-being in Finland is relatively high

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

Activity is picking up slowly but uncertainty remains high

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

Unemployment, as measured in the internationally comparable labour force survey (LFS), has risen only modestly relative to the drop in output, and long-term unemployment has been contained (Figure 3, Panel A and B). Nevertheless, employment has fallen and registered unemployment is rising (Figure 3, Panel C). The divergence in unemployment trends between the data from the employment offices and those from the LFS suggests an increase in the number of discouraged workers, as the definition of active job search is more restrictive in the LFS. The rise in unemployment has been limited by relatively effective active labour market policies, although these could be improved further in terms of work incentives and earlier activation (OECD, 2012a and 2013c). A shift in the production structure from high-productivity manufacturing to lower-productivity services has also exacerbated losses in output relative to employment. Shrinking labour supply and the move towards lower-productivity sectors have combined with slower growth of the capital stock, due to low investment in recent years, to reduce potential output growth. This will slow and weaken the recovery.
### Table 1. Macroeconomic indicators and projections

**Annual percentage change, volume (2000) prices**

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

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

Source: Update, based on the national accounts data as of end January 2014, of the projection presented in the OECD Economic Outlook 94, and Eurostat.
The outlook is surrounded by huge external and domestic uncertainties. As a small open economy, Finland is vulnerable to faltering global demand, but also to a slowdown in particular in Russia or other Nordic countries. The euro area recovery is still hesitant and could be derailed by adverse developments in vulnerable countries and insufficient agreement between European Union (EU) member states on crisis resolution mechanisms (OECD, 2013d). While low interest rates are beneficial in the current context of weak activity, they also entail significant risks. Lower interest income weakens banks’ profitability and may induce them to take more risks, as they become more dependent on revenue from trading and investment. Borrowers may underestimate the burden of rising repayments once interest rates go up, build up excessive leverage and push up asset prices. Weak activity also increases

![Figure 3. The labour market has held up relatively well](image)

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

credit risk, although bankruptcies and non-performing loans have so far remained limited. A highly skilled workforce and a favourable business environment suggest significant scope for a knowledge and innovation-led economic revival. However, if growth of new and young businesses turned out to be slower than anticipated, this would weigh on productivity and standards of living. Conversely, an improving export performance, as the economy restructures and cost competitiveness improves, could strengthen the recovery. A stronger than projected rebound in the global economy would also improve the prospects for the Finnish economy.

The economy is undergoing deep restructuring

Growing sectors have not compensated losses in electronics and forestry

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

![Figure 4. The share of electronic and forest products in output has collapsed](image)

1. Excluding electronic and electrical products.

Source: Statistics Finland.

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

Production of goods and services has become increasingly fragmented into global value chains (GVCs) over the past decades (OECD, 2013e). Integration into GVCs offers huge opportunities to generate revenue from competitive advantage in specific areas. Finland benefitted from being well integrated into electronics GVCs from the late 1990s until recently. In 2009, the latest year for which data are available, nearly 15% of Finnish exports were linked to participation in electronics GVCs (Figure 6). However, as the electronics sector has shrunk since then, new opportunities for participation in GVCs need to be found to revive output growth and exports. While traditional sectors like chemicals and metals are already well integrated into GVCs, developments in new areas, such as electronic games, bio-technologies and bio-medicine and green technologies, are promising.
Figure 6. Finland was well integrated in global value chains¹

As a percentage of gross exports, 2009

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

Source: OECD-WTO Trade in Value Added database.

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

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

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

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

Finland, like other Nordic countries, has set climate change mitigation and green growth as strong priorities. The government is using a variety of demand and supply-side instruments to promote energy efficiency, which supplement EU legislation (Dreblow et al., 2013). In particular, energy taxes are based on energy content, CO₂ and particle emissions, following international best practice. They have been increased progressively and are high by OECD standards (Figure 7, Panel A). Feed-in tariffs for electricity produced from renewable energy were introduced in 2011. The share of renewable energy in overall energy production is about a third, one of the highest in the OECD, and Finland is likely to meet its ambitious target of a share of 38% for renewable energy by 2020 (Figure 7, panel B). The bio-fuel obligation will rise from the current 6% of transport fuels to 20% in 2020.

Figure 7. Policies are promoting green growth

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

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

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

While pricing environmental externalities through taxes or emission permits, along with adequate regulations, is a prerequisite for green growth, it is not sufficient. Most clean technologies are still in their infancy. The green technology sector is growing fast and applications with wide socio-economic impact build on Finland’s comparative advantage in forestry and high-tech. For example, wood-based energy accounts for more than half of North Karelia’s energy consumption. In the specific environment of this remote region, sustainable wood-based energy can compete with conventional sources in terms of costs and efficiency. Furthermore, renewables are contributing significantly to growth and employment in the region. Additional benefits include lower heating costs and improved energy security. Enhanced competitiveness in the forest industry and the manufacturing of forest machinery also generate opportunities for international expansion and integration into GVCs (OECD, 2012b).
As the national forest industry experiences structural difficulties resulting from a decline in the global paper market and increasing international competition, bio-energy is seen as a promising reconversion opportunity. As an illustration, a leading forest company is building a bio-refinery to produce wood-based bio-diesel on an industrial scale, which should be completed in 2014 and is not dependent on government grants. Second-generation bio-fuels do not compete with food production and are expected to have better energy yields and environmental balances than those of the first generation. They are likely to contribute significantly to allowing the transport sector to move towards more sustainable energy sources in the medium term, although major technical and economic challenges remain (Eisentraut, 2010).

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

### Recommendations on innovation and green growth policies

**Key recommendations**

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

**Further recommendations**

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

The financial sector is solid but remaining vulnerabilities should be addressed

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

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

Source: European Central Bank.

Growth in credit to households is now also subdued (Figure 8, Panel D). Nevertheless, household debt has increased rapidly over the past decade, although it is still fairly modest compared to other Nordics (Figure 9). Housing prices have increased markedly in the early 2000s, but they have been broadly flat since and do not seem to be out of line with underlying fundamentals (André and García, 2012). It is difficult to determine the risks associated with a specific level of debt, as they depend on a number of factors, in particular the volatility of the economy, the level and nature of assets, the sensitivity of debt servicing to interest rates and the distribution of debt across households. As a small open economy, Finland is vulnerable to external shocks. Finnish households do not have very high financial wealth, and first-time buyers tend to have little equity in their homes. In May 2012 more than half of first-time buyers had a loan-to-value ratio (LTV) in excess of 90% and more than 40% had a LTV over 100% (FIN-FSA, 2012). Most mortgages carry variable interest rates, exposing households to risks in the case of a sharp increase in interest rates. The government is reducing allowances for mortgage interest tax deduction, making borrowing less attractive. At present, the supervisory authority has the power only to lay down a recommendation on LTV caps on mortgage lending, but no juridical power to impose a binding LTV cap. While the current conditions of the housing market do not call for immediate action,
the supervisory authorities should have the possibility to use macro-prudential tools, such as LTV limits if debt accumulation gathers pace (in line with recommendations from the EU Capital Requirement Directive IV, which entered into force in 2013). In that case, risk weights for mortgages in capital requirement calculations could also be increased, as in Norway and Sweden. In addition, underwriting practices and product development should be closely monitored to avoid excessive loosening of credit standards and proliferation of high-risk products, as happened in recent years with deferred-amortisation loans in Denmark (OECD, 2014).

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

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

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

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

Source: IMF, Financial Soundness Indicators.

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

Recommendations on financial policy

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

Some medium-term consolidation is warranted

A strong fiscal position at the beginning of the slowdown allowed Finland to avoid damaging procyclical fiscal consolidation (Figure 11, Panel A). However, gross government debt is rising towards 60% of GDP, as the protracted slump in activity delays the return to budget surpluses (Figure 11, Panel B). Even though government assets dwarf liabilities, largely as a result of pre-funding of pensions, the rise in gross debt needs to be halted.
The Ministry of Finance and the European Commission estimate the fiscal sustainability gap – the permanent fiscal consolidation needed to cover future obligations – at respectively 4.7% and 6% of GDP. The corresponding OECD estimate amounts to around 7% of GDP, out of which 5% stem from increasing pension and health care outlays (OECD, 2013b). The larger OECD estimate reflects higher pension and health care costs, based on different assumptions regarding a range of parameters such as population and productivity growth or increases in relative prices of health care services. Although fiscal sustainability indicators vary and are surrounded by uncertainty, they all suggest that further fiscal consolidation is necessary over the medium term. Most of it should come through structural reforms. Fiscal sustainability should be monitored closely and the fiscal stance adjusted accordingly, taking into account the cyclical situation and the medium- and long-term challenges.

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

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

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

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

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


**Recommendations on fiscal policy and structural reforms**

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

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

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

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

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

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

Population ageing will put pressure on pension and health spending

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

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

1. Refers to expenditure excluding investment. 

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

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

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

Ageing will also reduce labour supply and potential output growth

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

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

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

Figure 14. Indexing the retirement age to life expectancy could stabilise labour force participation¹

![Figure 14. Indexing the retirement age to life expectancy could stabilise labour force participation](image)

1. Labour force participation rate of people aged 15 and over. 
   Source: Johansson et al. (2013).

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

Raising the minimum retirement age by two years would lead to an increase in the effective retirement age by 8 to 10 months by 2025, but only if the unemployment tunnel and part-time pensions were abolished; otherwise, it would fail to raise the effective retirement age (Finnish Centre for Pensions, 2013). This underlines the need to abolish both the unemployment tunnel and part-time pensions. Another way to retire earlier is through access to disability benefits. Even though the share of new retirees being granted a disability pension has decreased, there is further room for improvement, as more than 20% of retiring people still go on disability pension. Access to disability pensions should be based on medical reasons only (Braconier, 2010).

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

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

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

## Strengthening other groups’ labour market participation

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

### Recommendations on pension, health and labour market reforms

#### Key recommendations

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

Further recommendations

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

Enhancing public sector efficiency

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

Municipalities are small and have broad responsibilities

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

Figure 15. Local government expenditure is high as a share of GDP

![Figure 15. Local government expenditure is high as a share of GDP](image)

1. In 2011. Includes unitary countries only. Data for the OECD refer to an unweighted average.

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

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

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

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

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

Debt varies widely across municipalities, reflecting both differences in population needs, operating environments and efficiency. The distribution of municipal debt has widened over the past decade, even before the global economic and financial crisis (Figure 17, panel B). Some municipalities suffered large drops in revenue recently, notably as a result of falls in corporate profits and plant closures that eroded tax revenue. Expenditure per capita has also increased unevenly, especially in health care and social services. As some municipalities are relying increasingly on central government transfers, planned cuts in grants by more than 10% at the 2015 horizon will increase pressure to rein in spending or raise taxes.

1. In thousands of inhabitants.
2. In real terms.

*Source: Statistics Finland and OECD calculations.*

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

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Municipal debt is rising and unevenly distributed

1. Maastricht definition. Data for 2012 are preliminary, and from 2013 are projections. The series in levels is adjusted using the GDP deflator.
2. Kernel density. Municipal debt deflated by the government consumption price index.
Source: Ministry of Finance, OECD database on sub-national finances (Directorate for Public Governance and Territorial Development), and OECD calculations.

**Strengthening the fiscal framework**

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

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

**The reform of municipalities has the potential to generate efficiency gains**

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

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

**Figure 18. Municipal costs are lowest at about twenty thousand inhabitants**

Expenditure per person by municipality size, 2011

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

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

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

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

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

Key recommendations

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

Further recommendations

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

Progress in structural reform

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

- Past recommendations
  - Actions taken and current assessment

**Fiscal framework**

- Strengthen the fiscal framework by adopting a medium-term fiscal target for the general government balance (while allowing automatic stabilisers to work) that is consistent with a debt target. Contain spending growth, especially in municipalities, preferably by expanding the expenditure ceiling to cover a larger share of general government spending.

  - A new steering system for local government finances will be introduced with the aim of safeguarding the sustainability of local government finances, which will be comparable to the present central government spending limits procedure. The new system will ensure that municipalities’ tasks and obligations are consistent with balanced local government budgets.

**Health care reform**

**Efficiency and quality of care**

- Ensure that the merger process leads to the establishment of municipalities that are large enough to ensure efficient provision of health care and social services. Ensure that mergers result in efficiency-enhancing re-organisation of services.

  - The number of municipalities dropped from 336 at year-end 2011 to 320 currently. The municipal reform programme should lead to further consolidation from 2015 onwards. The health care reform aims to consolidate the organising structure of social and health care services.

- Rationalise the organisation of health services to achieve a better balance between primary and specialised care.

  - The proposed reform aims to integrate responsibility for primary and specialised care, which will make for a more practical division of labour between the two.

**Incentives for a better balance between primary and specialised care**

- Introduce a mix of capitation and fee-for-service payment in health teams’ remunerations to encourage activity in primary care.

  - Municipalities have considerable autonomy in how they remunerate public health care staff. This allows them to develop remuneration practices suitable to local conditions.

- Encourage the effective use of diagnosis-related groups (DRGs) in hospitals by adopting national guidelines and encourage developing DRGs for primary care.

  - The first national guidelines for specialised care DRGs were published at the end of 2012. The development of primary care DRGs should be ready for municipal use in 2014.
User choice

- Drawing on existing experiences in some municipalities, a purchaser-provider split (PPS) should be adopted in areas where the population base and the level of complexity of treatment allow meaningful competition.
  - Municipalities have considerable autonomy in how they provide the required health services and the use of PPS is expanding.

- Competition on prices should be permitted wherever the level of complexity and the density of population allows, accompanied by appropriate benchmarking of health care providers, possibly requested from the National Institute for Health and Welfare (THL).
  - Negotiations on prices have been part of discussions on partnerships between municipalities and private providers. The expansion of DRG use and patient choice between public providers aim to enhance quality of care in the public sector.

Information flows

- Complete the nationwide patient record, which is essential to improve co-ordination of care.
  - Electronic prescriptions should be in use by both public and private organisations by April 2014. Patient records should be archived by public organisations from September 2014 and from September 2015 in private organisations.

- Continue to develop electronic tools to promote evidence-based medicine and health provider benchmarking.
  - Care practices are developed by Current Care Guidelines; THL compiles benchmarking statistics on provider performance. The increased electronic storage of information can be used to further develop care practices.

Prevention and promotion of healthy lifestyles

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

Non-institutional long-term care

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

Availability of an adequate health workforce

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

- Adjust active labour market policies so that activation takes place earlier.
  - *From 2014, activation will be offered within three months from the start of unemployment. The so-called youth guarantee, which offers everyone under the age of 25, as well as recent graduates under the age of 30, a job or training, a study place, or a place in rehabilitation within three months after becoming unemployed, took effect at the beginning of 2013.*

- Adjust the temporary lay-off scheme so that the employer bears some of the costs of the programme.
  - *No action taken.*

- Lower high replacement rates in the unemployment insurance and related benefit systems to improve work incentives. Work incentives for second earners in families with small children should also be improved.
  - *No action has been taken to lower replacement rates in unemployment insurance. However, the earned income tax credit has been increased to boost incentives to work. Also, a protected portion in the unemployment benefit has been introduced coming into effect in 2014.*
  - *To support mothers' labour market participation, a new flexible child care allowance for parents with children under the age of three has been introduced, whose aim is to make part-time work more attractive for those currently at home taking care of children, increase women's employment, and make it easier to combine work and family.*
  - *Half of the home care allowance period, i.e. about 12.5 months, will be for the father only. If the father decides not to use his right to the allowance, these 12.5 months are lost.*

- Taper unemployment benefits over time as is currently done in many other OECD countries.
  - *No action taken.*

- Tighten access to sickness and disability benefits by pairing stricter activation requirements with improved retraining to match skills to the new structure of the economy.
  - *No action taken (rehabilitation requirements already extensive, but no major changes in recent years).*

- Abolish the unemployment “tunnel” to retirement.
  - *The age limit for the right to a continued unemployment allowance will be increased by one year for those born in or after 1957.*

- Strengthen central coordination in the Public Employment Service to harmonise intervention procedures across local labour market boards and improve efficiency. Extend performance-based pay in the Public Employment Service.
  - *The Public Employment Service and its management were reformed in early 2013. The 74 local Employment and Economic Development offices were merged into 15 regional offices, allowing better coordination. Efficiency is also pursued by multichannel services provision where an increasing share of the customer services is provided on the internet and a nationwide telephone service.*

- Consider nationalising unemployment insurance.
  - *No action taken.*
Productivity enhancing reforms

**Entrepreneurship, innovation and R&D**

- Maintain a strong government support role in basic R&D and education. Academic performance should be improved by distributing research grants according to performance. Administrative rules for student financing should be tightened to shorten university study times.
  - *The national target set by the Government in Europe 2020 Strategy is maintaining R&D spending at a minimum of 4% of GDP.*
  - *The university funding model was revised at the start of 2013 and that of universities of applied sciences will be revised at the start of 2014. The number of completed qualifications and study progress will affect funding more than before. The reform will accelerate the completion of studies (along with tighter indicative completion times) and the transition to working life, boost the quality and internationalisation of teaching and research, and strengthen the specialisation of higher education institutions.*
  - *The level of financial aid to higher education students will be raised cost-neutrally as the period of entitlement to financial aid is shortened.*

- Lower business subsidies and shrink the number of business supporting institutions.

  Lower or terminate government funding in areas (like venture capital) where markets nowadays provide equal or better services.
  - *The structure of the business subsidies will be reviewed as part of the structural programme next year. No other major changes.*

- Consider whether a R&D tax credit would be a more efficient instrument for supporting private sector R&D.
  - *A time-limited trial on R&D tax credit is ongoing.*

- Align capital taxation across organisational forms.
  - *The proposal to cut the corporate income tax rate and to change dividend taxation at the start of 2014 is expected to narrow the differences in tax treatment of income that different kinds of business forms distribute to their owners.*

**Competition and deregulation**

- Pursue more structural reforms within network industries and open up government dominated sectors to private provision, e.g. in health, in order to increase productivity and provide stronger incentives for private sector R&D in those sectors.
  - *The structural reform of the health sector is at the planning stage.*

- Follow up the 2011 Competition Act by ensuring that the competition authority has sufficient resources to fulfill its extended mandate.
  - *Resources have been increased.*

- Loosen zoning and planning restrictions on retail development to encourage competition and increase store-level scale economies.
  - *No major action taken.*
Public sector efficiency

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

Tax reform

- Continue to lower the taxation of labour with priority given to lowering the top marginal tax rate on labour in order to keep and attract highly skilled jobs and to reduce incentives for income reclassification.
  - Taxation of labour has been decreased moderately. At the start of 2013 the EITC was increased and it will be increased further at the start of 2014. The EITC is targeted mainly to low and middle income groups.
- Raise property tax revenues by setting property assessment values (for tax purposes) equal to 100% of market valuations and by raising property tax rates.
  - Government has proposed to raise property taxes in 2014 by increasing the assessment values for both land and buildings. Also the tax rates for unbuilt land will be increased in 2014 to encourage sales of land and building of dwellings.
  - Assessment values are to be adjusted via a reduction in the maximum amount of age-discount for dwellings and an increase in the assessment values for buildings and cadastral values for land. These changes will bring property assessment values closer to market prices.
  - The proposed change of the property tax rate on land increases the tax for unbuilt land in the metropolitan area of Helsinki and the surrounding municipalities.
● Eliminate the share of corporate income tax flowing to municipalities. Fill the resulting funding gap by a combination of higher property taxes and higher state grants.

❖ The municipalities get around one third of the corporate income tax revenue. The property tax is a local tax, and the increase in the assessment values in 2014 will boost tax revenue by about EUR 100 million (see the previous point).

● Consider ways to further broaden the corporate tax base and lower the rate.

❖ At the start of 2013 some temporary tax incentives for companies and investors were introduced to boost growth and investments. However, the temporary tax incentives will be shortened when the corporate income tax rate drops from 24.5% to 20% at the start of 2014. The tax package including these proposals has yet to be approved by Parliament.

❖ The deductibility of interest expenses on intra-group loans in business taxation is restricted from 2014 and onwards to curb tax planning and safeguard the corporate income tax base.

● Raise the revenue efficiency of the VAT by eliminating reduced VAT rates.

❖ The structure of the VAT rates has been kept intact since the previous survey though all VAT rates were increased by one percentage point at the start of 2013.
Chapter summaries

Chapter 1. The economic consequences of ageing

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

Chapter 2. Local public finances and municipal reform

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

The economic situation and policies of Finland were reviewed by the Committee on 16 January 2014. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 30 January 2014.

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

The previous Survey of Finland was issued in February 2012.

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• See also http://www.oecd.org/eco/surveys/Finland.

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