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This Survey *is published on the responsibility of the Economic and Development Review Committee (EDRC) 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 25 January 2018. 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 6 February 2018.

The Secretariat's draft report was prepared for the Committee by Christophe André, Jon Kristian Pareliussen and Hyunjeong Hwang, with contributions from Heikki Viitamäki, under the supervision of Vincent Koen. Secretarial assistance was provided by Sisse Nielsen and Mercedes Burgos.

The previous Survey of Finland *was issued in January 2016.*

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BASIC STATISTICS OF FINLAND

(Data refer to 2016 or latest available. Numbers in parentheses refer to the OECD average)

LAND AND PEOPLE

Population (millions)	5.5		Population density per km^2	18.1	(37.2)
Under 15 (%)	16.4	(17.9)	Life expectancy (years)	81.4	(80.5)
Over 65 (%)	20.8	(16.6)	Men	78.8	(77.9)
Foreign-born (%)	6.2	(12.7)	Women	84.1	(83.1)
Latest 5-year average growth (%)	0.4	(0.6)	Latest general election	19 April 2015	

ECONOMY

Gross domestic product			Value added shares (%)		
In current prices (billion USD)	232.4		Primary	2.5	(2.5)
Latest 5-year average growth (%)	-0.2	(1.8)	Industry including construction	26.9	(26.7)
Per capita (thousand USD PPP)	43.1	(42.1)	Services	70.6	(70.8)

GENERAL GOVERNMENT

Expenditure (% of GDP)	55.8	(40.8)	General government gross debt (% of GDP)	75.4	(112.5)
Revenue (% of GDP)	54.0	(37.9)	General government net debt (% of GDP)	53.4	(73.6)

EXTERNAL ACCOUNTS

Exchange rate (EUR per USD)	0.90		Main exports (% of total merchandise exports)		
PPP exchange rate (USA = 1)	0.90		Machinery and transport equipment	30.0	
In per cent of GDP			Manufactured goods	28.0	
Exports of goods and services	35.2	(28.1)	Crude materials (ex food/fuel)	8.9	
Imports of goods and services	36.5	(27.7)	Main imports (% of total merchandise imports)		
Current account balance	-1.4	(0.22)	Machinery and transport equipment	32.7	
Balance of income	0.8		Mineral fuels, lubricants and related materials	12.1	
Net transfers	-1.0		Chemicals and related products, n.e.s.	11.1	

LABOUR MARKET, SKILLS AND INNOVATION

Employment rate for 15-64 year-olds (%)	69.1	(67.0)	Unemployment rate, Labour Force Survey (15-64 year-olds, %)	8.9	(6.3)
Men	70.5	(74.7)	Youth (age 15-24, %)	19.1	(13.0)
Women	67.6	(59.3)	Long-term unemployed (1 year and over, % of unemployed)	26.6	(30.5)
Participation rate for 15-64 year-olds (%)	76.0	(71.3)	Tertiary educational attainment 25-64 year-olds (%)	43.6	(35.5)
Average hours worked per year	1 653.0	(1 766)	Gross domestic expenditure on R&D (% of GDP)	2.9	(2.4)

ENVIRONMENT

Total primary energy supply per capita (toe)	6.2	(4.1)	CO_2 emissions from fuel combustion per capita (tonnes)	9.0	(9.4)
Renewables (% of TPES)	31.2	(9.6)	Municipal waste per capita (tonnes)	0.5	(0.5)
Fine particulate matter concentration ($PM_{2.5}$, µg/m^3)	6.9	(15.2)			

SOCIETY

Income inequality (Gini coefficient)	0.26	(0.31)	Education outcomes (PISA score)		
Relative poverty rate	6.3	(11.3)	Reading	526.0	(493)
Public and private spending (% of GDP)			Mathematics	511	(490)
Health care, current expenditure	8.6	(9.0)	Science	531.0	(493)
Education (primary, secondary, post sec. non tert.)	3.9	(3.7)	Share of women in parliament	42.5	(28.7)
Pensions	11.7	(9.1)	Net official development aid (% of GNI)	0.4	(0.39)

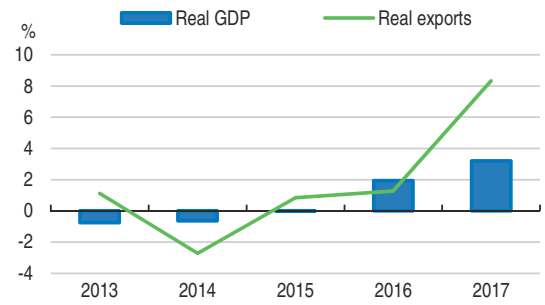
Source: Calculations based on data extracted from the databases of the following organisations: OECD, International Energy Agency, World Bank and World Health Organisation.

Executive summary

- *The economy has gained momentum as exports have surged*
- *Reforming taxation could boost growth*
- *Redesigning social welfare is necessary to lift employment while protecting the vulnerable*

The economy has gained momentum as exports have surged

Output and exports are growing strongly[1]



1. OECD estimates for 2017 exports.

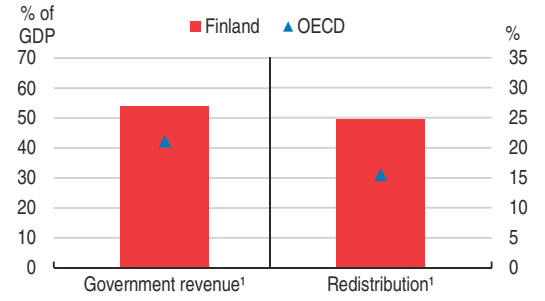
Source: OECD National Accounts.

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After a long period of lacklustre economic performance, a strong rebound in exports is boosting the economy. Despite slow income growth, private consumption remains healthy and both business and residential investment are buoyant. Competitiveness is being restored through ambitious and comprehensive structural reforms and an agreement between social partners on wage moderation. Employment is expanding, but the fall in the unemployment rate is slowed by the return of people who had given up job search to the labour market. The government deficit is shrinking and public debt is stabilising.

Reforming taxation could boost growth

Income redistribution lowers inequality



1. 2016 or latest. Redistribution is the difference between the Gini coefficients before and after taxes and transfers.

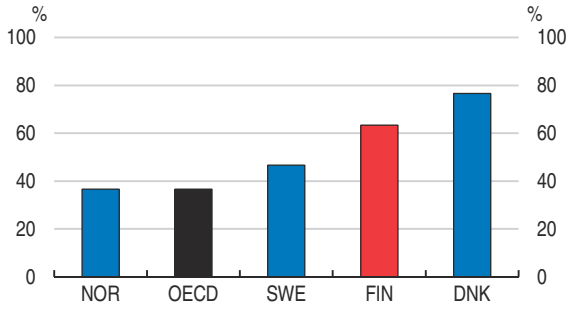
Source: OECD National Accounts; and Income Distribution and Poverty Database.

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Government revenue as a share of output, which is high by OECD standards, contributes to high-quality public services and low and relatively stable income inequality. However, rising age-related costs and the increased mobility of tax bases related to globalisation create long-term fiscal challenges. Preserving the quality of welfare provision requires that the tax and benefit system supports growth, competitiveness and employment, while maintaining its ability to contain income inequality. International cooperation to fight tax evasion can protect corporate tax revenue. A budget-neutral shift from labour taxes towards indirect, property and environmentally-related taxes can alleviate the burden on employment and foster greener growth.

Redesigning social welfare is necessary to lift employment while protecting the vulnerable

Work does not always pay[1]



1. Incidence of average effective tax rates at or above 80% for individuals going from unemployment to full-time work, calculated on the basis of six household types and five income levels.

Source: Pareliussen et al. (2018).

StatLink http://dx.doi.org/10.1787/888933662768

Finland's employment rate is markedly lower than in the other Nordic countries. The combination of different working-age benefits, childcare costs and income taxation creates complexity, reduces work incentives and holds back employment. Coordinating the tapering of various working-age benefits against earnings could drastically improve work incentives and transparency, while preserving the current level of social protection, and is hence a more promising route for future reform than a basic income. Furthermore, specific measures could lift work incentives for parents and older workers. Combined with the new income registry linking benefit payments to real-time incomes from 2020, such reforms would make for a truly efficient and inclusive benefit system, adapted to evolving work patterns.

MAIN FINDINGS	KEY RECOMMENDATIONS
Fiscal sustainability	
The pick-up in output growth and measures to contain government spending are stabilising public debt. However, as age-related spending increases, lifting the employment rate and enhancing the efficiency of public services is necessary to ensure long-term fiscal sustainability.	Timely strengthening of budget buffers is needed.
Financial stability	
Household debt is fairly high relative to income. Housing prices have remained subdued so far, but could be pushed up by the pick-up in economic growth.	Contain growth in household debt through macro-prudential tools, such as a loan-to-income cap, a debt service-to-income ratio or higher risk weights on mortgages.
Tax reform to support growth	
The tax mix has become more growth-friendly over recent years, with an increasing share of revenue from indirect, property and environmentally-related taxes. Nevertheless, the tax wedge on labour remains high. Reduced value added tax (VAT) rates lower tax revenue significantly.	Further reduce the tax burden on labour. Increase minimum- and maximum- rates on recurrent taxes on immovable property, and better align the tax base with market valuations. Increase environmentally-related taxes. Broaden the consumption tax base and phase out reduced VAT rates. Continue to phase out mortgage interest deductibility.
Finland has high energy taxation, but also many environmentally harmful subsidies.	Phase out environmentally harmful subsidies.
Benefit reform for employment and equal opportunity	
The combination of different working-age benefits, childcare costs, personal income taxation and social security contributions creates complexity, reduces work incentives and holds back employment.	Harmonise working-age benefits and coordinate their tapering against earnings.
Benefit complexity and administrative procedures create uncertainty about the amount and timing of cash receipts when circumstances change. This reduces the attractiveness of work, notably part-time and temporary assignments, for risk-adverse, often cash-strapped, individuals.	Upon completion, use the income registry to adjust benefits to income in real-time. Use the income registry to provide better tools for clients to evaluate the financial consequences of their work decisions.
The homecare allowance and the childcare fee structure reduce the attractiveness of work for parents, notably second earners in couples with children aged one to six.	Restructure the homecare allowance to foster participation in childcare and incentivise employment. Calculate childcare fees on individual incomes.
Unemployed aged above 61 are entitled to longer periods on unemployment insurance benefits, effectively providing a bridge to retirement.	Increase the age threshold for extended unemployment benefits at least in line with the statutory pension age.

Assessment and recommendations

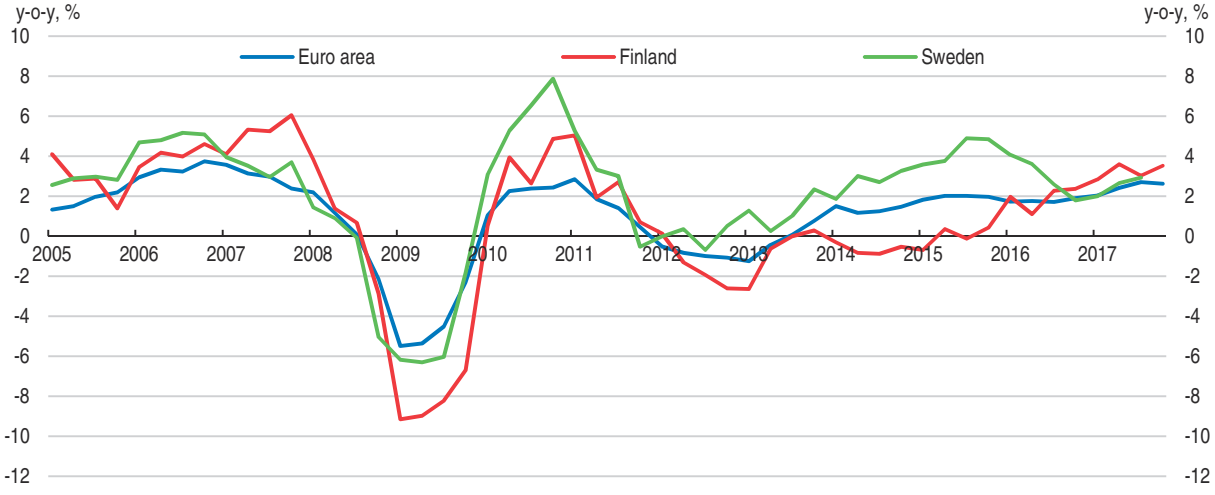
- *A strong revival in exports is boosting growth*
- *Strong economic performance and low inequality foster well-being*
- *Environmental achievements and ambitions are high*
- *Structural vulnerabilities remain in the financial sector*
- *Public finances are under pressure from an ageing population*
- *Reforms to the tax system would enhance growth*
- *Work incentives need to be strengthened, while maintaining strong social protection*
- *Finding direction for benefit reform*
- *Reform priorities within the current system*

A strong revival in exports is boosting growth

After a long period of lacklustre economic performance, robust growth has resumed. The Finnish economy suffered a series of sizeable adverse shocks alongside the global financial and economic crisis, facing major difficulties in the electronic and forest industries, in addition to a severe recession in Russia (OECD, 2012, 2014, 2016a). Sound fundamentals and policy settings helped weather the impact of those shocks and by early 2017 the economy had regained strong momentum, with recovering exports joining private consumption and investment as engines of growth (Figure 1). Domestic demand has expanded since 2015, as households have dipped into their savings to smooth consumption and invest in real estate. Investment in machinery and equipment picked up, as new industrial projects emerged and spare capacity began shrinking. Investment in R&D now also seems to be turning around after six years of decline, which bodes well for future productivity growth. The recovery is broad-based across economic sectors and high business and consumer confidence point to a strong expansion.

Nevertheless, Finland faces challenges. GDP per capita, while exceeding the OECD average, is significantly lower than in Denmark, Germany and Sweden, reflecting differences both in productivity and labour utilisation (Figures 2 and 3). In Denmark and Norway, labour utilisation is relatively low despite high employment rates, due to the relatively few hours worked per person employed. A rapidly ageing population reduces labour supply and puts pressure on public finances. Hence, future growth and well-being will hinge on a higher employment rate and productivity gains, both in the private and public sectors.

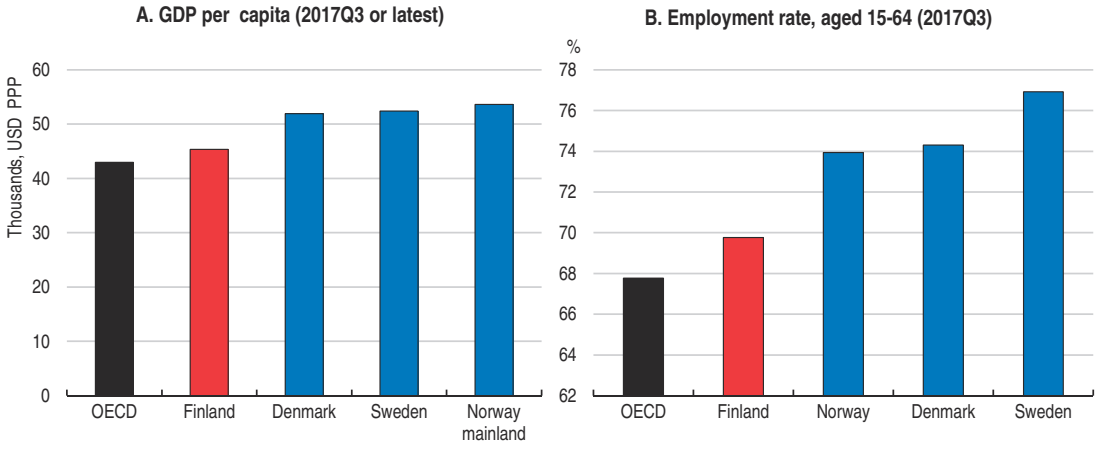
Figure 1. **Real GDP growth is gathering momentum**



Source: OECD National Accounts Database.

StatLink http://dx.doi.org/10.1787/888933662312

Figure 2. **GDP per capita and employment rate are below the other Nordics**

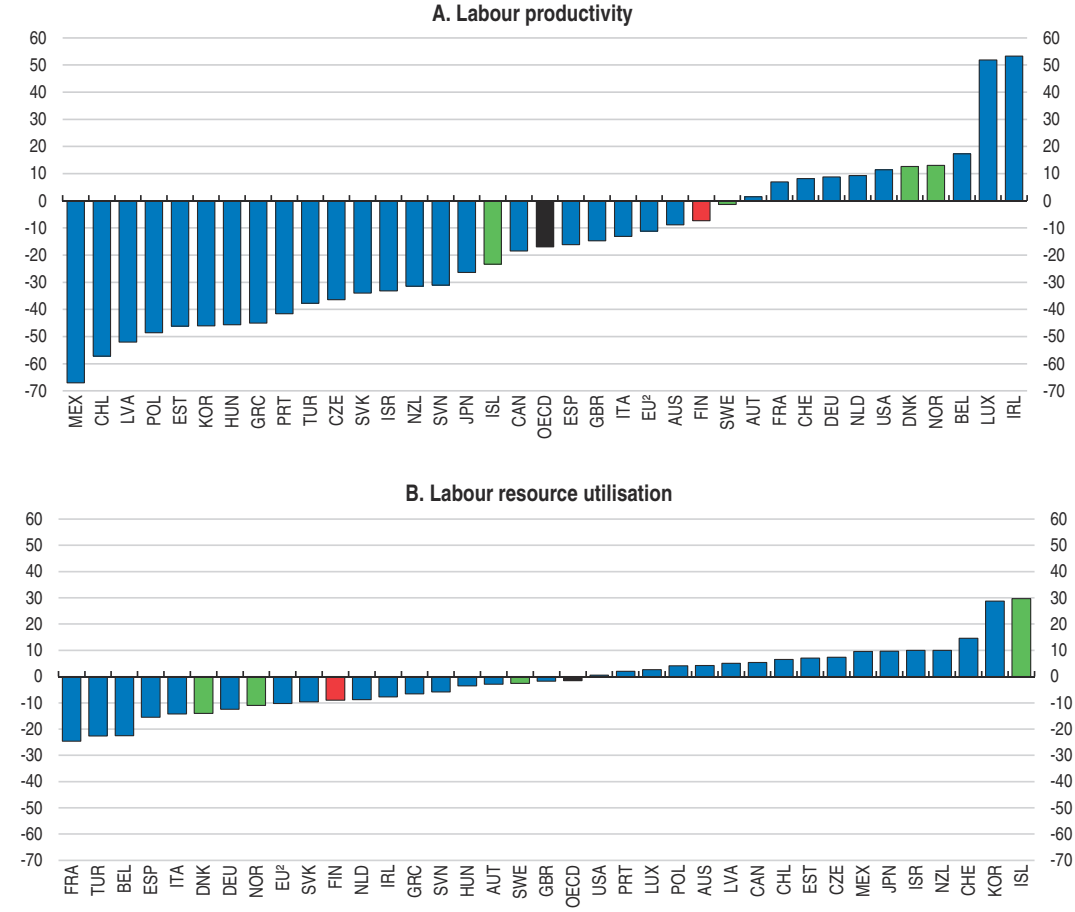


Source: *OECD Economic Outlook Database*; and *OECD Labour Force Statistics Database* and *OECD Quarterly National Accounts*.

StatLink http://dx.doi.org/10.1787/888933662331

Figure 3. **GDP per capita gaps reflect both productivity and labour utilisation differences**[1]

Percentage difference vis-à-vis the upper half of OECD countries, 2016



1. Labour productivity is measured as GDP per hour worked. Labour resource utilisation is measured as the total number of hours worked per capita.
2. Average of European Union countries in the OECD.

Source: OECD, Productivity and Labour Force Statistics Database.

StatLink http://dx.doi.org/10.1787/888933662350

The government has been implementing structural reforms across a wider range and with more determination and coherence than in most other OECD countries. It is pushing forward an ambitious and comprehensive programme aimed at enhancing competitiveness and boosting the growth potential of the economy, while ensuring the long-term sustainability of public finances. The Competitiveness Pact signed by the social partners in 2016 lowers unit labour costs by about 4% from 2017 (Box 1). The new wage negotiation model, agreed in principle as part of the Competitiveness Pact, implies a move from national-level collective agreements, extended by law to cover around 90% of workers, towards a system where sector-level collective agreements are coordinated following the lead of export industries. Such a system of "organised decentralisation" can contribute to constructive labour relations and flexibility at the different bargaining levels on wages and non-wage factors, such as working-time arrangements. Sectoral agreements concluded so far have been in line with the example set by exporting industries and are expected to slightly improve price competitiveness. Coordination hence seems to work despite the failure of social partners to reach a more detailed formal agreement on a Finnish wage bargaining model. The government programme also includes savings on government expenditure and a social welfare and health care reform aiming at reducing costs and enhancing equality in access to services, to be implemented from 2020 (Box 2).

Box 1. **The Competitiveness Pact**

The Competitiveness Pact, a tripartite labour market agreement signed in June 2016, aims at improving companies' price competitiveness, increasing exports and employment and boosting economic growth. It is estimated to have lowered unit labour costs by about 4% from 2017, reversing a sizeable share of the competitiveness loss relative to Finland's main trading partners over the preceding decade. Continued wage moderation and structural reforms pushing up productivity are expected to close the remaining gap over the next few years.

The cost reduction was achieved through the following measures:

- Employees work 24 hours more per year for the same pay.
- Public sector holiday bonuses are cut by 30% in 2017-19.
- Employer social security contributions are permanently reduced and partly shifted to employees. The reduction amounts to about one percentage point in 2017-19 and minimum 0.58 percentage points after 2020.
- Wages were frozen in 2017.

The Competitiveness pact is expected to increase employment by around 40 000 persons in the long run (Ministry of Finance, 2016).

The reduction in employees' purchasing power implied by the Competitiveness Pact is broadly offset by cuts in income taxes targeted at low and middle income earners.

The reductions in labour costs reduce general government operating expenditure, but in the short run this is more than offset by the revenue lost from the tax and social insurance contribution cuts. Overall, the Competitiveness Pact and concomitant tax measures increase the budget deficit by about half a percentage point of GDP in 2017-19. However, as effects on economic growth and employment will gradually raise government revenue, the long-term fiscal impact is expected to be broadly neutral.

Box 2. **The health, social services and regional government reform**

The government has initiated an ambitious reform, which from January 2020 will shift the responsibility for organising health care and social services from municipalities to 18 newly created autonomous counties. The reform will change the structure, services and funding of publicly funded health and social services to increase customer focus, modernise services and improve the sustainability of general government finances. The aim is to provide people with services on a more equal basis, level out differences in health and well-being and curb cost increases. In addition, basic health and social services will be strengthened, individuals will have more freedom of choice and information technology will be used more effectively across the services. The reform will bring the sub-national government structure closer to that of the other Nordic countries, even though substantial organisational differences across these countries will remain.

The regions will be managed by elected councils, the first elections taking place in October 2018. As a result of the reforms, the 18 new counties will not only take over the responsibility for organising publicly funded health and social care, but also for rescue services, environmental healthcare, regional development, promotion of business enterprise, regional planning and steering, as well as promotion of the identity and culture of the counties. In addition, the counties will be responsible for other statutory regional services, including regional economic development and employment services. To support and facilitate cooperation between the counties, five collaborative catchment areas will be established to coordinate provision of services.

Financing for the counties will come entirely from the central government, imposing a strict budget constraint on counties. Funding will depend on needs, notably related to the age structure of the region's population, and will be reviewed annually. A financial evaluation procedure will encourage sound financial management and allow making timely adjustments measures whenever necessary.

The reform is welcome, as the Finnish health system, while generally providing high quality services, suffers from inefficiencies, in particular inequalities in access to health care and excessive reliance on specialised relative to primary care (*OECD Economic Survey of Finland, 2012*). Currently over 190 local organisations carry the responsibility for organising publicly funded health and social care. This results in fragmentation of service provision, hindering economies of scale and scope, and difficulties in organising services and recruiting qualified personnel.

A key challenge to improve the efficiency of the health care system will be to encourage competition between providers in a way which encourages innovation, with careful monitoring of the quality of care and enhanced dissemination of information and benchmarking of providers to facilitate user choice. Capitation-based compensation of primary care providers will help contain costs. The emphasis on prevention will be reinforced.

The success of the reform is crucial to meet the needs of an ageing population and ensure long-term fiscal sustainability. The government assumes that the reform will yield EUR 3 billion of savings annually, i.e. about 1.3% of 2017 GDP (Ministry of Finance, 2017a). This corresponds to a reduction in annual healthcare and social welfare real spending growth from 2.4% to 0.9% between 2020 and 2029. Achieving such cost containment seems feasible, but remains challenging. In particular, implementation costs of the new regional structures are uncertain, notably due to learning and recruitment challenges.

Key challenges are to increase the employment rate and to boost productivity. The government has set an ambitious target of 72% for the employment rate of the population aged 15-64 by 2019. Based on the OECD long-term growth framework (Guillemette et al., 2017) and assuming additional employees have average productivity, raising the employment to 72% would increase GDP per capita by about 1.5%. Reaching the employment rate of Sweden, which approached 77% in late 2017, would lift GDP per capita by 4.8%. Besides the Competitiveness Pact and measures to support business development and entrepreneurship, a better functioning labour market is needed to increase employment. The duration of unemployment benefits was reduced in 2017 by 100 days to 400 days for those with at least three years of work history, and to 300 days for those with a shorter work history, with the aim of strengthening work incentives. However, many unemployed workers will see only small net income increases, and some will even incur a loss upon return to work. The complexity of the benefit system is another obstacle to stepping into employment, particularly when responding to temporary job offers. A universal basic income, which is being experimented on a small scale, is sometimes presented as a solution. However, even though a basic income might enhance work incentives, its generalisation may increase poverty (from 11.4% to 14.1% in the scenario described below), and would require increasing income taxation by nearly 30% (OECD, 2017a). Hence, alternative routes to reform with the aim to simplify and coordinate working-age benefits to improve work incentives and adapt to a changing world of work need to be considered, taking into account the trade-offs they imply in terms of work incentives, distributional effects and fiscal costs.

Against this background, the key messages of this Survey are:

- Policy settings need to continue supporting a balanced recovery, in terms of competitiveness, financial stability, public finances and environmental sustainability.
- Reforms to the tax system would enhance support for growth.
- Raising the employment rate is essential for growth and long-term fiscal sustainability. Work incentives need to be strengthened, while maintaining strong protection for the most vulnerable.

Economic growth is expected to edge down after the strong 2017 rebound, but to remain healthy. Exports and investment will remain strong, while private consumption will be held back by stagnating real income, as inflation picks up (Table 1). As employment growth has been sluggish until very recently and labour force participation has risen, the unemployment rate has declined only slowly (Figure 4). Nevertheless, continued robust GDP growth is expected to reduce unemployment over the coming years.

The main risk for the Finnish economy is a slowdown in global growth, in a context where world trade prospects are clouded by policy uncertainty and geo-political risks. This would reduce demand for exports and weigh on income and investment. Finnish exports are particularly sensitive to demand for machinery and equipment, forest products, chemicals and metals (Figure 5, Panel A). Finland is mostly exposed to Europe, even though exports to Asia are also significant and growing rapidly (Panel B). Low probability events could hurt the economy (Table 2). On the contrary, a stronger-than-expected pick up in global investment would boost Finnish exports, as would a solid rebound of economic activity in Russia. The impact of competitiveness gains on exports could be stronger than foreseen. Domestic risks are limited. High indebtedness among some households could lower private consumption in the case of a rise in interest rates or a marked slowdown in

Table 1. **Macroeconomic indicators and projections**

	2015	2016	2017	2018	2019
GDP	0.0	1.9	3.1	2.5	2.0
Private consumption	1.7	1.8	2.6	2.3	1.3
Government consumption	0.0	1.2	-0.0	-0.3	1.0
Gross fixed capital formation	0.7	7.2	7.8	3.5	3.5
Housing	2.0	10.5	8.2	4.6	2.0
Business	2.3	6.6	10.0	3.5	5.0
Government	-5.2	3.9	1.0	2.0	0.9
Final domestic demand	0.1	2.8	3.1	2.0	1.7
Stockbuilding[1]	0.2	-0.2	-0.7	-0.1	0.0
Total domestic demand	1.2	2.6	2.4	1.9	1.7
Exports of goods and services	0.8	1.3	8.3	5.5	5.0
Imports of goods and services	3.2	4.4	2.5	4.4	4.3
Net exports[1]	-0.9	-1.2	2.0	0.4	0.3
Other indicators (per cent growth rates, unless specified)					
Potential GDP	0.6	0.6	0.8	0.9	1.0
Output gap[2]	-5.1	-3.9	-1.7	-0.2	0.7
Employment	-0.4	0.4	0.7	0.6	0.6
Unemployment rate[3]	9.4	8.8	8.7	8.4	8.0
GDP deflator	2.0	0.9	0.9	1.0	1.5
CPI	-0.2	0.4	1.0	1.7	2.0
Core inflation	0.8	1.1	0.7	1.4	2.0
Household saving ratio, net[4]	-1.0	-2.5	-2.8	-2.7	-2.8
Trade balance[5]	-0.5	-1.2	-0.3	0.4	0.4
Current account balance[5]	-1.0	-1.4	-0.4	-0.6	-0.6
General government financial balance[5]	-2.7	-1.7	-1.1	-1.1	-1.1
Underlying government net lending[2]	0.6	0.6	-0.1	-0.9	-1.6
Underlying government primary balance[2]	0.8	0.8	0.1	-0.8	-1.5
Gross government debt (Maastricht)[5]	63.6	63.1	62.5	62.2	61.9
General government net debt[5]	-53.1	-53.4	-50.2	-47.5	-44.7
Three-month money market rate, average	0.0	-0.3	-0.3	-0.3	-0.3
Ten-year government bond yield, average	0.7	0.4	0.6	0.8	1.0

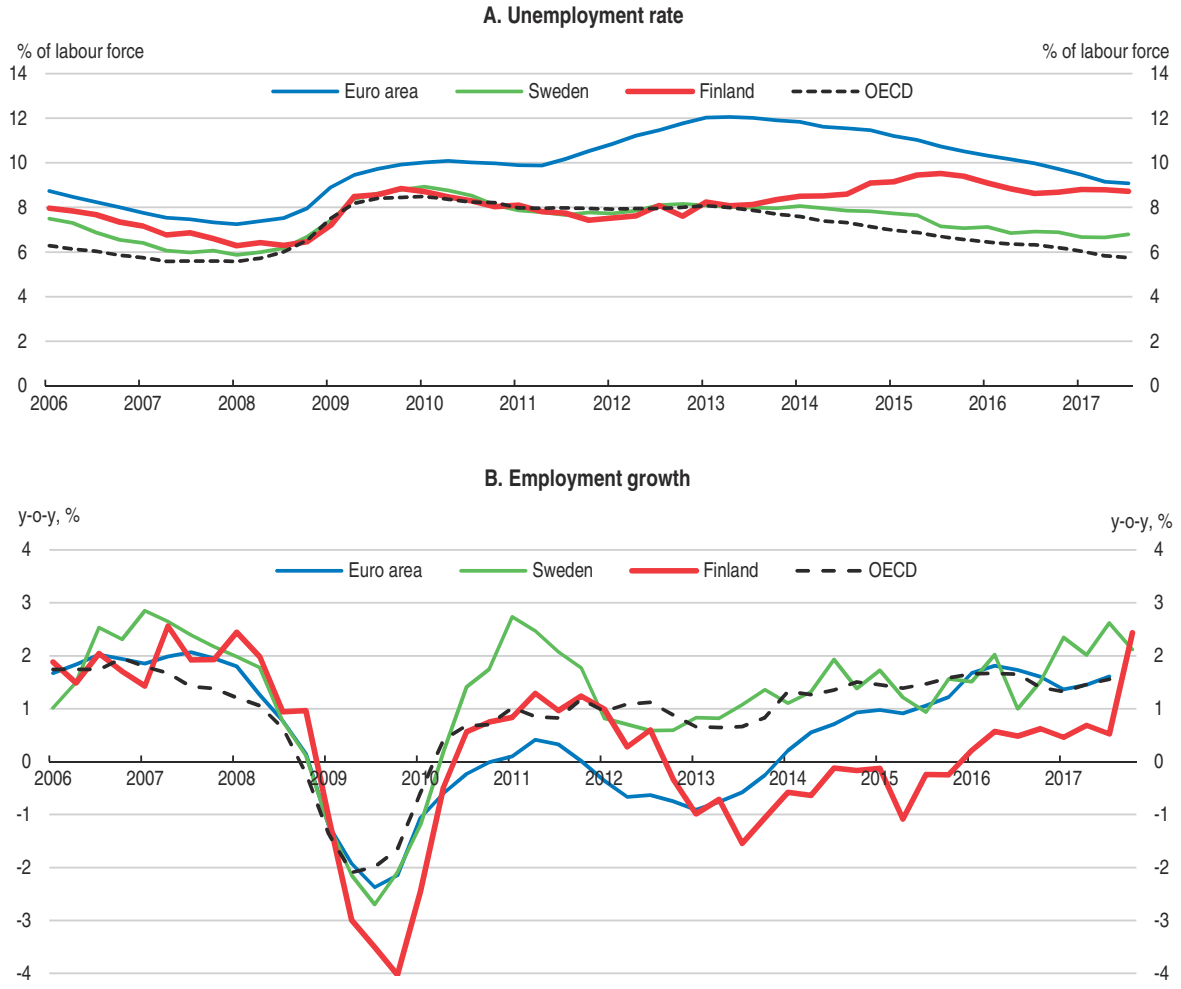
1. Contribution to changes in real GDP.
2. As a percentage of potential GDP.
3. As a percentage of labour force.
4. As a percentage of household disposable income.
5. As a percentage of GDP.

Source: OECD, *Economic Outlook Database* (EO 102).

income growth. On the upside, high consumer and business confidence may foreshadow stronger-than-projected private consumption and investment.

In the long term, steady growth and improvements in living standards hinge on productivity gains. Finland has an exceptional track record in education and innovation, which translated into strong productivity growth from the 1990s to the mid-2000s. However, multifactor productivity has stagnated since then, despite a recent rebound. This is partly due to cyclical factors and the global slowdown in productivity growth (*OECD Economic Survey of Finland*, 2016; OECD, 2015a), but Finland has lagged behind competitors over recent years (Figure 6). Educational performance, as measured by PISA and national surveys, has declined, but the government is currently upgrading comprehensive education, notably through enhancing learning environments, teacher competences and digitalisation, reforming vocational upper secondary education, and accelerating transitions to working life (Prime Minister's Office, 2017). The ongoing reform to reduce the fragmentation of higher

Figure 4. **Unemployment remains high**



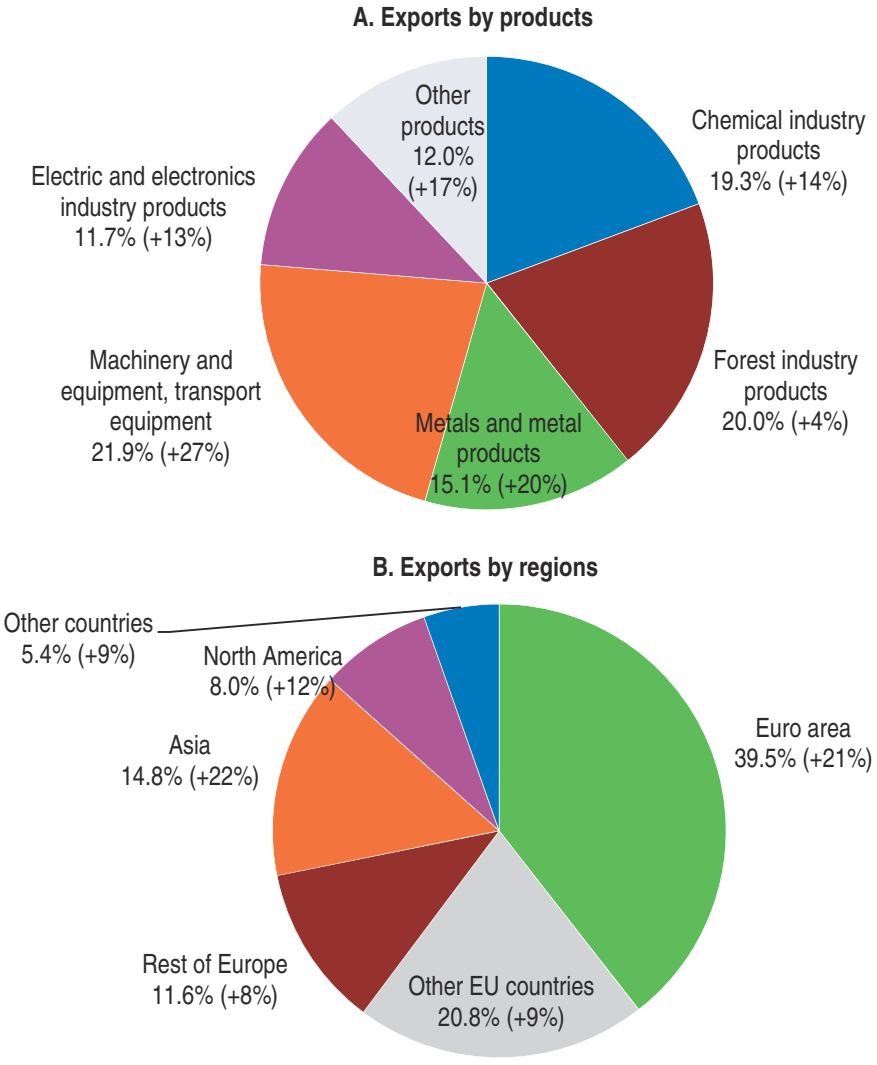
Source: OECD Labour Force Statistics, *OECD Economic Outlook Database*, Statistics Finland and Statistics Sweden.

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education needs to be completed to create more centres of excellence in teaching and research. Notwithstanding a recent pick-up, total investment in R&D is now below 3% of GDP compared to close to 3.5% before the 2007 crisis – largely because of a large drop in Nokia and the electronics industry more generally. Business subsidies largely support established industry and firm structures, especially in traditional sectors, rather than promoting innovation (Maliranta et al., 2016). But important productivity-enhancing structural reforms are being implemented to boost productivity, including an easing of retail trade and transport regulations, which will further alleviate product market regulations which are already fairly light on average.

Measures are also being taken to foster entrepreneurship, including from 2018 the merger of institutions promoting innovation, exports and investment into Business Finland, a one-stop-shop which will facilitate the creation of network projects responding to business needs and contribute to financing them. There is scope to reinforce cooperation between large firms, SMEs and public institutions, in particular with the aim of strengthening SMEs' access to research and ability to expand on foreign markets, which is crucial to foster growth and economic diversity (OECD, 2017b).

Figure 5. **Main export sectors and destinations**
Share and change from previous year (%), 2017 Q1-Q3



Source: Finnish Customs.

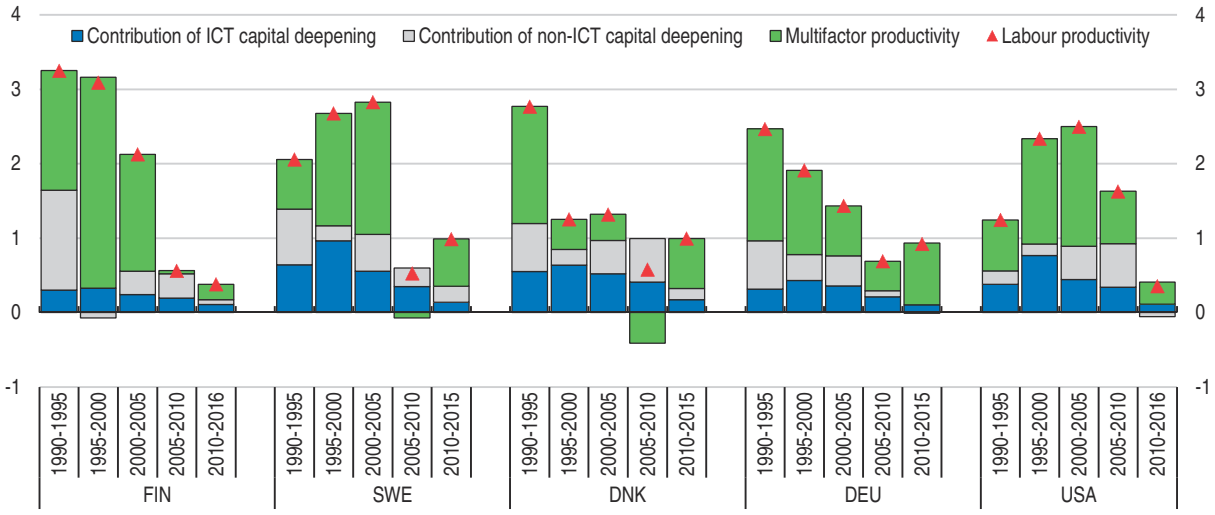
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Table 2. **Possible shocks and their economic impact**

Vulnerability	Possible outcome
Protectionist measures affecting world trade growth.	As Finland is very dependent on foreign trade, mounting protectionism would threaten growth.
Geopolitical tensions	Geopolitical tensions could hamper trade and investment.
Global or regional financial crisis contagion.	The Finnish financial system is dominated by Nordic banks with low liquidity buffers. A liquidity crisis triggered by events outside Finland could lead to difficulties in the banking sector, falling asset prices and a credit squeeze.

Figure 6. **Productivity needs a boost**

Contributions to labour productivity, total economy, annual percentage change, 1990-2016 or latest



Source: OECD Productivity Statistics Database.

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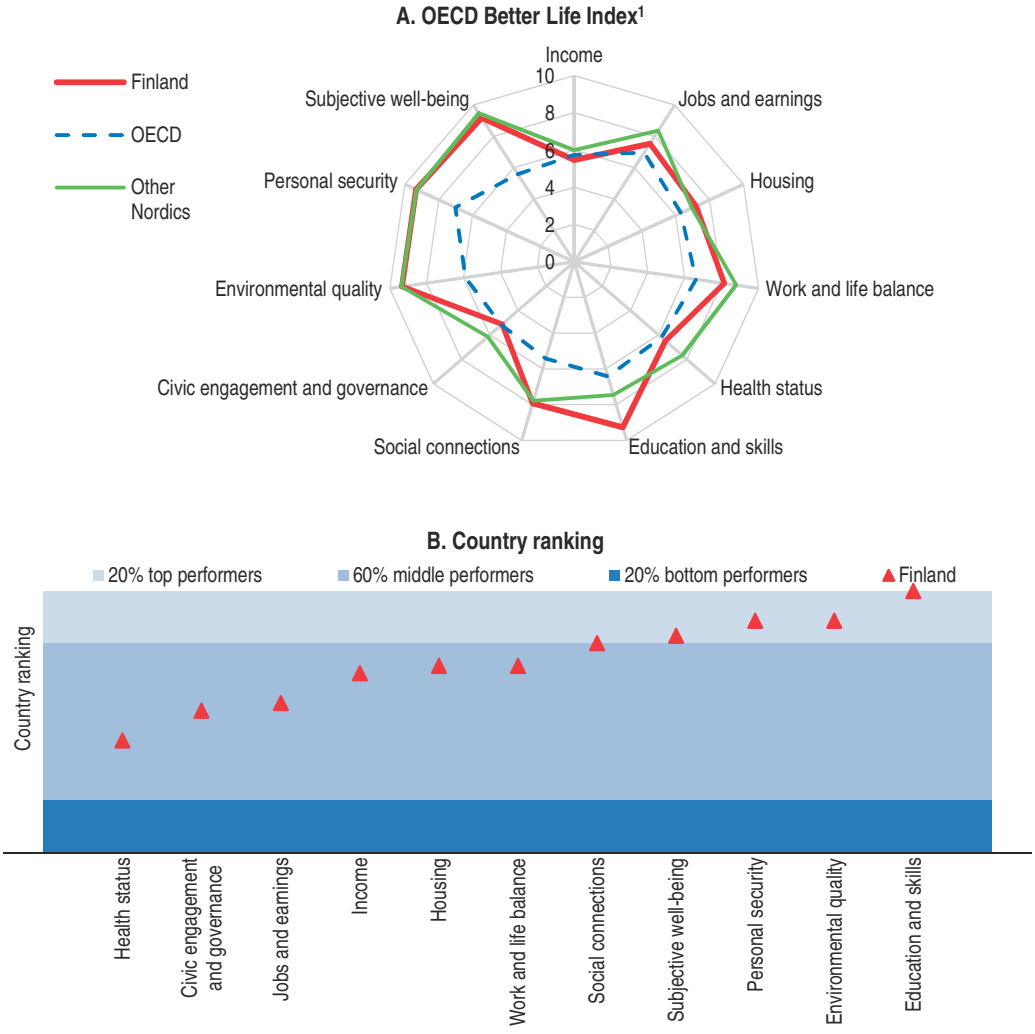
Table 3. **Past recommendations on productivity-enhancing reform**

Main recent OECD recommendations	Action taken since the 2016 Survey or planned
Streamline regulations in retail trade, transport and construction.	Land-use planning restrictions applying to large retail units have been eased. Rail passenger transport will be open to competition in the early 2020s and a new Act on Transport Services will facilitate interactions between different transport modes.
Use funding criteria for higher-education institutions or R&D vouchers, to reinforce co-operation between companies, particularly start-ups, and universities.	As of 2018, Business Finland will facilitate the creation of network projects responding to business needs and contribute to financing them.

Strong economic performance and low inequality foster well-being

Finns enjoy one of the highest levels of well-being in the OECD, performing among the top 20% in education and skills, environmental quality, personal security, subjective well-being and social connections (Figure 7). However, average household net adjusted disposable income per capita is slightly lower than the OECD average, partly reflecting sluggish growth over the past decade, even though high taxes, which help finance high-quality free social services, also play a role. Civic engagement and governance is only slightly above the OECD average, due to relatively low voter turnout in recent elections. Health status is lagging behind the other Nordics, pointing to the need for reforming the health care system, not only to ensure financial sustainability, but also to improve health outcomes, in particular reducing health inequality. The employment rate of the population aged 15-64 is three percentage points above the OECD average, but more than four percentage points lower than in all other Nordic countries. This highlights the importance of the government objective of lifting the employment rate. Work and life balance, while much better than in the average OECD country, is not as good as in the other Nordics.

Figure 7. **Finns enjoy a high quality of life**



1. Each well-being dimension is measured by indicators from the OECD Better Life Indicator set. Indicators are normalised to range between 0 (worst) and 10 (best).

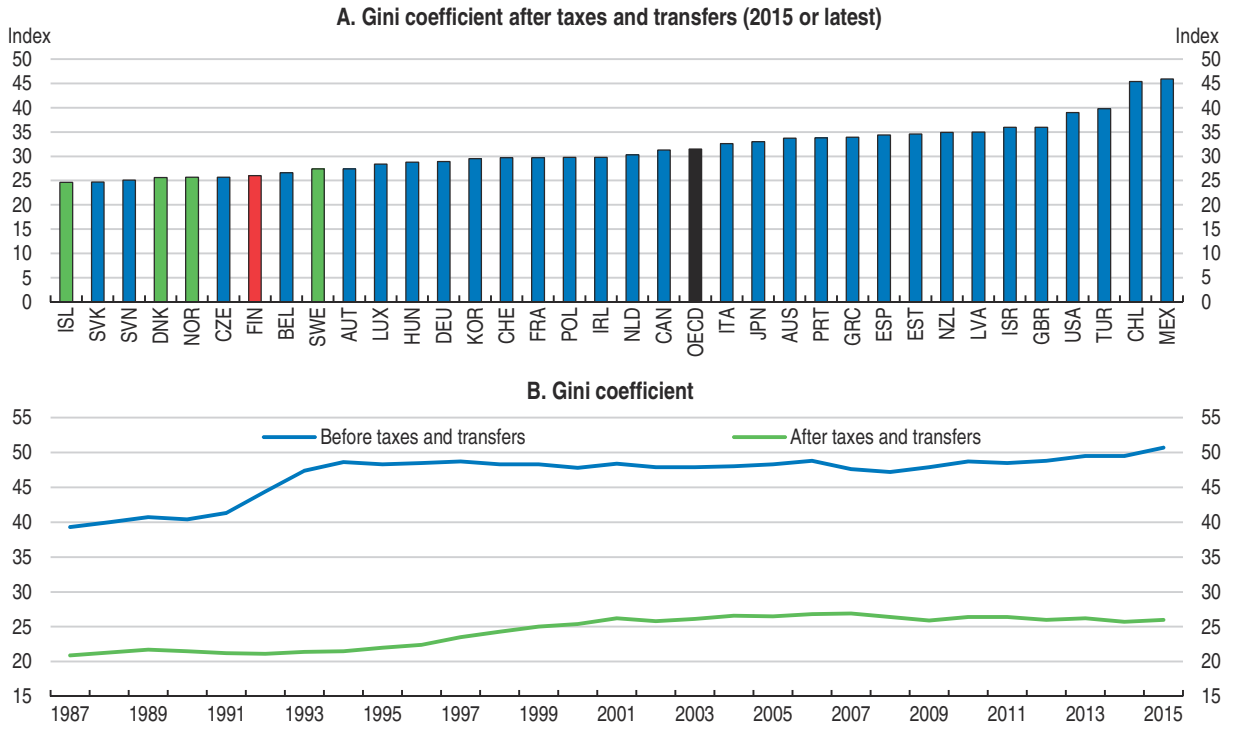
Source: OECD Better Life Index Database 2016.

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Income inequality remains low by OECD standards (Figure 8, Panel A). The Gini coefficient of income before taxes and transfers increased sharply in the early 1990s, mainly as a result of a large fall in employment during the deep recession which followed a financial crisis and the collapse of the Soviet Union (Panel B). The increase in market income inequality was initially offset by redistribution, but later in the 1990s lower taxes on capital income and reduced social benefits pushed up the Gini coefficient of income after taxes and transfers. Since the early 2000s, income inequality has remained broadly stable.

Gender inequality is very low in Finland, which comes second in the World Economic Forum Global Gender Gap Index 2016, behind Iceland and ahead of Norway and Sweden. The employment gap between men and women aged 15-64 is the second lowest in the OECD (Figure 9, Panel A). Women are well represented among top politicians, on the board of companies and among entrepreneurs, even though parity is not achieved. However, the

Figure 8. **Income inequality is low and stable**



Source: OECD Income Distribution Database (IDD).

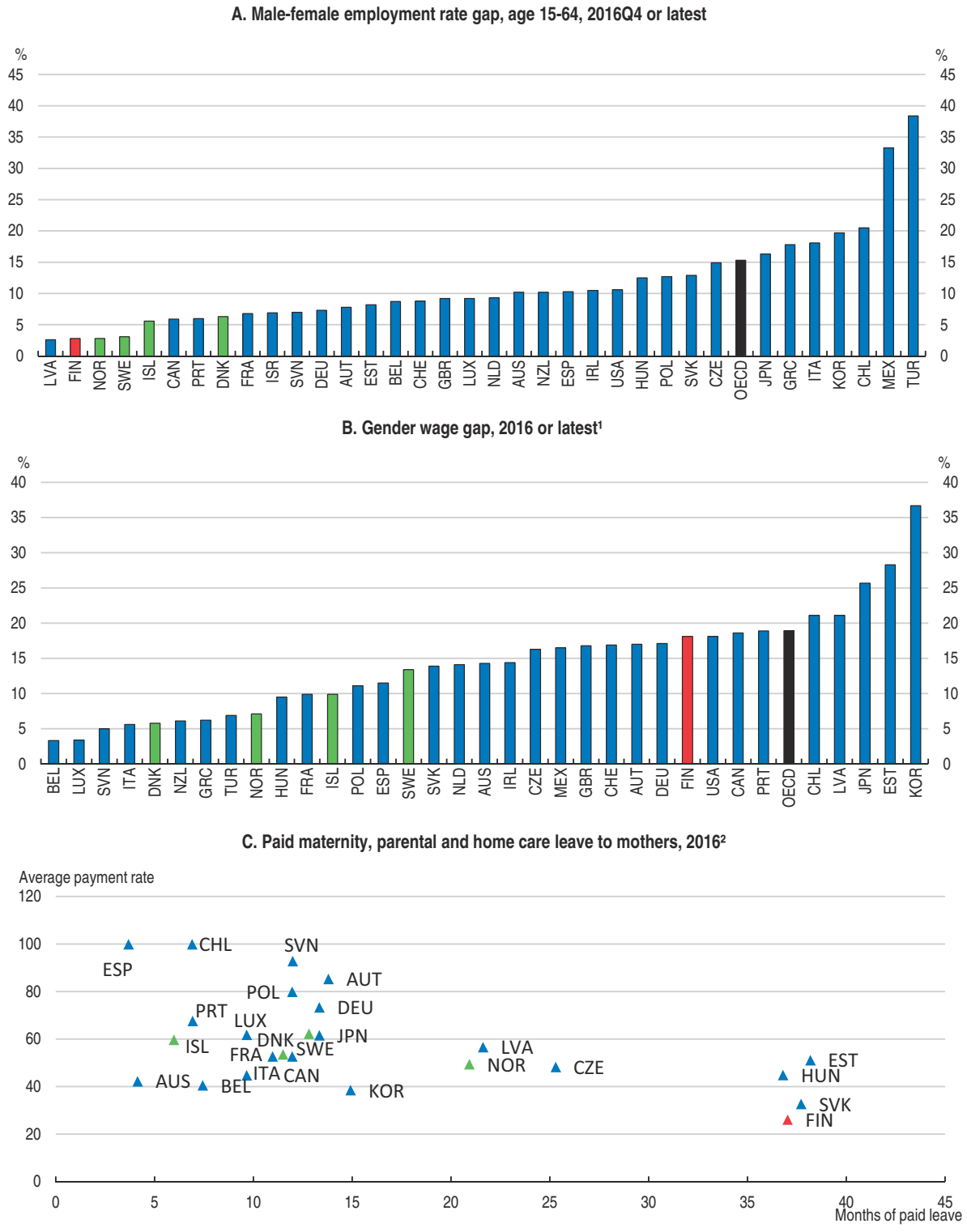
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gender pay gap is wide, partly because of strong gender specialisation across professions, with women being under-represented in well-paid activities like engineering and over-represented in public sector jobs, notably in health care and education (Panel B). Differences in fields of activity and jobs explain about half of the pay gap (National Institute for Health and Welfare, 2017). Young women are also more often in fixed-term employment than their male counterparts and tend to take long parental leaves, which weakens their career prospects. The combined duration of parental leave and home care allowance is among the longest in the OECD. The amount of the allowance is relatively low, but in combination with top-ups provided by some municipalities and childcare costs it can reduce incentives to work considerably (Panel C) (*OECD Economic Survey of Finland*, 2016).

Table 4. **Past recommendations to promote gender equality**

Main recent OECD recommendations	Action taken since the 2016 Survey or planned
Reduce the combined duration of parental leave and the homecare allowance to encourage female labour market participation.	No action taken.

Figure 9. **Gender inequalities persist**



1. The gender wage gap is defined as the difference between male and female median wages divided by the male median wage.
2. Countries with no paid homecare leave are not shown. The "average payment rate" refers the proportion of previous earnings replaced by the benefit over the length of the paid leave entitlement for a person earning 100% of average national (2015) earnings.

Source: *OECD Employment Database*; and *OECD Family Database*.

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Environmental achievements and ambitions are high

Overall energy intensity in Finland is significantly higher than the OECD average, in part because of the cold climate, the low population density and a relatively large share of energy-intensive industries (Figure 10, Panel A). A high share of renewables, especially the biomass by-products of the forestry sector, and the contribution of nuclear power keep average emissions per unit of energy relatively low, so that the economy's carbon intensity is in line with the OECD average, and falling (Panel B). The four nuclear power stations currently supply nearly 30% of total electricity; a fifth station is under construction and a planned sixth station, replacing CO_2-intensive coal, would bring that share to 60%. Finland is the first country in the world to license and start building a final repository for highly radioactive nuclear waste, with storage planned to begin from 2023 (Gibney, 2015).

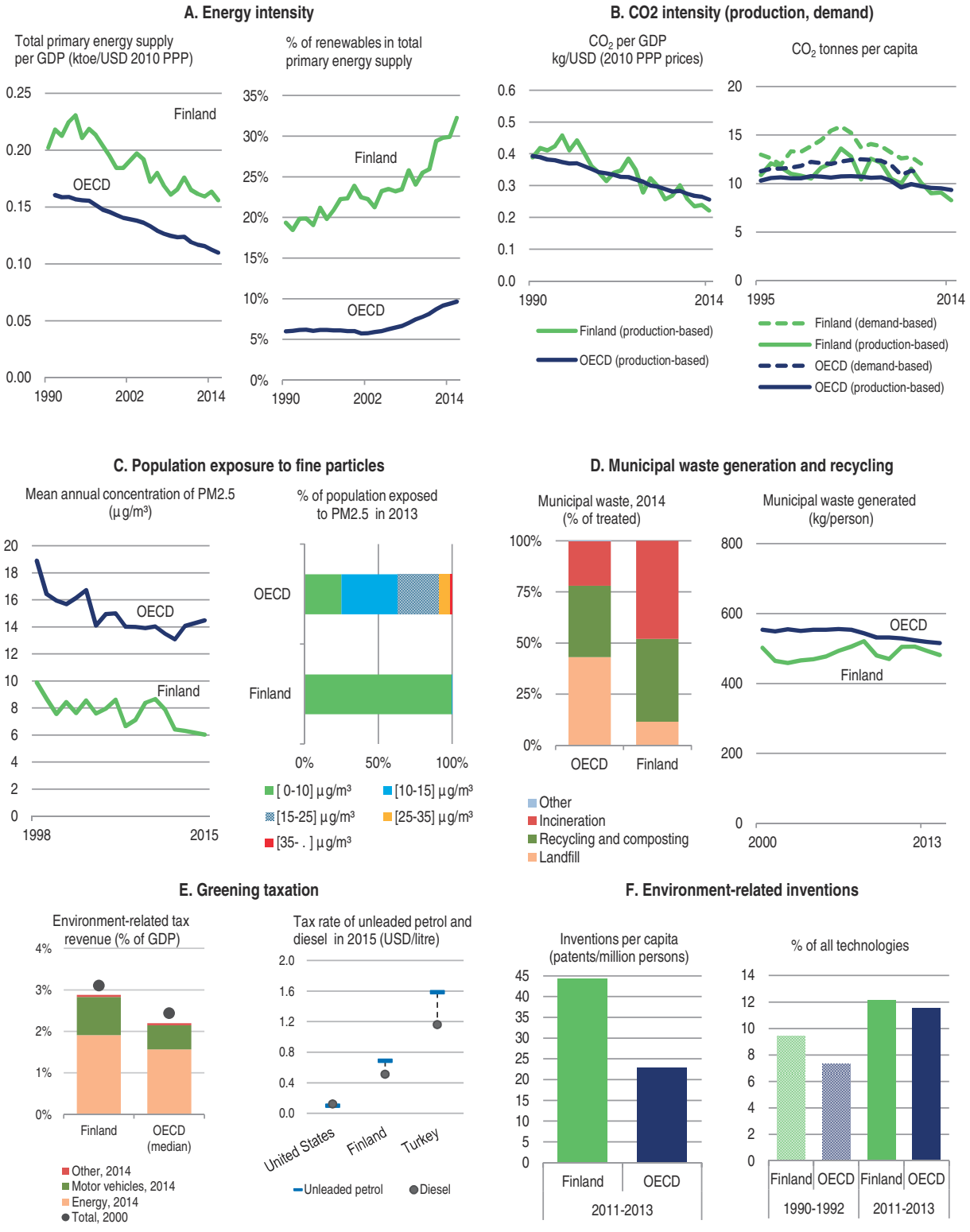
Overall air quality is among the best in the OECD and unlike nearly all other countries, good air quality is nearly uniform across the country (Panel C). Water quality is also generally good and all urban areas are well-served by sewage treatment; some rural areas have little or no collective treatment, but where population density is very low the pollution and health risks are likely minimal. Some surface waters and coastal areas do suffer from excessive nutrients, largely due to run-off from agriculture.

Per capita waste generation in Finland is just below the OECD average (Panel D). The share going to recycling is somewhat above the OECD average, while heavy use is made of incineration, whose share has grown six-fold over the past decade, increasingly with energy recovery in either district heating systems or electricity generation. The rise in the landfill tax from EUR 15 per tonne in 2001 to EUR 70 per tonne since 2016 has, along with regulatory changes, encouraged this switch from landfill to incineration.

Revenues from environmental taxation are somewhat above the OECD median, with relatively high taxation of vehicles like in other Nordic countries. As elsewhere, environmental taxation on non-energy items, other than vehicles, is negligible in terms of revenue (Panel E). The tax system, along with other instruments like the EU Emissions Trading System (ETS), regulations and R&D, has a key role to play in achieving Finland's ambitious climate change and environmental policy objectives. However, tax rates vary across energy uses – e.g. heating and process use, power production or transport – and sectors – e.g. energy producers, manufacturing industry or households. A number of industries or fuels benefit from reduced tax rates (OECD, 2013) or direct refunds. A few years ago, a working group led by the Ministry of Finance identified between EUR 2.7 and EUR 4.5 billion in production-linked reduced rates and direct subsidies which can heighten environmental pressures, mainly in energy, transport and agriculture (Hyyrynen, 2013). Although some of the environmentally harmful subsidies have been reduced since then, most remain, including in particular subsidies to energy-intensive industries, lower taxation of diesel compared to gasoline, low taxes on peat, agricultural direct and indirect (e.g. on fuel use) subsidies and the over-allocation of EU Emission Trading System (ETS) permits (Bragadóttir et al., 2014).

Diesel prices should be at least aligned with those of gasoline, but some compensatory measures may be required in the short term to preserve the competitiveness of the transport sector, including public transport. The transition should be gradual to allow users of diesel to adjust (Harding, 2014). Increasing taxes on peat should be considered, taking into account how substitution of imported fuels for peat would affect combined heat and power production and energy security, as well as activity and employment in some regions. Reforming agricultural subsidies is even more challenging, as a significant part of the sector

Figure 10. **Environmental performance is strong**



Source: OECD (2017), *Green Growth Indicators* (database); OECD Environment Statistics (database); *OECD National Accounts* (database); IEA World Energy Statistics and Balances (database); and IEA Energy Prices and Taxes (database). For detailed metadata, see *www.oecd-ilibrary.org/environment/green-growth-indicators-2017_9789264268586-en*.

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may not survive without subsidies. Supporting some activities may be justified on social, cultural, territorial planning, strategic or food security grounds. Furthermore, agricultural subsidies are influenced by EU policies, notably the Common Agricultural Policy, so altering them requires coordinated action with other member states.

Finnish patenting activity has been much higher than the OECD average, when adjusted for population size, in recent years, with some tendency for activity to be focused more on environment-related patents than elsewhere (Panel F).

Table 5. **Past recommendations on environmental sustainability**

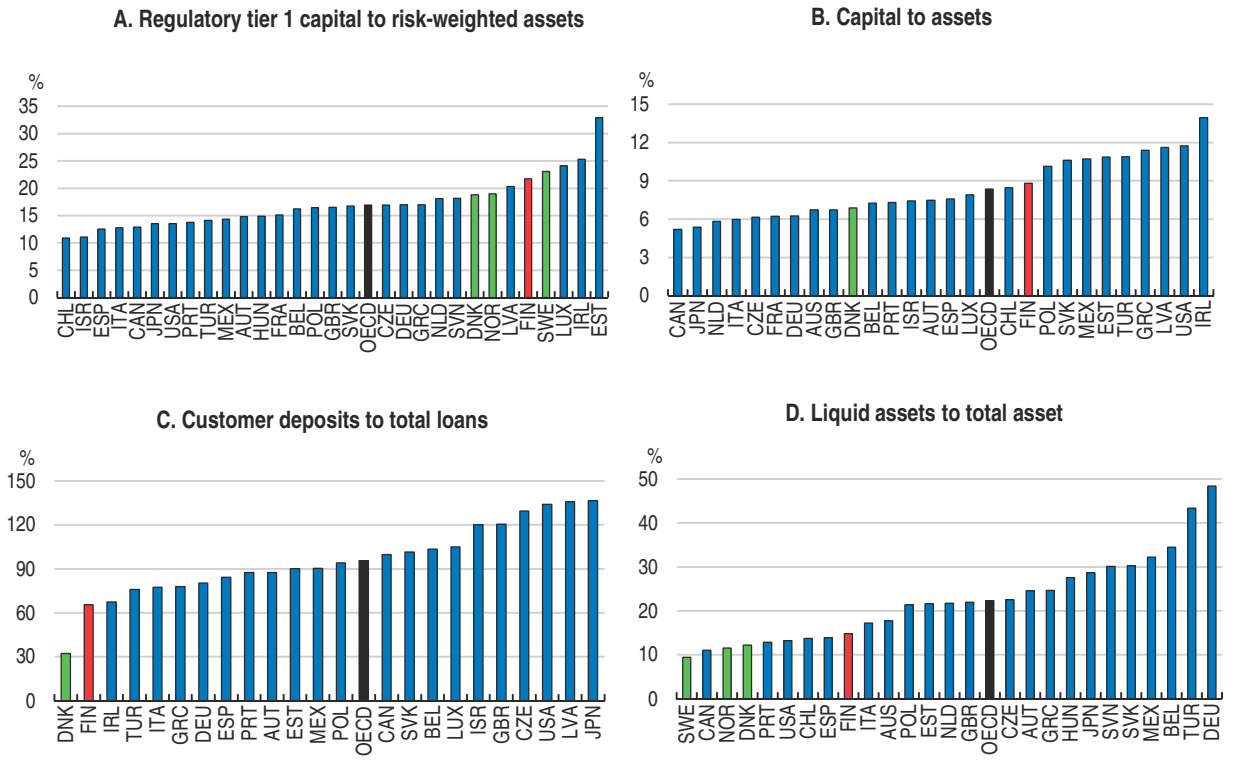
Main recent OECD recommendations	Action taken since the 2016 Survey or planned
To reduce greenhouse gas emissions further, phase out environmentally harmful subsidies and better align the tax rate on emissions across sectors.	Some energy, CO_2 and vehicle taxes have been increased, the tax exemption on liquefied petroleum gas has been removed and allowances to deduct commuting expenses have been reduced.

Structural vulnerabilities remain in the financial sector

The financial sector is dominated by large banks operating across Nordic countries, which manage large assets in relation to the size of the economies of the region. These banks are very profitable and strongly capitalised. However, liquidity buffers are low and concentration, interconnectedness and reliance on wholesale funding are high (Figure 11). To address these vulnerabilities, the government has proposed the introduction of a systemic risk buffer, which still has to be approved by Parliament. Nordea, the biggest Nordic bank, with assets of over twice Finland's GDP, decided in September 2017 to move its headquarters to Helsinki to be under the common rules and regulations of the European banking union. Although job and tax gains may be limited, this raises the profile of Helsinki as a regional financial centre. This will require Finnish and European financial supervisors to adapt. As a global systemically important financial institution, Nordea will be supervised through the European Single Supervisory Mechanism, which involves the European Central Bank and the national supervisory authorities of the countries participating in the banking union. Ensuring efficient supervision will require adequate resources for supervisors and cooperation between countries where Nordea has a strong presence. The resources of the Finnish Financial supervisory authority (FIN-FSA) are being substantially increased, and the monitoring of financial developments in the Nordic region has been reinforced. The Nordic countries have recently signed new Memorandums of Understanding, which will strengthen cooperation on the supervision of significant bank branches. Nordea's move would imply some risks for Finland in the unlikely case the bank were to experience financial difficulties. While recapitalisation could be provided through the European single resolution fund, Finland guarantees the first EUR 100 000 of deposits as long as there is no European single deposit guarantee scheme (Bank of Finland, 2017a). The announcement of Danske Bank's subsidiary conversion into a branch will also involve adjustments in supervision. The Nordic regulatory landscape could evolve further, especially if Denmark and/or Sweden decide to join the banking union.

Financial interconnections could propagate a shock hitting one of the Nordic countries, with real estate a particular area of concern, as it accounts for a large share of bank lending and valuations are high in many places. Real estate prices have increased rapidly in Norway and Sweden and household debt is high relative to income. In 2016, the European Systemic Risk Board (ESRB) issued warnings regarding medium-term housing market vulnerabilities

Figure 11. **The banking system shows some vulnerabilities (2017 Q3 or latest)**



1. OECD averages exclude countries not shown in the figure.
Source: IMF, Financial Soundness Indicators database.

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and potential systemic risks to eight countries, including Denmark, Finland and Sweden (ESRB, 2016). The Swedish Financial supervisory authority has also warned about risks associated with commercial real estate in Sweden (Thedéen, 2017). Commercial real estate prices are volatile and have historically often played an important role in financial crises in the Nordics and elsewhere. A real estate collapse in other Nordic countries could affect Finland through weakening regional financial institutions.

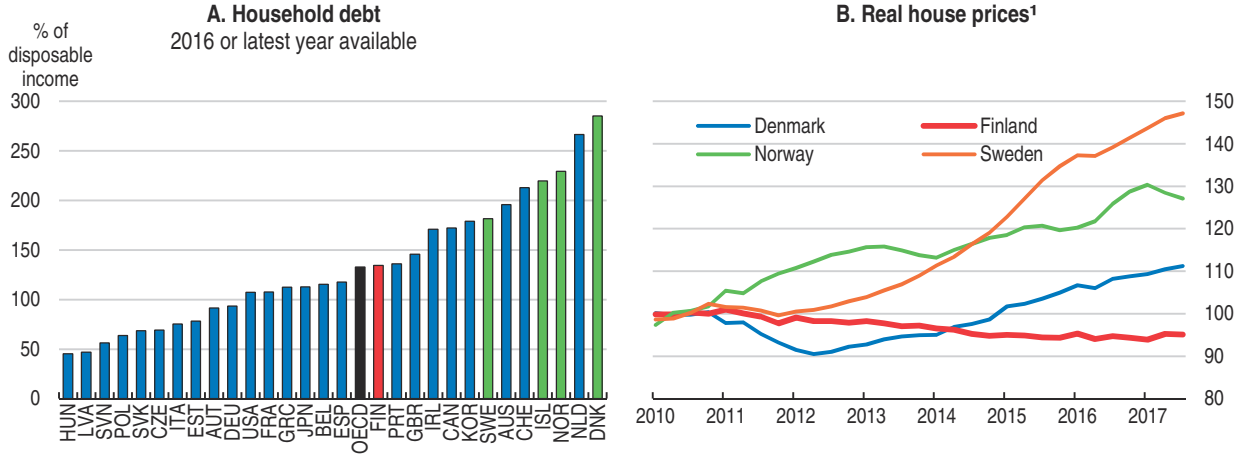
In Finland, the household debt-to-income ratio is relatively high in an OECD perspective, but much lower than in the other Nordic countries (Figure 12, Panel A). This partly reflects a more conservative behaviour of borrowers and financial institutions, in particular in terms of amortisation of loans. Housing prices have been relatively stable over the past decade (Panel B), although increases have been relatively stronger in the Helsinki region than in other parts of the country. However, as economic performance improves while interest rates remain low, housing price growth could accelerate in metropolitan areas. Hence, it is necessary to have the right macro-prudential framework in place to be able to respond rapidly, should the housing market overheat. A binding maximum mortgage loan-to-value ratio of 90% (95% for first-time buyers) came into force in 2016. A minimum 15% risk weight on mortgages is set to apply from 2018. As loan-to-value ratios tend to be pro-cyclical, a loan-to-income or a debt service-to-income limit would be a useful complement. Mortgage amortisation should also be monitored closely, as an increase in non-amortising loans could increase risks for households and financial institutions. Finally, against a backdrop of stagnating income, Finnish households have increasingly been using consumer credit, including from foreign

online providers and peer-to-peer lending services (Bank of Finland, 2017b). Even though consumer debt accounts for only 12% of total household debt and the bulk of it is still held by credit institutions, these developments require monitoring, both from a financial stability perspective and to ensure adequate consumer protection. Establishing a positive credit registry would facilitate underwriting of loans and monitoring of risks.

Table 6. **Past recommendations on financial stability**

Main recent OECD recommendations	Action taken since the 2016 Survey or planned
The macro-prudential tools available to the authorities could include caps on mortgage loan-to-value ratios and higher risk weights on mortgages to prevent potentially unsustainable developments in household debt.	A binding maximum mortgage loan-to-value ratio of 90% (95% for first-time buyers) was introduced in 2016. A minimum 15% risk weight on mortgages is set to apply from 2018.

Figure 12. **Household debt is moderate and housing prices are broadly stable**



1. Deflated by the private consumption deflator.
Source: OECD Economic Outlook Database.

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Public finances are under pressure from an ageing population

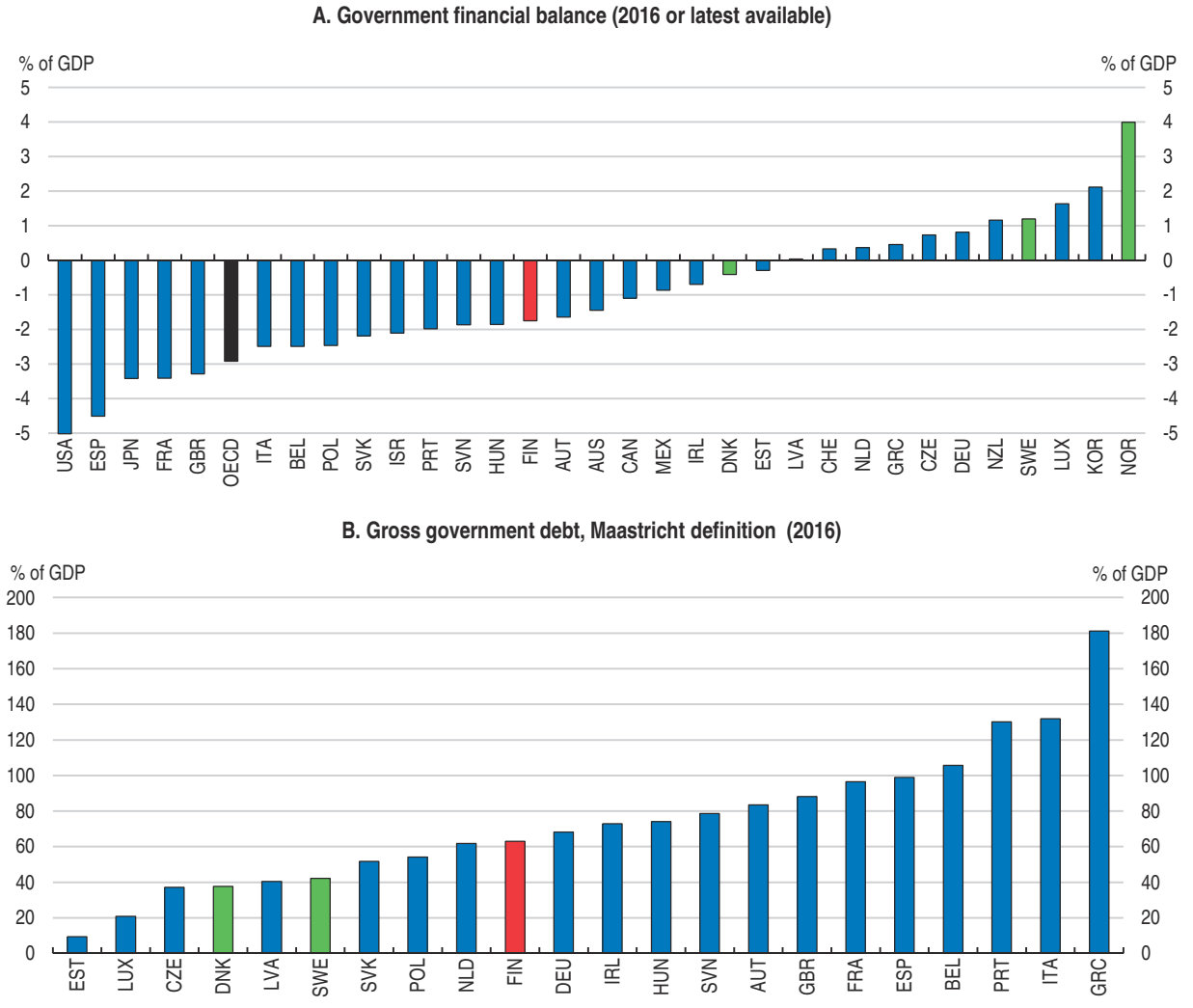
The budget deficit has fallen from a peak of 3.2% of GDP in 2014 to less than 2% of GDP in 2016 (Figure 13, Panel A) and likely shrank further in 2017. Fiscal consolidation has largely been achieved through spending containment. The positive impact of strengthening output growth on general government revenue has been partly offset by tax and social contribution cuts, amounting to 0.8% of GDP in 2017. After increasing rapidly over the past decade, government debt is stabilising, but gross debt (Maastricht definition) is over 60% of GDP (Panel B). The overall impact of budget measures over the period 2017-19 is fairly small (Table 7). Unless steps are taken to contain the increase in ageing-related costs or offset it through other tax or spending measures, debt will start rising again. Cost containment, as could be achieved by a successful health care and social services reform, would rein in debt. Halving the growth rate of spending on health care and social services compared to the no policy change scenario would leave debt close to 65% in 2030. A higher employment rate as a result of labour market reforms would bring debt down further (Figure 14).

Table 7. **Impact of budget measures**

Measure	Budget impact (% of GDP)		
	2017	2018	2019
Reduction in personal income tax	-0.3	-0.2	0.0
Reduction in social security contributions	-0.5	-0.1	0.1
Reduction in expenditure	0.9	0.2	0.2

Source: Ministry of Finance.

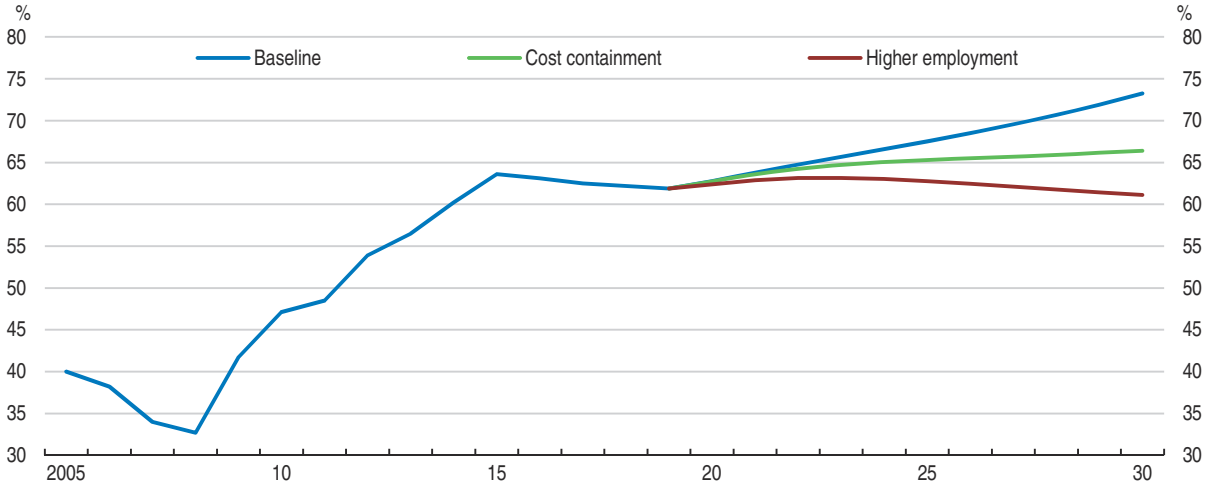
Figure 13. **The government deficit persists but debt is contained**



Source: *OECD Economic Outlook Database.*

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Figure 14. **Health reform and higher employment would help stabilise debt**



1. Economic Outlook No.102 projections are used until 2019. Thereafter, in the baseline scenario, increases in health and long term care spending are based on the cost pressure scenario in de la Maisonneuve and Oliveira Martins (2013), and increases in pension outlays are based on OECD (2017c). The cost containment scenario assumes that reforms to the provision of health care and social services reduce growth in related spending by half. The higher employment scenario assumes cost containment in age-related spending and a higher employment rate of the population aged 15-64, which rises to 74% in 2030.

Source: OECD Economic Outlook Database and OECD calculations.

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Table 8. **Past recommendations on fiscal policy**

Main recent OECD recommendations	Action taken since the 2016 Survey or planned
Consolidate public finances gradually as planned by the government by curbing public expenditure growth.	The deficit has been reduced to less than 2% of GDP in 2016 and government expenditure adjusted for inflation has declined in 2015 and 2016.

Table 9. **Past recommendations on health care**

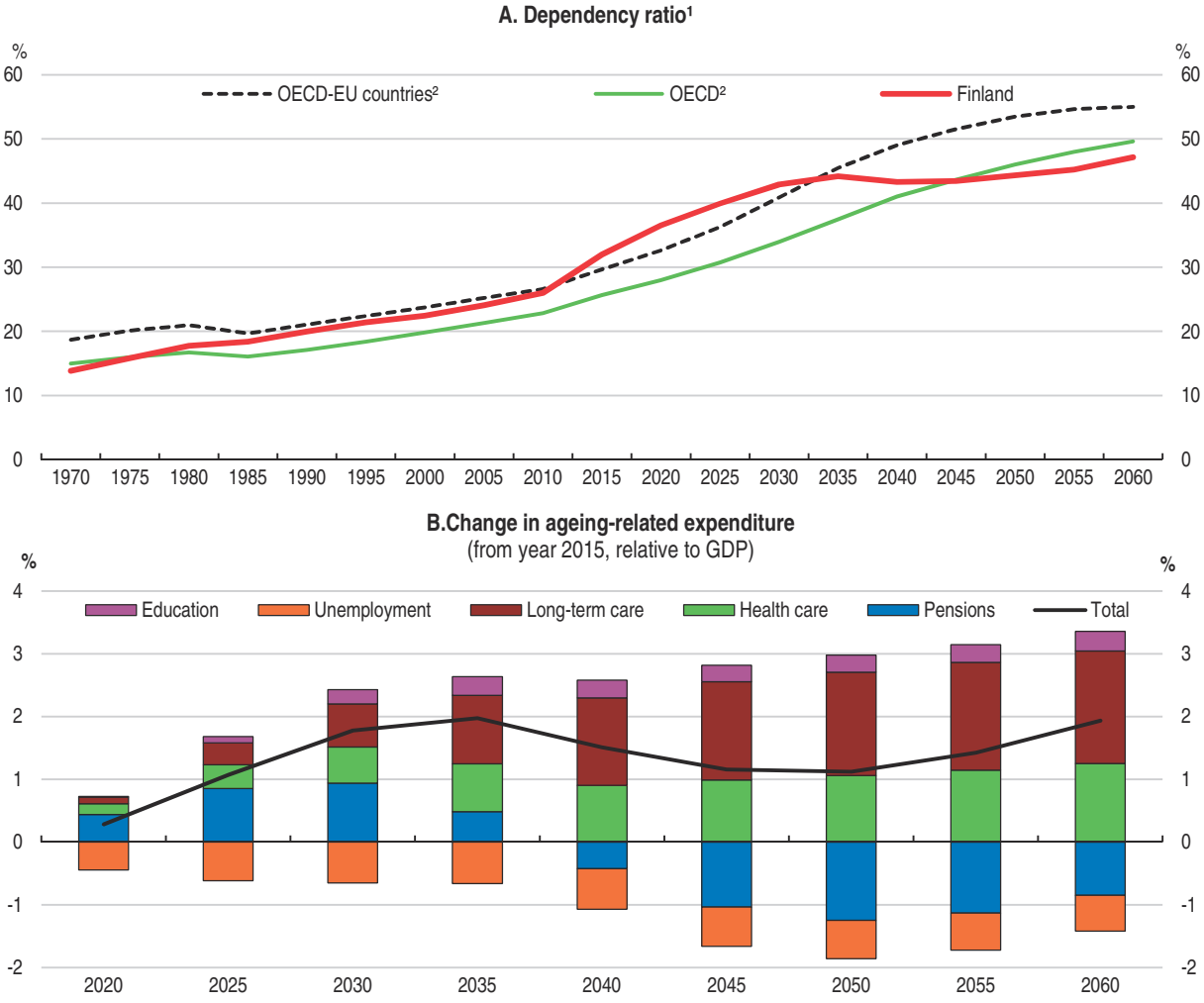
Main recent OECD recommendations	Action taken since the 2016 Survey or planned
Rationalise the organisation of health services to achieve a better balance between primary and specialised care.	A reform of health, social services and regional government set to enter into force on 1 January 2020 will shift most responsibilities for service provision from municipalities to new autonomous regions, creating opportunities for economies of scale and more equal access to services.
Drawing on existing experiences in some municipalities, a purchaser-provider split should be adopted in areas where the population base and the level of complexity of treatment allow meaningful competition.	The new social welfare and health care areas will be allowed to use private or third-sector service providers. Competitive neutrality between different providers will be emphasised. A scorecard will be prepared for assessing the efficiency and quality of service provision.

Reforms to the tax system would enhance growth

The Finnish welfare model, which has fostered strong inclusive growth until the global financial crisis, is facing challenges, in particular with respect to population ageing, which both increases spending pressures by several percentage points of GDP over the next decades and reduces the economic growth potential (Figure 15). Meanwhile, globalisation increases the mobility of tax bases, making it more difficult to fund welfare in a fair and efficient way. Addressing these challenges will require both enhancing the efficiency of public services, including through regular spending reviews, and ensuring that the tax and benefit system supports growth, competitiveness and employment, while preserving its

ability to contain income inequality. Increasing environmentally-related taxation and cutting environmentally-harmful subsidies would foster greener growth. Tax revenue as a share of GDP is among the highest in the OECD and comparable to the other Nordic countries (Figure 16).

Figure 15. **Ageing is increasingly weighing on public finances**



1. Ratio of population aged 65 and over per 100 people aged 15-64.
2. Weighted average.

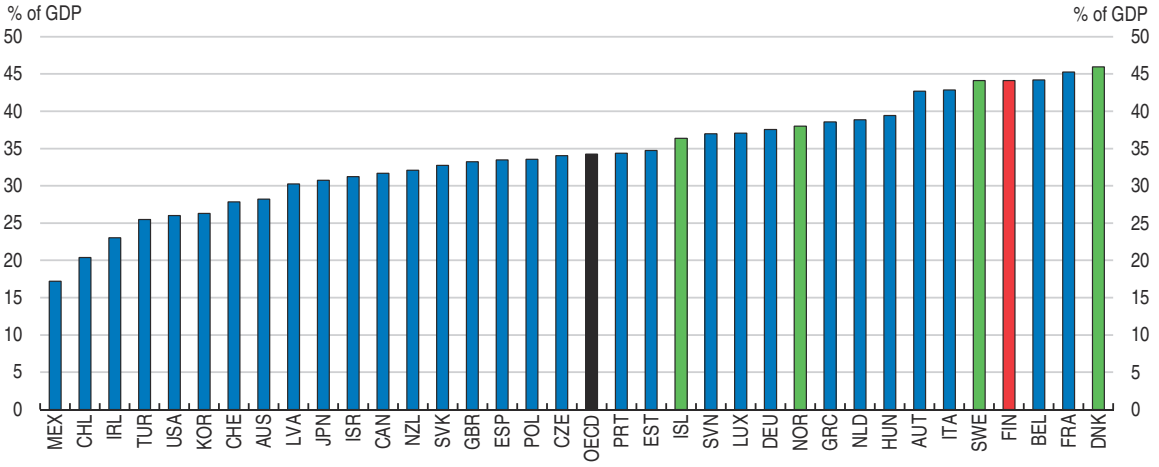
Source: United Nations Population Division, World Population Prospects: The 2017 Revision, OECD calculations; and Finnish Ministry of Finance.

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The large government size reflects extensive income redistribution, the provision of a wide range of public services, as well as high public social spending (Figure 17, Panel A). As the distribution of tasks between the public and private sector varies widely across countries, a more accurate assessment of welfare costs is given by total net social spending, which includes both public social expenditure and private social spending (e.g. private pensions or health care insurance benefits) and takes taxation of benefits into account (Adema et al., 2011). On this measure, social spending in Finland is not as high relative to other countries, even though it is still above the OECD average (Panel B).

Figure 16. **The tax burden is among the highest in the OECD**

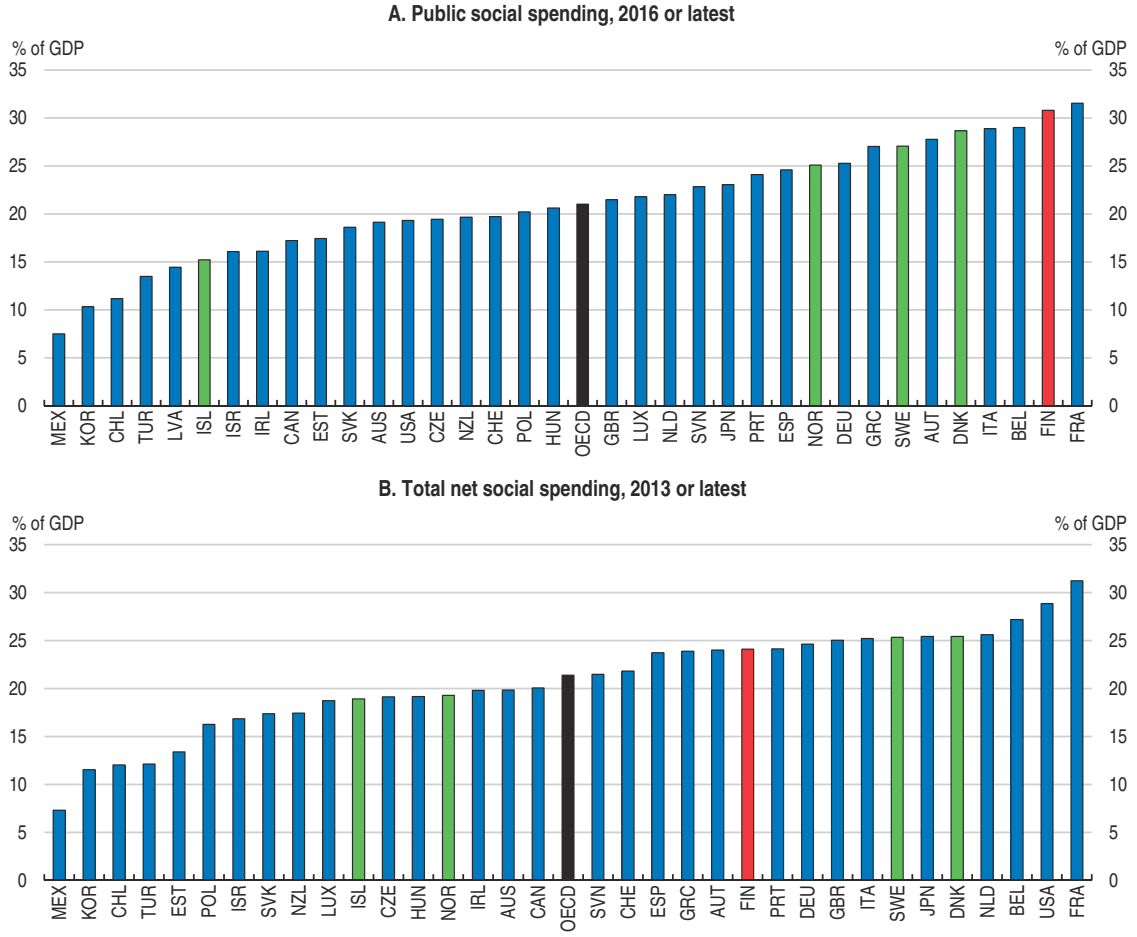
Taxes and social security contributions, 2016 or latest



Source: OECD Revenue Statistics Database.

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Figure 17. **Social spending is not as high in international comparison when private social spending and taxation of benefit income are taken into account**



Source: OECD Social Expenditure Database.

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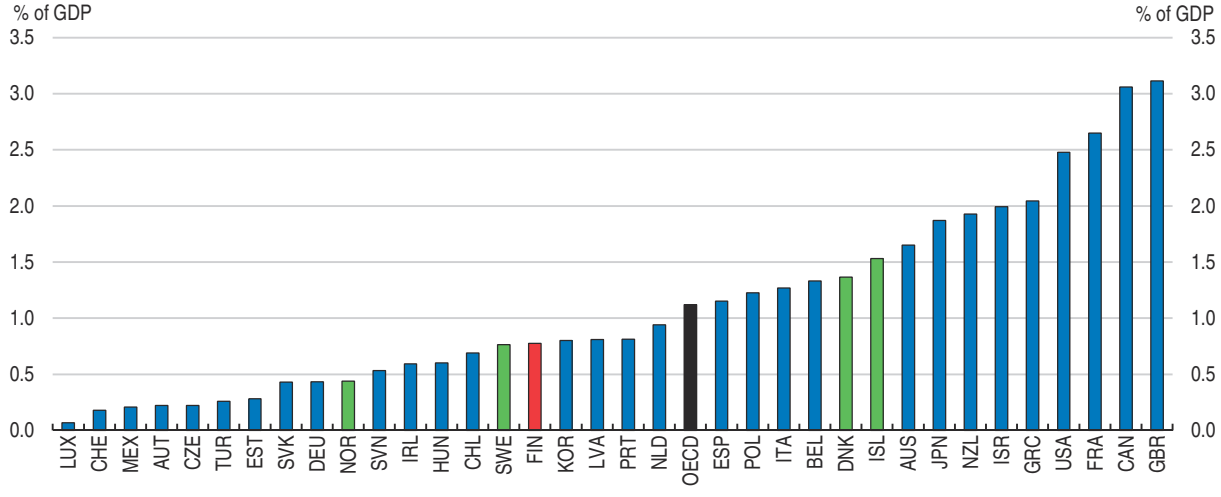
Raising property taxes and moving further towards tenure-neutral taxation of housing

Recurrent taxes on immovable property are generally considered as among the least harmful to economic growth (Arnold et al., 2011; Johansson, 2016). In addition, reducing the tax bias in favour of home-ownership and linking property taxes to regularly updated property valuations could reduce housing price volatility (Blöchliger et al., 2015a). Finland has been moving towards more even taxation of owner-occupiers and renters over recent years. In 2014, property assessment values were revised, and further updating to bring cadastral values closer to market values is expected to be completed by the early 2020s. The lower and higher thresholds of the range within which municipalities may set their property tax rate have been increased in steps. Mortgage interest deductibility from personal income tax is being gradually reduced, as in a number of other EU countries such as the Netherlands and Spain.

Nevertheless, property tax revenue remains below the OECD average (Figure 18). Residential property taxes are also regressive, as municipalities with high average incomes tend to set lower tax rates. Hence, there seems to be potential to raise a larger share of local government revenue through property taxation, as well as to make the tax more progressive. Higher revenue from property taxes also strengthens the incentives for municipalities to zone more land for development and speed up planning processes, enhancing the responsiveness of housing supply to demand. Property taxes are generally unpopular, especially because they are highly visible and sometimes perceived as unfair, insofar as they are disconnected from the ability to pay. In particular, property taxes may put a heavy burden on asset-rich income-poor households. However, these problems can be and are sometimes mitigated by means-tested exemptions for low-income households or measures to alleviate liquidity constraints, such as tax deferral (Blöchliger, 2015b).

Figure 18. **Tax revenue from recurrent taxes on immovable property is still relatively low**

2016 or latest



Source: OECD Revenue Statistics Database.

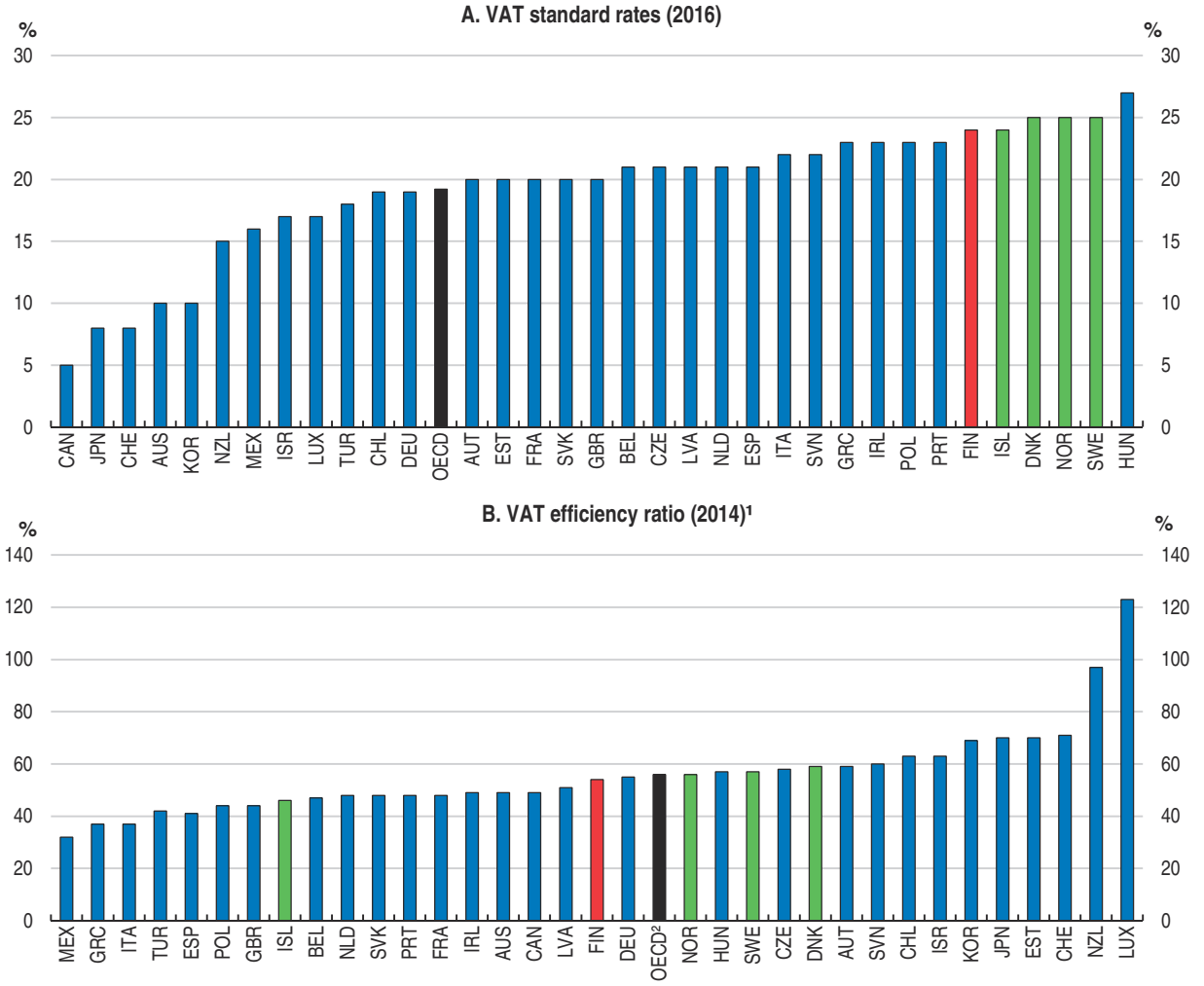
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Reducing the scope of reduced VAT rates

Finland has a 24% standard VAT rate, which is among the highest in the OECD (Figure 19, Panel A), but a number of goods and services are taxed at lower rates. A 14% rate

applies to food and restaurants. A 10% rate applies to a wide range of items, including books, pharmaceutical products, accommodation, passenger transport services and some sport and cultural activities. The VAT efficiency ratio (i.e. the ratio of actual VAT revenue to potential VAT revenue if all goods and services were taxed at the standard VAT rate) is only about 54%, slightly below the OECD average (Panel B). A number of countries achieve higher efficiency, even though Luxembourg and New Zealand are special cases, reflecting the VAT treatment of financial services and e-commerce in Luxembourg and the fact that public services are subject to VAT in New Zealand (OECD, 2016b).

Figure 19. **VAT rates are high but efficiency is slightly below average**



1. Ratio of actual VAT revenue to potential VAT revenue if all goods and services were taxed at the standard VAT rate.
2. OECD average excludes the United States.

Source: OECD (2016), *Consumption Tax Trends 2016: VAT/GST and excise rates, trends and policy issues*, OECD Publishing, Paris.

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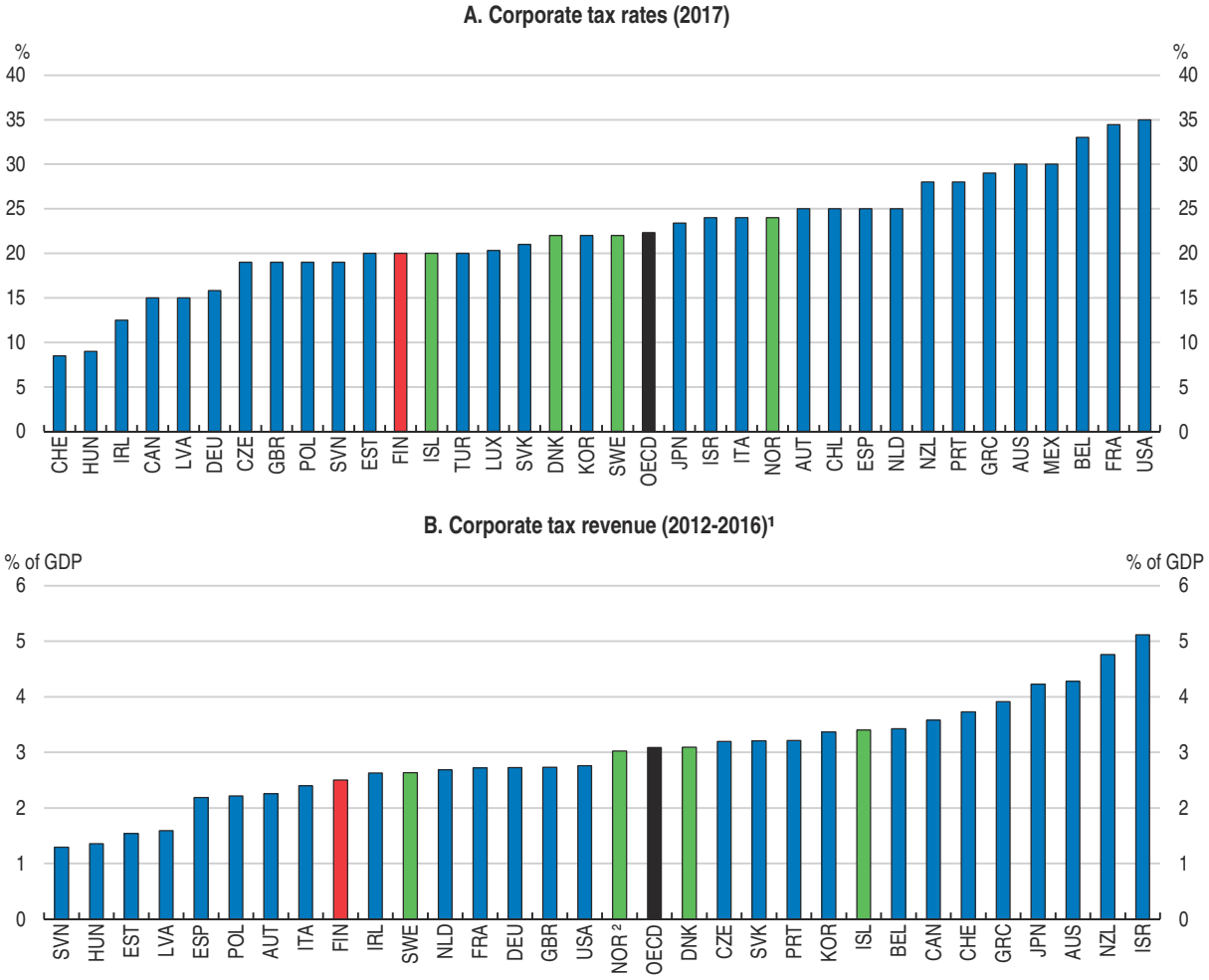
The relatively low efficiency of Finnish VAT is mainly related to exemptions and reduced rates, as compliance is high (Thackray et al., 2015; CASE, 2016). Reduced VAT rates cost about EUR 2 billion (1% of GDP) in 2014 and are the second largest tax expenditure after the total of deductions related to income taxes (Economic Policy Council, 2014). In most cases, reduced rates are justified by social and equity objectives, which could generally be achieved at a

lower cost using targeted instruments, for example means-tested allowances. Another argument often used to justify reduced VAT rates is to support labour-intensive economic activities, in particular restaurants. However, experience from both Finland and abroad suggest a limited impact (Harju and Kosonen, 2013; NIER, 2015; Conseil des Prélèvements Obligatoires, 2015). Furthermore, having several VAT rates generates administrative and compliance costs. This calls for narrowing the number of goods and services subject to reduced rates. Another option would be to tax all products subject to reduced rates at 14%, instead of taxing some at this rate and others at 10%. Such reforms would likely have distributional consequences, hurting low-income households, but this could be easily offset by slightly lower taxes on low-income households.

International cooperation is required to avoid a race to the bottom in business taxation

Business taxation is relatively similar across Nordic countries and moderate by OECD standards and Finland has a competitive corporate income tax (CIT) rate (Figure 20). It is crucial for taxation in small economies to remain competitive in order to attract investment

Figure 20. **Corporate tax rate and revenue are low**



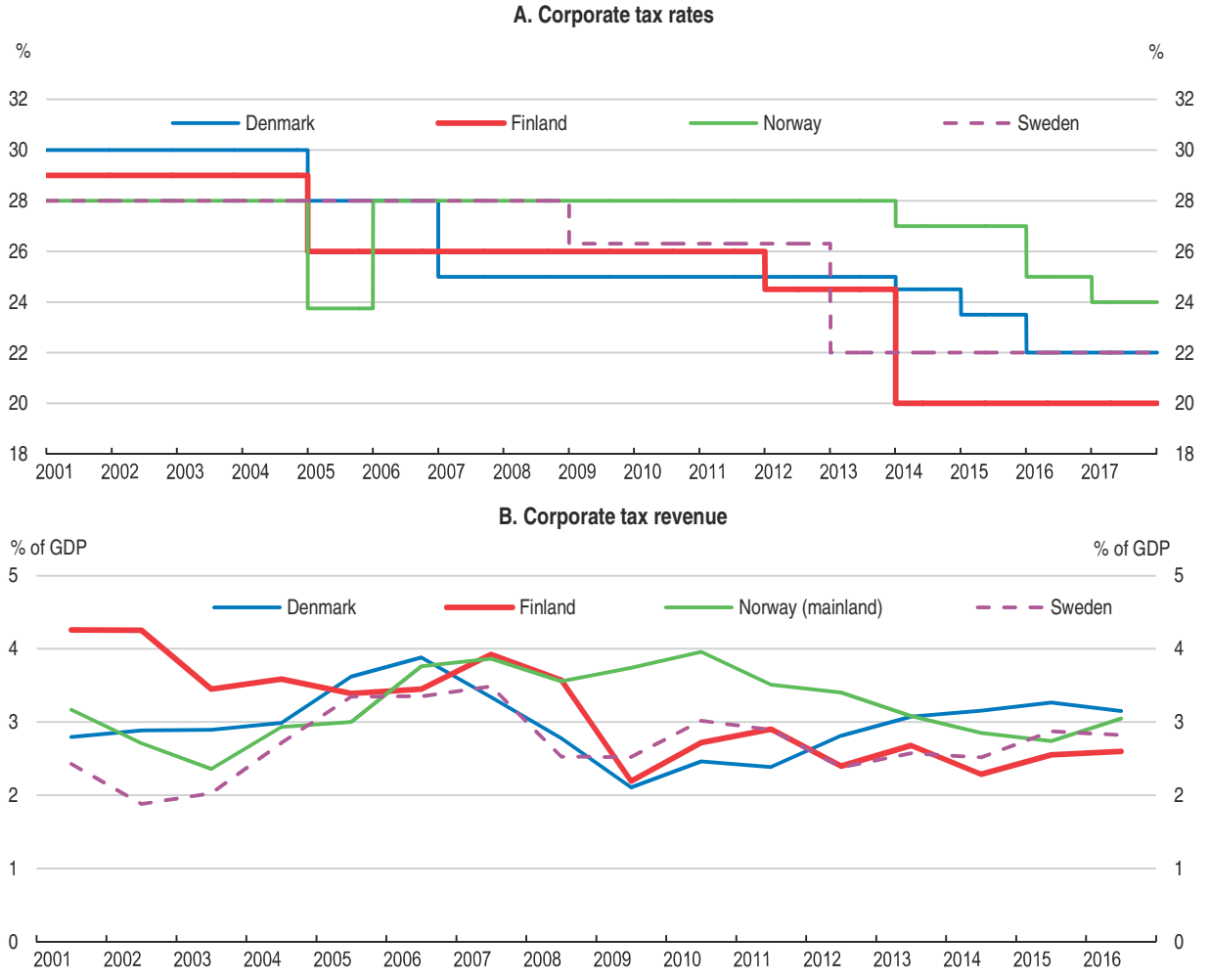
1. A five-year average is shown to account for the volatility of corporate tax revenue.
2. Mainland Norway.

Source: OECD Taxation Database.

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or maintain activity in the country, even though other factors like proximity to markets, good infrastructure, labour force skills and interdependence of activities within value chains are at least equally important in location decisions (Ketokivi et al., 2017). High marginal corporate tax rates are linked with significantly lower long-term output level (Akgun et al., 2017). The Nordic countries have reduced CIT rates significantly over the years (Figure 21, Panel A). Nevertheless, corporate tax revenue has so far held up relatively well (Panel B). Denmark, Estonia, Norway and Sweden are planning to further alleviate corporate income tax in different ways over the coming years. More generally, the global trend is towards lower CIT rates, with 15 OECD countries having implemented or announced CIT rate cuts since 2016 (OECD, 2017d).

Figure 21. **Corporate tax revenue has so far held up relatively well despite sharp tax rate cuts**



Source: OECD Taxation Database.

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Finland, together with 70 other jurisdictions, signed the multilateral instrument (MLI) which is part of the OECD/G20 project on Base erosion and profit shifting (BEPS) in June 2017. The MLI will allow Finland to transpose BEPS recommendations directly into its existing network of tax treaties; it will thus reinforce the anti-avoidance arsenal which is already part of Finnish tax legislation and includes controlled foreign company rules to limit tax

avoidance through the use of affiliates in low-tax jurisdictions, transfer pricing rules which follow OECD guidelines and interest deduction limitations which prevent profit shifting through debt financing. The restriction on intra-firm interest deductibility imposed in 2014 is estimated to have lowered the financial expenses of Finnish multinational companies by 25% to 30%, without noticeable effects on other profit shifting measures or real output (Harju et al., 2017).

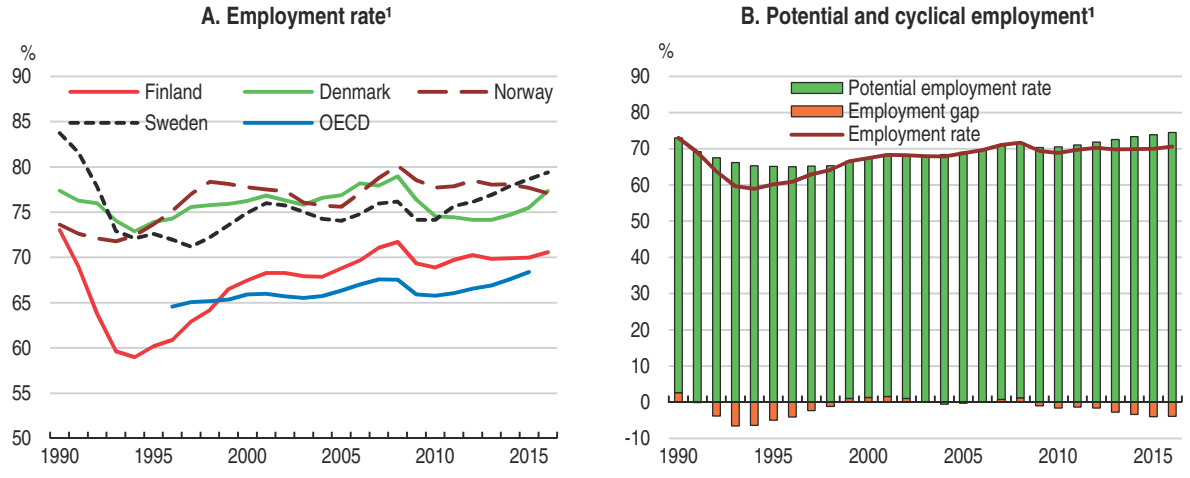
Table 10. **Past recommendations on tax reform**

Main recent OECD recommendations	Action taken since the 2016 Survey or planned
Continue to lower the taxation of labour and increase recurrent taxes on personal immovable property and indirect taxes.	Income taxes and social contributions have been reduced. Excise duties and property tax rates have increased.
Phase out mortgage interest deductibility.	Mortgage interest deductibility is being reduced in steps.
Raise the revenue efficiency of the VAT by eliminating reduced VAT rates.	No action taken.

Work incentives need to be strengthened, while maintaining strong social protection

Employment is lower in Finland than in all the other Nordics, even though skill levels are higher despite somewhat weakening PISA results over recent years. Cyclical factors play a role, with significant employment losses following the Great Recession (Figure 22). The current economic upturn increases the chances of reaching the government's 72% employment target by 2019, but this remains challenging. Moreover, Finland needs to boost employment further to counter ageing, strengthen public finances and increase well-being. And the potential to expand the labour force is considerable, with lower employment than the Nordic average for all gender-age groups. Men of all ages are less likely to be employed than in the other Nordics, but especially so in older cohorts. Women in childbearing age are much less likely to be employed than in Sweden and Norway, despite taxation applying to individual incomes and generous parental leave and childcare arrangements in all three countries (Figure 23; *OECD Economic Survey of Finland*, 2016; Economic Policy Council, 2017).

Figure 22. **The labour market has been hard hit by crises**

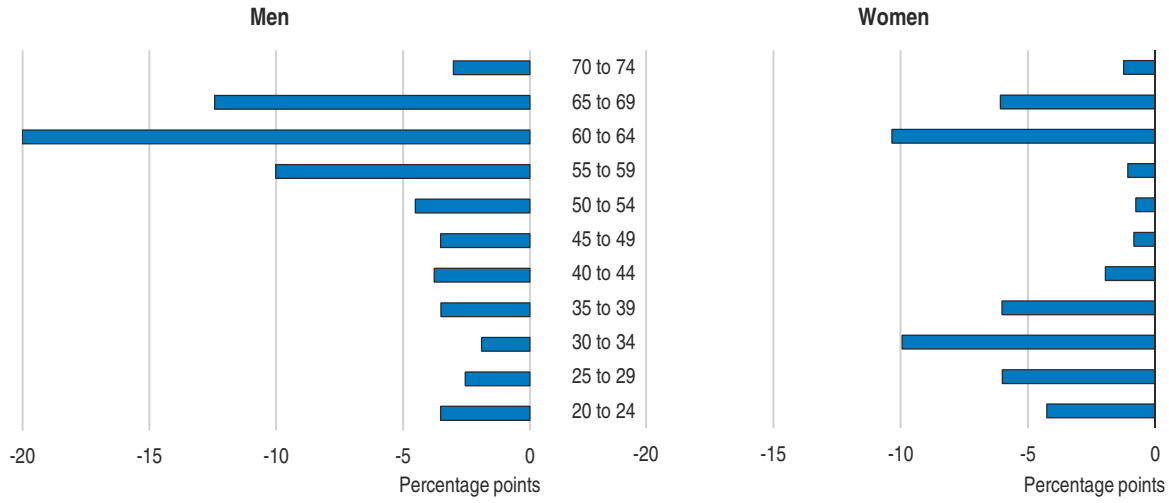


1. Percentage of population aged 15-64.
Source: *OECD Economic Outlook Database*; and Labour Force Statistics.

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Figure 23. **Compared to other Nordics, employment is low across gender and age**

Employment gap to Nordics (2016)[1]



1. Difference in employment rates between Finland and the Nordic average (Denmark, Norway and Sweden), within each age-gender sub-group.

Source: OECD Labour Force Statistics Database.

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A number of recommendations made in the *OECD Economic Survey of Finland 2016* to improve the labour market functioning, including with respect to education, activation policy, employment protection legislation and wage bargaining, have since been addressed by the government and social partners. Important steps have also been taken to improve work incentives for the unemployed.

But more needs to be done. A complex system built around the traditional employer-employee model will likely be increasingly challenged in a rapidly changing world of work, and work incentives can still be very weak for many individuals when different benefits and taxes interact. Working may therefore not always be the most attractive option, and disincentives may be compounded by work-related expenses, spouse income, the number and age of children, regional housing price differences and individual preferences. The benefit reform scenarios below are used to unmask weaknesses of the current system and to show how the general direction of reform affects incentives, inclusiveness and affordability – the policy trilemma at the heart of social insurance and redistribution policy. These and similar analyses can serve to help formulate a vision for social welfare in Finland and to give a clear direction for benefit reform. However, major reorganisations can come with significant costs. Implementation should hence be stepwise, building on the existing system and institutional context, and important technical building blocks should be fully operational and well-tested before full roll-out.

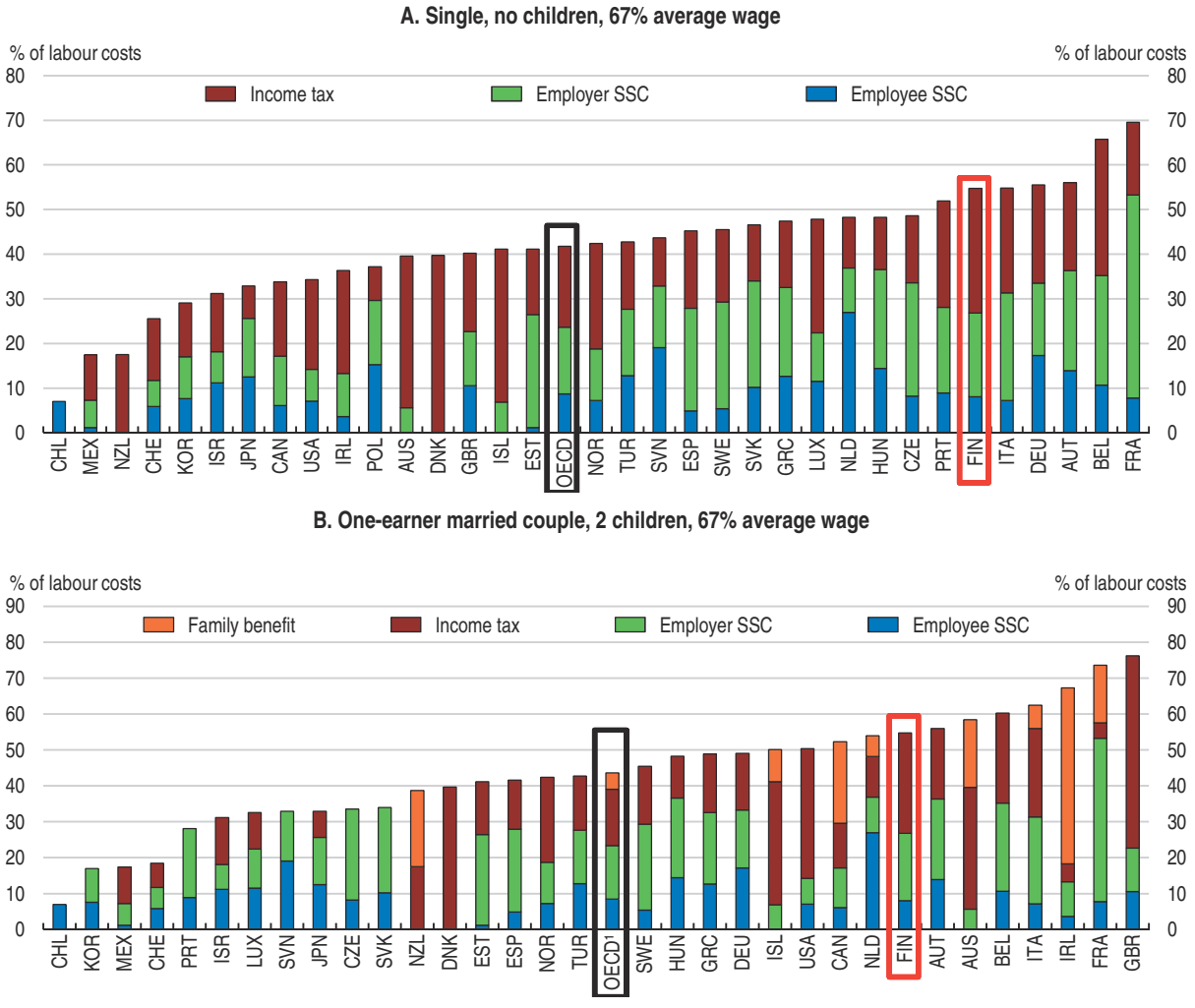
Incentive- and bureaucratic traps in the current system

Finland has one of the highest tax wedges in the OECD, even though the tax wedge may be underestimated in some countries, where some mandatory social contributions are not taken into account (Figure 24). On the basis of recent OECD estimates (Égert and Gal, 2017), lowering the tax wedge to the level of the OECD average (holding the government budget balance constant) would raise GDP per capita by more than 2.5% after 10 years. Lowering it to the level of Sweden would raise GDP per capita by 1.8% after 10 years.

The tax wedge interacts with a patchwork of different working-age benefits introduced over the years to cater for different needs and insure against different circumstances. The combination of different working-age benefits, childcare costs and income taxation continues to create multiple incentive traps in OECD countries. Average effective tax rates can exceed 100% in some OECD countries, including Finland, and average effective tax rates above 80%, which also constitute weak incentives, are quite common (Figure 25).

Figure 24. **The tax wedge on labour remains high**

2016



1. OECD average excludes Poland.

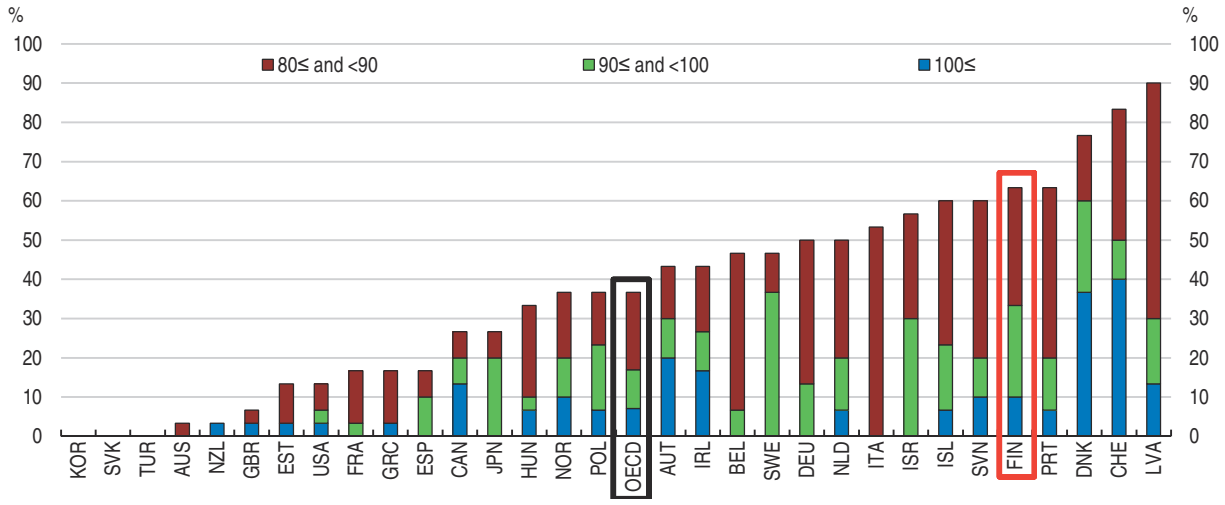
Source: OECD Taxation Database.

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Finland is no exception, with major disincentives appearing when unemployment, housing and social assistance benefits interact, and compounded by income taxation. A homecare allowance and a childcare fee designed as an additional income tax further reduce the pay-off from going from benefits to work for parents. "Bureaucratic traps", where complex benefit rules combined with administrative practices create a real or

Figure 25. **Work does not always pay**

Incidence of unemployment traps[1]



1. Incidence of an average effective tax rate within the indicated range for individuals transitioning from unemployment to full-time work in the initial phase of unemployment. A value of 100 means that all modelled individuals face inactivity traps. Zero means that none do. Unemployment insurance and means-tested top-ups are included. Average effective tax rates are modelled for six household types: single; single parent; couple, inactive spouse, no children; couple, inactive spouse, two children; couple, working spouse, no children, and; couple, working spouse, two children, and for five income levels: 33%, 50%, 67%, 100% and 150% of the national average wage. Households with children are assumed to have two children aged four and six.

Source: Simulations with the OECD TaxBen model, in Pareliussen et al. (2018).

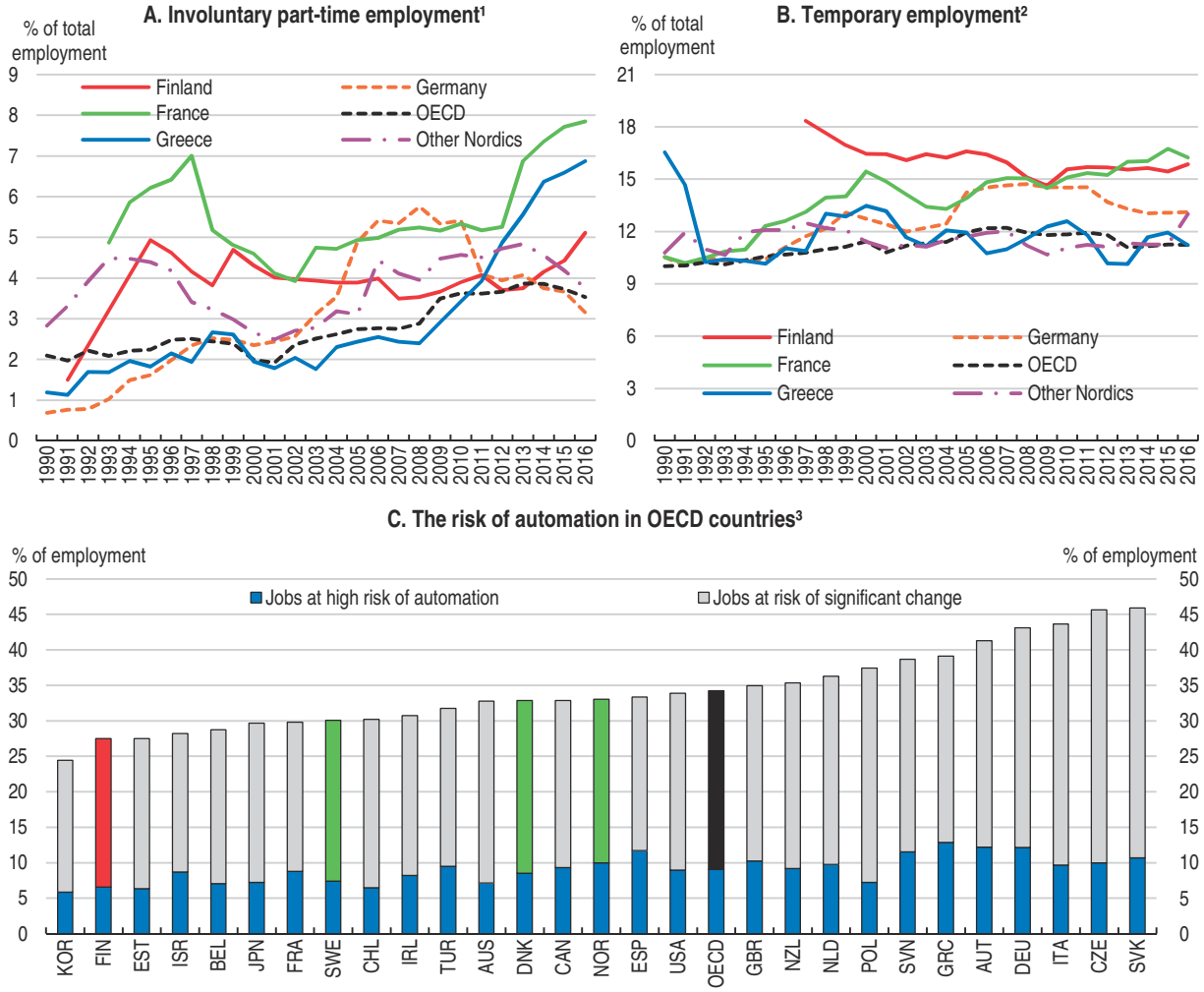
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perceived risk of losing eligibility or delayed benefit payments, can further reduce the attractiveness of work for risk-adverse, often cash-strapped, Finnish benefit recipients (Pareliussen et al., 2018).

Social protection needs to be fit for the future of work

Digitalisation, automation and globalisation have led to profound changes in working life over the past few decades, and will continue to do so going forward (Figure 26). Evidence of under-qualification and under-skilling is mainly found for older workers in Finland, which may call for strengthening lifelong learning, although participation in adult education is among the highest in the OECD (OECD, 2017e). Conversely, younger generations are more likely to be over-qualified and over-skilled (Pareliussen, 2016). Adapting the social safety net to the future of work and treating freelancers and self-employed as far as possible on an equal footing with regular workers is a major challenge to social protection systems across the OECD, but not an insurmountable one. And technology can help. The opportunities from freelancing and platform work should be welcomed by public employment services, and technology can facilitate automation of benefit payments, if they are linked to a real-time registry of incomes, as planned in Finland from 2020 (OECD, 2016c; OECD, 2017f).

Figure 26. **The world of work is changing**



1. Involuntary part-time employment is defined as people who work part-time because full-time work is not available.
2. Temporary employment includes wage and salary workers whose job has a pre-determined termination date.
3. Based on the analysis of the task content of individual jobs using the OECD Adult Skills Survey (PIAAC). Jobs are at high risk of automation if the likelihood of being automated is at least 70%. Jobs at risk of significant change are those with the likelihood of being automated estimated at between 50 and 70%. For more details, see OECD Employment Outlook 2017.

Source: OECD *Labour Force Statistics Database*; and *OECD Employment Outlook 2017*, OECD Publishing, Paris.

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Finding direction for benefit reform

Two benefit reform scenarios have been developed to explore how benefit design affects trade-offs between incentives, inclusiveness and affordability. In a basic income scenario, a lump-sum benefit replaces a number of existing benefits, financed by increasing income taxation by nearly 30% or around 4% of GDP. It provides basic security for all, hence simplifying the benefit system and making coverage universal. A second scenario, inspired by the universal credit in the United Kingdom, but adapted to the Finnish context, harmonises tapering rules for the current set of working-age benefits by merging them into one single benefit, tapered against net income with one single taper rate. Furthermore, it abolishes the link between public childcare and the homecare allowance and changes the childcare fee structure (Pareliussen et al., 2018).

Both scenarios can realistically be implemented without increasing net fiscal expenditure, although the basic income requires significant increases to income taxation. Both resolve some serious incentive issues in the current system (Table 11). However, a revenue-neutral scenario with the basic income set approximately at the level of the on-going basic income trial (Box 3) would imply significant redistribution of income, as the basic income is higher for couples than singles compared to the current system with benefits targeted to specific circumstances, unemployment insurance is abolished, benefit take-up increases and taxation changes. Overall, the basic income scenario increases the Gini coefficient by approximately 0.4 percentage points. The poverty rate increases from 11.4% to 14.1%, and of the 150 000 persons falling below the poverty line, 30 000 are children, and 50 000 early pensioners. In contrast, in the universal credit scenario, the Gini coefficient falls by 0.9 percentage points, and 90 000 people exit poverty, thereby reducing the poverty rate by 1.7 percentage points to 9.7% (Figure 27). It alleviates complexity and strengthens work incentives consistently for a variety of individual circumstances.

It should be noted that these results depend on the assumptions underlying the scenarios. The basic income for example is designed as one uniform benefit for all, in line with what is commonly associated with the term. Other lump-sum benefit structures, more targeted towards individuals in need, would likely perform better along the inequality dimension.

Table 11. **Reform could reduce average effective tax rates**

A. In %, individual entitled to unemployment insurance[1]

Household type	Going back to work full time with 100% of previous earnings			Going back to work full time with 80% of previous earnings		
	Current system	Basic income	Universal credit	Current system	Basic income	Universal credit
Single	79.1	72.0	73.4	89.4	78.3	72.2
Single parent	97.7	86.2	73.4	99.5	91.4	72.2
Single earner in childless couple	86.5	68.2	73.4	90.3	73.6	72.2
Single earner in couple with children	88.3	74.4	73.4	93.8	81.3	72.2
Second earner in childless couple	74.6	43.9	64.8	83.7	43.2	71.5
Second earner in couple with children	102.0	66.1	73.4	118.0	71.0	72.2

B. In %, individual only entitled to social assistance and housing benefit[2]

Household type	Half time			Full time		
	Current system	Basic income	Universal credit	Current system	Basic income	Universal credit
Single	87.6	87.9	69.1	72.0	72.0	72.0
Single parent	67.6	92.5	69.1	77.1	86.2	73.4
Single earner in childless couple	87.6	87.9	69.1	86.5	68.2	73.4
Single earner in couple with children	87.6	87.9	69.1	80.6	74.4	73.4
Second earner in childless couple	11.6	41.9	11.6	24.0	43.9	24.0
Second earner in couple with children	89.4	86.3	56.0	66.6	66.1	46.3

1. Previous earnings equal to 67% of national average wage. Means-tested benefits are allowed as top-ups. Households with children are assumed to have two children aged two and five. The person is going into work in the initial phase of unemployment. This implies that individuals in the current system and the universal credit scenario are entitled to an increased income-related allowance, resulting in somewhat higher average effective tax rates than without this allowance. See Pareliussen et al. (2018) for a detailed explanation and comparisons of incentives with and without the increased allowance.
2. Hourly wage equal to 67% of the national average wage. Households with children are assumed to have two children aged two and five.

Source: Simulations with the OECD TaxBen model, in Pareliussen et al. (2018).

Box 3. **The Finnish basic income trial**

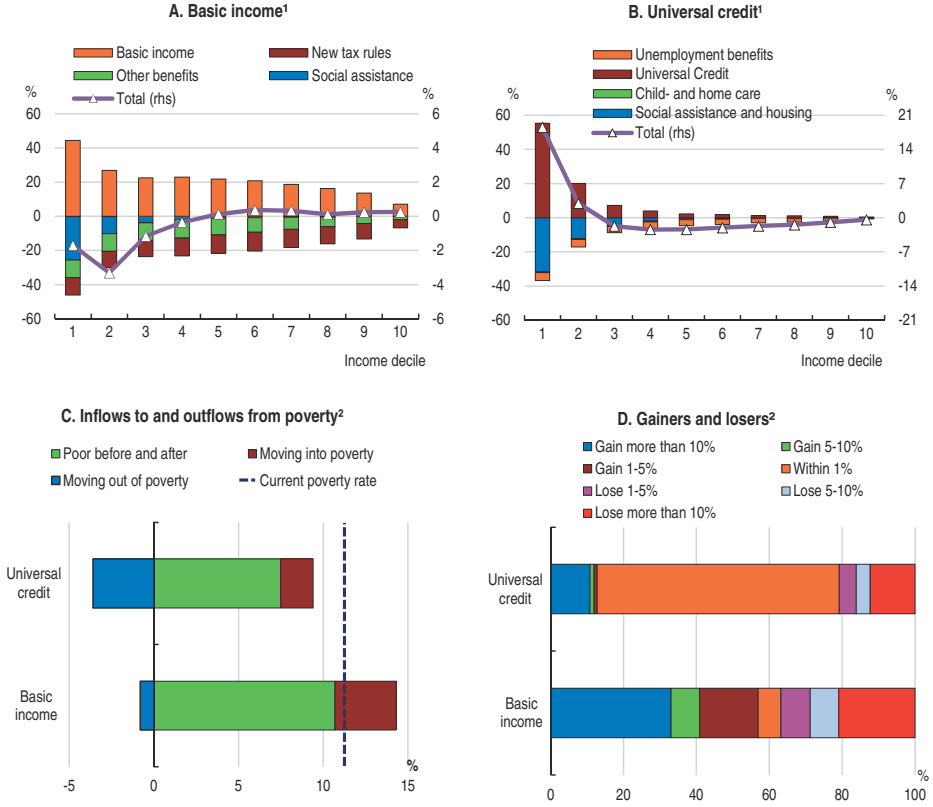
A basic income is a uniform benefit to all, regardless of their earnings or individual circumstances. The concept of a basic income is not new, and most OECD countries already include unconditional transfers to certain groups in the form of, for example, child benefits and basic old-age pensions. However, the idea of such a benefit for the whole population has gained renewed attention lately as a possible way to adapt to challenges facing traditional social protection systems, such as the rise of atypical forms of employment and risk of job losses due to automation by way of simplification, improved work incentives and coverage.

In Finland, a lively academic and political debate about the subject eventually led to the implementation of a two-year basic income trial, which started in January 2017. The experiment covers 2 000 recipients of unemployment assistance, and converts the EUR 560 a month (before tax) unemployment assistance into an unconditional benefit in the sense that tapering and mandatory activation and job search requirements are abolished for the individuals concerned.

In the trial, income taxation and other benefits are kept unchanged, so that no participant loses out compared to the current system. This would be too costly to implement on a national scale: if existing spending on all working-age benefits was distributed with an equal amount to all, the benefit level would only constitute 13% of the median income, or 26% of the relative poverty threshold. Financing a basic income at a meaningful level thus would require considerable additional tax revenue, and heavier taxation of income would at least partially undo any improvement in work incentives.

Source: OECD, 2017a.

Figure 27. **A basic income would alter the income distribution**



1. Percentage change compared to pre-reform disposable income within each income decile.
2. Share of individuals in working-age households.

Source: Simulations with the TUJA model, in Pareliussen et al. (2018).

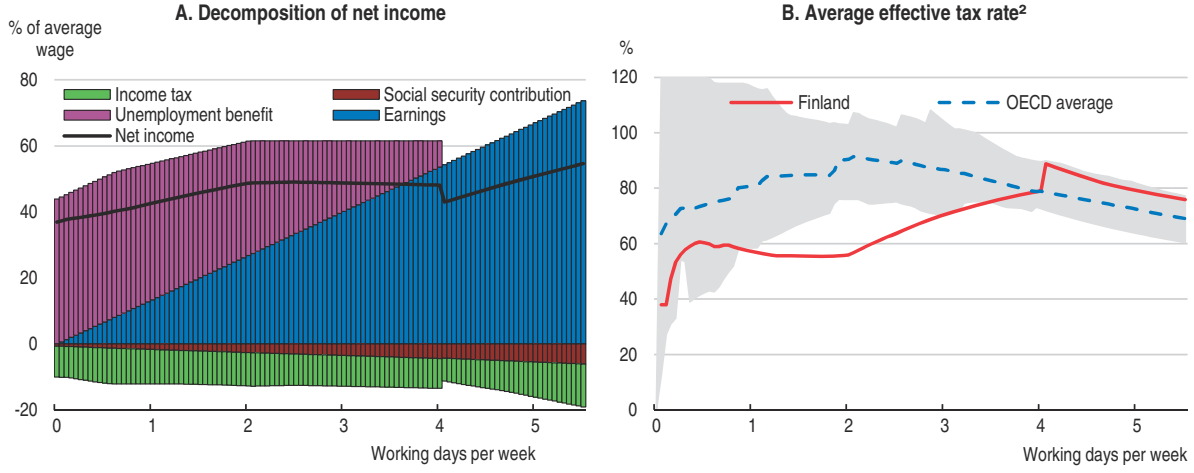
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Reform priorities within the current system

Moving in the direction of coordinated benefit tapering, as illustrated in the universal credit scenario, would thus balance incentives, affordability and social protection, in line with Finnish social preferences. However, such reform should be gradual, as major welfare reforms can come with significant costs (Fimreite et al., 2012; NAO, 2013). In this process, important technical building blocks should be fully operational and well-tested before full roll-out, and resolving specific incentive issues should be prioritised over immediate, full-fledged benefit reform.

One such issue arises because unemployment insurance benefits are fully withdrawn when working more than 80% of full time, resulting in a "cliff-edge" loss of income (Figure 28). The cliff-edge loss of benefits can strongly disincentivise full-time work, and should be abolished. Somewhat higher tapering on low incomes combined with a lower initial benefit level could make the 80% limit obsolete, and is hence an alternative solution, but would entail a trade-off with somewhat weaker protection and weaker incentives to take up part-time jobs.

Figure 28. **Net income and work incentives in the current system**[1]



1. A single person entitled to unemployment insurance going into work, with hourly earnings pre- and post-unemployment of 67% of the national average wage, in the initial phase of unemployment. Means-tested benefits are allowed as top-ups to unemployment insurance.
2. Extreme positive rates have been capped 120%. The shaded area denotes the range between the 25th and the 75th percentile in the OECD area.

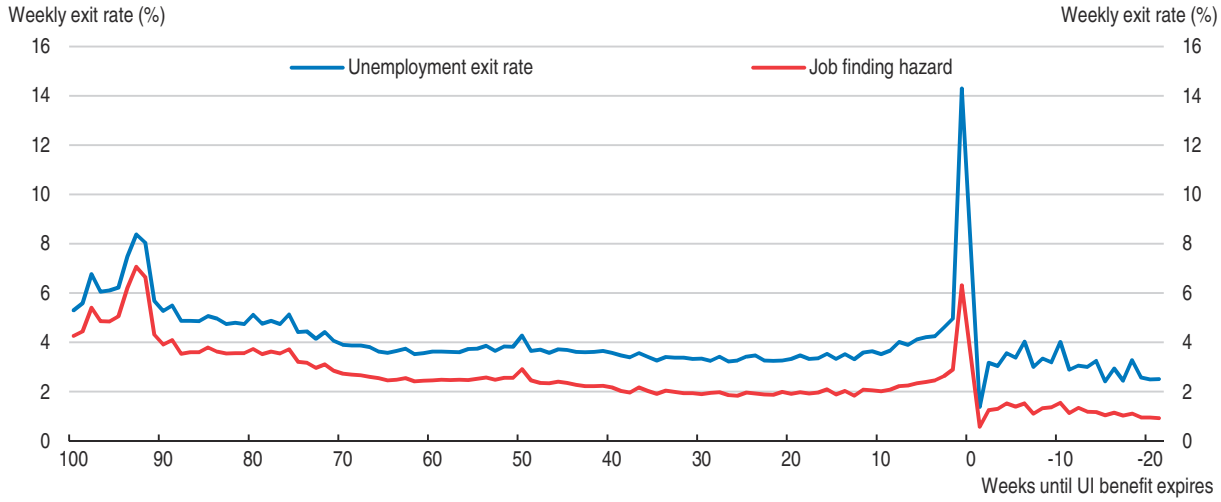
Source: Pareliussen et al. (2018).

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The existence of a time limit to the earnings-related unemployment insurance increases incentives to go back to work, including when the earnings-related unemployment insurance runs out (Figure 29), but actually mainly earlier on in the unemployment spell. The reduction in benefit duration by 100 days in January 2017 is estimated to reduce average time in unemployment by 10%, increase employment significantly, and lead to fiscal savings of more than EUR 100 million. Increasing inequality from lower benefit payments is expected to be neutralised by job creation (Kyyrä et al., 2017a and b; Ministry of Finance, 2017b; Kotamäki et al., 2017). A new activity requirement from January 2018, stipulating that those who do not work or participate in activation activities for at least 18 hours during each three-month

period following unemployment will get their unemployment insurance reduced by 4.5% in the following three-month period, may trigger similar threshold effects earlier in the unemployment spell (Ministry of Finance, 2017c).

Figure 29. **Exit rates spike immediately before unemployment benefit expiry**[1]



1. Unemployment and job finding rates as a function of time-to-exhaustion for all those entitled to unemployment insurance.
Source: Kyyrä et al. (2017a).

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Making work pay for parents

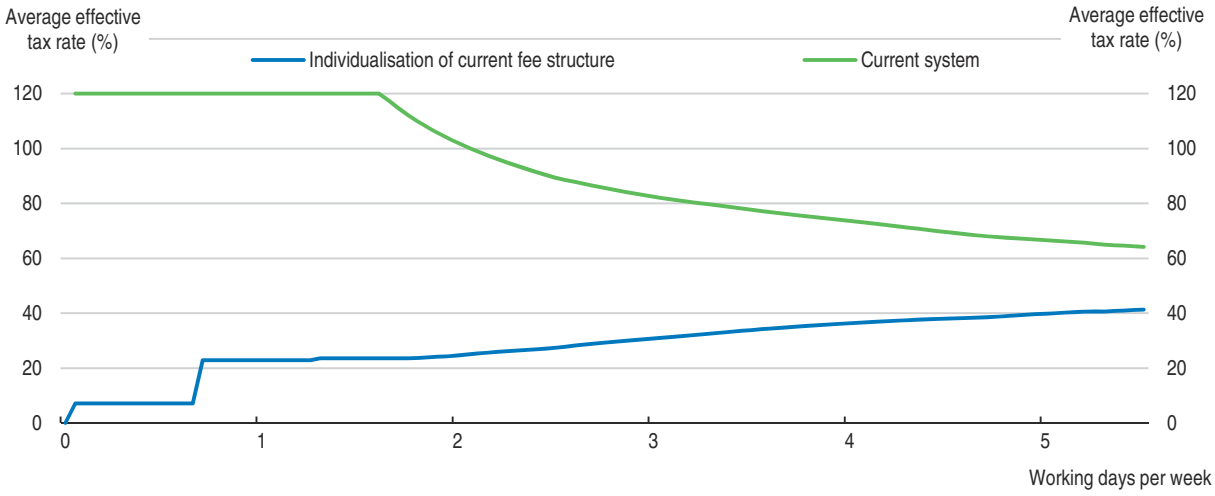
The homecare allowance is equivalent to a direct subsidy to stay out of the workforce for parents, notably second earners (*OECD Economic Survey of Finland*, 2016). To remove disincentives, the direct link to participation in childcare needs to be broken. Such a restructuring could be achieved by removing the allowance as it is today, while at least partially compensating losers by increasing the basic parental leave amount. In order to preserve the free choice to stay at home with young children up to three years, as the combination of parental leave and homecare allowance allows in the current system, parents should have the option to extend the parental leave duration while lowering the monthly benefit accordingly.

Individual income taxation in Finland strongly incentivises work for second earners. However, the childcare fee is designed as an additional income tax calculated on family income. Gains to second earners entering work can hence be strongly reduced by the fee, and may even be negative in some circumstances. The government reduced the childcare fee for families with two or more children in public childcare by approximately 20% from 2017. Although a significant step in the right direction, resolving the current incentive issues requires a more profound restructuring. Calculating the childcare fee on the basis of the lowest-earning spouses' income is a possible solution which, combined with a restructuring of the homecare allowance, would profoundly transform work incentives for second earner parents (Figure 30).

Shortening the unemployment tunnel for older workers

As in many other European countries, older unemployed are entitled to longer periods on unemployment insurance benefits, effectively providing a bridge to retirement. In

Figure 30. **Reforms to child-related fees and benefits would improve work incentives for second earners**[1]



1. Average effective tax rate for a second earner with two children aged two and five. The homecare allowance is abolished in the "Individualisation of current fee structure" scenario, and the income test to set the level of the childcare fee is applied to the spouse with the lowest earnings. The modelled individual is not entitled to unemployment insurance, and he or she is going into work with hourly earnings of 67% of the national average wage.

Source: Pareliussen et al. (2018).

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Finland, those aged above 61 on the day their unemployment insurance expires qualify for extended unemployment benefits until the statutory pension age – the "unemployment tunnel" (Kyyrä and Pesola, 2017; *OECD Economic Survey of Finland*, 2016).

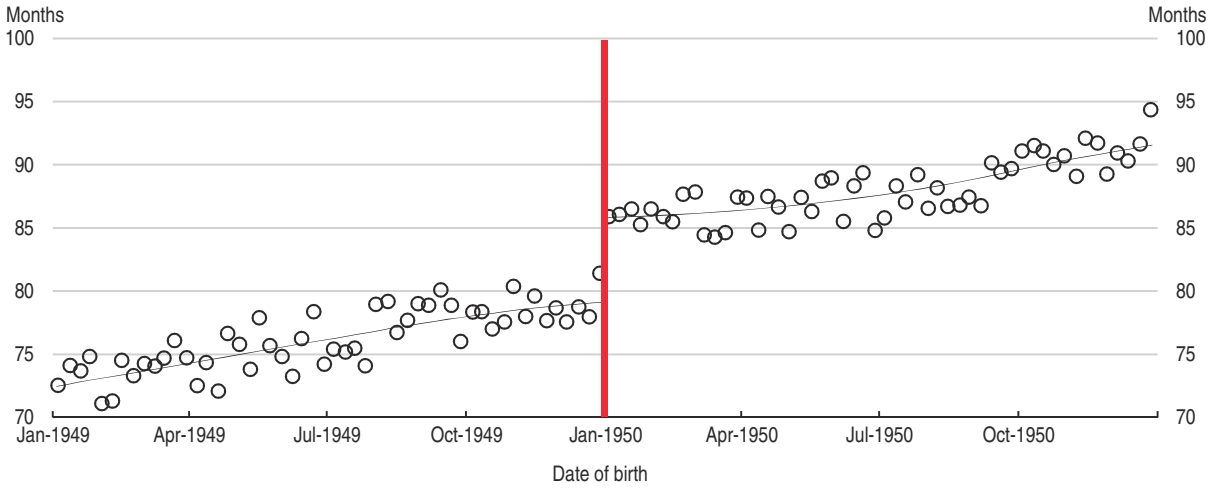
A pension reform taking effect in 2017 raises the statutory pension age gradually from 63 to 65 before linking it to life expectancy from 2030 onwards, and increases the age threshold for the unemployment tunnel from 61 to 62 years. Increasing the pension age has put the pension system on a sustainable trajectory, but ageing costs are still expected to show up in unemployment, health and long-term care expenditures. The unemployment tunnel is expected to reduce the overall employment effect of the pension reform (Economic Policy Council, 2015). A previous increase in the age threshold increased employment and individual net income considerably, as individuals covered by the new rules postponed retirement by an average of seven months (Figure 31). Furthermore, it resulted in considerable fiscal savings and no negative spill-over effects were found (Kyyrä and Pesola, 2017). To consolidate employment gains from the pension reform, the unemployment tunnel threshold should at least increase in line with the statutory pension age, and access to other routes to early retirement should be restricted (*OECD Economic Survey of Finland*, 2016).

Ensuring smooth transitions between work and benefits

Recent centralisation of benefit administration in the Social Insurance Institution of Finland (Kela) and major simplifications to the housing benefit are important first steps towards benefit harmonisation. Further simplification and improved incentives could be achieved by merging the housing benefit and the social assistance housing supplement, reducing the social assistance taper rate and coordinate the tapering of the two. It is also worth considering incentives that would push tenants who receive housing support through social assistance to look for housing with lower rents. Further harmonisation of

Figure 31. **Shortening the unemployment tunnel increases employment substantially**[1]

Months employed in 2004-2013 by birth week



1. The unemployment tunnel age threshold was increased from 55 to 57 years in 2005, only applicable to individuals born after 1949.
Source: Kyyrä and Pesola (2017).

StatLink http://dx.doi.org/10.1787/888933662882

the tax treatment and income definitions of benefits could pave the way for restructuring benefits into their core functions: a personal basic amount, a child supplement, a housing supplement and an unemployment insurance supplement, with coordinated tapering as described in the universal credit scenario.

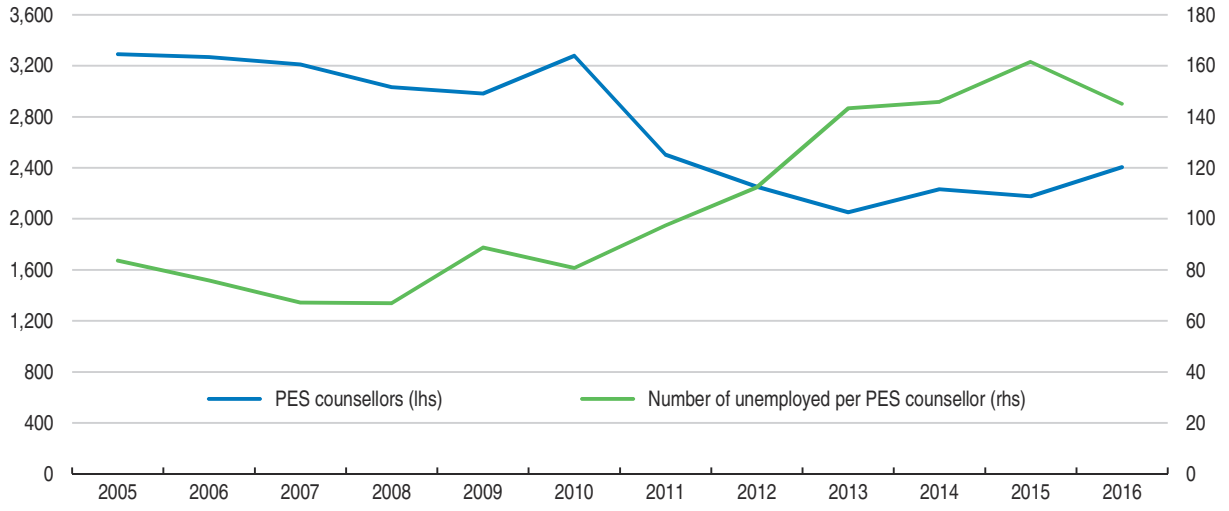
In the short to intermediate term, a combination of timely benefit decisions when individual circumstances change and extending rights to full benefits for a limited period of time after taking up work would go a long way in removing bureaucratic traps. The basic unemployment benefit can be used as a mobility and wage subsidy as of 2017, which is a step in this direction. Furthermore, the government plans to extend unemployment benefits for four months to recipients who start an entrepreneurial activity (Ministry of Finance, 2017c). Real-time coordination of earnings and benefits is planned with the new real-time income registry as from 2020. The registry, coupled with on-line user tools, will improve transparency and holds the potential to provide seamless transitions between work and benefits even when the underlying benefit rules are complex. Strengthened work incentives combined with real-time coordination of benefits and earnings and a strong activation framework, would make for a truly efficient and inclusive benefit system.

Active labour market policies

The number of unemployed per caseworker more than doubled from 2008 (Figure 32), putting the employment service under strain. New initiatives, such as job-search and reporting requirements and more frequent meetings with caseworkers, are positive, but their follow-up requires additional resources. Funding for the employment service increased in 2017, and shifting some funding from relatively expensive activation programmes towards more and earlier face-to-face contact with a jobseeker should be considered. Effective activation of non-standard workers requires equal quality of activation policies for all workless, regardless of which benefit they receive. Furthermore, "in-work progression" services could be considered, for example by offering training and mentoring to individuals in non-standard or unstable employment (OECD, 2016d; OECD, 2015b; OECD, 2017f).

Figure 32. **Rising unemployment and budget cuts have put the employment service under strain**

Number of PES counsellors and jobseekers per counsellor



Source: Ministry of Employment and Industry of Finland.

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As part of the 2020 health, social services and regional government reform, 18 new regions will take over the responsibility for employment services, which they will purchase from public, private and third-sector providers. This reform represents a leap into uncharted territory, and its success depends on a number of factors, including the development of the necessary IT infrastructure and appropriate procurement models and systems to ensure quality in provision, foster competition and avoid cream-skimming from service providers. Furthermore, funding for the new regions will not be earmarked to different purposes. Hence, there is a risk that overruns in healthcare or social expenditures could crowd out funding for employment services. A shift towards payments to providers based on employment outcomes, as signalled in the 2018 budget proposal, has shown some merit in initial trials (OECD, 2016d) and a similar model targeted towards immigrants is being trialled, where returns to investors in a "social impact bond" are tied to participants gaining employment. Such experiments provide useful experience in preparation for the 2020 regional reform.

Conclusions from the benefit simulations

The combination of different working-age benefits, childcare costs and income taxation creates complexity, reduces work incentives and holds back employment. Major disincentives in Finland are related to tapering rules for unemployment benefits, social assistance and the housing benefit, the extended unemployment benefit for older workers, the childcare fee structure and the homecare allowance. Improved benefit design combined with efficient activation policies can reduce complexity and remove the strongest disincentives. Comparing two different scenarios – a uniform benefit for all ("basic income") versus a universal tapering rule ("universal credit") – shows how much the general direction of reform matters, as they lead to considerable differences in incentives, inclusiveness and affordability.

The current benefit system targets transfers according to people's needs and circumstances. For this reason, replacing current benefits with a basic income, a uniform

benefit for all, would lead to a drastic redistribution of income and likely increase poverty, even though it would entail a simplification and improve incentives for some.

Merging working-age benefits with similar aims and coordinating their tapering against earnings would on the other hand drastically improve work incentives and transparency, while preserving or strengthening social protection. Moving the benefit system step by step in this direction therefore seems to be a solution better adapted to Finland than implementing a basic income. Once the new income registry comes online, linking benefit payments to real-time incomes, combined with strengthened work incentives and a strong activation framework, would make for a truly efficient and inclusive benefit system, fit for the future of work.

Table 12. **Past recommendations on labour market reform**

Main recent OECD recommendations	Action taken since the 2016 Survey or planned
Reduce the combined duration of parental leave and the homecare allowance to encourage female labour market participation.	No action taken.
Shorten the duration of the unemployment benefit and reduce benefits over the unemployment spell. Systematically enforce mandatory job-search and reporting requirements starting early in the unemployment spell.	The unemployment benefit duration has been cut by 100 days, and mandatory job-search and activation requirements introduced.
Strengthen the roles of the state mediator and of the local level of unions in the wage setting process to raise local flexibility without compromising competitiveness.	Legislation to extend the scope for local-level agreement has been passed. As part of the competitiveness pact, coordinated sector-wise bargaining is set to replace the tri-partite central agreement as the main wage-setting model.
Strengthen foundation skills in vocational education and training (VET),	A new core curriculum puts more emphasis on foundation skills, the VET programme structure has been reformed, with fewer and broader qualifications, and a new structure of modular qualifications is to be implemented in VET, universities and universities of applied science.

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ANNEX

Progress in structural reform

This table reviews action taken on key recommendations from previous Surveys. *Recommendations that are new in this* Survey *are listed at the end of the relevant chapter.*

Recommendations in previous Surveys	Action taken since February 2016
A. Pension reform	
Increase the minimum pension age gradually, with some linking of both the retirement age and the benefits to life expectancy.	A pension reform which came into force in 2017 will raise the retirement age to 65 by 2027, and will thereafter link it to life expectancy. Benefits are also linked to life expectancy.
Phase out the option to extend unemployment benefits until retirement, and limit rights to disability pensions to medical reasons only. Adjust the new pension scheme for those in demanding jobs to life expectancy.	The age threshold for extended unemployment benefits will, conditional on agreement between the social partners, rise from 61 to 62 years as from 2023 as part of the 2017 pension reform.
B. Health care reform	
Rationalise the organisation of health services to achieve a better balance between primary and specialised care.	A reform of health, social services and regional government set to enter into force on 1 January 2020 will shift most responsibilities for service provision from municipalities to new autonomous regions, creating opportunities for economies of scale and more equal access to services.
Drawing on existing experiences in some municipalities, a purchaser-provider split 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 purchaser-provider split is expanding. The new social welfare and health care areas will be allowed to use private or third-sector service providers. Competitive neutrality between different providers will be emphasised. A scorecard will be prepared for assessing the efficiency and quality of service provision.
Continue to develop electronic tools to promote evidence-based medicine and health-provider benchmarking.	Progress is ongoing and digitalisation of public services is high on the government agenda.
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.	Developing home care for the elderly further is part of the government programme.
C. Labour market reform	
Reduce the combined duration of parental leave and the homecare allowance to encourage female labour market participation.	No action taken.
Shorten the duration of the unemployment benefit and reduce benefits over the unemployment spell. Systematically enforce mandatory job-search and reporting requirements starting early in the unemployment spell.	The unemployment benefit duration has been cut by 100 days, and mandatory job-search and activation requirements introduced.
Strengthen the roles of the state mediator and of the local level of unions in the wage setting process to raise local flexibility without compromising competitiveness.	Legislation to increase the scope for local-level agreements has been passed. As part of the competitiveness pact, coordinated sector-wise bargaining is set to replace the tri-partite central agreement as the main wage-setting model.
Strengthen foundation skills in vocational education and training (VET).	A new core curriculum puts more emphasis on foundation skills, the VET programme structure has been reformed, with fewer and broader qualifications, and a new structure of modular qualifications is to be implemented in VET, universities and universities of applied science.
D. Productivity-enhancing reforms	
Streamline regulations in retail trade, transport and construction.	The size limit for large retail units has been raised from 2000 to 4000 m^2. Rail passenger transport will be open to competition in the early 2020s. A new Act on Transport Services will be implemented in steps and will facilitate interactions between different transport modes. A reform to increase the flexibility of postal services has been initiated. New legislation on freedom of choice in health care is expected in 2018. Changes to the regulation of pharmacies are being discussed.
Use funding criteria for higher-education institutions or R&D vouchers, to reinforce co-operation between companies, particularly start-ups, and universities.	As of 2018, Business Finland will facilitate the creation of network projects responding to business needs and contribute to financing them.
E. Green growth	
To reduce greenhouse gas emissions further, phase out environ-mentally harmful subsidies and better align the tax rate on emissions across sectors.	Some energy, CO_2 and vehicle taxes have been increased, the tax exemption on liquefied petroleum gas has been removed and allowances to deduct commuting expenses have been reduced.
F. Tax reform	
Reduce taxes on labour to improve work incentives, and raise recurrent taxes on personal immovable property and indirect taxes.	Income taxes and social contributions have been reduced. Excise duties and property tax rates have been increased.
Phase out mortgage interest deductibility.	Mortgage interest deductibility is being reduced in steps.
Raise the revenue efficiency of the VAT by eliminating reduced VAT rates.	No action taken.

Thematic chapters

Chapter 1

Tax reform to support growth and employment

Finland raises a large amount of taxes to finance high-quality public services and redistribute income. Public finances are currently relatively solid and taxes and transfers reduce income inequality significantly. However, a rapidly ageing population pushes up public spending, while globalisation creates challenges in raising revenue. Hence, ensuring long-term fiscal sustainability requires both containing spending through efficiency gains in the provision of public services and raising revenue in a way that minimises deadweight costs and distortions weighing on growth and employment. Reducing further the tax wedge on labour income would lift employment. More revenue could be raised through a reduction in the range of goods and services subject to reduced VAT rates, higher taxes on consumption that is harmful to the environment or health and higher property taxes. A competitive corporate taxation, combined with international cooperation to avoid base erosion and profit shifting, is needed to foster local production.

Until the global financial crisis, the Finnish economic model has successfully fostered inclusive growth. Economic efficiency, innovation and strong integration in the global economy are combined with a solid social safety net which dampens income inequality and preserves social cohesion. However, the past decade has been challenging, due to the global economic slump, difficulties in the electronic and paper industries, a deep recession in Russia and rising ageing-related costs. The government budget balance has moved from a healthy surplus to a moderate deficit and gross government debt now exceeds 60% of GDP. Hence, government spending needs to be contained and more revenue raised in an efficient way to preserve the sustainability of public finances, while continuing to provide high-quality public services. Moreover, robust public finances are important to leave space for fiscal stimulus in the event of a large adverse economic shock, like the global financial and economic crisis of 2008. A number of measures to strengthen the fiscal position have already been taken. A pension reform entered into force in 2017, a health care and social services reform is under preparation, with implementation due in 2020, and more immediate savings measures have been taken. Moreover, the tax mix has become more growth-friendly over recent years, with an increasing share of revenue from indirect, property and environmentally-related taxes. The government has committed not to raise the total tax rate and to reduce labour taxes (Prime Minister's Office, 2015).

Nevertheless, as the population ages and globalisation increases the mobility of tax bases, funding the welfare state in a fair and efficient way is becoming more challenging. The government estimated the public finance sustainability gap, i.e. the structural excess of spending over revenue, at about EUR 8 billion or around 3% of GDP in September 2017 (Ministry of Finance, 2017a). The 2015 government programme set out to close the sustainability gap, then estimated at EUR 10 billion, through EUR 4 billion of short-term savings, EUR 1 billion in long-term public sector cost reductions, EUR 3 billion of efficiency gains due to the health care and social services reform, and EUR 2 billion additional revenue generated by employment and growth measures. While short-term savings are being achieved, the outcome of the other policies is still uncertain. In addition to raising the efficiency of public spending, ensuring that the tax and benefit system supports growth, competitiveness and employment is crucial to ensure long-term fiscal sustainability, while providing high-quality public services and preserving the ability of the welfare state to contain income inequality.

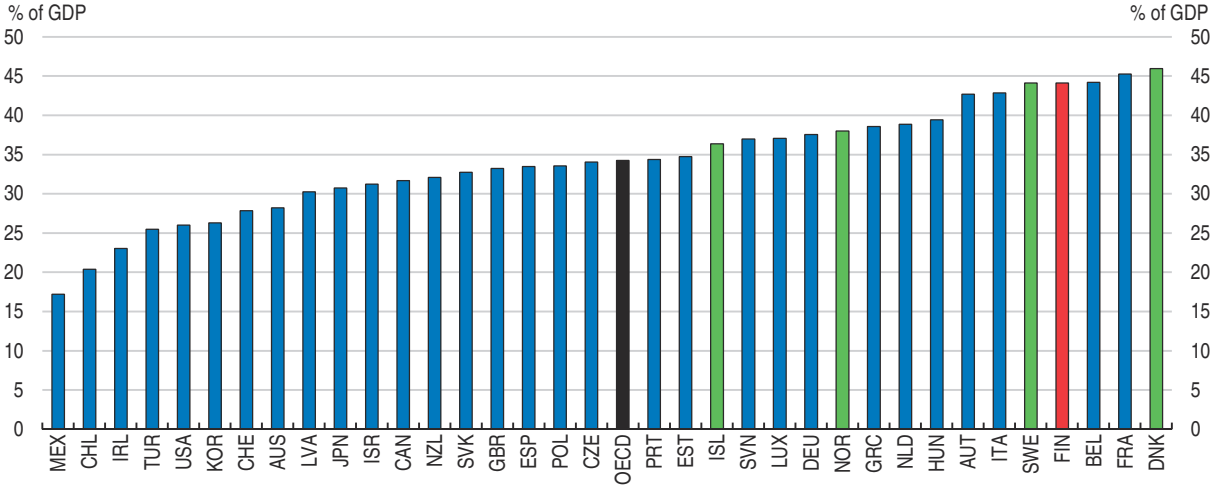
The public finances are currently healthy but face mounting challenges

Government revenue as a share of GDP is among the highest in the OECD and comparable to that of the other Nordic countries (Figure 1.1). This reflects high tax rates on broad tax bases. Across OECD countries, higher government spending tends to be correlated with lower long-term growth. However, the correlation does not hold for countries with well-functioning governments. This is particularly the case for the Nordic countries, where government effectiveness is at its highest (Fournier and Johansson, 2016). The large government size reflects extensive income redistribution, the provision of a wide

range of public services, as well as high public social spending (Figure 1.2, Panel A). As the distribution of tasks between the public and private sector varies widely across countries and benefits in Finland are taxed, which is not always the case in other countries, a more accurate assessment of welfare spending is given by total net social spending, which includes both public social expenditure and private social spending (e.g. private pensions or health care insurance benefits) and takes taxation of benefits into account (Adema et al., 2011). Finnish net social spending is considerably lower than gross spending, even though it is still above the OECD average (Figure 1.2, Panel B).

Figure 1.1. **The tax burden is among the highest in the OECD**

Taxes and social security contributions, 2016 or latest



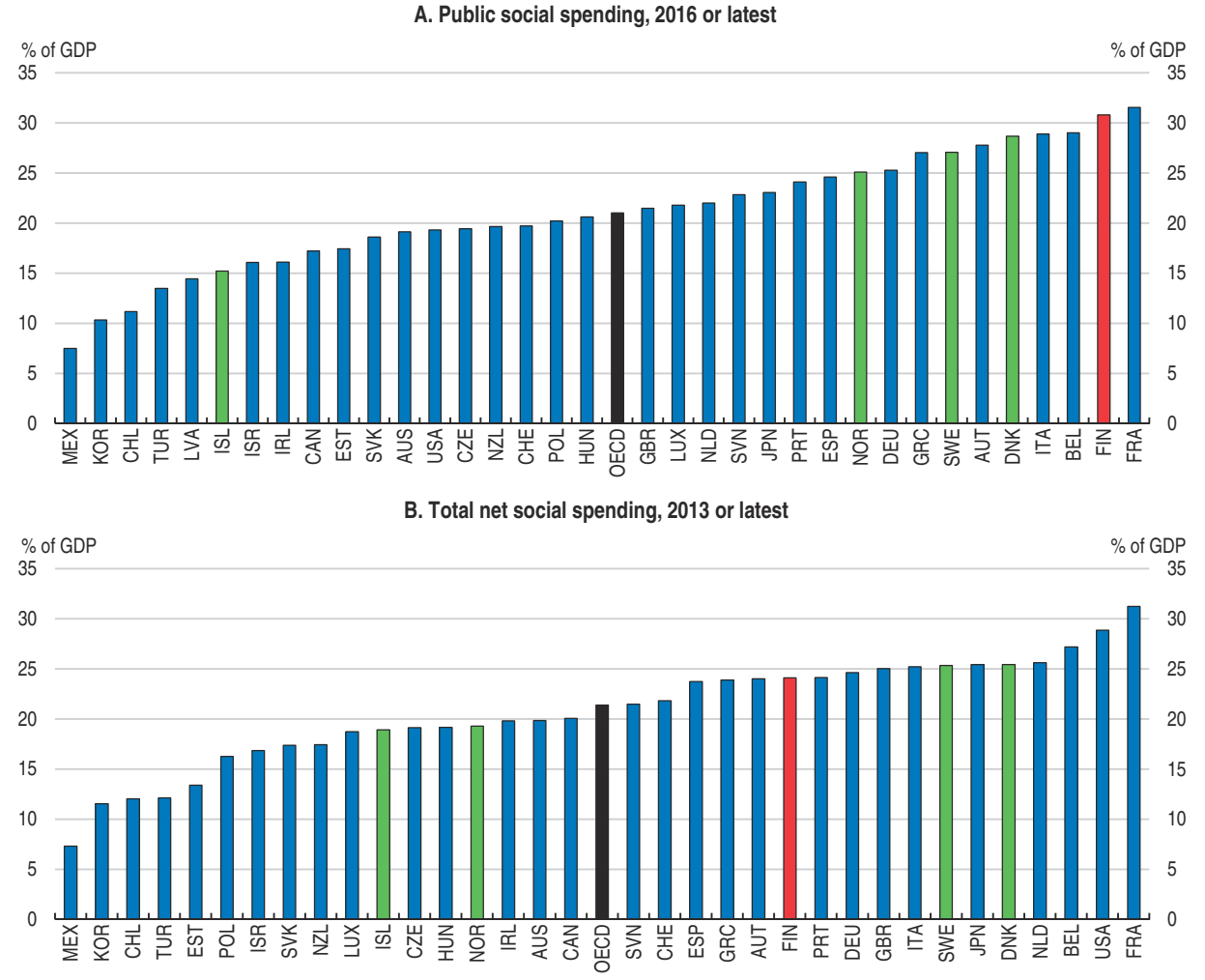
Source: OECD Revenue Statistics Database.

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Since 2009, the general government budget has shown small deficits, driving general government debt (Maastricht definition) over 60% of GDP (Figure 1.3). Some taxes, including the standard VAT rate and some excise duties have been increased. Nevertheless, with a stagnating economy, increases in revenue have failed to match spending growth, even though the recent pick-up in growth has generated higher revenue and spending has been contained since 2015 (Figure 1.4). Expenditure growth has been driven by social benefits, which were pushed up by population ageing and higher unemployment (Table 1.1). The level of gross government debt remains relatively modest by OECD standards and the government has a positive net asset position thanks to partial pre-funding of pensions (Figure 1.5). However, population ageing is starting to weigh heavily on the public finances, even though ongoing and planned reforms will help. The pension reform put in place in early 2017 will gradually raise the lower pension age limit from 63 to 65 years and link it to longevity thereafter, which is expected to strengthen the government balance by approximately 1% of GDP once the reform is fully implemented (Finnish Economic Policy Council, 2015). Even so, pension spending will rise significantly until 2030 (Figure 1.6). So will health and long-term care expenditures, even though their increase could be dampened by the health care and social services reform to be implemented in 2020.

The government expects the health care and social services reform to boost the annual growth of productivity in health care and social services by around 1.5 percentage points in

Figure 1.2. **Social spending is not as high in international comparison when private social spending and taxation of benefit income are taken into account**

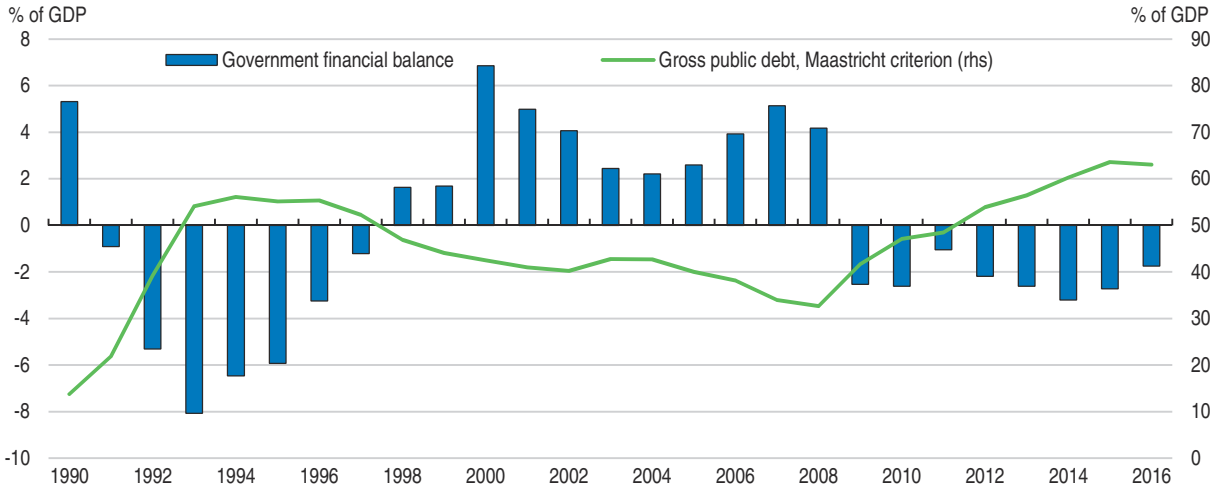


Source: OECD Social Expenditure Database.

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the 2020s and to reduce the sustainability gap by 1.3 percentage points of 2017 GDP (Ministry of Finance, 2017a). However, such estimates are very uncertain. In addition, the declining share of the working age population, as well as weak productivity developments, lowers potential output and hence the possibility to raise fiscal resources. Indeed, Finland is among the few OECD countries where fiscal space has shrunk since 2014, as the fall in real interest rates on public debt has been more than offset by the reduction in potential output (Botev et al., 2016).

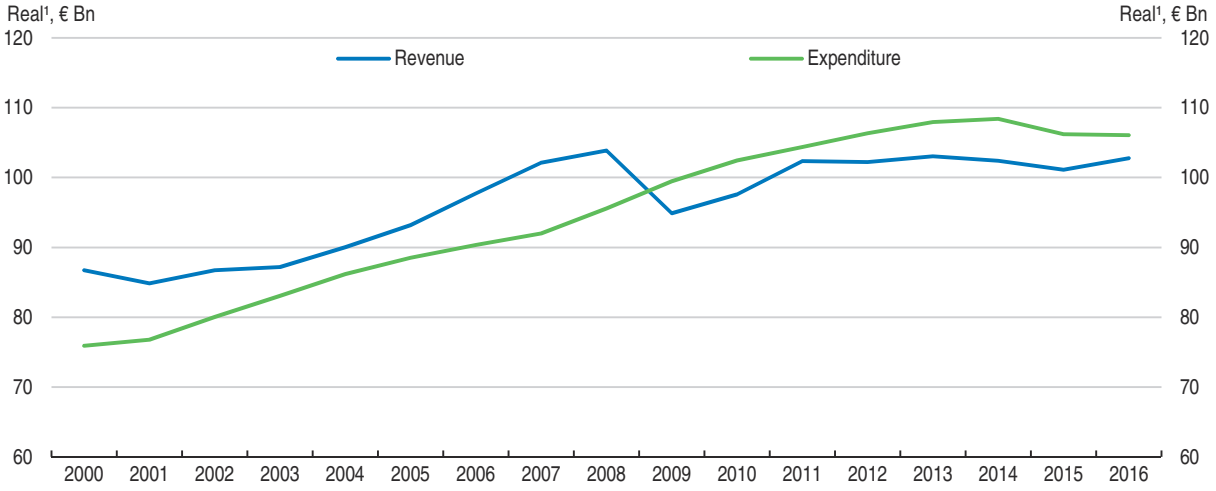
Figure 1.3. **The government deficit is modest but debt has risen markedly**



Source: OECD National Accounts Database.

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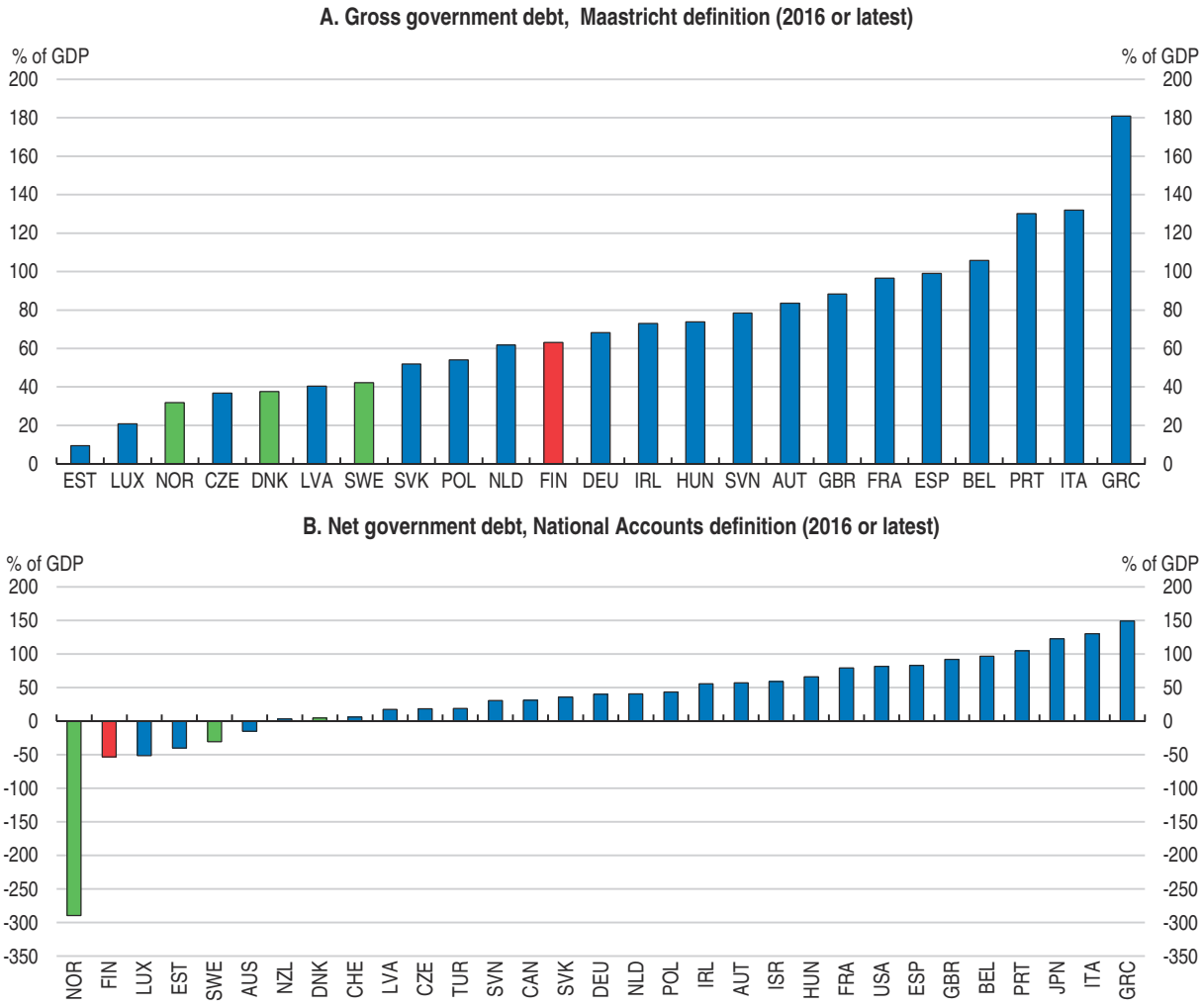
Figure 1.4. **Government revenue has failed to keep up with spending over the past decade**



1. Deflated by GDP deflator (2010 = 1).
Source: OECD National Accounts Database.

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Figure 1.5. **Government gross debt remains relatively low and assets are large**



Source: OECD National Accounts Database.

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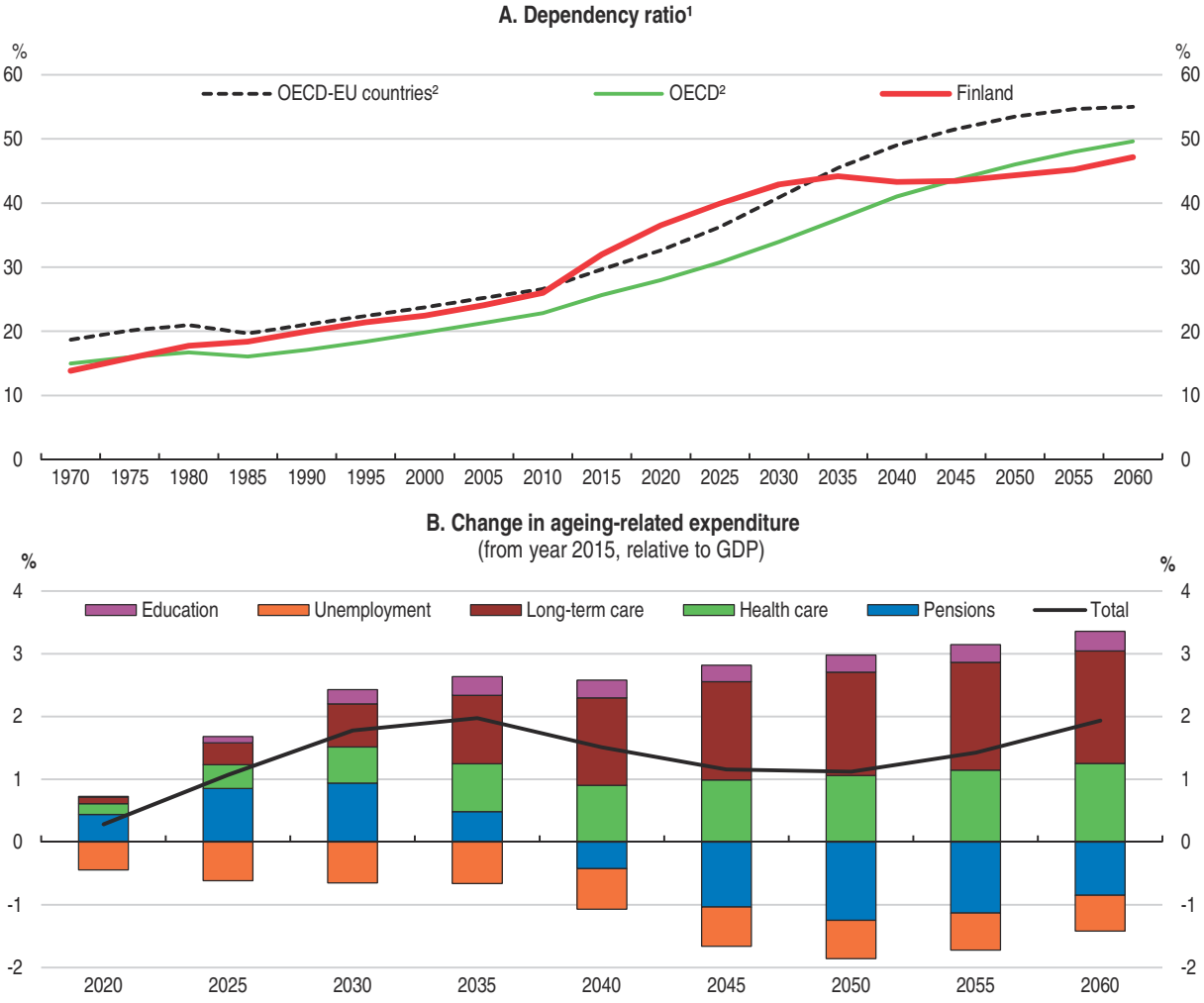
Table 1.1. **Breakdown of government expenditure and revenue**

Per cent of GDP

	Level			Change		
	2001	2008	2016	2001-16	2001-08	2008-16
Total expenditure	**47.3**	**48.3**	**56.1**	**8.8**	**1.0**	**7.8**
of which:						
Consumption	20.0	21.7	24.2	4.2	1.7	2.5
of which: wages	12.6	12.9	13.5	0.9	0.3	0.6
Social benefits	15.3	14.7	19.8	4.5	-0.6	5.1
Total receipts	**52.3**	**52.4**	**54.2**	**1.9**	**0.1**	**1.8**
of which:						
Direct taxes						
Households	14.1	13.2	14.0	-0.1	-0.9	0.8
Corporations	4.3	3.6	2.6	-1.7	-0.7	-1.0
Indirect taxes	12.9	12.4	14.4	1.5	-0.5	2.0
Social contributions	11.8	11.6	13.1	1.3	-0.2	1.5

Source: OECD, Economic Outlook Database.

Figure 1.6. **Ageing is increasingly weighing on the public finances**



1. Ratio of population aged 65 and over per 100 people aged 15-64.
2. Weighted average.

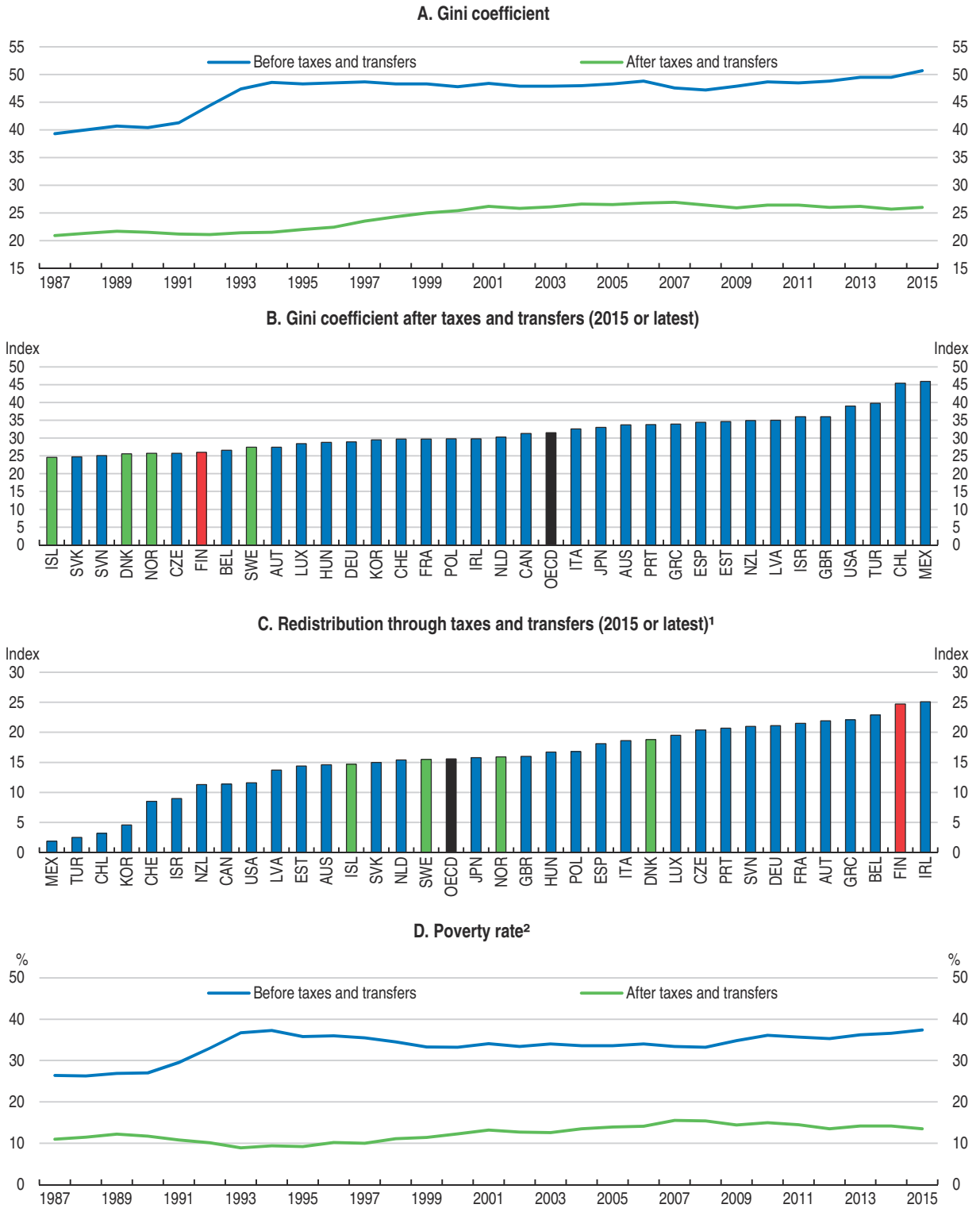
Source: United Nations Population Division, World Population Prospects: The 2017 Revision; OECD calculations; and Finnish Ministry of Finance.

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Redistribution lowers income inequality

The Gini coefficient of market income increased rapidly in the early 1990s, mainly because of a sharp fall in employment as the economy went through a deep recession. Meanwhile, redistribution kept the Gini coefficient of disposable income (i.e. after tax and transfers) broadly stable. However, later in the decade, inequality in disposable income increased significantly, albeit from a very low level (Figure 1.7, Panel A). Redistribution through benefits has declined, largely because of falling unemployment, even though benefit cuts also played a role. The 1993 introduction of the dual income tax system, which lowered capital income taxation considerably for high-income households also increased inequality (Riihelä et al., 2002 and 2008; Moisio et al., 2016). Cuts in labour taxes between 1998 and 2008 increased the concentration of income and wealth only modestly, while raising employment somewhat (Lehmus, 2014). Since the early 2000s, the Gini coefficient of disposable income has been relatively stable and it remains among the lowest in the OECD (Panel B).

Figure 1.7. **Redistribution lowers income inequality**



1. The difference between the Gini coefficients for market income and disposable income.
2. The poverty rate is the percentage of households whose income falls below the poverty line, taken as 60% of the median household income of the total population.

Source: OECD Income Distribution Database (IDD).

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The contribution of the tax and benefit system to reducing income inequality is one of the strongest in the OECD (Panel C). Taxes and benefits also contribute to reducing relative poverty (Panel D).

Promoting output and employment growth

Reducing the tax wedge on low-income earners would lift employment

The tax wedge on labour was among the highest in the OECD in 2016, even though the tax wedge may be underestimated in some countries, where some mandatory social contributions are not taken into account (Figure 1.8). Tax and social contribution cuts related to the Competitiveness Pact signed by the social partners in 2016 reduce this wedge somewhat from 2017 onwards. Substantial increases in the maximum amount of the earned income tax credit in 2016 and 2017 enhance work incentives (OECD, 2017a). Nevertheless, reducing the tax wedge further would push up labour supply and demand, thereby contributing to lift the employment rate, which is the lowest among the Nordic countries. The tax wedge can be reduced through lowering taxes on labour and offsetting the revenue loss by higher indirect taxes and recurrent taxes on personal immovable property. Chapter 2 provides a more detailed analysis of the marginal effective tax rates different population groups are facing when modifying their labour supply and assesses the impact of the tax and benefit system on work incentives.

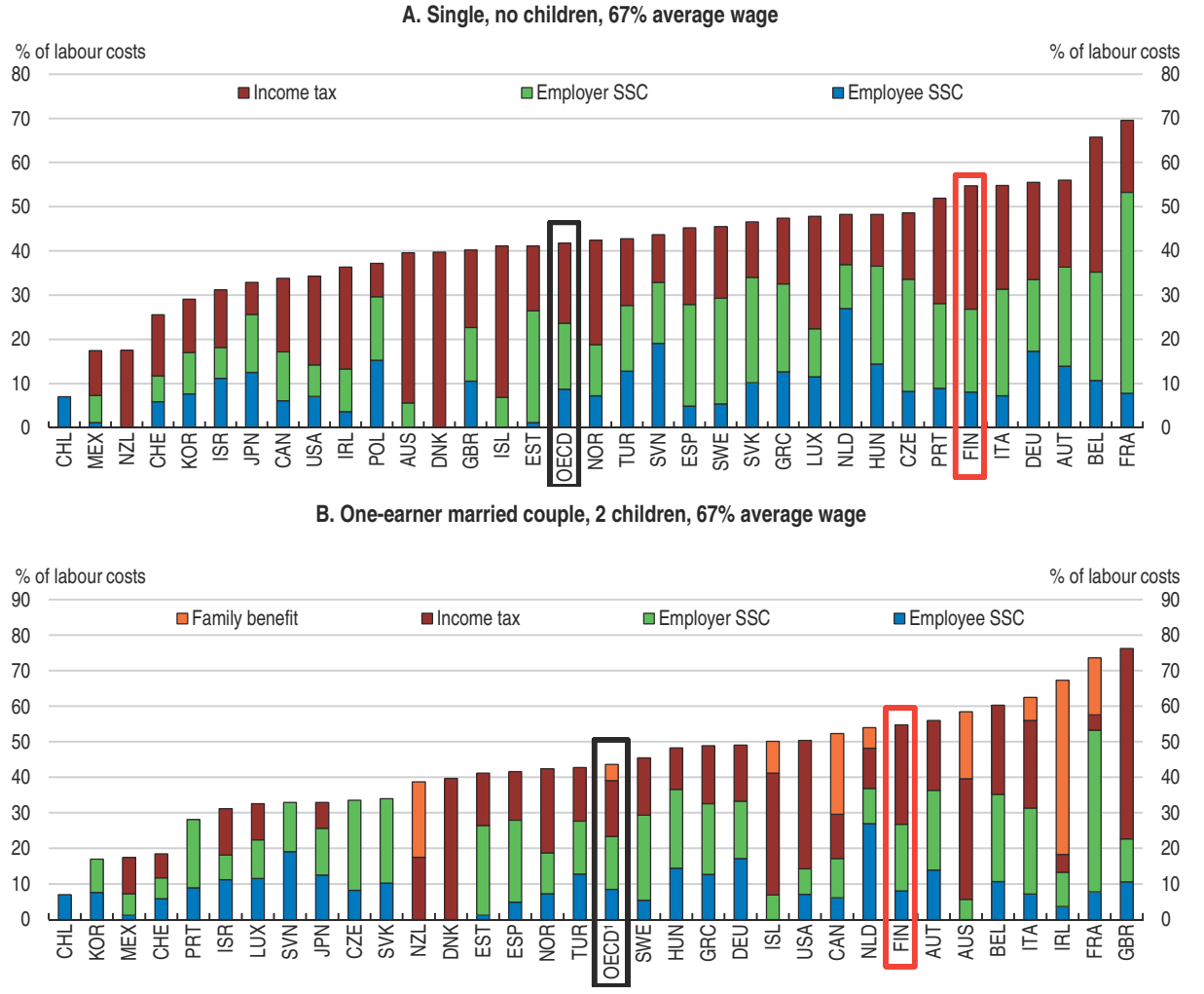
As in the other Nordics, the combined top marginal rate of personal income tax and employee social security contributions is high (Figure 1.9, Panel A). The top marginal personal tax rate applies at a relatively low threshold (Panel B). Moreover, this threshold has been lowered temporarily for the current government's term, through the solidarity tax. To promote entrepreneurship, the government recently introduced a 5% PIT deduction for entrepreneurs and the self-employed and increased the tax deduction for work-related expenses. However, this may create incentives for employees to become self-employed or to contract their labour to their employers (OECD, 2015b). A potential adverse effect of a high top marginal PIT rate in international comparison is that it may make it difficult to retain or attract highly skilled individuals. However, labour mobility remains limited and most neighbouring countries also apply high PIT top rates. Another mitigating factor is that qualified foreign experts may apply for a special tax status, under which they are taxed at a flat rate of 35% for 48 months.

Raising property taxes and moving further towards tenure-neutral taxation of housing

Recurrent taxes on immovable property are generally considered as among the least harmful to economic growth (Arnold et al., 2011; Johansson, 2016). Property taxes can also be designed to be progressive, and can reduce distortions in the way households allocate their savings across assets. In addition, reducing the tax bias in favour of home-ownership and linking property taxes to regularly updated property valuations could reduce housing price volatility (van den Noord, 2005; Muellbauer, 2006; Blöchliger et al., 2015a). Finland has been moving away from favouring home-ownership towards more tenure-neutral taxation over recent years, through higher property taxes and reduced tax relief on mortgages. In 2014, property assessment values were revised and further updating to bring cadastral values closer to market values is expected to be completed by the early 2020s. The lower and higher thresholds of the range within which municipalities may set their property tax rate have been increased in steps. Mortgage interest deductibility from personal income tax is being gradually reduced, as in a number of other EU countries.

Figure 1.8. **The tax wedge on labour remains high**

2016



1. OECD average excludes Poland.

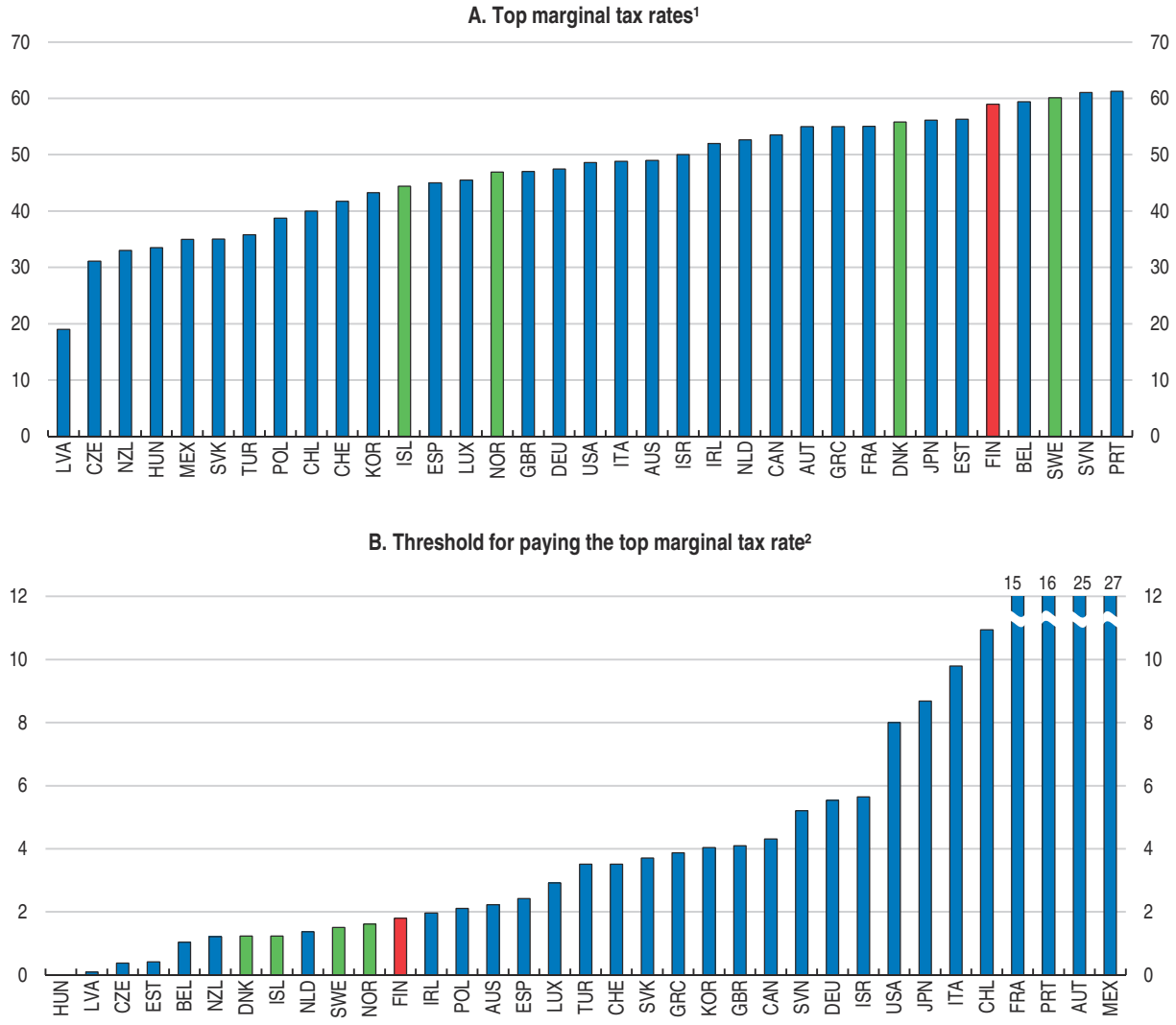
Source: OECD Taxation Database.

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Nevertheless, property tax revenue in Finland remains below the OECD average (Figure 1.10). Residential property taxes are also regressive, as municipalities with high average incomes tend to set lower tax rates. Hence, there is potential to raise a larger share of local government revenue through property taxation, as well as to make the taxation of property more progressive. For municipalities, higher property taxes can alleviate the effect of cuts in grants from central government. Higher revenue from property taxes also strengthens the incentives for municipalities to zone more land for development and speed up planning processes, enhancing the responsiveness of housing supply to demand. Property taxes are generally unpopular, especially because they are highly visible and sometimes perceived as unfair, as they are disconnected from the ability to pay. In particular, property taxes may put a heavy burden on asset-rich income-poor households. However, these problems can be mitigated by means-tested exemptions for low-income households or measures to alleviate liquidity constraints, such as tax deferral (Blöchliger, 2015b).

Figure 1.9. **The combined top marginal rate of personal income tax and employee social security contributions is high**

2016



1. Personal income tax and employee social security contributions (all-in rate).
2. Expressed as a multiple of the average wage.

Source: OECD Taxation Database.

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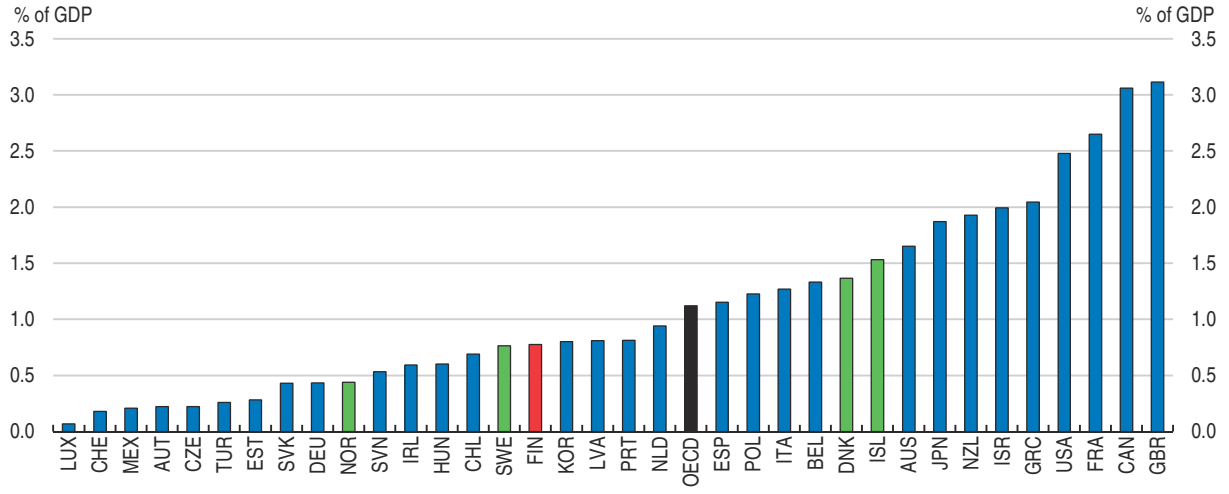
User fees imply efficiency-equality trade-offs

Finnish local authorities raise a substantial amount of user fees, representing more than 9% of general government revenue and about a fourth of local government income. The high share of user fees in OECD comparison partly reflects the wide range of services provided by Finnish municipalities. The largest part of user fees relates to utility charges and public transport, with modest fees charged on public health care, while basic education is free.

Finland, like the other Nordic countries, charges no tuition fees for national students on public tertiary education. Most other OECD countries charge tuition fees, albeit at widely varying rates (OECD, 2016a). Tuition fees may be justified by the earnings premium derived from tertiary education; tertiary students will earn far more than these fees on higher

Figure 1.10. **Tax revenue from recurrent taxes on immovable property is still relatively low**

2016 or latest



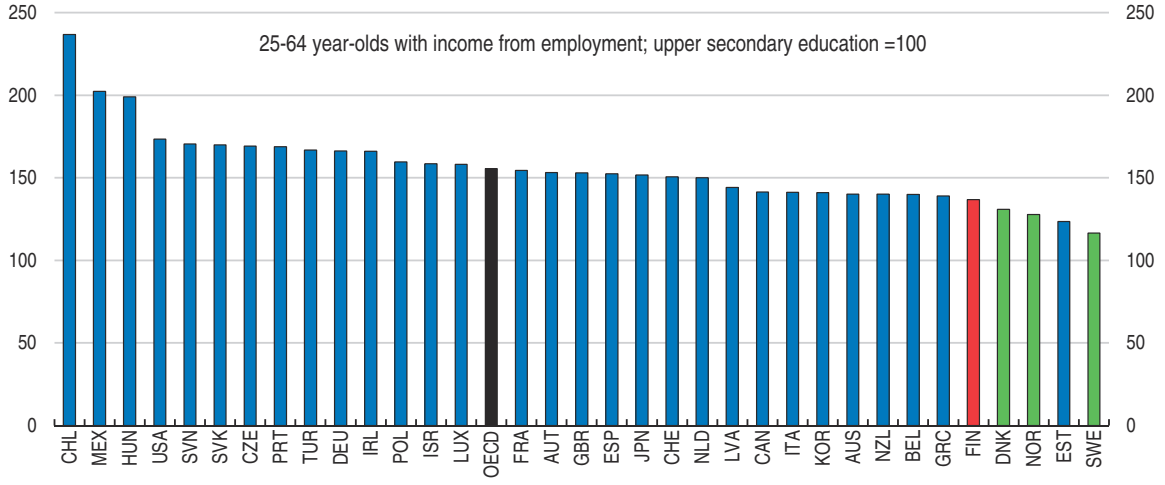
Source: OECD Taxation Database.

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education in higher earnings over their lifetimes (OECD, 2017b). In addition, they may enhance the efficiency and quality of education by encouraging timely completion of studies, raising student expectations for value for money and increasing the responsiveness of institutions to student and labour market demand. In the Nordic countries, however, tuition fees tend to face strong opposition, in part because high value is put on financial independence of young adults from their parents (Koutsogeorgopoulou, 2016). The earnings premium for tertiary graduates in Finland is below the OECD average, but somewhat higher than in the other Nordic countries (Figure 1.11). Completion times are long by OECD standards (*OECD Economic Survey of Finland 2016*).

Figure 1.11. **The earnings premium from tertiary education is higher than in the other Nordics**[1]

2015



1. Earnings of 25-64 year-old full-time full-year workers who attained tertiary education, relative to those who attained upper secondary education.

Source: OECD (2017), *Education at a Glance 2017*, Table A6.1.

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Economists from the Research Institute of the Finnish economy have recently suggested that tertiary education establishments should be allowed to charge moderate tuition fees to increase their resources on a permanent basis (Määttänen and Vihriälä, 2017). If such a measure were to be adopted, it would need to be combined with expanded grants to at-risk students, or with a system of income-contingent loans, as in Australia, the Netherlands, New Zealand and the United Kingdom. Such a system can reduce the long-run public cost of higher education and increase funding for higher education institutions, as well as promote access, equity, completion, and positive outcomes for students (OECD, 2012). Careful design, in particular regarding the level of tuition fees, interest rates on loans, repayment thresholds and rates, and write-off periods are crucial to ensure efficiency and fairness (Barr et al., 2017; Belfield et al., 2017; OECD, 2017b).

Reducing the scope of VAT reduced rates

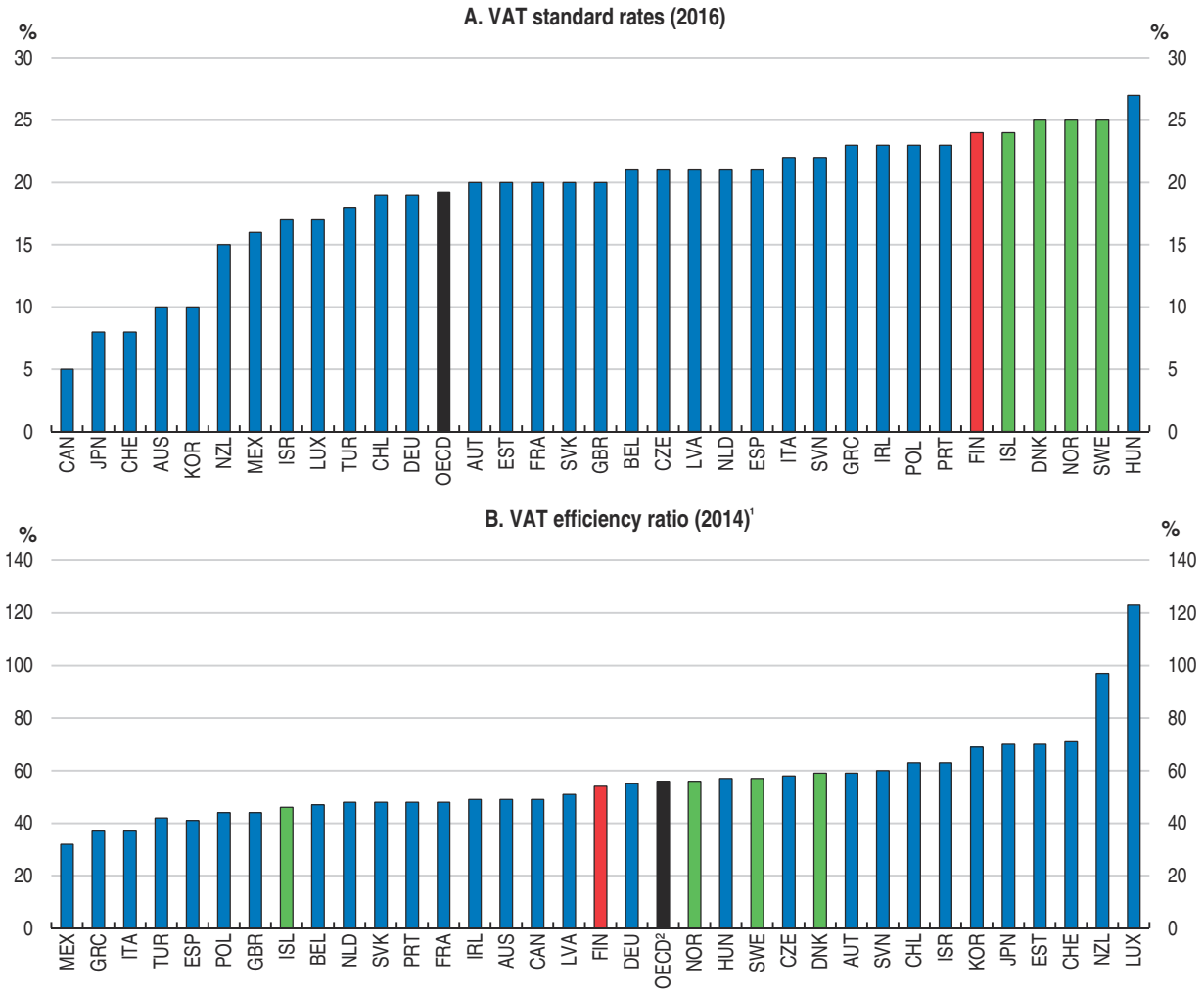
Finland has a 24% standard VAT rate, which is among the highest in the OECD (Figure 1.12, Panel A), but a number of goods and services are taxed at lower rates or exempt. A 14% rate applies to food and restaurants. A 10% rate applies to a wide range of items, including books, pharmaceutical products, accommodation, passenger transport services and some sport and cultural activities. VAT-exempt goods and services include health care, social services and education, as well as most financial and insurance services. These exemptions are similar to those applied in most other OECD countries. Nonetheless, they create significant distortions to prices and a bias against outsourcing. The VAT efficiency ratio (i.e. the ratio of actual VAT revenue to potential VAT revenue if all goods and services were taxed at the standard VAT rate) is only about 54%, slightly below the OECD average (Figure 1.12, Panel B). A number of countries achieve higher efficiency, even though Luxembourg and New Zealand are special cases, reflecting the VAT treatment of financial services and e-commerce in Luxembourg and the fact that public services are subject to VAT in New Zealand (OECD, 2016c).

Finland, like seven other EU countries (including Denmark and Sweden), has a refund system to compensate public entities for not being able to deduct VAT on their inputs, which eliminates distortions in interactions with the private sector. In particular, in the absence of refunds, there is a bias against outsourcing, as external inputs are subject to non-deductible VAT, while internally-produced inputs are not (OECD, 2016c).

The main reason for exempting financial services from VAT is the difficulty in measuring the tax base. However, taxing financial services in a way which would achieve a similar outcome as VAT seems feasible (Mirrlees, 2011). Countries which have pursued this avenue include France and Denmark where a special tax is levied on wage costs in the financial sector. The project for a similar tax in Sweden was strongly resisted by the financial sector and abandoned in 2017. Iceland and Norway have introduced a tax on wage costs and profits in 2012 and 2017 respectively.

The relatively low efficiency of Finnish VAT is mainly related to exemptions and reduced rates, as compliance is high (Thackray et al., 2015; CASE, 2016). Reduced VAT rates cost about EUR 2 billion (1% of GDP) in 2014 in forgone tax revenue (Economic Policy Council, 2014). In most cases, reduced rates are justified by social and equity objectives. However, access to specific goods and services, such as food or cultural items for low-income households can generally be obtained more efficiently through targeted measures than through reduced VAT rates, which benefit all consumers and therefore imply large deadweight costs. Furthermore, having several VAT rates generates administrative and compliance costs.

Figure 1.12. **VAT rates are high but efficiency slightly below average**



1. Ratio of actual VAT revenue to potential VAT revenue if all goods and services where taxed at the standard VAT rate.
2. OECD average excludes the United States.

Source: OECD (2016), *Consumption Tax Trends 2016: VAT/GST and excise rates, trends and policy issues*, OECD Publishing, Paris.

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Another argument often used to justify reduced VAT rates is to support labour-intensive economic activities, in particular restaurants. Reducing informality in these sectors may be a further motivation. However, the efficiency of such policies is questionable. The 2010 cut in the VAT rate for restaurants from 22% to 13% in Finland is estimated to have resulted in limited pass-through to prices and no significant impact on restaurants turnover and wage bill (Harju and Kosonen, 2013). Similar results were found with respect to the 2007 cut in VAT rates on hairdressing services from 22% to 8% (Kosonen, 2015). These findings are also broadly consistent with international experience. In Sweden, the 2012 cut in the VAT rate on restaurants and catering services from 25% to 12% is estimated to have had a modest positive impact on employment in the sector (Falkenhall, 2015; NIER, 2015). However, the impact on economy-wide employment is estimated to be very small and given the revenue foregone through the rate cut, its efficiency is questionable. The 2009 cut in the VAT rate on restaurants in France from 19.6% to 5.5% is estimated to have raised employment in the sector somewhat, but the cost per new job is

very high compared to other policy measures. Furthermore, as high-income households tend to spend more on restaurants than low-income ones, the VAT cut is regressive (Conseil des Prélèvements Obligatoires, 2015).

Altogether, reduced VAT rates decrease government revenue significantly and in most cases their policy objectives could be achieved at a lower cost using targeted instruments. In addition, they reduce welfare by distorting spending decisions, as they modify relative prices. This calls for narrowing the number of goods and services subject to reduced rates. Nevertheless, this is likely to have distributional consequences, especially hurting low-income households. Changes to other taxes and benefits can offset the increase in inequality generated by harmonising VAT rates.

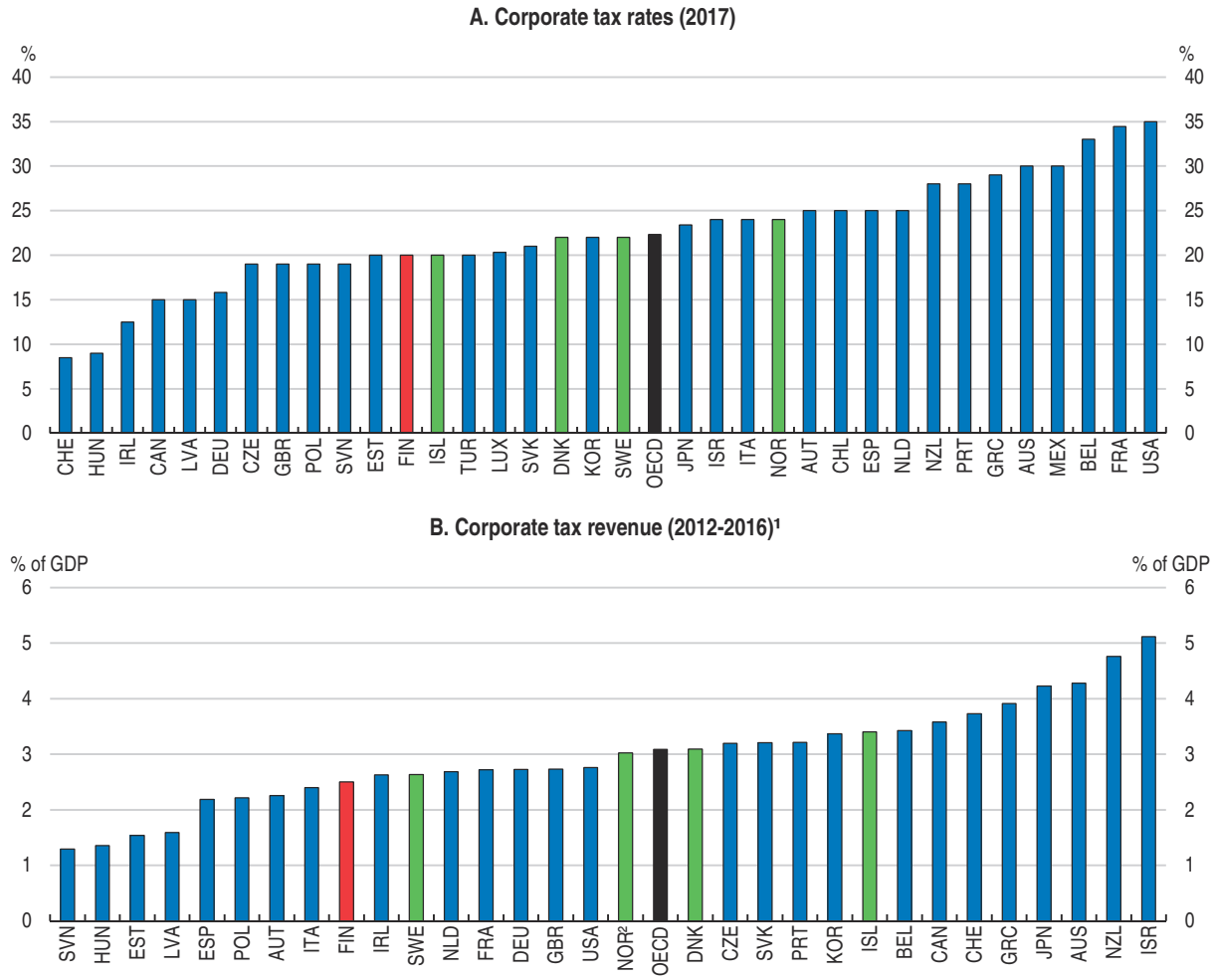
Business taxation is aligned with other countries in the region

At 20%, the Finnish corporate income tax (CIT) rate is relatively low by OECD standards and close to those of the other Nordic countries (Figure 1.13, Panel A). Corporate tax revenue, as a share of GDP is also fairly low by OECD standards (Panel B). Competitive business taxation helps attract investment, but other factors like proximity to markets, good infrastructure, labour force skills and interdependence of activities within value chains are at least equally important in location decisions (Ketokivi et al., 2017). High marginal corporate tax rates are linked with significantly lower long-term output level (Akgun et al., 2017) and increase incentives for tax avoidance, as multinational companies can often shift profits from high to low-tax jurisdictions. Finnish business taxation is currently competitive, but corporate tax rate are being cut in neighbouring countries. Sweden is contemplating a cut in its corporate income tax rate from 22% to 20% taking effect in mid-2018, whose impact will, however, be mitigated by tighter limitations on interest deductibility. Denmark, while retaining a 22% CIT rate, will introduce an allowance for corporate equity and additional allowances for R&D investment and SMEs in 2019. Norway is gradually reducing its CIT rate, which nevertheless remains higher than in Finland. The Estonian government has announced its intention to reduce the CIT rate, which only affects distributed profits, from 20% to 14%. More generally, the global trend is towards lower CIT rates, with 15 OECD countries having implemented or announced CIT rate cuts since 2016 (OECD, 2017a).

The successive cuts in corporate tax rates across Nordic countries look like a race to the bottom (Figure 1.14, Panel A). However, as such cuts are generally accompanied by base broadening and as the profit share in the economy has risen in most OECD countries, CIT revenue has not fallen proportionally to the statutory rate (Figure 1.14, Panel B). This is in line with broader international experience, where most countries which lowered their CIT rates significantly were able to offset the revenue loss through base broadening, raising other tax revenue or dynamic effects associated with the tax rate cut. Nevertheless, the opportunity to compensate rate cuts by tax-base broadening may be reaching its limits and dynamic effects are uncertain.

In a global economy, protecting the tax base from erosion is a major challenge. Together with 70 other jurisdictions, Finland has signed the multilateral instrument (MLI) in June 2017. The MLI covers treaty-related minimum standards that were agreed as part of the Base Erosion and Profit Shifting (BEPS) package. These standards relate to the prevention of treaty abuse (Action 6) and the improvement of dispute resolution (Action 14). Furthermore, the MLI enables the parties to implement other tax treaty measures developed in the BEPS

Figure 1.13. **Corporate tax rate and revenue are low**



1. A five-year average is shown to account for the volatility of corporate tax revenue.
2. Mainland Norway.

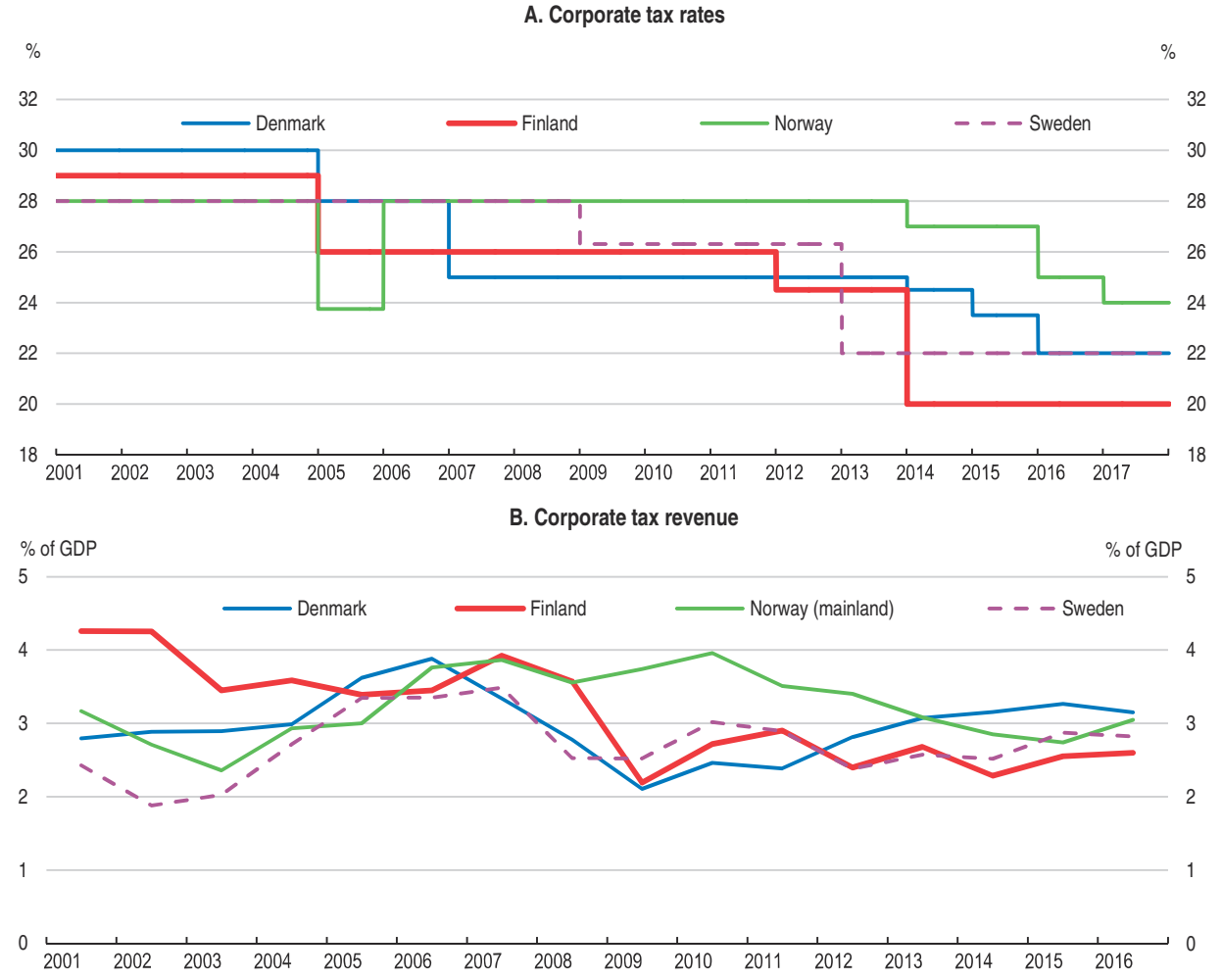
Source: OECD Taxation Database.

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project, e.g. mandatory binding arbitration, or measures against artificial avoidance of permanent establishment status through commissionaire arrangements. Currently, Finland has chosen 71 tax treaties to be amended through the MLI, and opted for certain reservations. Finland is one of the 25 countries that have signed up for the multilateral arbitration mechanism, but has done so lodging some reservations. The MLI will allow Finland to transpose BEPS recommendations directly into its existing network of tax treaties; it will thus reinforce the anti-avoidance arsenal which is already part of Finnish tax legislation and includes controlled foreign company rules to limit tax avoidance through the use of affiliates in low-tax jurisdictions, transfer pricing rules which follow OECD guidelines and interest deduction limitations which prevent profit shifting through debt financing. The restriction on intra-firm interest deductibility imposed in 2014 is estimated to have lowered the financial expenses of Finnish multinational companies by 25% to 30%, without noticeable effects on other profit shifting measures or real output (Harju et al., 2017).

The taxation of unlisted corporations involves different challenges. While the main rationale for source-based taxation of big corporations is to tax location-specific economic

Figure 1.14. **Corporate tax revenue has so far held up relatively well despite sharp tax rate cuts**



Source: OECD Taxation Database.

StatLink http://dx.doi.org/10.1787/888933662692

rents, taxation of smaller companies is more about protecting the personal income tax base (Mirrlees et al., 2011). Like most other Nordic countries, Finland has a dual income tax system (DIT), where capital income is taxed at a flat rate (although a slightly higher rate applies beyond a certain threshold), while revenue from labour and transfers is taxed at a progressive rate schedule. The system was put in place in 1993, mainly to reduce the risk of capital flight. A drawback of this system is that it creates incentives for reclassifying labour income as capital income, where the earnings of owners are a combination of both types of income. Indeed, analyses of the impact of the tax reforms of 1993 and 2005, which modified the relative taxation of labour and capital, find evidence of income reclassification (Pirttilä and Selin, 2011; Harju and Matikka, 2015). Reclassification of income from labour to capital can be addressed through anti-avoidance legislation, but this addresses the symptoms rather than the causes and can vastly increase complexity, generating important compliance and administrative costs. Aligning taxation of labour and capital is arguably a better option.

Norway introduced a rate of return allowance (RRA) in its personal income tax in 2006. Dividends and realised capital gains below a notional return are exempt from personal income tax, as profits have already been taxed at the corporate level. Capital income in

Box 1.1. **Tackling tax avoidance: The OECD/G20 BEPS project**

Base erosion and profit shifting (BEPS) refers to tax planning strategies of multinational enterprises (MNEs) that exploit gaps in tax rules to artificially shift profits to low- or no-tax locations where they have little or no economic activity. BEPS poses a serious risk to government tax revenue. It is estimated that between 4% and 10% of global corporate income tax revenue, i.e. USD 100 to 240 billion annually, is being lost due to BEPS (OECD, 2015a). In addition to tax revenue losses, BEPS has other adverse economic effects, including exacerbating the corporate debt bias and misdirecting foreign direct investment. It also undermines competition by giving an unfair advantage to tax-aggressive MNEs relative to domestic enterprises whose opportunities for tax planning are more limited. The OECD/G20 BEPS project produced a 15-point Action Plan including minimum standards, common approaches, best practices and new guidance in the main policy areas.

- Minimum standards have been agreed upon in the areas of fighting harmful tax practices (Action 5), preventing treaty abuse (Action 6), country-by-country reporting (Action 13) and improving dispute resolution (Action 14). All participating countries are expected to implement these minimum standards and implementation will be subject to peer review.
- A common approach, which will facilitate the convergence of national practices by interested countries, has been outlined to limit base erosion through interest expenses (Action 4) and to neutralise hybrid mismatches (Action 2). Best practices for countries which seek to strengthen their domestic legislation are provided on the building blocks for effective controlled foreign company (CFC) rules (Action 3) and mandatory disclosure by taxpayers of aggressive or abusive transactions, arrangements or structures (Action 12).
- The permanent establishment (PE) definition in the OECD Model Tax Convention has been changed to restrict inappropriate avoidance of tax nexus through commissionaire arrangements or exploitation of specific exceptions (Action 7). Follow-up work is being undertaken which will also provide further guidance on the attribution of profits to PEs. In terms of transfer pricing, important clarifications have been made with regard to delineating the actual transaction, and the treatment of risk and intangibles. More guidance has been provided on several other issues to ensure that transfer pricing outcomes are aligned with value creation (Actions 8-10).
- The changes to the PE definition, the clarifications on transfer pricing, and the guidance on CFC rules are expected to substantially address the BEPS risks exacerbated by the digital economy. Several other options, including a new nexus in the form of a significant economic presence, were considered, but not recommended at this stage given the other recommendations plus Value Added Taxes (VAT) will now be levied effectively in the destination- country facilitating VAT collection (Action 1).
- The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (the Multilateral Instrument or MLI) has been signed in June 2017 to facilitate the modification of bilateral tax treaties (Action 15). The modifications made to existing treaties will address the minimum standards against treaty abuse as well as the updated PE definition.

At the February 2016 G20 Finance Ministers meeting, the Inclusive Framework for the global implementation of the BEPS project was endorsed, with a reiteration of the commitment to timely implementation of the BEPS project and to continue monitoring and addressing BEPS-related issues for a consistent global approach.

Monitoring the implementation and impact of the different BEPS measures is a key element of the work of the Inclusive Framework. Members of the Inclusive Framework are developing a monitoring process for the four BEPS minimum standards as well as put in place the review mechanisms for other elements of the BEPS package. In June 2017, 102 countries have become a member of the Inclusive Framework on BEPS.

For more information: *www.oecd.org/tax/beps/inclusive-framework-on-BEPS-progress-report-july-2016-june-2017.pdf*.

excess of the RRA is subject to personal income tax. The overall tax rate on capital income, accounting for both corporate and dividend taxation, is close to the top marginal labour income tax rate (including statutory personal income tax and employee and employer maximum social security contributions), which reduces income reclassification opportunities. The RRA system displays a number of attractive properties. In particular, it is neutral with respect to the marginal cost of investment and treats dividends and retained earnings symmetrically, avoiding lock-in effects hampering the reallocation of capital. The remaining distortion due to taxation on realised income is mitigated by the possibility to carry the RRA forward (Sørensen, 2010).

The introduction of the RRA has also contributed to increase income redistribution by removing opportunities to lower taxes through income reclassification (Norwegian Ministry of Finance, 2011). However, the RRA does not generate neutrality between debt and equity financing at the corporate level for non-resident investors in an open economy, as distortions are only removed for domestic investors. Similarly, the cost of capital for large firms is unlikely to be reduced, as it essentially depends on required returns at the global level. Nevertheless, the cost of capital may be reduced for smaller companies, which are not fully integrated in the global financial market, although views on the issue differ (Lindhe and Södersten, 2012; Sørensen, 2014). Adopting a RRA system in Finland would reduce distortions to investment and financing, but similar neutrality properties may be obtained by modifying some tax parameters of the current system, notably the normal rate of return (Kari and Ropponen, 2016).

In Finland, for dividend income above EUR 150 000 and below 8% of the value of the shares owned, 15% of dividend income is exempt from capital income tax. For a return above 8% of the value of the shares owned, 75% of the dividend income is taxed as earned income and the remaining 25% is tax-exempt. In principle, there is no reason to exempt dividends beyond a risk-free return, provided the tax treatment of profits and losses is symmetric (Mirrlees, 2011), which to a large extent is the case in Finland (Hanappi, 2016). The 10-year limit on loss carry-forward and a restriction to deductions from the same category of revenue (business, agricultural or personal income) seem to be binding only in a limited number of cases. Hence, with a rate of return of 8% used to determine dividend tax relief and current government bond yields well below 1%, the risk premium looks excessive. It encourages accumulation of capital in unlisted companies, which may result in sub-optimal allocation of capital across the economy.

The expert group on business taxation appointed by the Ministry of Finance proposed a number of changes to enhance neutrality between investments in businesses of different legal forms. In particular, it recommended reducing the maximum rate of return used for determining the share of the dividends eligible for tax relief to 4% and lifting some restrictions on loss deductions (Ministry of Finance, 2017b). The recommended rate of 4% could be seen as a nominal risk-free rate, insofar as it is roughly equivalent to the long-term average real government bond rate augmented by the current inflation target of 2%. Hence, the expert groups' recommendations seem reasonable, even though defining the normal rate as a spread over the government bond yield, may be preferable in order to allow automatic adjustments in the future.

Encouraging greener growth

Finland has ambitious climate change and environmental policy objectives, in line with its commitment under the Paris Climate Agreement and the EU 2030 energy policy targets. The objectives include lifting the share of renewable energy to 50% of final consumption,

phasing out coal use, halving the domestic use of imported oil and raising the share of renewable transport fuels to 40% by 2030. A further objective is to lower greenhouse gas emissions by at least 80% relative to the 1990 level by 2050 (Ministry of Economic Affairs and Employment, 2017). The tax system, along with other instruments like the EU Emissions Trading System (ETS), regulations and R&D, has a key role to play in achieving these objectives. The distributional effects of energy taxes are mixed. Taxes on transport fuels tend to make up a smaller share of total pre-tax expenditure for the poorest households, in Finland as in most OECD countries. Conversely, taxes on heating fuels and electricity weigh more on the poorest, although they amount for a small share of their consumption (respectively 0.4% and 0.7% for heating fuels and electricity in the lowest consumption decile, versus 1% for transport fuels). Besides, energy taxes impose a heavier burden on households in rural areas than on urban dwellers, which use less transport fuels (Flues and Thomas, 2015). Overall, the risk of adverse distributional impacts of increasing energy taxation looks relatively modest.

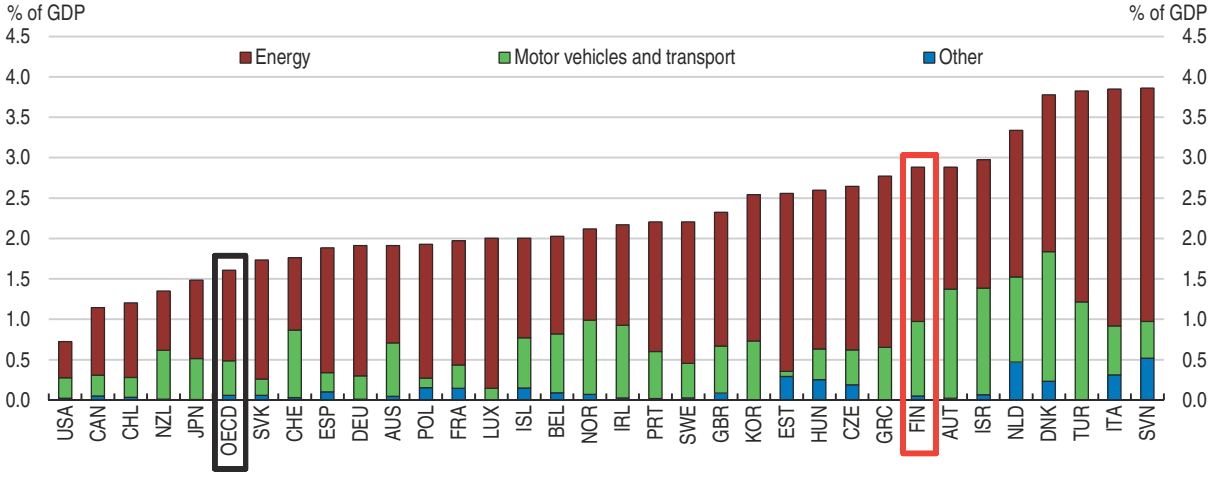
Revenues from taxes on energy use have increased gradually and when measured as a percentage of GDP they are high by OECD standards (Figure 1.15). However, tax rates vary across energy uses – e.g. heating and process use, power production or transport – and sectors – e.g. energy producers, manufacturing industry or households. A number of industries or fuels benefit from reduced tax rates (OECD, 2013) or direct refunds. A few years ago, a working group led by the Ministry of Finance identified between EUR 2.7 and EUR 4.5 billion in production-linked reduced rates and direct subsidies which can heighten environmental pressures, mainly in energy, transport and agriculture (Hyyrynen, 2013). In particular, the following reduce the effectiveness of energy taxation:

- Energy-intensive industries paying more than 0.5% of their annual value added in fuel and electricity tax are entitled to a tax refund of 85% of the amount paid above that threshold. The refund only applies to the share exceeding EUR 50 000.
- Tax rates are lower on diesel than on gasoline, as in most OECD countries (Figure 1.16), although combusting diesel emits higher levels of carbon dioxide per litre than gasoline and, depending on the emission control technology employed, often also more harmful air pollutants. This gap is partly (yet not very effectively) offset by a higher annual tax on diesel vehicles, but diesel remains advantageous for intensive users, despite a higher environmental cost per kilometre for diesel than for petrol vehicles (Harding, 2014). Furthermore, raising diesel taxation to the level applied on gasoline would spur the development of alternative fuels and transport modes (Bragadóttir et al., 2014).
- Taxation of peat, which generates high CO_2 emissions and air pollution, is low due to its technical qualities in combined heat and power production, energy security, widespread availability, price stability and contribution to regional economic development (IEA, 2013). The energy tax on peat was re-introduced in 2011, but at a much lower level than for other fuels (OECD, 2013).
- Agriculture benefits both from direct subsidies for activities with a potentially harmful impact on the environment and from subsidies on fuels. Intensive agriculture can have a negative impact on the environment through greenhouse gas emissions and through nutrient leaching, which causes eutrophication of rivers, lakes and seas.
- Over-allocation of EU Emission Trading System (ETS) permits can be considered as an environmentally harmful subsidy, as it lowers the average price of emitting CO_2 for ETS sectors below its social cost. The low carbon price resulting from the surplus of trading

permits following the global economic slowdown has encouraged the use of more CO_2-intensive energy sources (Bragadóttir et al., 2014). In addition, the free allocation of permits can create windfall profits for carbon-intensive industries and can skew investment decisions towards carbon-intensive technologies. Full auctioning of tradable permits avoids these drawbacks (OECD, 2017c).

Figure 1.15. **Environmentally related tax revenue is high compared to other OECD countries**

2015 or latest

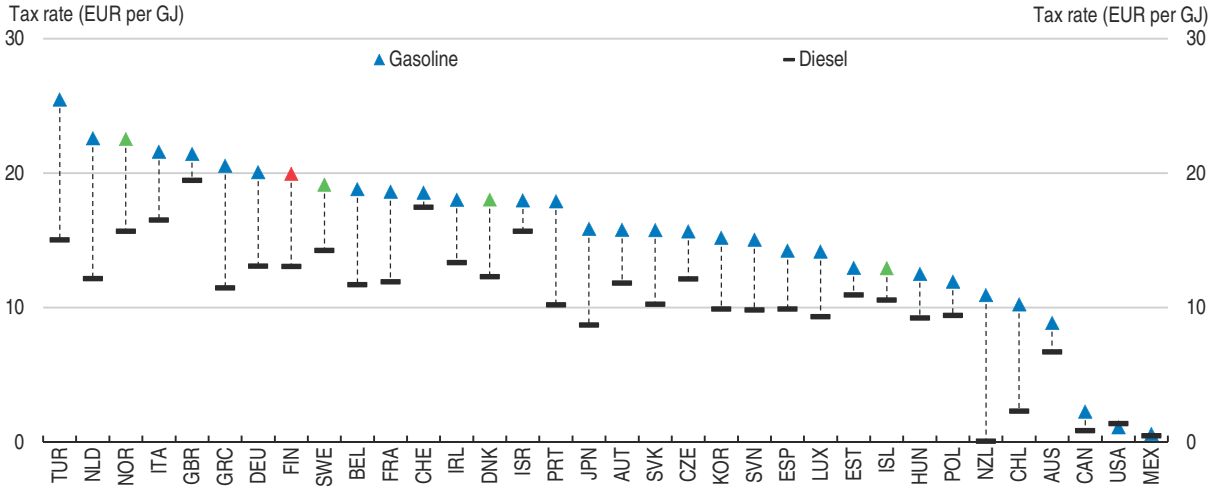


Source: OECD Instruments Used for Environmental Policy Database.

StatLink http://dx.doi.org/10.1787/888933663034

Figure 1.16. **Diesel is lightly taxed compared to gasoline**

Effective tax rates on gasoline and diesel for road use



Source: OECD (2015c), *Taxing Energy Use 2015: OECD and Selected Partner Economies*, OECD Publishing, Paris.

StatLink http://dx.doi.org/10.1787/888933663053

Increasing environmentally-related taxes and reducing or removing environmentally harmful subsidies is a challenging task, as this often raises concerns relating to the competitiveness of firms and industries and the income distribution of households. A number of measures have been taken in recent years, including increases in some energy,

CO_2 and vehicle taxes, the removal of the tax exemption on liquefied petroleum gas and reductions on allowances to deduct commuting expenses. Although further progress is necessary to reach the climate change and environmental policy objectives at a low cost for society and to reflect the environmental damage of energy use in prices, advances will require taking into consideration wider socio-economic and competitiveness effects. However, competitiveness and equity objectives, where relevant, are typically better addressed by flanking measures than by adjusting the rates or coverage of environmentally related taxes (OECD, 2017d).

Recommendations on taxation

Key recommendations

Further reduce the tax burden on labour.

Increase minimum- and maximum- rates on recurrent taxes on immovable property, and better align the tax base with market valuations.

Increase environmentally-related taxes.

Broaden the consumption tax base and phase out reduced VAT rates.

Continue to phase out mortgage interest deductibility.

Phase out environmentally harmful subsidies.

Further recommendations

Lower the normal interest rate used in the calculation of the unincorporated business taxation equity allowance.

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Chapter 2

Benefit reform for employment and equal opportunity

The combination of different working-age benefits, childcare costs and income taxation creates complexity, reduces work incentives and holds back employment. Major disincentives in Finland are related to tapering rules for unemployment benefits, social assistance and the housing benefit, the extended unemployment benefit for older workers, the childcare fee structure and the homecare allowance. Improved benefit design combined with efficient activation policies can reduce complexity and remove the strongest disincentives while minimising adverse fiscal and social impacts. Replacing current benefits with a basic income would improve incentives for some, but with a drastic redistribution of income and likely increasing poverty as a result. Merging working-age benefits with similar aims and coordinating their tapering against earnings would on the other hand drastically improve work incentives and transparency, while preserving social protection. Once the new income registry comes online, linking benefit payments to real-time incomes, combined with strengthened work incentives, would make for a truly efficient and inclusive benefit system, fit for the future of work.

Working-age benefits in Finland are a patchwork of different schemes introduced and reformed over the years to cater to different needs, and previously administered at different levels of government. Notwithstanding a trend towards simplification and centralisation, complex interactions between different benefits and income taxation create unemployment and inactivity traps, compounded by schemes targeting older workers and families with children.

Technological progress induces important changes to working life, with an increasing share of free-lance and part-time workers. Traditional benefit systems, such as the Finnish one, are built up around traditional employer-employee relationships, and lack the flexibility to adapt benefits to volatile incomes and frequent transitions in and out of work. Non-standard workers are therefore less likely to qualify for unemployment benefits and less likely to participate in activation policies. But technology also opens up opportunities. A simplified benefit system with stronger work incentives combined with real-time income reporting holds a great potential to facilitate transitions between benefits and work for people on standard- and non-standard contracts alike.

However, creating a well-functioning system of social insurance and redistribution is a delicate balancing act in which work incentives must be weighed against social protection and impact on public finances. This chapter presents and analyses different solutions to the challenges of complexity and disincentives on the backdrop of a rapidly changing world of work, and how different possible directions for future reform would affect the balance between incentives, inclusiveness and affordability, the policy trilemma at the heart of social insurance and redistribution policy.

These and similar analyses can help formulate a vision for social welfare in Finland and show a clear direction for benefit reform. However, major reorganisations can come with significant costs. Implementation should hence be stepwise, building on the existing system and institutional context, and important technical building blocks should be fully operational and well-tested before full roll-out.

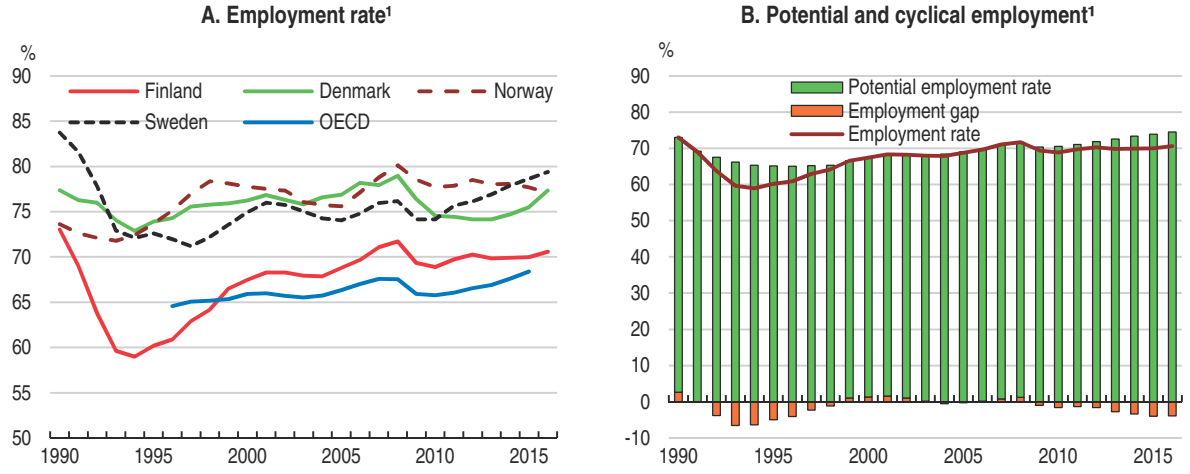
The rest of the chapter is structured as follows: Section two explains why reform of social benefits is needed in Finland. Strengths and weaknesses of the current benefit system are compared with two stylised reform scenarios in section three. Section four discusses the main reform priorities within the existing benefit system and labour market context. Recommendations and a summary of main findings are presented in section five.

The case for benefit reform

The employment rate is lower in Finland than in all the other Nordics, which is partly compensated in terms of total labour input by more hours worked per employee and a lower prevalence of part-time work. Cyclical factors play a role in explaining the employment rate gap. The Finnish labour market was particularly hard hit by the 1990s banking crisis, which coincided with the collapse of the Soviet Union, an important trading partner (Ahtiala and Junttila, 2015). This crisis had persistent effects on employment as

early retirement policies introduced in the 1970s and 1980s, notably early old-age pension, unemployment pension and disability pension, were actively used to reduce labour supply (Gould and Saurama, 2017). More recently, employment growth was weakened by the slow recovery from the Great Recession, due to difficulties in the forestry industry, the collapse of Nokia and weak economic conditions in Russia (Figure 2.1). However, policy settings also hold back labour supply. The *OECD Economic Survey of Finland 2016* points to a considerable potential to expand the labour force by speeding up the labour market entry of youth, postponing the exit of older workers, improving work incentives and activation policies for the unemployed and increasing the labour market participation of women of childbearing age.

Figure 2.1. **The labour market has been hard hit by crises**



1. Percentage of population aged 15-64.
Source: *OECD Economic Outlook Database*; and Labour Force Statistics.

StatLink http://dx.doi.org/10.1787/888933662711

Higher employment fosters equity and well-being in a number of ways. Raising employment increases equity directly, as those out of work face the highest risk of poverty, and indirectly, as it generates tax revenue, which can be used to finance public services and the social safety net. Well-being is also higher for the employed, who on average enjoy higher purchasing power, better housing conditions, better health and better opportunities to interact socially. Furthermore, higher female employment can improve work-life balance for both genders, if work and domestic responsibilities are shared more equally. The government has the ambition to increase the employment rate of the population aged 15-64 to 72% and reduce the unemployment rate to 5% by the end the end of the parliamentary term in 2019 (Ministry of Finance, 2014). The current economic upturn increases the chances of reaching this bold employment target, but this remains challenging. Even if employment reaches 72%, a significant untapped potential would remain. Moreover, even higher employment is needed on a lasting basis to counter the impact of ageing and strengthen public finances (*OECD Economic Survey of Finland*, 2016; Economic Policy Council, 2017; European Commission, 2017).

Women's employment rate is almost at the level of men's in Finland, making for the second lowest gender employment gap in the OECD. Nonetheless, employment rates of both men and women are lower in Finland than in the other Nordics, and male employment is

lower than the OECD average (Figure 2.2, Panels A and B). Men of all ages are less likely to be employed than in the other Nordics, but especially so in older cohorts. Women aged 40 to 60 do relatively well, with employment rates close to the Nordic average. In contrast, women in childbearing age are much less likely to be employed than in Sweden and Norway, despite taxation applying to individual incomes and generous parental leave and childcare arrangements in all three countries. Accounting for different statistical classification of Swedish and Finnish women in maternity leave reduces the difference, but a considerable gap remains (Pärnänen and Kambur, 2017). The employment rate of young adults is lower in Finland than in Norway and Denmark, despite higher tertiary enrolment in those countries (Panel C). Given the high attendance in upper secondary vocational education and training (VET), Finland should target youth employment rates comparable to Norway, Germany and Denmark. Indeed, individuals with a vocational education enter the Finnish labour market fairly smoothly at a young age, but their work-specific skills may become obsolete as society changes, increasing the likelihood of early labour market exit (*OECD Economic Survey of Finland*, 2016). Certain immigrant groups, notably humanitarian immigrants from Afghanistan, Iraq and Somalia, have very low employment rates and earnings, even many years after arrival (Sarvimäki, 2017).

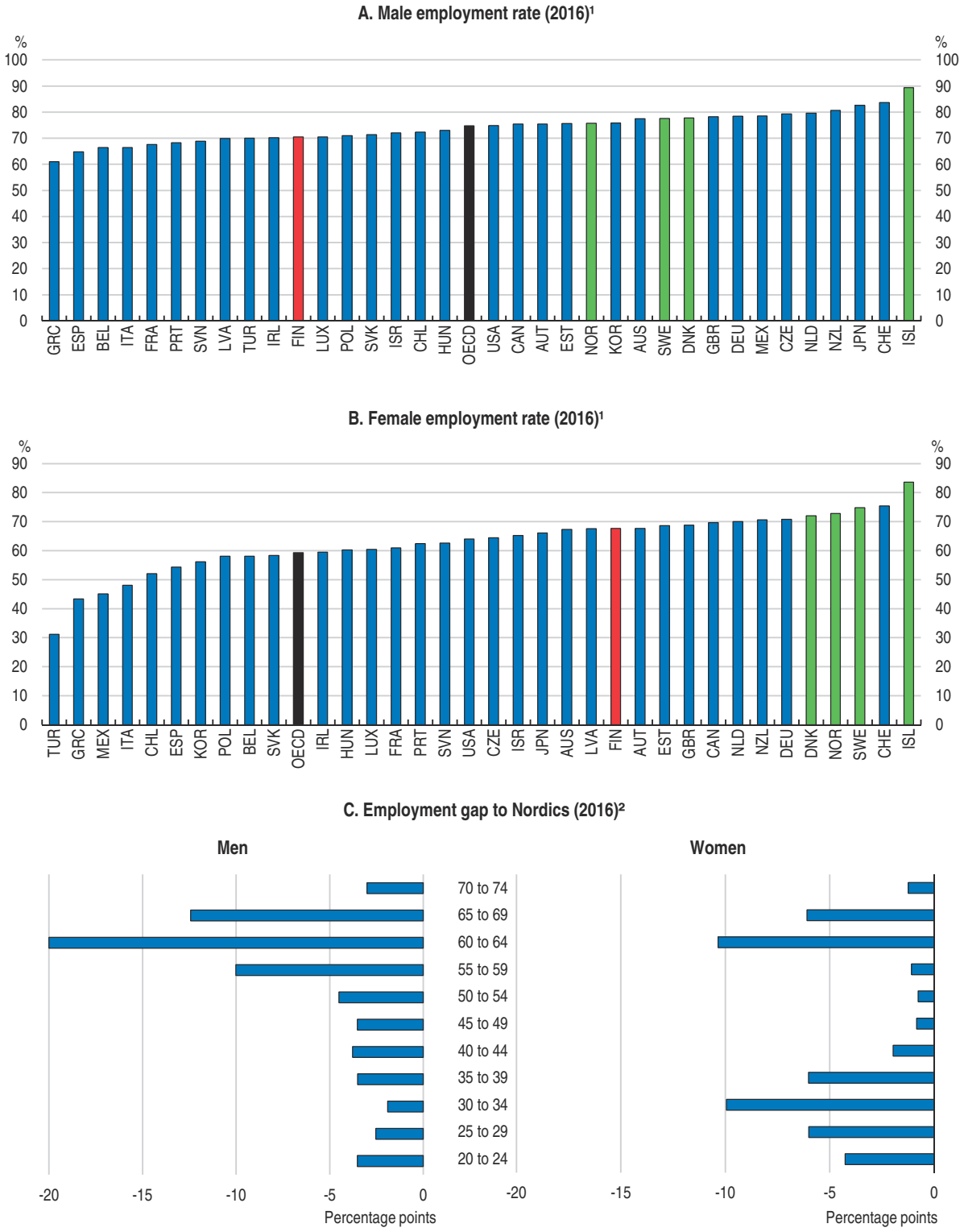
A number of recommendations made in the *OECD Economic Survey of Finland 2016* to improve the labour market functioning, including with respect to education, activation policy, employment protection legislation and wage bargaining, have since been addressed by the government and social partners. Important steps have also been taken to improve work incentives for the unemployed. But more needs to be done. A complex system built around the traditional employer-employee model will likely be increasingly challenged in a rapidly changing world of work, and work incentives can still be very weak for many individuals when different benefits and taxes interact.

Weak incentives and complexity can hold back employment

The *OECD Economic Survey of Finland 2016* points to relatively high benefit levels with long duration in combination with relatively weak activation as a partial explanation as to why labour market outcomes fall short of those in the other Nordics. However important, these average measures are only rough indicators of the problems of the current Finnish benefit system, and a more detailed analysis is needed to correctly gauge work incentives and set out directions for future reform.

On the surface, incentives to go from unemployment (Figure 2.3, Panel A) or inactivity (Panel B) to work are weaker than the OECD average, but stronger than in a number of countries. However, these average calculations ignore that the pay-off of going from inactivity to work can be very low or even negative in a number of situations. These incentive problems are created by interactions between different benefits and income taxation, as argued later in this chapter. Unemployment benefits are available in three forms, tapered on individual income. Housing benefits and social assistance are means-tested on family income. Social assistance can provide a top-up to the other benefits, and it contains a housing element with rules differing from the ordinary housing benefit. All the benefits share the same main goals of providing income security and adequate living standards for the jobless, and they all account for children and family size in various ways. As of 2017, all the benefits are administered by the Social Insurance Institution of Finland (Kela), except for income-related unemployment insurance, which is paid by unemployment funds, but coordinated with the unemployment benefits administered by Kela and subject

Figure 2.2. **Employment is low compared to other Nordics across gender and age**

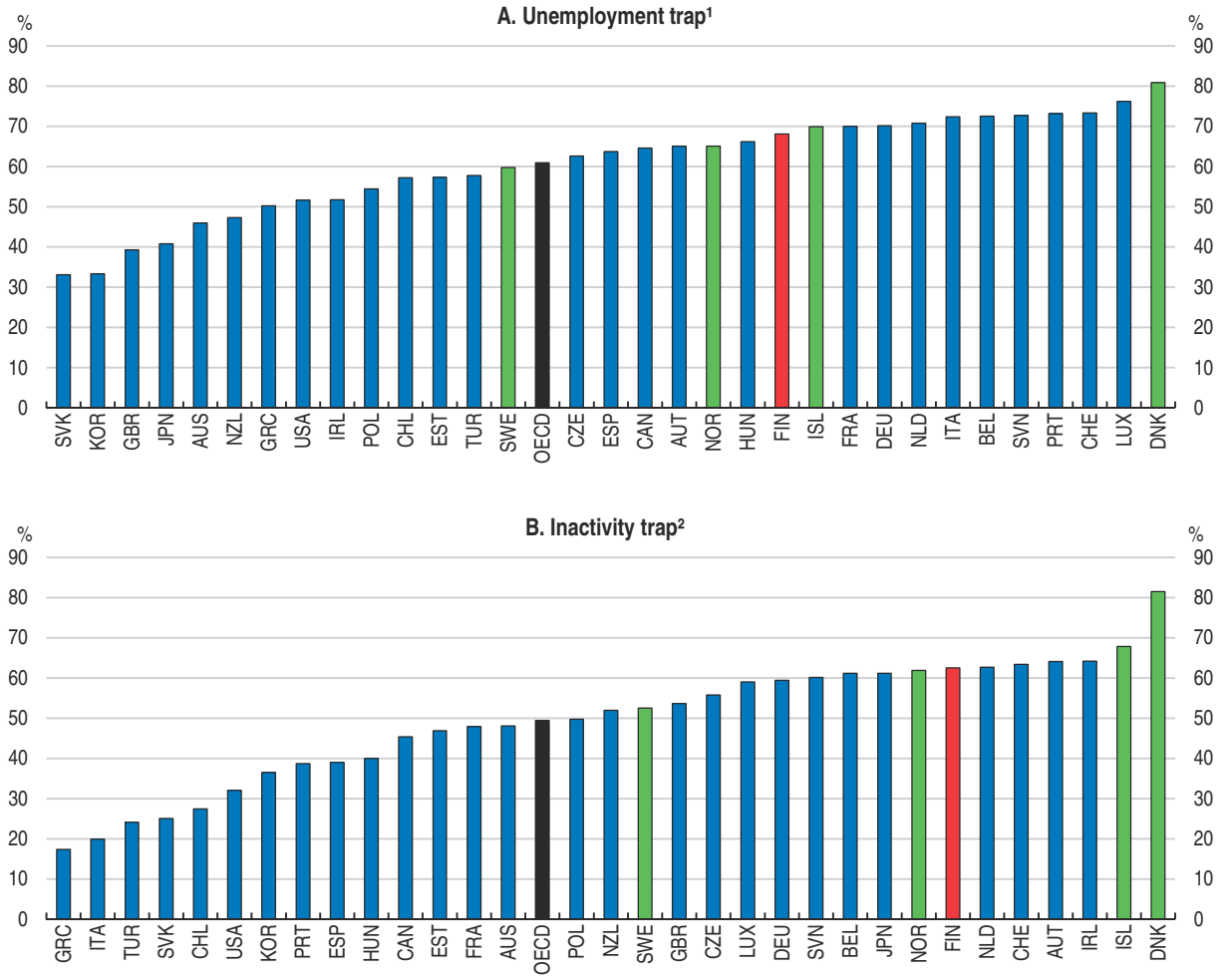


1. Percentage of population aged 15-64.
2. Difference in employment rates between Finland and the Nordic average (Denmark, Norway, and Sweden), within each age-gender sub-group.

Source: OECD Labour Force Statistics Database.

StatLink http://dx.doi.org/10.1787/888933663072

Figure 2.3. **High unemployment traps and inactivity traps in Finland**



1. Average effective tax rate (AETR) in the initial phase of unemployment for an individual entitled to unemployment insurance but not to means-tested benefits. The AETR measures the proportion of earnings that are "taxed away" by income taxation and loss of benefits when moving from inactivity to full-time work. AETRs are modelled as an average for six household types: single; single parent; couple, inactive spouse, no children; couple, inactive spouse, two children; couple, working spouse, no children, and; couple, working spouse, two children; and five earning levels: 33%, 50%, 67%, 100%, and 150% of the national average wage. Households with children are assumed to have two children aged four and six. Child-related benefit- and tax rules are taken into account. Childcare related costs and benefits are not. Reference year 2015.
2. As in Panel A, but for an individual entitled to means-tested social assistance and housing benefits, but no unemployment insurance.

Source: OECD TaxBen models.

StatLink http://dx.doi.org/10.1787/888933663091

to the same set of activation requirements. Disincentives from the uncoordinated tapering of these benefits with largely overlapping aims are compounded by childcare related fees and benefits, as well as extended unemployment insurance eligibility for older workers ("the unemployment tunnel").

These incentive traps, discouraging individuals on benefits to take up work or increase work efforts, are compounded by what can be termed "bureaucratic traps", where the complexity of benefit rules combined with administrative practices create uncertainty about the amount and timing of cash receipts, further reducing the attractiveness of work efforts for risk-adverse, often cash-strapped, individuals (European Commission, 2017). A change of circumstances usually leads to benefits being frozen while eligibility is

reassessed and benefits re-calculated by Kela and unemployment funds on the request of the employment service caseworker. Facing the real or perceived risk of losing eligibility or delayed benefit payments combined with liquidity constraints can thus render temporary or part-time work unattractive even if monetary incentives are decent (Pareliussen et al., 2018a; European Commission, 2017; Economic Policy Council, 2017).

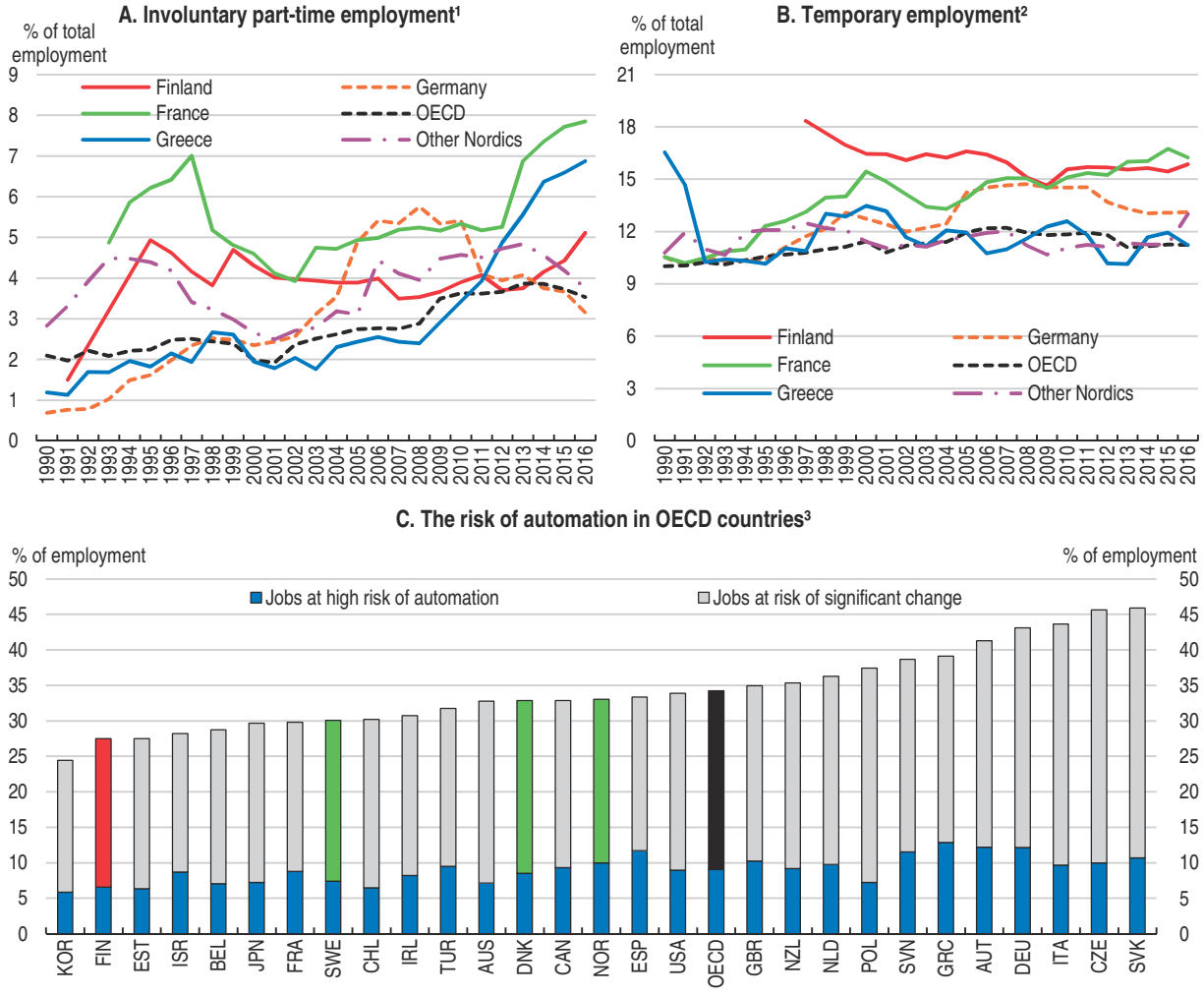
Matching future social protection to the future of work

An increasing share of non-standard work arrangements poses further challenges to welfare systems (Figure 2.4, panels A and B). Digitalisation has led to profound changes in working lives over the past few decades. It has enabled automation of routine tasks and facilitated the expansion of global value chains, important forces behind the decline of routine manufacturing jobs (Goos et al., 2009; Eurofound, 2017; OECD, 2017a). Despite being less exposed than most OECD countries, more than 25% of Finnish jobs face the risk of significant change from automation going forward (Figure 2.4, panel C; OECD, 2016a). Platform-based delivery of goods (e.g. Amazon) and information (e.g. Google and Facebook) has been around for a while, but more recently the platform-based delivery of physical services, such as transportation and accommodation (e.g. Uber and AirBnB) has become mainstream. Platforms for a number of other services, such as financial services, legal advice, coding, design, personal services and handyman services have also emerged. Such trends are likely to continue, leading to continued structural changes in working lives.

New technologies bring opportunities to use society's resources more effectively, but also challenges (Table 2.1). Freelance work ("the gig economy") and other forms of non-standard employment are not new, and the platform economy represents only a small, albeit growing share of total employment. Even so, digital service platforms will change firms' employment decisions at the margin, and a rising share of freelance work should be expected going forward. Improving protection of freelancers and self-employed to put them as far as possible on an equal footing with regular workers is a major challenge to social protection systems across the OECD (OECD, 2016a; OECD, 2017a). But the challenge is not insurmountable. Some countries, for example Belgium, have systems where specific categories of self-employed are entitled to an unemployment-like benefit in case of bankruptcy. In addition, freelance and platform work should be accommodated by public employment services, with flexible benefit adjustments, continued eligibility and demands for job-search and other activation measures adapted for individuals engaging in part-time platform work while unemployed. Indeed, technology is also an integral part of the solution to these challenges as it can facilitate automation of benefit payments, adjusted in real-time to individual earnings. Automating parts of the public employment service, such as regular activity reporting, can free human resources for coaching, mentoring and individually tailored activation.

Digitalisation splits processes into specialised tasks which can be bought from different providers. Buyers of platform services thus have incentives to buy services from freelancers with high customer ratings on similar tasks in the past, and freelancers gain from specialising. The incentives to broaden skills through new work experience can therefore be limited in the "gig economy". Furthermore, the employer's incentive to invest in training of their employees is very weak for platform workers, notwithstanding some examples of platforms offering training. Skill development will therefore mostly need to be initiated by individuals. Online learning platforms can help, as they provide a more flexible way of learning, but are a long way from replacing flexible and affordable education opportunities in

Figure 2.4. **The world of work is changing**



1. Involuntary part-time employment is defined as people who work part-time because full-time work is not available.
2. Temporary employment includes wage and salary workers whose job has a pre-determined termination date.
3. Based on the analysis of the task content of individual jobs using the OECD Adult Skills Survey (PIAAC). Jobs are at high risk of automation if the likelihood of being automated is at least 70%. Jobs at risk of significant change are those with the likelihood of being automated estimated at between 50 and 70%. For more details, see OECD Employment Outlook 2017.

Source: *OECD Labour Force Statistics Database*; and *OECD Employment Outlook 2017*, OECD Publishing, Paris.

StatLink http://dx.doi.org/10.1787/888933662787

Table 2.1. **Opportunities and challenges associated with non-standard work**

Opportunities	Challenges
Labour markets	
Flexible access to work and income opportunities	Non-standard work, small jobs, micro tasks
Possible inclusion of marginal groups in the labour force	Potential "race to the bottom" and wage penalty
Low barriers to work entry and exit	Less employer-sponsored training of workers
Working conditions	
Flexible working time (and space for digital services)	Job insecurity, higher unemployment risk
Autonomous work organisation	Cost and coverage of social protection and benefits
Potential productivity gains	Potential stress of self-management and social isolation

Source: OECD, 2016a.

the public education system throughout working life (OECD, 2016a). Finland, renowned for its excellent, publicly funded education system, is taking steps in the direction of modular upper secondary and tertiary education, an important effort to adapt to the challenges coming from digitalisation, longer careers and changing skill needs.

Unionisation of self-employed platform workers could strengthen their voice, increase their rights and help them insure against some adverse risks. Experiences from other freelance unions, such as journalists, artists and lawyers can provide a basis, but reaching platform workers would require some new thinking about the role and shape of trade unions and freelancers' legal right to collective wage bargaining. Across OECD countries, several projects are underway, spanning from bottom-up initiatives to create app-based unions and lawsuits to protect platform-workers' rights, to top-down initiatives from trade union confederations (ETUC, 2016; Taylor Review, 2017).

Finding direction: benefit reform scenarios

Complex benefit systems creating multiple stumbling-blocks to employment today, and ill-adapted to the future of work, need to be seen in light of their history and the multitude of individual risks and circumstances they are targeting. The main motive for insurance benefits such as pensions, sickness and unemployment insurance, is to smooth individual income over the lifetime in the face of changing life situations and a multitude of adverse risks. Assistance benefits such as social assistance, housing benefits and minimum pensions, redistribute tax revenue to individuals in need and benefit low-income individuals disproportionally. In practice, social protection systems in all OECD countries involve a mix of redistribution between rich and poor and redistribution over the lifecycle (Causa and Hermansen, 2017).

A good system should contribute to employment, via strong work incentives, offer strong social protection and be affordable. However, these goals form a policy trilemma: high benefit levels can only be combined with strong work incentives if benefits are withdrawn (tapered) slowly against income from work, and generosity combined with slow tapering has a significant fiscal cost. But good design and efficient flanking policies can ease this trade-off: removal of incentive traps combined with efficient activation policies will boost employment, partly offsetting the fiscal cost of higher average benefit payments. It is therefore necessary to find a balance between an adequate initial benefit level, an adequate speed of tapering, efficient benefit design and other measures encouraging work.

In looking for the right balance of benefit levels it is worth keeping in mind that the current systems in Finland and elsewhere differentiate payments to different groups for good reasons, with some groups, such as lone parents, receiving higher payments because of higher need. This targeting has been built up through political processes spanning several decades, and hence reflect a society's social preferences. Furthermore, Finland relies on a so-called "flexicurity model", where constructive labour relations and openness to structural change depends on adequate income protection for those who lose out, notably the unemployed. Last but not least, unemployment insurance is an important automatic stabiliser for economic activity.

The monetary pay-off is not the only factor affecting individual decisions to take up work or increase work efforts. Work-related expenses, spouse income, the number and age of children, regional housing price differences and individual preferences will for example play important roles. For these reasons and because of the need for balancing incentives

with inequality and affordability, it is impossible to determine a single optimal incentive level for any individual. However, marginal effective tax rates and/or average effective tax rates (Box 2.1) exceeding 100% are clearly too high and should be avoided, as this means that individuals will lose money from taking up work or working more. Nonetheless, some OECD countries fail to meet this simple rule of thumb for some specific individual circumstances, and average effective tax rates above 80%, which also constitute weak incentives, are quite common (Figure 2.6).

The OECD TaxBen model embodies the rules governing the main working-age benefits of most OECD countries from 2001 to 2015. This model is used below to describe the main features, strengths and weaknesses of the existing tax-benefit system compared to two possible directions of reform: a uniform benefit for all (universal basic income); and a uniform tapering rule for all existing benefits (universal credit). Estimates on how these scenarios affect inequality and public finances are obtained within the Finnish TUJA microsimulation framework, where tax- and benefit rules are linked to microdata (Pareliussen et al., 2018a).

Box 2.1. **Interpreting common measures of work incentives**

This chapter uses three common measures to evaluate work incentives and illustrate the causes of inactivity- and incentive-traps.

Net income, the income an individual is left with after paying taxes and receiving transfers, is a natural place to start when evaluating the effect of taxes and benefits. The level and composition of net income are interesting in themselves, but the slope of the net income curve as a function of work income (or work hours) also gives considerable information about the strength and causes of incentives to take up work and marginally increase work.

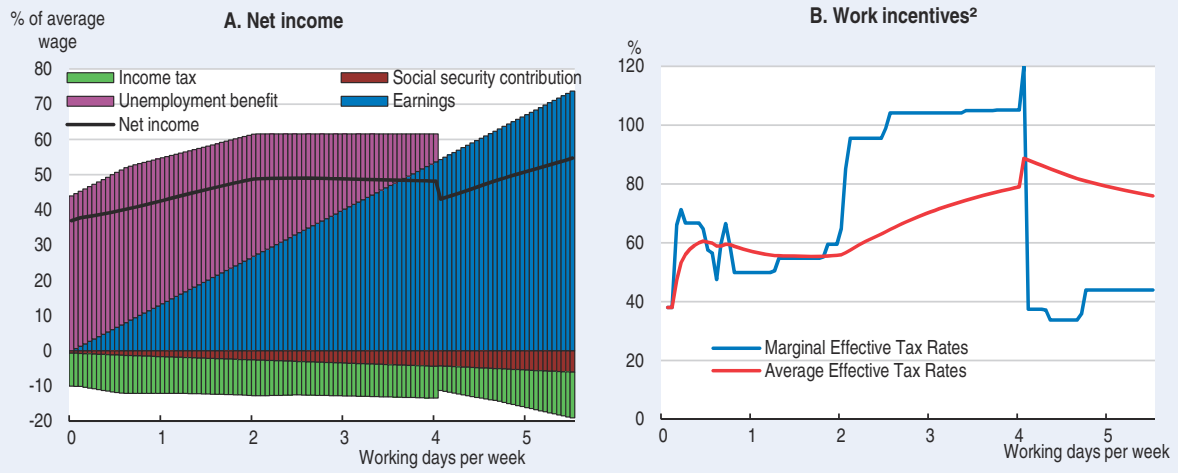
The average effective tax rate (AETR) measures how much of the additional earnings from moving into work will be lost to taxes, charges and benefit withdrawal (tapering). For example, an AETR of 60% at three workdays a week means that if an individual goes from zero to three workdays a week, her net income will increase by 40% of her work income, while 60 cents in a euro will be taxed or taken away by the tapering of benefits.

The marginal effective tax rate (METR) is a common measure of incentives to progress in work. It measures the marginal increase in net income resulting from a marginal increase in work income. For example, a METR of 80% at three workdays a week means that if an individual increases the amount of hours marginally above three days, she will keep 20% of the additional pay, or 20 cents for each additional euro earned.

The interpretation of these measures is illustrated in Figure 2.5, showing the situation of a single person entitled to unemployment insurance in Finland. Unemployment benefits are reduced by 50% of additional earnings after a threshold at less than one workday a week. Benefit withdrawal and income taxation together result in a METR around 100% from about 2 workdays a week until unemployment insurance is entirely withdrawn at four workdays a week. The “cliff-edge” loss of benefits at four days of work is reflected in a sudden jump in the AETR, as well as a pronounced spike in the METR. In sum, these figures show good work incentives working part-time for up to two workdays, and weak incentives to work more. These incentive issues are clearly caused by the design of the unemployment insurance.

Box 2.1. **Interpreting common measures of work incentives** *(cont.)*

Figure 2.5. **Net income and work incentives in the current benefit system**[1]



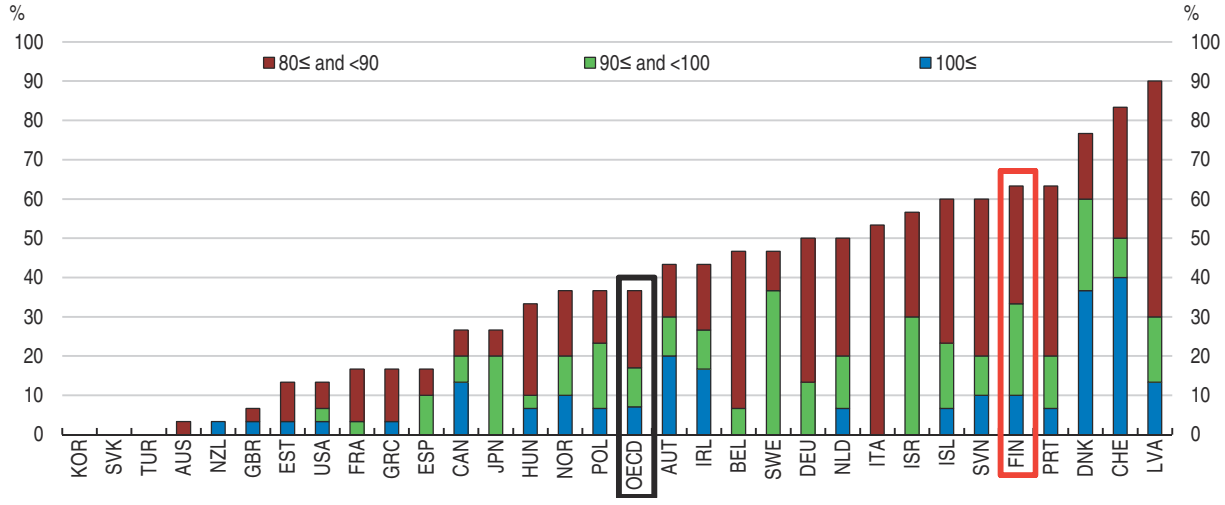
1. A single person entitled to unemployment insurance going into work in the initial phase of unemployment but following any waiting period, with hourly earnings pre- and post-unemployment of 67% of the national average wage. Means-tested benefits are allowed as top-ups to unemployment insurance.
2. Extreme positive rates have been capped at 120%.

Source: Simulations with the OECD TaxBen model, in Pareliussen et al. (2018a).

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Figure 2.6. **Work does not always pay**

Incidence of unemployment traps[1]



1. Incidence of an average effective tax rate within the indicated range for individuals transitioning from unemployment to full-time work in the initial phase of unemployment. A value of 100 means that all modelled individuals face inactivity traps. Zero means that none do. Unemployment insurance and means-tested top-ups are included. Average effective tax rates are modelled for six household types: single; single parent; couple, inactive spouse, no children; couple, inactive spouse, two children; couple, working spouse, no children, and; couple, working spouse, two children, and for five income levels: 33%, 50%, 67%, 100% and 150% of the national average wage. Households with children are assumed to have two children aged four and six.

Source: Simulations with the OECD TaxBen model, in Pareliussen et al. (2018a).

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Strengths and weaknesses of the current system

Unemployment benefits, housing benefits, and social assistance fulfil related purposes and operate along the same dimensions, but have their particular sets of rules that are only partially harmonised. It is justified that different benefits have different eligibility criteria and formulas to calculate the initial benefit, as this reflects different needs and rights. Unemployment insurance depends on work history, active job search and participation in activation activities. The means-tested housing benefit depends on housing costs, subject to a ceiling determined by household size and local housing costs. Social assistance is a last-resort benefit aiming to raise living standards of all individuals to a minimum level, also accounting for family size and housing expenses. A homecare allowance is available for those who choose to forego public childcare and take care of their own children. Many municipalities also provide top-ups to the homecare allowance (Table 2.2; OECD, 2016b; Pareliussen et al., 2018a).

Table 2.2. **Main working-age benefits and income taxation**

Benefit	Eligibility criteria	Initial amount	Income/wealth definition for tapering	Taxable
Labour market subsidy (*Työmarkkinatuki)*	Registered as unemployed and available for work or activation policies[1]	A personal "basic amount" and supplements for children	Gross individual earnings plus capital income and parents' income if living together	Yes
Basic unemployment insurance (*Peruspäiväraha)*	As in the labour market subsidy, plus 26 weeks of work for the past 28 months[1]	As in the labour market subsidy	Gross individual earnings	Yes
Income-related unemployment insurance (*Ansiosidonnainen työttömyyspäiväraha)*	As in basic unemployment insurance, plus membership in unemployment fund[1]	As in basic unemployment insurance plus a percentage of pre-unemployment income	Gross individual earnings	Yes
Housing allowance (*Yleinen asumistuki)*	Low income	Housing costs, family size and composition, geographical area	Gross household income including taxable benefits	No
Social assistance (*Toimeentulotuki)*	Low income	Housing costs, family size and composition, geographical area, childcare costs	Net household income after tax and benefits, wealth	No
Homecare allowance (*Kotihoidontuki)*	Does not use public childcare and has children aged 1-3	Number of children and their age; municipal supplement follows local rules	Gross household income (only applies for means-tested supplement)	Yes
Tax/fee	**Criteria**	**Structure**	**Income definition**	
Childcare fee (*Päivähoitomaksu)*	Number of children aged 1-6 in public childcare	Flat rate with floor and ceiling	Gross household income	
Income taxation and social security contributions		Progressive tax schedule	Gross individual income	

1. Working hours may not exceed 80% of full-time work in the case of part-time unemployment benefits.
Source: OECD (2016b).

The analyses in this chapter focus solely on work incentives and other policies and institutions directly affecting employment, but the benefit system can also have wider effects. For example, benefits covering housing costs may contribute to push up rents, which would in turn increase the level of benefits and thus reduce work incentives. Eerola and Lyytikäinen (2017) find no effects on rents from thresholds in the housing allowance, but the overall size of the housing allowance may nonetheless affect overall rent levels. Effects on rents can be expected to be more pronounced for the housing element of social assistance, as it covers full rents up to a threshold (the housing allowance only covers up to 80% of actual rents), but data to test for such effects has so far not been available.

Incentive issues arise primarily as a consequence of the speed at which benefits are scaled back (tapered) against earnings from work and income taxation. The different benefits apply different income definitions and different tapering rules. Unemployment insurance benefits are taxable and tapered on gross individual earnings. Social assistance and housing benefits provide top-ups to household income, and are not taxable. As in the other Nordics, the income tax is applied to individual income. Individual income taxation generally favours two-earner couples compared to taxation of household income, since second earners then benefit from tax allowances, tax credits and lower marginal taxes in progressive tax schedules. Income taxation in Finland consists of a flat-rate social security contribution, a flat-rate municipal income tax with a basic allowance and an allowance based on earned income, a progressive central government income tax, an earned income tax credit and a child tax credit in addition to various other deductions covering special circumstances. Furthermore, the childcare fee for one to six year-old children attending public childcare is equivalent to an additional income tax with a floor and a ceiling but, contrary to regular income taxation, it is calculated on the basis of household income (Table 2.2; OECD, 2016b; Pareliussen et al., 2018a).

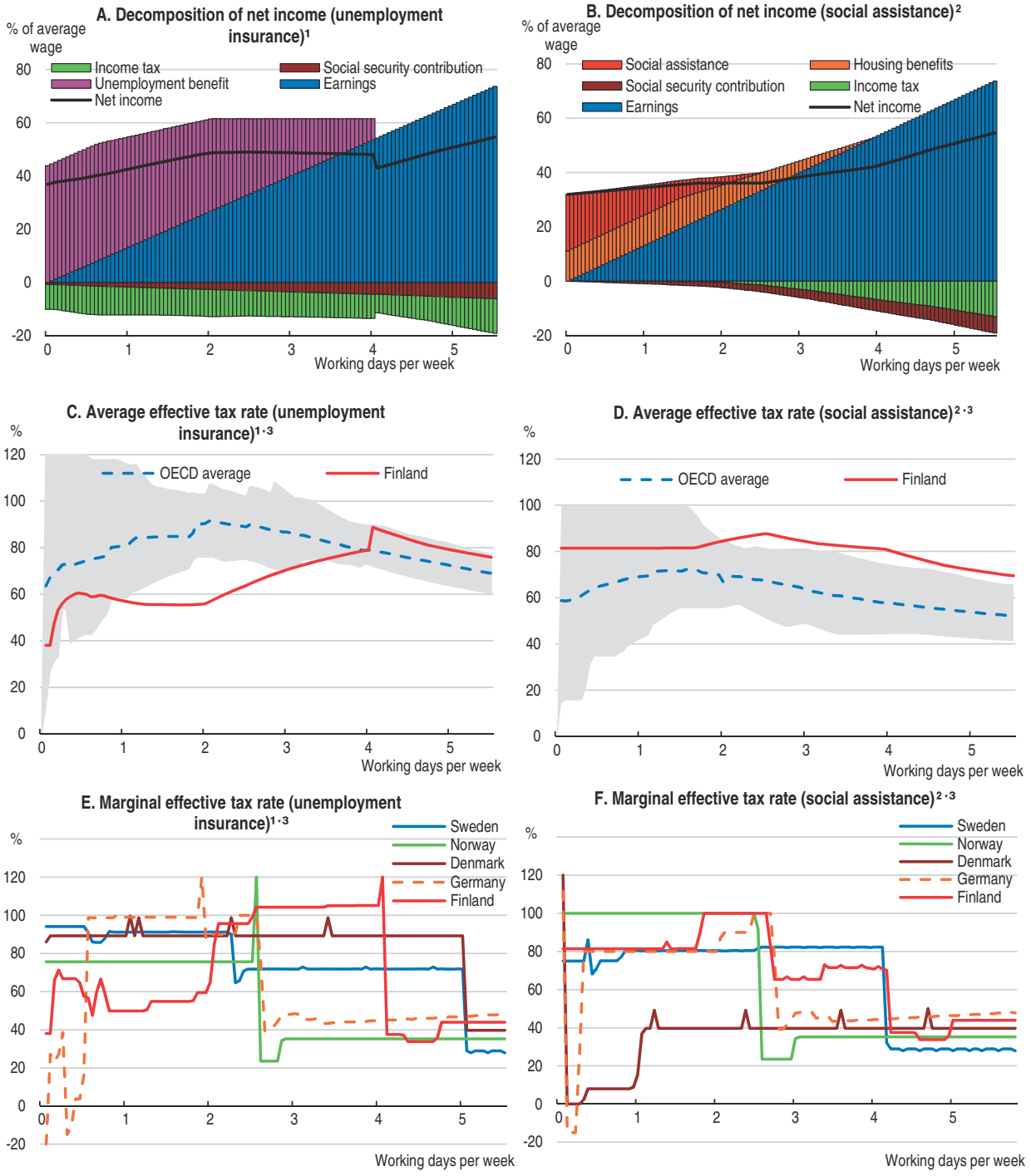
The monetary gain from taking up a job can be unattractive for many individuals on unemployment insurance, and is not even positive for all. The main disincentives originate in unemployment insurance tapering, even though housing benefits also matter (Figure 2.7, Panel A). Work incentives for those eligible to keep their benefit while working part-time are quite strong in Finland up to a certain point, with among the lowest average effective tax rates in the OECD. This is due to earned income tax credits, a EUR 300 monthly earnings disregard and relatively slow tapering of unemployment benefits (at a rate of 50% of earnings). However, working a bit more than 40-50% of full-time is discouraged by marginal effective tax rates slightly above 100% (Panel E), and working more than 80% of full time leads to the loss of the unemployment benefits, discouraging full-time work (Panel C).

Individuals eligible for means-tested social assistance will also usually receive the means-tested housing benefit (Figure 2.7, Panel B). Social assistance is tapered at a rate of 80% of net income up to a threshold, after which it is reduced euro by euro. The housing benefit has relatively complex tapering rules translating to a taper rate of approximately 34% of gross household income, but since it is part of the income definition for social assistance, marginal effective tax rates for the two benefits combined never exceed 100% (Panel, F). One-earner households (singles and couples with or without children) with moderate earnings prospects face average effective tax rates between 70 and 90% in most situations, which is high compared to the OECD average, but not unique (Panel D). However, second earners with children are eligible to receive the homecare allowance, and will also pay the childcare fee when entering work, resulting in an average effective tax rate well above 100% when working less than approximately 40% of full-time (Pareliussen et al., 2018a).

Universal basic income: a uniform benefit for all

A universal basic income has been proposed as an option to remove complexity and improve work incentives in Finland. The concept of a basic income is not new, and most OECD countries already include unconditional transfers to certain groups in the form of, for example, child benefits and basic old-age pensions. However, the idea of a benefit for the whole population, equal for all regardless of individual circumstances and other income, has gained renewed attention lately as a possible response to challenges facing traditional social protection systems, such as the rise of atypical forms of employment and risk of job losses

Figure 2.7. **Net income and work incentives in the current system**



1. A single person entitled to unemployment insurance going into work, with hourly earnings pre- and post-unemployment of 67% of the national average wage in the initial phase of unemployment. Means-tested benefits are allowed as top-ups to unemployment insurance.
2. A single person not entitled to unemployment insurance going into work with hourly earnings of 67% of the national average wage.
3. Extreme positive rates have been capped at 120%. Extreme negative rates have been capped at -20%. The shaded area denotes the range between the 25th and the 75th percentile in the OECD area.

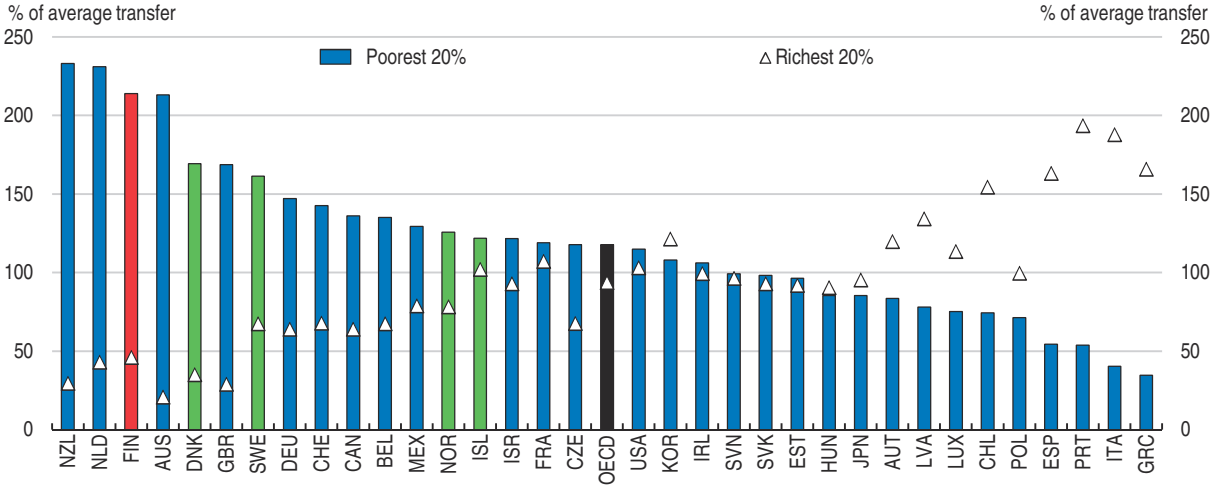
Source: Simulations with the OECD TaxBen model, in Pareliussen et al. (2018a).

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due to automation, as well as imbalances between work, family and leisure. Incomplete coverage of insurance transfers leading to insufficient security for the poor in existing cash support is a further argument, although one with relatively little relevance for Finland, a country with low inequality and benefits effectively sheltering the poor (Figure 2.8). Furthermore, basic income has been put forward as a major simplification of existing benefit systems, and could improve work incentives significantly, since a basic income is not tapered against earnings. However, if existing spending on all working-age benefits was distributed to the same age group as a basic income with an equal amount to all, the benefit level would only constitute 26% of the relative poverty (50% of median income) threshold. Financing a basic income at a meaningful level thus requires additional tax revenue, and heavier taxation of income will hence, at least partially, neutralise enhanced work incentives (OECD, 2017b).

Figure 2.8. **Existing cash support is targeted towards the poor in Finland**[1]

2013 or latest year available



1. Public social cash transfers received by working-age individuals in low and high-income groups (equivalised disposable incomes). Age group 18-65, 18-62 in France.

Source: OECD (2017b).

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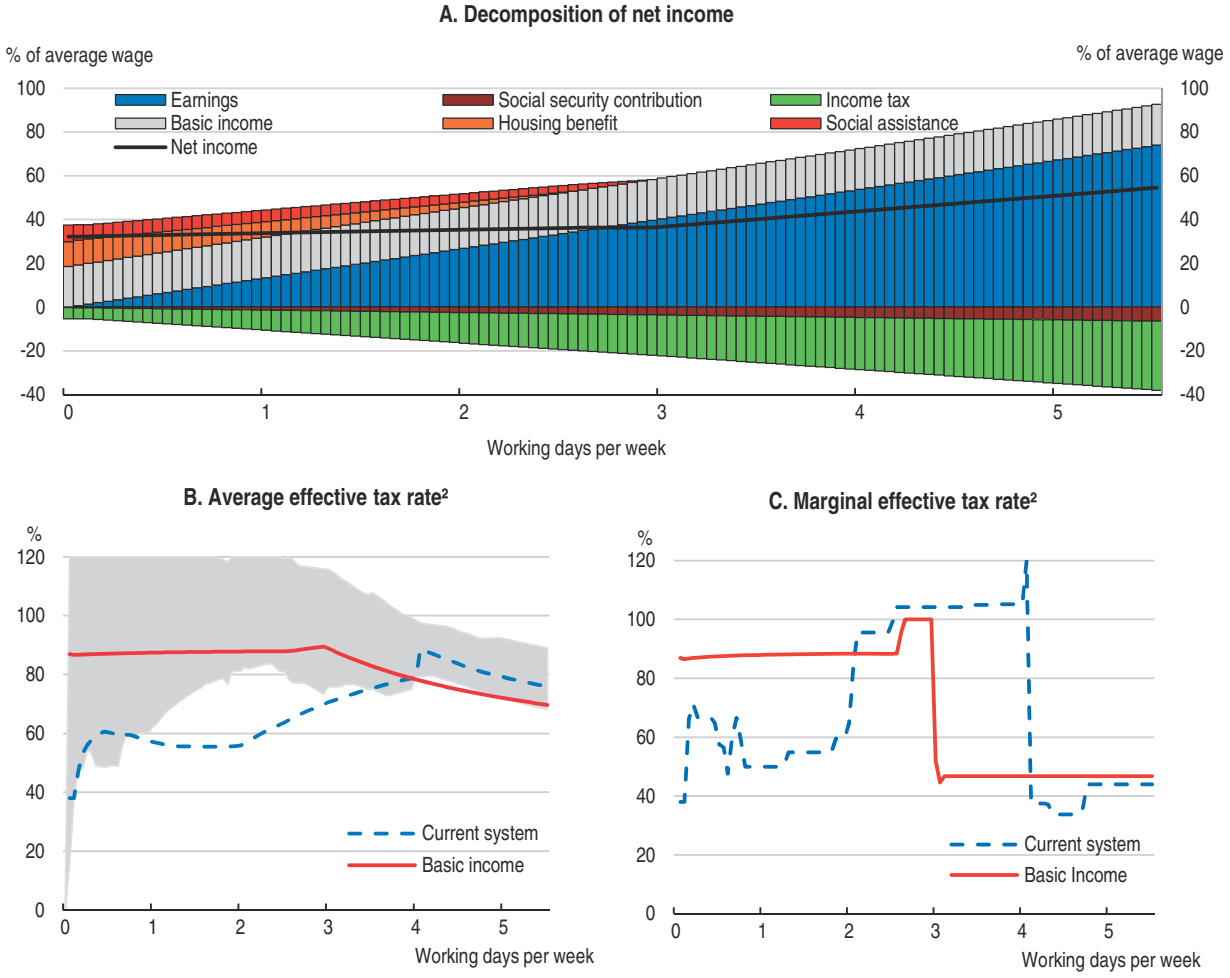
In Finland, a lively academic and political debate about the subject eventually led to the implementation of a two-year basic income trial, that started in January 2017. The experiment covers 2 000 recipients of unemployment assistance, and converts the EUR 560 a month (before tax) unemployment assistance into an unconditional benefit in the sense that tapering and job search requirements are abolished for the individuals concerned. Income taxation and other benefits are kept unchanged, so that no participant loses out compared to the current system, contrary to what would happen if the scheme was implemented nationally and financed through taxation (Kela 2016; OECD, 2017b).

The basic income scenario presented here follows closely the scenario outlined in Browne and Immervoll (OECD, 2017b and Browne and Immervoll, 2017), with some exceptions (see Pareliussen et al., 2018a). The basic income applies to working-age individuals and is set at EUR 573 (486) per month before (after) tax, a level corresponding to social assistance for adults, with basic income for children derived from social assistance child supplements (EUR 237 before tax). The new benefit replaces unemployment, social assistance (except the housing element) and early retirement benefits, but disability benefits

and cash support for housing are retained. Setting the basic income at a level that would fully remove the need for needs-tested housing related top-ups would imply crippling income taxation (Kela, 2016). All tax credits and allowances are removed to fund the reform. There is little rationale for a tax-free earnings allowance when everyone receives a minimum level of income. Furthermore, the zero bracket in the government income tax is abolished and all other brackets are shifted proportionally, which implies raising taxes significantly. The basic income is taxable, introducing some progressivity reflecting the income taxation schedule.

The basic income in this scenario undeniably reduces complexity in entitlement rules (Figure 2.9, Panel A). The cliff-edge loss of income associated with the loss of unemployment benefits when working more than 80% is also eliminated, enhancing incentives to work full-time for the unemployed. However, incentives to take on part-time jobs would be fairly weak, as the combination of heavier taxation on low incomes and tapering of housing benefits would imply high marginal effective tax rates on low earnings (Panel B), and average effective tax rates of around 90% or above for individuals with moderate earnings

Figure 2.9. **Net income and work incentives in the basic income scenario**[1]



1. A single person going into work, with hourly earnings of 67% of the national average wage.
2. Extreme positive rates have been capped at 120%. The shaded area denotes the range between the 25th and the 75th percentile in the OECD area.

Source: Simulations with the OECD TaxBen model, in Pareliussen et al. (2018a).

StatLink http://dx.doi.org/10.1787/888933663148

potential working up to around 60% of full-time (Panel C). Second earners dependent on public childcare would, as in the current system, lose out compared to inactivity if working less than approximately 40% of full-time (Pareliussen et al., 2018a).

Universal credit: a uniform tapering rule for all existing benefits

A very different approach to reducing complexity and disincentives lies in harmonising tapering rules for the different working-age benefits. In practice, such an approach is equivalent to merging the benefits in question into one single benefit, and it requires centralisation of benefit administration and harmonisation of the tax treatment of benefits. If well-executed and linked to a functioning real-time income registry, such a benefit holds the potential to provide seamless transition from unemployment to work and adjustment to varying work hours. The most prominent example of this type of benefit system is found in the United Kingdom, where the process of rolling out a universal credit nationally is ongoing. This benefit reform has been criticised, but mostly on account of implementation issues and benefit cuts enacted in parallel with the reform (Box 2.2).

Box 2.2. **Universal credit in the United Kingdom**

The universal credit welfare reform alters the structure of benefits, not the benefit levels, which by design are the same as before the reform for non-working individuals. The reform brings together six working-age benefits and tax credits related to social assistance, unemployment, housing and child support into one single benefit with one single taper rate. It is a monthly benefit, where the initial benefit is calculated on the basis of individual circumstances, and tapered against net real-time household income data. Policy aims were to simplify the benefit system from the viewpoint of users and administrators, to smooth the transition into work and to tackle poverty by increasing benefit take-up and make work pay regardless of the number of hours worked (Department for Work and Pensions, 2016).

The Department for Work and Pensions began rolling out the universal credit welfare reform in 2013. The roll-out has been gradual, starting with a limited number of employment offices and eligibility limited to single, childless and unemployed persons who did not own their own home. Full-scale roll-out in the North-West of England started mid-2014, where eligibility was subsequently extended to couples and families with children. The universal credit was rolled out nationwide between 2015 and 2016, but full service, digitally delivered and including all claimant groups, is only expected to be completed by 2022. Earnings data are collected from the HM Revenue & Custom's Real Time Information system, where employers and pension providers report earnings every time an employee is paid. Analyses of the initial roll-out show a positive labour market effect. Universal credit recipients were four percentage points more likely to be in work six months after the initial benefit claim than similar claimants under the old system (Department for Work and Pensions, 2016 and 2017).

Microsimulations have shown that the universal credit reform holds significant potential to boost incentives, notably for part-time work which is incentivised by earnings disregards, even though some alternative design choices could have further optimised work incentives. Second earners with children will see weaker incentives than before, the failure to include the Council Tax Reduction, a means-tested discount on the property tax, can weaken gains in work incentives somewhat, and means-testing against wealth can discourage savings (Department for Work and Pensions, 2011; IFS, 2016; Pareliussen, 2013).

Box 2.2. **Universal credit in the United Kingdom** *(cont.)*

Furthermore, implementation has been delayed significantly compared to original plans, which were ambitious in timeframe and scope. Delivering the necessary IT infrastructure also proved more challenging than foreseen (National Audit office, 2013). Other relevant criticism relates to benefit cuts and an extension of the waiting period from 3 to 7 days which are not integral parts of the universal credit design, but as the cuts were enacted in parallel, the universal credit is often cited as the culprit of the resulting precariousness. However, initial difficulties have been overcome, and adjustments made along the way to allow for a continued roll-out of the universal credit as set out in the revised plan from 2016. Notable changes include reducing the taper rate from 65% to 63% in 2017, and abolishing the 7 waiting days from January 2018.

The universal credit scenario merges unemployment related benefits, the housing allowance, social assistance and some child benefits into one single benefit with one single tapering rule. The calculation of the benefit amount for an individual out of work follows exactly the same rules as in the current system. An individual out of work should therefore receive (approximately) the same net income as in the current system. The universal credit is non-taxable and tapered on after-tax income, securing by design that the marginal effective tax rate never exceeds 100%, and smoothing out marginal incentives for different earnings levels. Abolishing the homecare allowance and changing the childcare fee from the current income-tax structure to a lump-sum fee, offset by a new childcare supplement to the universal credit removes the current incentive traps for parents of children aged one to six. For simplicity, the scenario applies one single taper rate of 65% and no earnings disregard. Choosing a lower taper rate and/or a higher disregard would improve work incentives, but increase the cost of the benefit. The universal credit in the United Kingdom provides earnings disregards, varying by family type, with the explicit aim to improve work incentives for part-time workers (Pareliussen et al., 2018a).

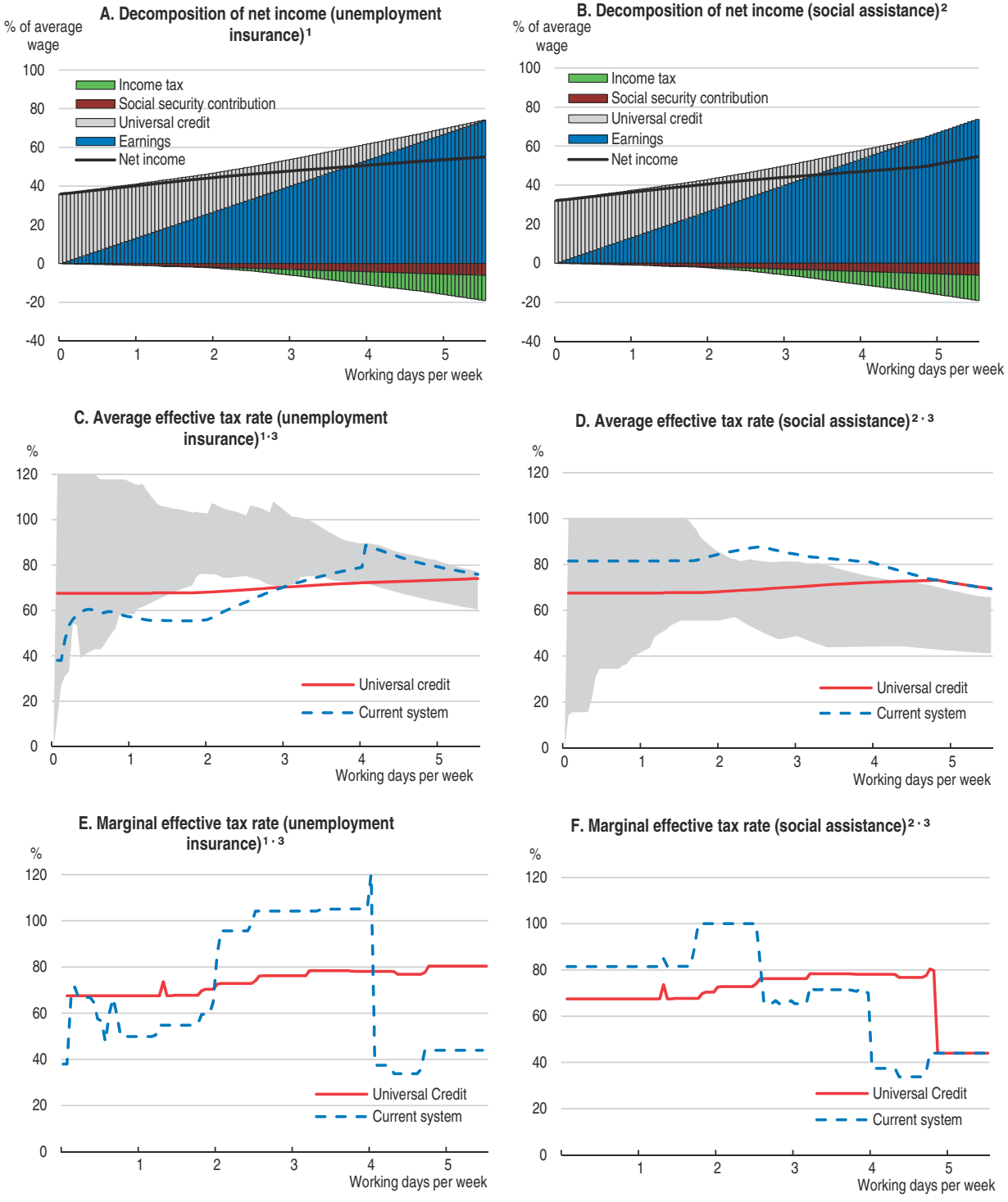
Despite preserving the relatively complex rules of the current system governing eligibility and calculation of the initial amount, transparency and predictability would increase dramatically from the point of view of the benefit recipient. Once the eligibility and initial amount are confirmed by the public employment service, the pay-off from working or increasing work time is quite transparent (Figure 2.10, Panels A and B).

More importantly, the pay-off will always be positive (Panels C and D). However, avoiding peaks in the marginal effective tax rate results in benefits being completely tapered off at higher earnings levels than before and it comes at the cost of inferior incentives to take on part-time jobs (up to around 40%-50% of full-time) compared to unemployment insurance recipients in the current system. Nonetheless, a longer interval of relatively high marginal effective tax rates is likely preferable to the "cliff-edge" benefit loss associated with unemployment insurance in the current system (Panels E and F). Individuals on social assistance have lower or equal average effective tax rates in the universal credit than in the current system.

Comparing the scenarios: incentives, inclusiveness and affordability

Full-time work is still the norm in Finland, and the most useful measure of work incentives for people on unemployment insurance, presumably relatively close to the labour market, may therefore be the average effective tax rate for full-time workers. However, many

Figure 2.10. **Net income and work incentives in the universal credit scenario**



1. A single person entitled to unemployment insurance going into work, with hourly earnings pre- and post-unemployment of 67% of the national average wage. Means-tested benefits are allowed as top-ups to unemployment insurance.
2. A single person not entitled to unemployment insurance going into work with hourly earnings of 67% of the national average wage.
3. Extreme positive rates have been capped at 120%. The shaded area denotes the range between the 25th and the 75th percentile in the OECD area.

Source: Simulations with the OECD TaxBen model, in Pareliussen et al. (2018a).

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skills are job-specific, earnings potential deteriorates quickly following involuntary unemployment, shrinking regional job markets offer few attractive jobs, and the incidence of non-standard types of work also increases after displacement. A significant share of the unemployed may therefore not recoup the same salary level as before their unemployment spell (OECD, 2013). Deteriorating earnings potential can add to disincentives, because the benefit amount in the current unemployment insurance is calculated on the basis of previous earnings, while tapering is partially based on work hours.

In the current system an unemployed person with moderate pre-unemployment earnings and the possibility to go back to full-time work with 80% of previous earnings would face high average effective tax rates (84 to 118%) when taking up employment, regardless of his or her family situation. This is mainly because unemployment benefit is cut off for those going back to working more than 80% of full-time. Even though this cut-off applies to all three versions of the unemployment benefit, it is more likely to be binding for recipients of income-related unemployment insurance than for those receiving more modest amounts in the basic unemployment insurance or the labour market subsidy, a benefit available to those who are not eligible for the other two versions, for example after long-term unemployment. Even with the same salary as in the old job, monetary incentives for an individual entitled to the earnings-related insurance would in many cases be weak, with 75 to 102% of earnings being taxed away, depending on family situation (Table 2.3). Work incentives are stronger under both the basic income and the universal credit. They would vary considerably with family type in the basic income, while they by design would be fairly uniform with the universal credit, never exceeding 73.4%. Improved incentives under the basic income are partly a result of a considerably lower initial benefit level than in both the current system and the universal credit.

Table 2.3. **Comparative average effective tax rates, income-related unemployment insurance**

Previous earnings 67% of national average wage[1]

Household type	Going back to work full time with 100% of previous earnings			Going back to work full time with 80% of previous earnings		
	Current system	Basic income	Universal credit	Current system	Basic income	Universal credit
Single	79.1	72.0	73.4	89.4	78.3	72.2
Single parent	97.7	86.2	73.4	99.5	91.4	72.2
Single earner in childless couple	86.5	68.2	73.4	90.3	73.6	72.2
Single earner in couple with children	88.3	74.4	73.4	93.8	81.3	72.2
Second earner in childless couple	74.6	43.9	64.8	83.7	43.2	71.5
Second earner in couple with children	102.0	66.1	73.4	118.0	71.0	72.2

1. A person entitled to unemployment insurance. Means-tested benefits are allowed as top-ups to unemployment insurance. Households with children are assumed to have two children aged two and five. The person is going into work in the initial phase of unemployment but following any waiting period. This implies that individuals in the current system and the universal credit scenario are entitled to an increased income-related allowance, resulting in somewhat higher average effective tax rates than without this allowance. See Pareliussen et al. (2018a) for a detailed explanation and comparisons of incentives with and without the increased allowance.

Source: Simulations with the OECD TaxBen model, in Pareliussen et al. (2018a).

Simulations of work incentives of model households based on benefit rules, like the ones presented here, are useful to identify incentive issues and compare countries, but do not reveal how representative and relevant such stylised examples are. Kotamäki (2016) estimates that the incidence of average effective tax rates above 80% among unemployment insurance recipients is about 16%. The highest concentration of disincentives is found among those receiving the earnings-related unemployment insurance, and disincentives hit

parents in particular, with one third of single parents and one fifth of parents in couples facing average effective tax rates above 80%.

Individuals not entitled to earnings-based unemployment insurance can typically be expected to have low earnings prospects and weak labour market attachment. Comparing the average effective tax rate for individuals with modest earnings prospects entitled to social assistance entering work shows that incentives in the basic income scenario are inferior or equivalent to the current system for half-time workers. This is due to the higher marginal tax rates necessary to fund the benefit, combined with the tapering of housing-related benefits. The universal credit on the other hand, displays equivalent or better incentives for all household types because of a lower taper rate. For full-time workers, different work incentives between the basic income and the current system reflect that a basic income is more generous towards couples, while the combination of higher income taxation and tapering of the housing-related benefits, reduces incentives for single-headed households. Tax rates in the universal credit scenario never exceed 73.4%, a considerable improvement compared to the current system (Table 2.4).

Table 2.4. **Comparative average effective tax rates, social assistance and housing benefit**

Hourly wage equal to 67% of the national average wage

Household type	Half time			Full time		
	Current system	Basic income	Universal credit	Current system	Basic income	Universal credit
Single	87.6	87.9	69.1	72.0	72.0	72.0
Single parent	67.6	92.5	69.1	77.1	86.2	73.4
Single earner in childless couple	87.6	87.9	69.1	86.5	68.2	73.4
Single earner in couple with children[1]	87.6	87.9	69.1	80.6	74.4	73.4
Second earner in childless couple	11.6	41.9	11.6	24.0	43.9	24.0
Second earner in couple with children[1]	89.4	86.3	56.0	66.6	66.1	46.3

1. Households with children are assumed to have two children aged two and five.
Source: Simulations with the OECD TaxBen model, in Pareliussen et al. (2018a).

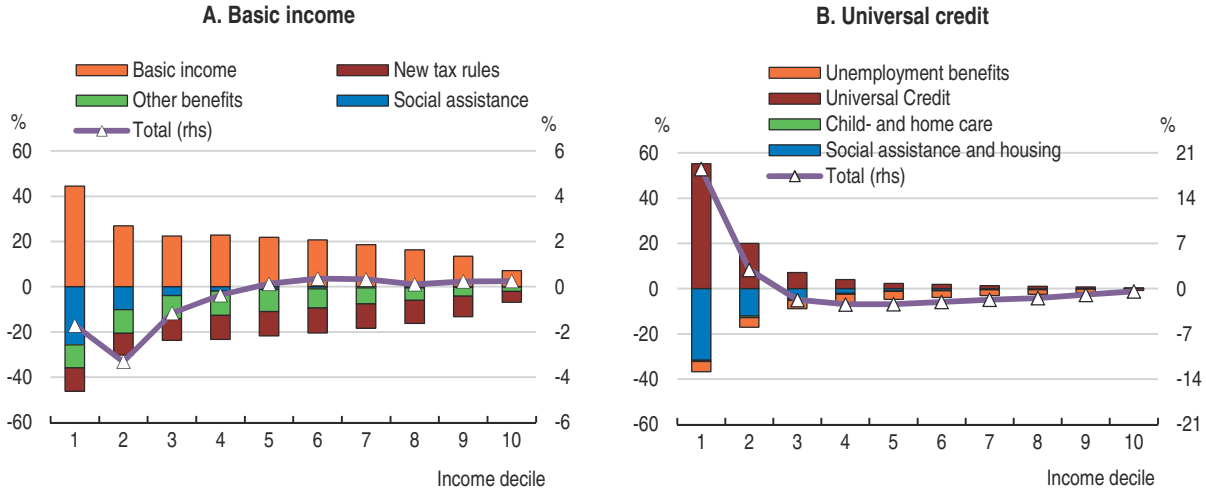
Behavioural effects on employment and income under the basic income cannot be quantitatively estimated in a static microsimulation framework, but are likely to be significant under such an extensive reform. Work incentives would be more favourable for some because of less means-testing and lower benefit levels, and less favourable for others because of heavier income taxation. The absence of activation requirements would likely contribute to reducing employment, when seen in isolation. In contrast, the universal credit would resolve a number of incentive issues, while keeping existing activation policies in place. The overall employment effect of this scenario should hence be positive.

The static effects of the basic income scenario would strengthen the budget balance by EUR 4.6bn, or 2% of GDP. The cost of the basic income (17bn) is more than offset by increased taxation (13.1bn), and reduced net expenditure, notably on social assistance (2.5bn), unemployment benefits (2.1bn), early pensions (1.2bn) and the child benefit (1bn). In the universal credit scenario, the budget balance strengthens by EUR 0.8bn. However, this scenario is modelled with tapering of the universal credit on family income, as it is methodologically difficult to calculate the individual part of the universal credit with annual microdata. The fiscal savings are thus likely overstated compared to a scenario with individual rights to an unemployment insurance supplement (Pareliussen et al., 2018a).

Fiscally neutral scenarios are constructed to isolate the redistribution effects of potential reforms. Reducing the marginal income tax by 4 percentage points makes the basic income scenario close to fiscally neutral. Such a reform would change the income distribution significantly, with losses in the bottom four income deciles and small gains in the top six. Incomes in the lowest deciles are reduced most strongly by abolishing social assistance and unemployment benefits, but abolishing early pensions, student grants and income tax allowances and credits also affect low incomes disproportionally. The basic income offsets these income losses to an extent, but not completely. The modified income tax schedule, along with abolishing child benefits, sickness benefits and parental leave reduces middle incomes disproportionally (Figure 2.11, Panel A). A fiscally neutral universal credit scenario is constructed by lowering the universal credit taper rate to 38%. The average income in the two lowest deciles increases, likely as a result of higher benefit take-up and slower tapering of social assistance. Falling incomes in the middle of the distribution are mainly related to the loss of unemployment benefits. These losses would be lower with an unemployment insurance supplement tapered on individual income (Panel B).

Figure 2.11. **A basic income would reduce incomes in the bottom of the distribution**

Changing disposable incomes under benefit reform scenarios[1]



1. Percentage change compared to pre-reform disposable income within each income decile.

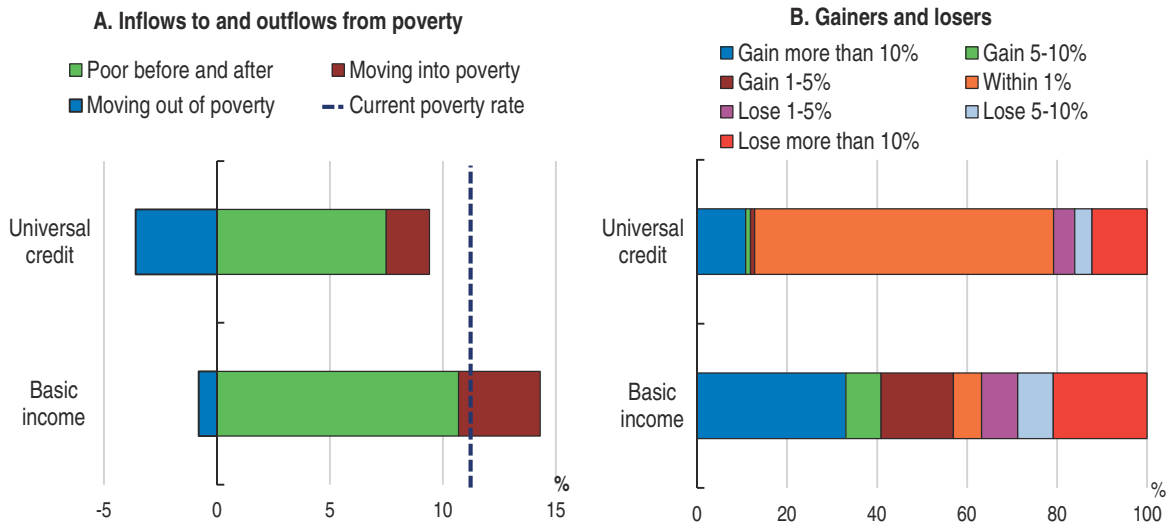
Source: Simulations with the TUJA model, in Pareliussen et al. (2018a).

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Overall, in the fiscally neutral basic income scenario the Gini coefficient increases by approximately 0.4 percentage points. The poverty rate rises from 11.4% to 14.1%, and of the 150 000 persons falling below the poverty line, 30 000 are children, and 50 000 early pensioners. Furthermore, the structure of the benefit system changes, substantially affecting most individual incomes. Only around 6% of the population will see their incomes unchanged, a third of the population will see income gains of over 10%, and a fifth will lose more than 10%. Many of the people who would be poor after a basic income reform would not be those who are poor today: 3.6% of the working-age population would fall into poverty as a consequence of this reform, while 0.8% would move out of poverty (Figure 2.12). This significant redistribution of income arises because the universal individual benefit in this scenario is more generous towards couples than singles than the current targeted system,

Figure 2.12. **A basic income scenario would alter the income distribution**

Share of individuals in working-age households



Source: Simulations with the TUJA model, in Pareliussen et al. (2018a).

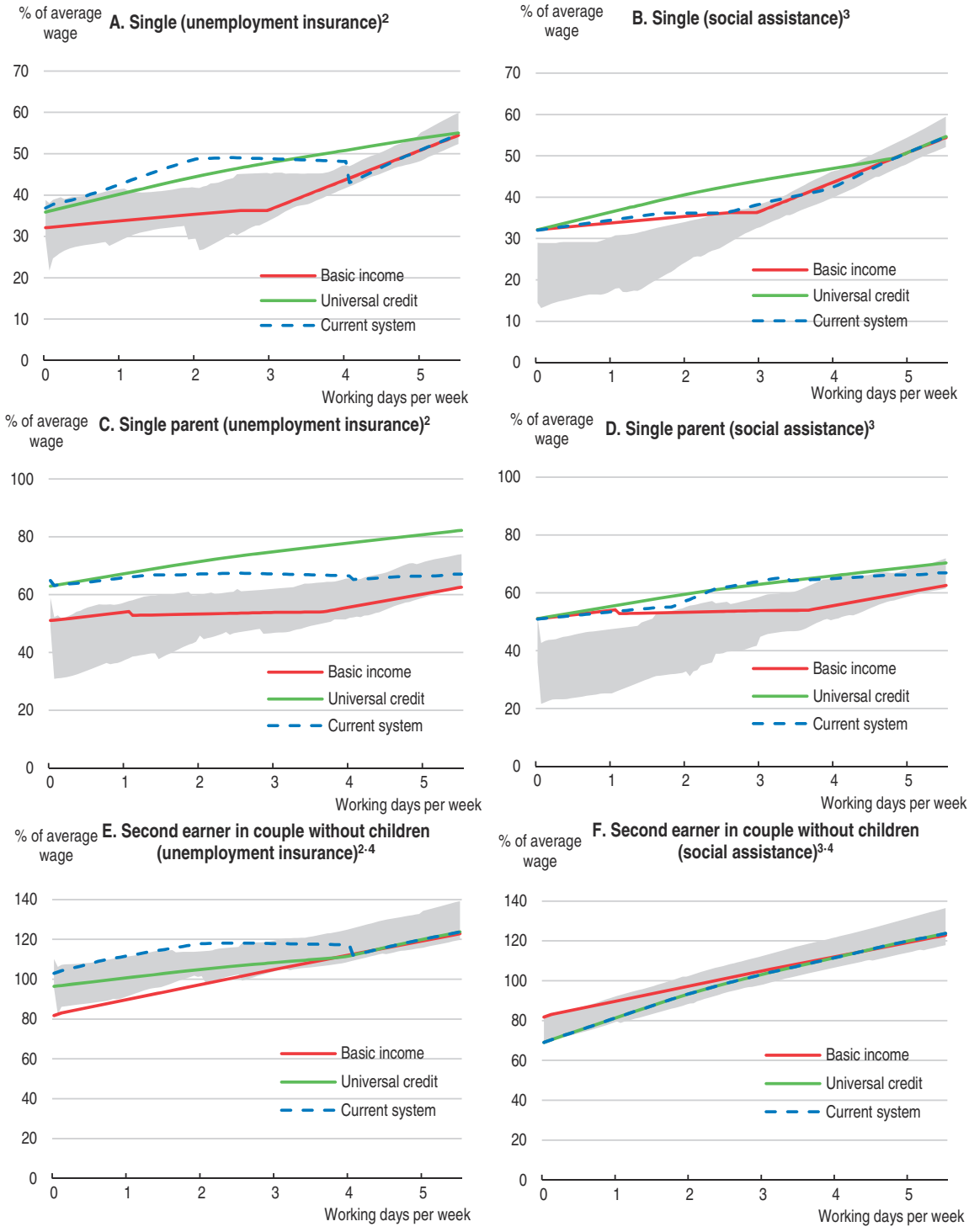
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the income-based unemployment insurance is abolished, benefit take-up increases and taxation changes (Figure 2.13).

In contrast, in the universal credit scenario, the Gini coefficient falls by 0.9 percentage points, and 90 000 people exit poverty, thereby reducing the poverty rate by 1.7 percentage points to 9.7%. In general, fewer people see their incomes affected in this scenario, and households losing over 10% of their income mostly do so because unemployment insurance is tapered on household- rather than individual income. Large gains for some individuals, notably in the first decile, are probably partly a result of increased take-up, but likely also reflect less steep benefit tapering in the universal credit scenario (Figure 2.13).

It should be noted that these results depend on the assumptions underlying the scenarios. The basic income for example is designed as one uniform benefit for all, in line with what is commonly associated with the term. Other lump-sum benefit structures, more targeted towards individuals in need, would likely perform better along the inequality dimension.

Figure 2.13. **Net household income in the different scenarios**[1]



1. The shaded area denotes the range between the 25th and the 75th percentile in the OECD area.
2. A person entitled to unemployment insurance going into work, with hourly earnings pre- and post-unemployment of 67% of the national average wage. Means-tested benefits are allowed as top-ups to unemployment insurance.
3. A person not entitled to unemployment insurance going into work with hourly earnings of 67% of the national average wage.
4. The primary earner earns the national average wage.

Source: Simulations with the OECD TaxBen model, in Pareliussen et al. (2018a).

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Towards robust work incentives and protection for all

The simulations above illustrate in the case of Finland how different models of tax-transfer systems perform in the balancing act between incentives, protection and affordability. They also illustrate some of the problems with corner solutions: full means-testing and "cliff-edges", with sudden benefit reductions or loss of benefit eligibility can undermine work incentives. A universal basic income at a level that does not imply crippling income taxation, bearing in mind that there are limits to taxation of capital, consumption and externalities (Chapter 1), is not generous enough to protect individuals in vulnerable life situations. Even when retaining means-tested top-ups, a basic income will imply that the current targeting of benefits changes drastically, resulting in a major redistribution of income, presumably at odds with social preferences. A basic income may also increase poverty as illustrated in the basic income scenario, although the exact redistribution effects depend on the design of the basic income scheme.

In contrast, moving towards coordinated benefit tapering as illustrated in the universal credit scenario can alleviate complexity and strengthen work incentives without reducing social protection. However, benefit reform does not need to be a revolution as described in the two scenarios above, and many of the weaknesses in the current system can be mitigated without replacing the full benefit system. Indeed, experience from the implementation of major welfare reforms, such as the Universal credit in the United Kingdom (Box 2.2) and the Norwegian NAV reform (Fimreite et al., 2012) illustrate that major reorganisations can come with significant costs. Implementation should hence be stepwise, building on the existing institutional context, and important technical building blocks should be fully operational and well-tested before full roll-out.

Ensuring smooth transitions between work and benefits

Finland has already moved towards better coordination of benefits, by centralising benefit administration in Kela. This is an important first step towards better harmonisation. Furthermore, the housing benefit went through a major simplification in 2015. In the long term, harmonising the tax treatment and income definitions of working-age benefits by making all either taxable or non-taxable and calculating them on either gross or after-tax income could pave the way for restructuring benefits into their core functions, with coordinated tapering as described in the universal credit scenario. To fill the functions of the current benefit system, such a system would consist of a personal basic amount, a child supplement, a housing supplement and an unemployment insurance supplement.

In the short to medium term, bureaucratic traps could be fought by investing in better software for the public employment service (PES), which would enable caseworkers to better analyse individual circumstances and give more precise advice about the consequences of taking up work. Taking this one step further, delegating decision power to PES staff, at least for relatively straightforward cases, could be considered. A combination of timely decisions and a change in rules extending rights to benefits without tapering for a limited period of time after taking up work would go a long way in resolving this issue and reinforcing incentives to enter work. The basic unemployment benefit can be used as a mobility and wage subsidy as of 2017, which is a step in this direction (European Commission, 2017). Furthermore, the government plans to extend unemployment benefits for four months to the unemployed who start an entrepreneurial activity (Ministry of Finance, 2017a).

The planned implementation of a real-time income registry and its link to benefit payments in 2020 holds the potential to provide truly seamless transitions between work and benefits. It also opens up the possibility for on-line applications that could accurately assess the consequences of freelance work, taking up regular work or increasing efforts, based on individual real-time circumstances. The real-time registry could hence promote transparency and predictability, even if the underlying benefit rules are complex. However, the development of integrated IT systems for the public sector is often challenging for multiple reasons, including diverging stakeholder goals, the need to balance different user needs, technological integration and compatibility issues, as well as constraining regulations and requirement specifications (Moe and Päivärinta, 2013). Privacy issues and IT security also need to be taken into account. A transition to real-time coordination of earnings and benefits should hence only be made when the real-time income registry is fully operational and tested.

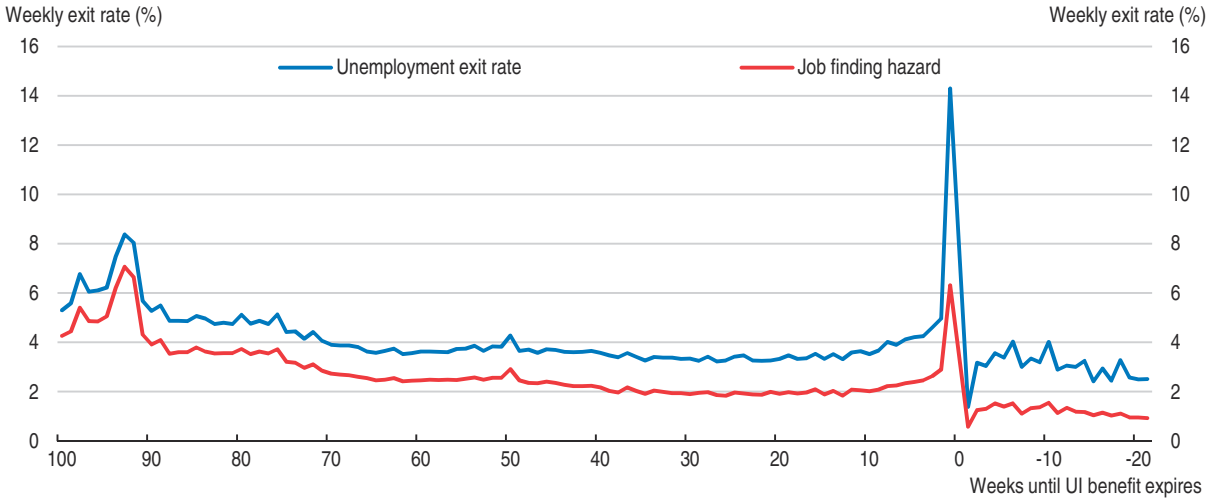
Improving work incentives for prime-age workers

The cliff-edge loss of unemployment insurance benefits when working more than 80% of full time strongly discourages full-time work, and should be abolished. Replacing the 80% limit by other mechanisms would avoid that the unemployment insurance becomes a general labour market subsidy. A time limit for receiving unemployment insurance while working close to full-time is one possible solution. Somewhat higher tapering on low incomes combined with a lower initial benefit level could make the 80% limit obsolete, and is hence an alternative, but positive effects should be weighed against reduced incentives to take on part-time jobs and a weakened insurance function of the unemployment benefit.

Incentives are also a function of the time dimension. Outflows from unemployment increase drastically towards the end of eligibility for the earnings-related unemployment insurance. About half of those who exit just before earnings-related unemployment insurance expiry find a new job or are recalled to their old job. The other half enters job-placement programmes or exit the unemployment insurance altogether (Figure 2.14). The spike in outflows at exhaustion is a useful illustration, but with limited impact on overall unemployment, as only a minor fraction of recipients stay unemployed until benefit exhaustion.

However, reducing unemployment benefit duration also increases job-finding rates earlier in the unemployment spell, and is therefore effective in reducing unemployment, while preserving meaningful insurance. The duration of the earnings-related unemployment benefit was cut by 100 days from 500 to 400 days (300 days for careers shorter than three years) in January 2017. This reduction is estimated to reduce average unemployment duration by 10%, and to significantly increase employment. Furthermore, the reform could result in fiscal savings of more than EUR 100m. Increasing inequality from lower benefit payments is expected to be neutralised by increasing employment (Kyyrä, et al., 2017a and b; Ministry of Finance, 2017b; Kotamäki et al., 2017). Seeking to trigger similar threshold effects earlier in the unemployment spell, the government introduced a new activity requirement from January 2018. Those who do not work or participate in activation activities for at least 18 hours during each three-month period following unemployment will get their unemployment insurance reduced by 4.5% in the following three-month period (Ministry of Finance, 2017a).

Figure 2.14. **Exit rates spike immediately before unemployment benefit expiry**



1. Unemployment and job finding rates as a function of time-to-exhaustion for all those entitled to unemployment insurance.
Source: Kyyrä et al. (2017a).

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Social assistance is tapered at a rate of first 80%, then 100% of net income. Lowering the tapering rate would improve incentives somewhat, but would lead to interactions with the tapering of the housing benefit, which is part of the social assistance income definition. Marginal effective tax rates would therefore remain high unless the two benefits are merged or tapered in sequence. Merging the two benefits into one should be possible, as social assistance already contains a housing element, and both benefits are means-tested on family income and administered by Kela. However, their income definitions would need to be fully harmonised and legal issues concerning the role of social assistance as a last-resort benefit would need to be resolved. Moving away from the current model where the full rent is covered by social assistance towards a model where tenants have an incentive to search for housing with lower rents should be considered.

Making work pay for parents

A combined restructuring of the homecare allowance and the childcare fee would transform work incentives for parents of children aged 1-6 years completely and likely reduce the average duration of leave following childbirth, in line with previous OECD recommendations (*OECD Economic Survey of Finland, 2016*). The government reduced the childcare fee for families with two or more children in public childcare by approximately 20% (depending on individual circumstances) from 2017. Although a significant step in the right direction, resolving the current incentive issues requires a more profound restructuring.

The homecare allowance is equivalent to a direct subsidy to stay out of the workforce for parents who depend on public (municipal) childcare, and strongly disincentivises second earners from taking on part-time work. It consists of a basic amount per child and a means-tested supplement, and many municipalities provide additional top-ups to reduce demand for childcare. In 2015, the employment gap between women aged 20-49 with young children and women in the same age group without children was 15.7 percentage points (European Commission, 2017). The homecare allowance may not be combined with unemployment benefits. Furthermore, inactive single parents will normally not face adverse incentives from

the allowance, since it is counted as income in calculating social assistance and housing benefits. It therefore mainly affects second earners, notably women with low education and skills resulting in modest earnings prospects (Figure 2.15). One option is to abolish the homecare allowance entirely. Alternatively, using the savings from removing the homecare allowance to increase the basic parental leave amount would largely remove disincentives, while partially compensating losers. Increasing the flexibility to take out a lower parental leave benefit to three years would preserve free choice to stay at home with young children as in the current system, but without subsidising labour market exit.

Figure 2.15. **Employment rate by skills and age**



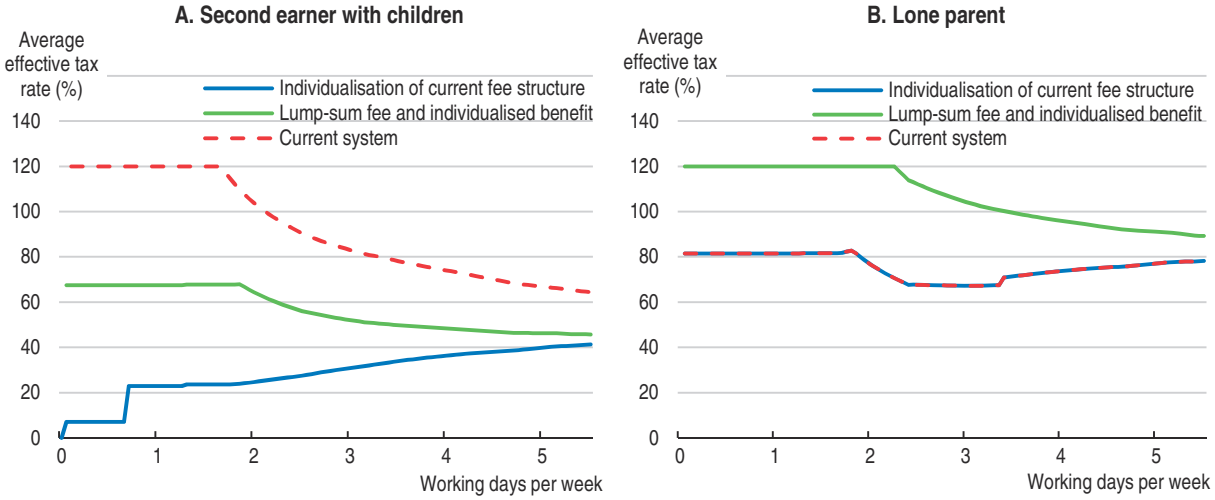
1. Low skills are defined as literacy proficiency at or below PIAAC level 2. High skills are defined as PIAAC level 3 or above. Data were collected in 2012.

Source: OECD Survey of Adult Skills, 2012.

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The childcare fee is only payable above an income threshold, after which it increases gradually with household income up to a ceiling. Second earners will normally be well above the threshold as a consequence of the spouse's income. Entering work, even at low hours, will in this case entail significant childcare payments. A solution to significantly strengthen incentives for second earners would be to individualise the current fee by calculating it on the basis of the lowest-earning spouses' income. Alternatively, the current structure could be replaced by a lump-sum fee combined with an offsetting, individualised childcare benefit, as in the universal credit scenario (Figure 2.16, Panel A). In the latter case, tapering would need to be coordinated with other benefits to avoid creating new disincentives for single parents (Panel B). Removing disincentives for mothers would increase the demand for public childcare, and hence increase childcare expenditure. However, changing the childcare fee structure as described above would create some room to increase the fee with limited additional disincentives. The cost of individualising the existing fee could be limited somewhat by removing the floor in the fee structure for second earners.

Figure 2.16. **Improving incentives for second earners**[1]



1. The homecare allowance is abolished in both scenarios. The "lump-sum fee and individualised benefit" scenario replaces the childcare fee structure by a lump-sum fee combined with a childcare benefit tapered off by 65% of after-tax income. Tapering is not coordinated with tapering of other benefits. In couples, the benefit is individualised and tapered against the income of the spouse with the lowest earnings. The "Individualisation of current fee structure" scenario keeps the current childcare fee structure, but the income test to set the level of the childcare fee is applied to the spouse with the lowest earnings. The modelled individual is not entitled to unemployment insurance, and he or she is going into work with hourly earnings of 67% of the national average wage.

Source: Simulations with the OECD TaxBen model, in Pareliussen et al. (2018a).

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Narrowing the unemployment tunnel for older workers

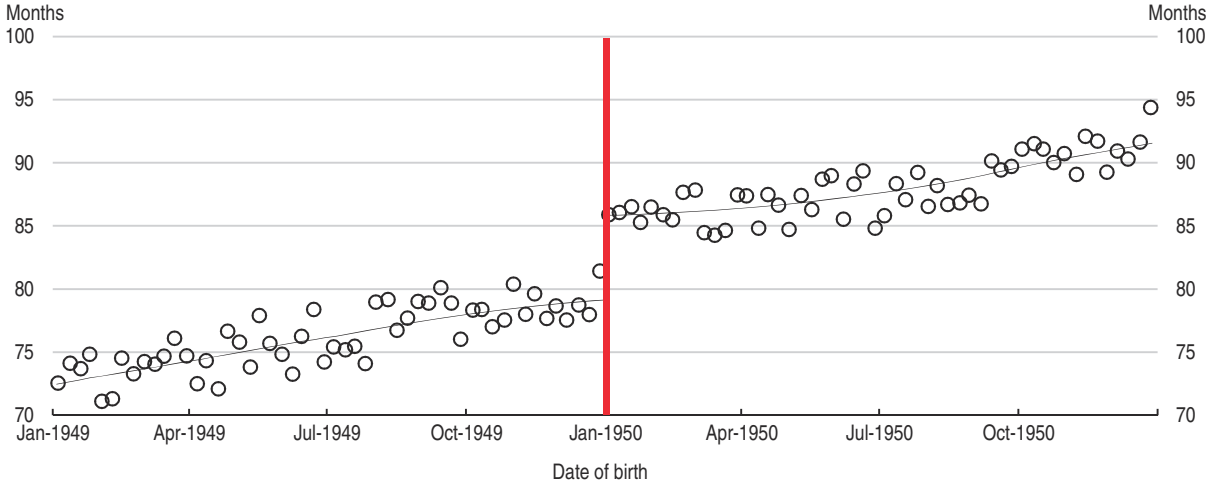
As in many other European countries, longer entitlement periods to unemployment insurance benefits are provided for older unemployed. In Finland, those aged above 61 on the day their unemployment insurance expires qualify for extended unemployment benefits until the statutory pension age (the "unemployment tunnel"). The unemployment tunnel increases inflows to unemployment substantially, as employers tend to target dismissals to eligible individuals, and because eligible workers may voluntarily choose to use the tunnel. Furthermore, the tunnel reduces outflows from unemployment, as extended eligibility to unemployment benefits discourages job-search. The tunnel is often used as a bridge to retirement, in practice extending benefit eligibility indefinitely. Indeed, the incidence of unemployment peaks at the age of 62, and the unemployed aged 62 or more tend not to search for jobs (Kyyrä and Pesola, 2017; *OECD Economic Survey of Finland, 2016*).

A pension reform taking effect in 2017 raises the statutory pension age gradually from 63 to 65 years before linking it to life expectancy from 2030 onwards, and increases the age threshold for the unemployment tunnel from 61 to 62 years. Increasing the pension age has put the pension system on a sustainable trajectory, but ageing costs are still expected to show up in unemployment, health and long-term care expenditures. The reform is expected to raise the average retirement age by one year, but only increase time in employment by five months due to higher unemployment. Time in employment would only increase by three months if the age threshold for the unemployment tunnel was not raised (Economic Policy Council, 2015). A previous two-year increase in the age threshold increased employment within the affected age group by seven months (a 9% increase) (Figure 2.17) and resulted in a substantial increase in individual net income, as well as EUR 500 million in fiscal savings for each birth cohort over a 10-year period. Disability and sickness benefits were not affected by the reform, and no effects were found on mortality

and the spouse's labour force participation (Kyyrä and Pesola, 2017). Even though a positive employment effect can be expected from raising the threshold in the latest pension reform, the distance between the statutory pension age and the unemployment tunnel age threshold widens, and changes to pension accrual rules considerably increase incentives to opt for the unemployment tunnel. Given the substantial positive effects on employment and public finances from increasing the age threshold, together with the absence of negative side-effects, the unemployment tunnel threshold should as a minimum increase in line with the statutory pension age. Furthermore, disability pensions should be restricted to medical conditions only, the eligibility criteria for the new years-of service pension should be kept strict and selective measures to allow early retirement should be avoided (*OECD Economic Survey of Finland, 2016*; European Commission, 2017).

Figure 2.17. **Shortening the unemployment tunnel increases employment substantially**

Months employed in 2004-13 by birth week



1. The unemployment tunnel age threshold was increased from 55 to 57 years in 2005, only applicable to individuals born after 1949.
Source: Kyyrä and Pesola (2017).

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Flanking policies to boost matching, supply and demand for labour

The employment impact of a given policy reform, such as improving work incentives, depends on the institutional context, and tends to be greater the more employment-friendly the overall institutional framework is (Bassanini and Duval, 2009). Notwithstanding some room for improvement, the institutional context in Finland is generally favourable.

Education and life-long learning

Labour market outcomes depend crucially on education and skills (OECD, 2015). In Finland and the other Nordic countries, a compressed wage distribution leads to relatively low skill premiums. The return to education is hence to a large extent reflected in higher and more stable employment (Pareliussen et al., 2018b).

Finland is renowned for its excellence and equity in compulsory education, and still ranks among the top countries in the OECD Programme for International Student Assessment (PISA), despite a downward trend in PISA results since 2006 and some skill shortages (OECD, 2016c; OECD, 2017c). Furthermore, skill use at work is among the highest in the OECD (OECD, 2016d). Some areas of concern remain, apart from overall declining results.

Boys are increasingly falling behind girls, notably in reading, the drop-out rate from secondary education is high, and enrolment in early childhood education is low, a feature which should be seen in the context of work incentives for single parents and second earners (*OECD Economic Survey of Finland, 2016*). Steps are taken to further improve compulsory education, notably through "phenomenon-based learning", which consists of multidisciplinary collaborative projects resembling real-life problem solving more closely.

Around 40% of upper secondary students follow the three-year vocational track. The *OECD Economic Survey of Finland 2016* pointed to the need to strengthen foundation skills within vocational education and consolidating the high number of programmes and formal vocational qualifications in order to improve graduates' adaptability to a changing world of work. Engaging employers in the apprenticeship system can also improve the alignment between the supply and demand of skills (OECD/ILO, 2017). A new core curriculum came into force in the second half of 2016, putting more emphasis on basic skills, such as reading and mathematics. The programme structure has also been reformed, with fewer and broader qualifications. The strict distinction between universities and universities of applied science (formerly termed polytechnics) has been removed, the use of university entrance exams will be strictly limited from 2020 and a series of mergers in the university sector is underway. This consolidation of the tertiary education sector, together with a move towards modular qualifications in universities and upper secondary education hold the potential to improve people's flexibility to re-train and adapt their qualifications to the changing needs of the labour market.

Active labour market policies

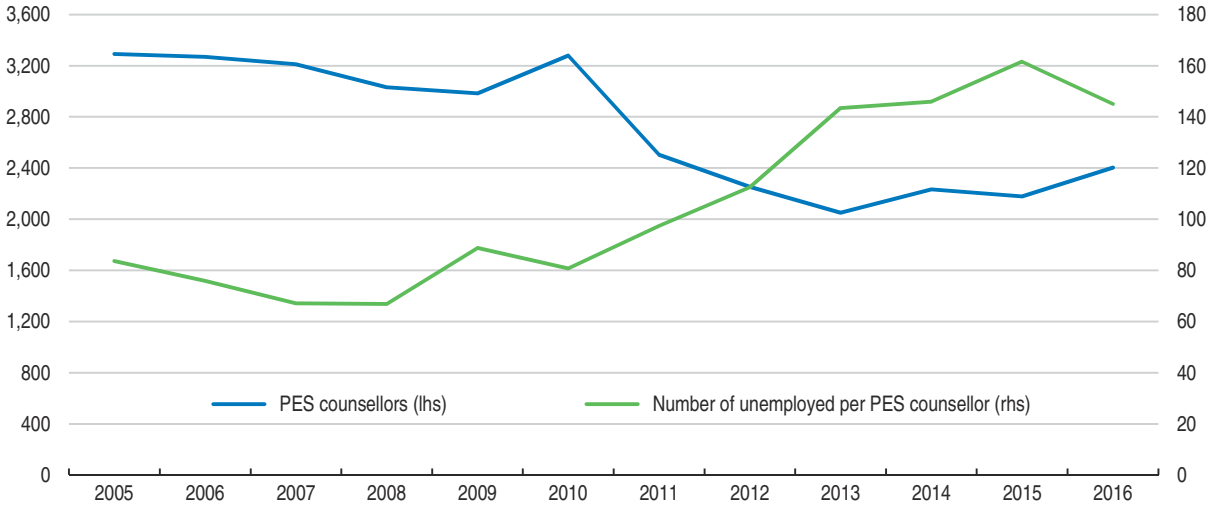
The Finnish public employment service has undergone major changes in the past few years, from being highly decentralised to the current centralised structure, with the aim to harmonise services and improve efficiency in delivery (OECD, 2016e). A centralised structure aligns incentives with responsibilities, since the bulk of the cost of unemployment is borne by the central government. However, as of 2020, 18 new regions are to take over the responsibility for employment services, which they will purchase from public, private and third-sector providers. This reform represents a leap into uncharted territory, and its success depends on a number of factors, including the development of the necessary IT infrastructure and appropriate procurement models and systems to ensure quality in provision, foster competition and avoid cream-skimming from service providers. Furthermore, funding for the new regions will not be earmarked to different purposes. Hence, there is a risk that overruns in healthcare or social expenditures could crowd out funding for employment services. A shift towards payments to providers based on employment outcomes, as signalled in the 2018 budget proposal, has shown some merit in initial trials (OECD, 2016e), and a similar model targeted towards immigrants is being trialled, where returns to investors in a "social impact bond" is tied to participants gaining employment. Such trials provide useful experience in preparation for the 2020 regional reform.

The unemployment surge following the 2008 financial crisis, along with budget cuts, have put the employment service under strain. The number of unemployed per caseworker more than doubled from 2008, despite a slight improvement in 2016 (Figure 2.18). Although spending on active labour market policies is high, notably on labour market training, total public expenditure on employment service administration and counselling is low relative to unemployment benefit spending. The new requirement to work or participate in activation activities at least 18 hours every three months, the new job-search requirement and recent

tightening of the obligation to accept job offers or participate in activation schemes can improve outcomes, together with long-standing practices of job referrals and individual employment plans as well as cooperation with employers (OECD, 2016f). However, these policies require close follow-up, coaching and monitoring to be effective, in line with the government's decision to have more frequent meetings with caseworkers from the beginning of 2017. Funding for the employment service was increased in 2017, and shifting some funding from relatively expensive activation programmes towards more and earlier face-to-face contact with a jobseeker could be considered. Policies towards older and low-skilled displaced jobseekers who seem to have less access to ALMPs compared to other groups and who find it more difficult to return to employment should also be strengthened (OECD, 2016e; OECD, 2015; Ministry of Finance, 2017b; European Commission, 2017; *OECD Economic Survey of Finland, 2016*).

Figure 2.18. **Rising unemployment and budget cuts have put the employment service under strain**

Number of PES counsellors and jobseekers per counsellor



Source: Ministry of Employment and Industry of Finland.

StatLink http://dx.doi.org/10.1787/888933662901

A further challenge is to adapt activation policies to non-standard workers, and also seize the opportunities from new types of employment. A first step is to provide the same quality of activation to those who are out of work, but not entitled to unemployment benefits. Finland already requires social assistance recipients to participate in activation. Furthermore, services targeted at disadvantaged groups need not necessarily be limited to those out of work. Providing "in-work progression" services, for example offering training and mentoring, could help individuals in non-standard or unstable employment. Attendance could be voluntary, or it could be mandatory in cases where individuals receive housing, social assistance or unemployment benefits as earnings top-ups (OECD, 2015; OECD, 2017a).

Even though employment outcomes from several activation policies in Finland seem positive, it is not possible to establish causality between measures and outcomes (OECD, 2016e). Building on its strong tradition of performing small-scale trials before rolling out new policy initiatives, Finland could emulate several countries which have set up special "behavioural economics" teams responsible for performing controlled experiments to improve the effectiveness of policies (Box 2.3).

Box 2.3. **Examples of controlled experiments in activation policies**

The use of behavioural sciences to guide policy has become commonplace in many countries. Case studies from the United Kingdom and Singapore illustrate how controlled experiments can contribute to improving design, implementation, and effectiveness of policy.

United Kingdom: Interventions encouraging people to search for work were implemented gradually in Jobcentre Plus in 2013-14. The order in which the centres made the switch was randomised, creating a treatment group and control group. The interventions consisted of:

- **Simplification:** The first appointment in Jobcentre Plus was streamlined, with job-seekers building a relationship with their advisor and discussing their job search from the start.
- **Planning aid:** A commitment pack specifying where, when and how job-seekers were going to complete their job search activities was developed in cooperation between job-seekers and caseworkers. The new commitment pack asked job-seekers to plan their job search and then carry it out, rather than simply requiring that job-seekers document what they had done retrospectively.

The result of the interventions showed a 1.7 percentage point increase in the proportion of people exiting benefits in 13 weeks relative to the business-as-usual model. This suggests that simplifying processes, focusing on job search rather than meeting minimum requirements, and planning aids were successful at supporting job-seekers to find employment.

Singapore: A study identified four key barriers to re-employment. Job-seekers tended to be passive in the job search process and rely on caseworkers to look out for and arrange job interviews for them. Commitment and turnout for training sessions and interviews arranged by their caseworker were low. Job goals and wage expectations were unrealistic. Repeated failed attempts to find a job led to loss of motivation and self-esteem. In 2013, a test group and a control group were randomly selected. The test group received the following interventions:

- **Commitment device:** Job-seekers signed their commitment to the job search programme on the cover page of a job booklet.
- **Chunking:** The job booklet guided job seekers to plan the specific job search activities, with the process broken down into a series of smaller tasks. In meetings with their caseworker every one to two weeks, accomplishments would be reviewed and feedback given to reinforce positive behaviour.
- **Incentive:** Those who completed five sessions or found a job received a SGD 100 (about USD 80) voucher.
- **Social norms and priming:** The consultant rooms were re-designed with visual representation of the number of successful job seekers and information about "hot jobs" for motivation. Vacancy statistics and information about average salary ranges were displayed to nudge job seekers into adopting more realistic job expectations.

The job-finding rate after three months was 53% higher in the treatment group than in the control group. Job-seekers developed a stronger sense of ownership and accountability, and the increased frequency of meetings, along with the structured job search process, had nurtured stronger and more positive relationships between career consultants and job seekers.

Source: OECD (2017d), *Behavioural Insights and Public Policy: Lessons from Around the World*, OECD Publishing, Paris.

Wage bargaining

National-level collective agreements extended by law to cover around 90% of workers, the previous norm in Finland, is ending after the Finnish Confederation of Industries decided to unilaterally terminate all central-level agreements in 2017. The new Sweden-inspired "Finnish model" agreed in principle as part of the competitiveness pact implies a move towards a system where sector-level collective agreements are coordinated following the lead of export industries. Such a system can yield efficient macroeconomic outcomes while increasing the flexibility to adjust relative wages between sectors. The government has taken steps to increase the scope for firm-level bargaining, leaving room for local agreements better suited to local conditions and the needs and preferences of individual workers and employers. Successful examples of such "organised decentralisation" of wage bargaining can be found in Sweden, Germany and Norway, among others (OECD, 2017a). These systems generally perform better in achieving efficient macroeconomic outcomes than in adapting relative wages between sectors and professions, but can contribute to constructive labour relations and flexibility at the different bargaining levels (Pareliussen et al., 2018a). Wage increases can for example be traded for more flexible working time arrangements in order to adapt production better to fluctuations in demand and input prices.

However, attempts to decentralise the Finnish bargaining process from 2007 to 2010 contributed to eroding competitiveness, as coordination broke down. Institutionalising the sequence of negotiations with exporting sectors taking the lead, strengthening the state mediator and strengthening the process to build a common understanding and common analyses of the underlying facts, fundamentals and a reasonable level of overall wage growth, would increase the likelihood of efficient overall wage growth. However, the strength and resilience of wage bargaining institutions depends on their ability to repeatedly prove their usefulness and build trust by securing fair, efficient outcomes and peaceful, constructive labour relations. Wage negotiations taking place in 2017 and 2018 will be the first test of the new Finnish model (*OECD Economic Survey of Finland*, 2016; OECD, 2017a). Sectoral agreements concluded so far have been in line with the example set by exporting industries and are expected to slightly improve price competitiveness. Coordination hence seems to work despite the failure to reach a formal agreement on a Finnish wage bargaining model.

Employment protection legislation

The *OECD Economic Survey of Finland 2016* pointed to restrictions to hiring workers on temporary contracts and a short trial period as an impediment to hire, as employers had little opportunity to test the capabilities of new hires. The trial period has since been extended, and conditions for hiring on temporary contracts eased. Furthermore, strict regulation of individual dismissals induces costs and uncertainty, potentially harming productivity by impeding efficient flows of human capital. At the margin, flexibility in traditional employment contracts will affect firms' decisions to hire on temporary or regular contracts, but it will also affect the choice between hiring or buying services from freelancers. Flexible employment protection combined with a solid and flexible social safety net is thus the best option to provide stable and secure situations for workers in general.

Summary and recommendations

The combination of different working-age benefits, childcare costs and income taxation creates complexity, reduces work incentives and holds back employment. Major disincentives in Finland are related to tapering rules for unemployment benefits, social assistance and the housing benefit, the extended unemployment benefit for older workers, the childcare fee structure and the homecare allowance. Improved benefit design combined with efficient activation policies can reduce complexity, remove the strongest disincentives and make the benefit system more robust to changes in working life. Comparing two different scenarios: a uniform benefit for all ("basic income") and a universal tapering rule ("universal credit"), shows that the general direction of reform matters, and leads to considerable differences in incentives, inclusiveness and affordability.

The current benefit system targets transfers according to peoples' needs and circumstances. For this reason, replacing current benefits with a basic income would lead to a drastic redistribution of income and likely increasing poverty, even though a basic income would entail a simplification and would improve incentives for some.

Merging working-age benefits with similar aims and coordinating their tapering against earnings would on the other hand drastically improve work incentives and transparency, while preserving or strengthening social protection. Moving the benefit system step by step in this direction therefore seems to be a solution better adapted to Finland than implementing a basic income. Once the new income registry comes online, linking benefit payments to real-time incomes, combined with strengthened work incentives and a strong activation framework, would make for a truly efficient and inclusive benefit system, fit for the future of work.

Recommendations to reform working-age benefits

Main recommendations

Harmonise working-age benefits and coordinate their tapering against earnings.

Upon completion, use the income registry to adjust benefits to income in real-time.

Use the income registry to provide better tools for clients to evaluate the financial consequences of their work decisions.

Restructure the homecare allowance to foster participation in childcare and incentivise employment.

Calculate childcare fees on individual incomes.

Increase the age threshold for extended unemployment benefits at least in line with the statutory pension age.

Further recommendations

Strengthen employment services.

Ensure a stepwise and gradual transition and adequate resources in connection with the regional reform.

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