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OVERVIEW



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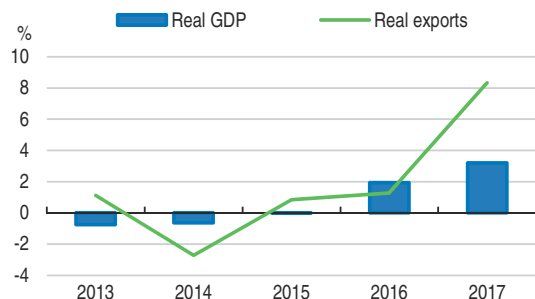
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Executive summary

- *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 strongly¹



1. OECD estimates for 2017 exports.

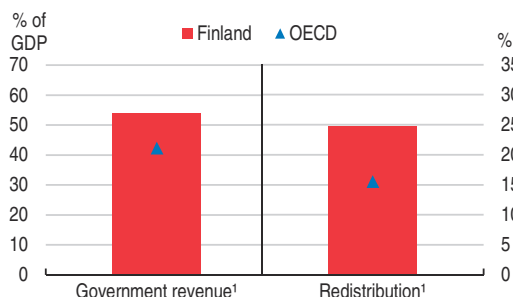
Source: OECD National Accounts.

StatLink <http://dx.doi.org/10.1787/888933662217>

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.

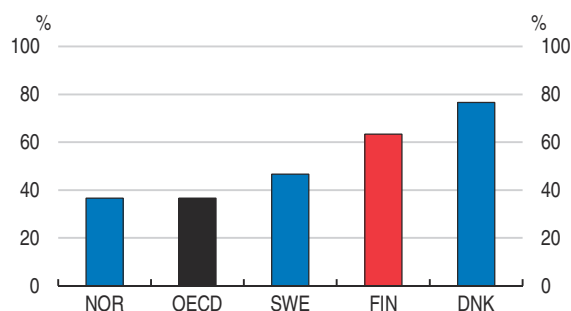
Source: OECD National Accounts; and Income Distribution and Poverty Database.

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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 pay¹



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).

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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	
<p>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.</p>	<p>Timely strengthening of budget buffers is needed.</p>
Financial stability	
<p>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.</p>	<p>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.</p>
Tax reform to support growth	
<p>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.</p>	<p>Further reduce the tax burden on labour.</p> <p>Increase minimum- and maximum- rates on recurrent taxes on immovable property, and better align the tax base with market valuations.</p> <p>Increase environmentally-related taxes.</p> <p>Broaden the consumption tax base and phase out reduced VAT rates.</p> <p>Continue to phase out mortgage interest deductibility.</p>
<p>Finland has high energy taxation, but also many environmentally harmful subsidies.</p>	<p>Phase out environmentally harmful subsidies.</p>
Benefit reform for employment and equal opportunity	
<p>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.</p>	<p>Harmonise working-age benefits and coordinate their tapering against earnings.</p>
<p>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.</p>	<p>Upon completion, use the income registry to adjust benefits to income in real-time.</p> <p>Use the income registry to provide better tools for clients to evaluate the financial consequences of their work decisions.</p>
<p>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.</p>	<p>Restructure the homecare allowance to foster participation in childcare and incentivise employment.</p> <p>Calculate childcare fees on individual incomes.</p>
<p>Unemployed aged above 61 are entitled to longer periods on unemployment insurance benefits, effectively providing a bridge to retirement.</p>	<p>Increase the age threshold for extended unemployment benefits at least in line with the statutory pension age.</p>

Assessment and recommendations

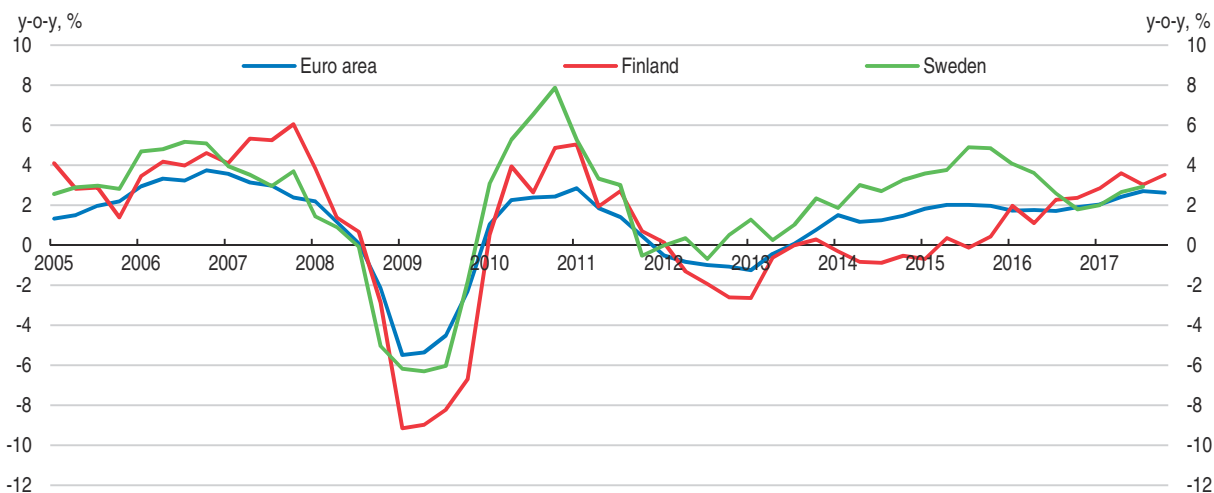
- *A strong revival in exports is boosting growth*
- *Strong economic performance and low inequality foster well-being*
- *Environmental achievements and ambitions are high*
- *Structural vulnerabilities remain in the financial sector*
- *Public finances are under pressure from an ageing population*
- *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.


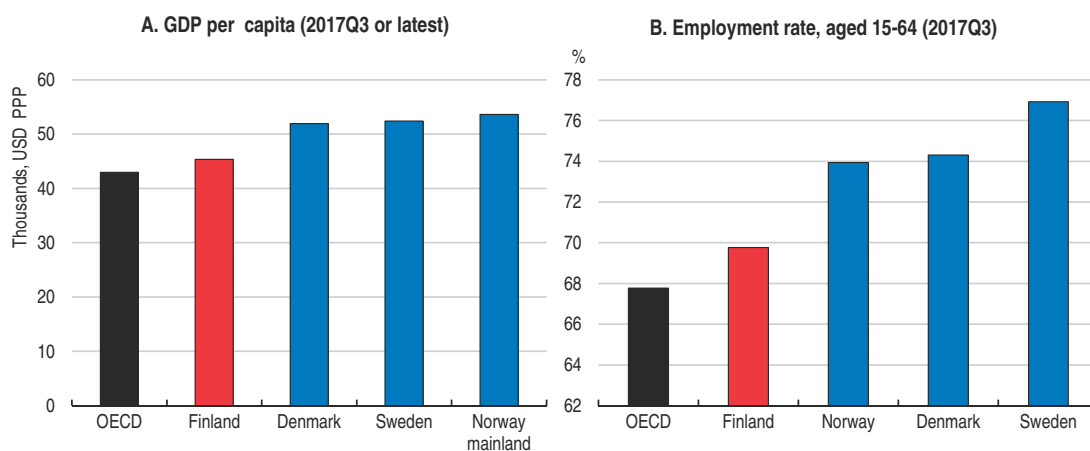
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Figure 2. GDP per capita and employment rate are below the other Nordics

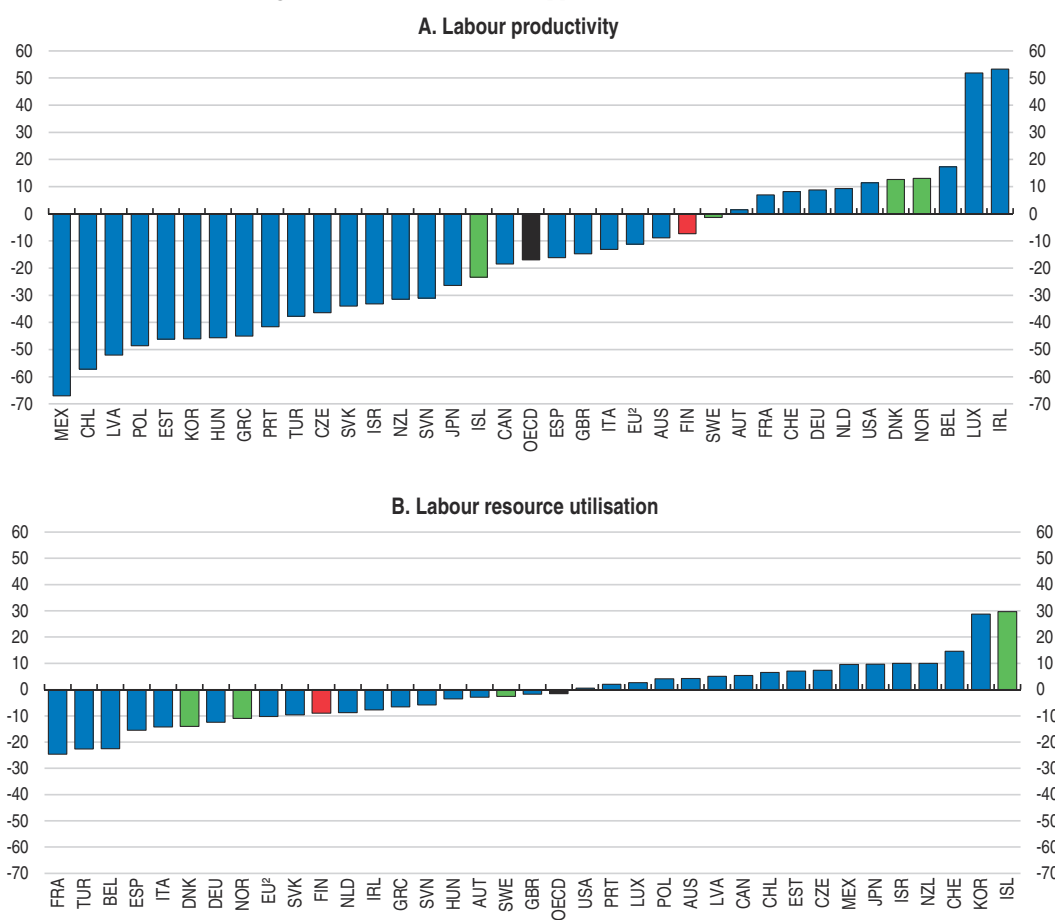


Source: OECD Economic Outlook Database; and OECD Labour Force Statistics Database and OECD Quarterly National Accounts.

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Figure 3. GDP per capita gaps reflect both productivity and labour utilisation differences¹

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.

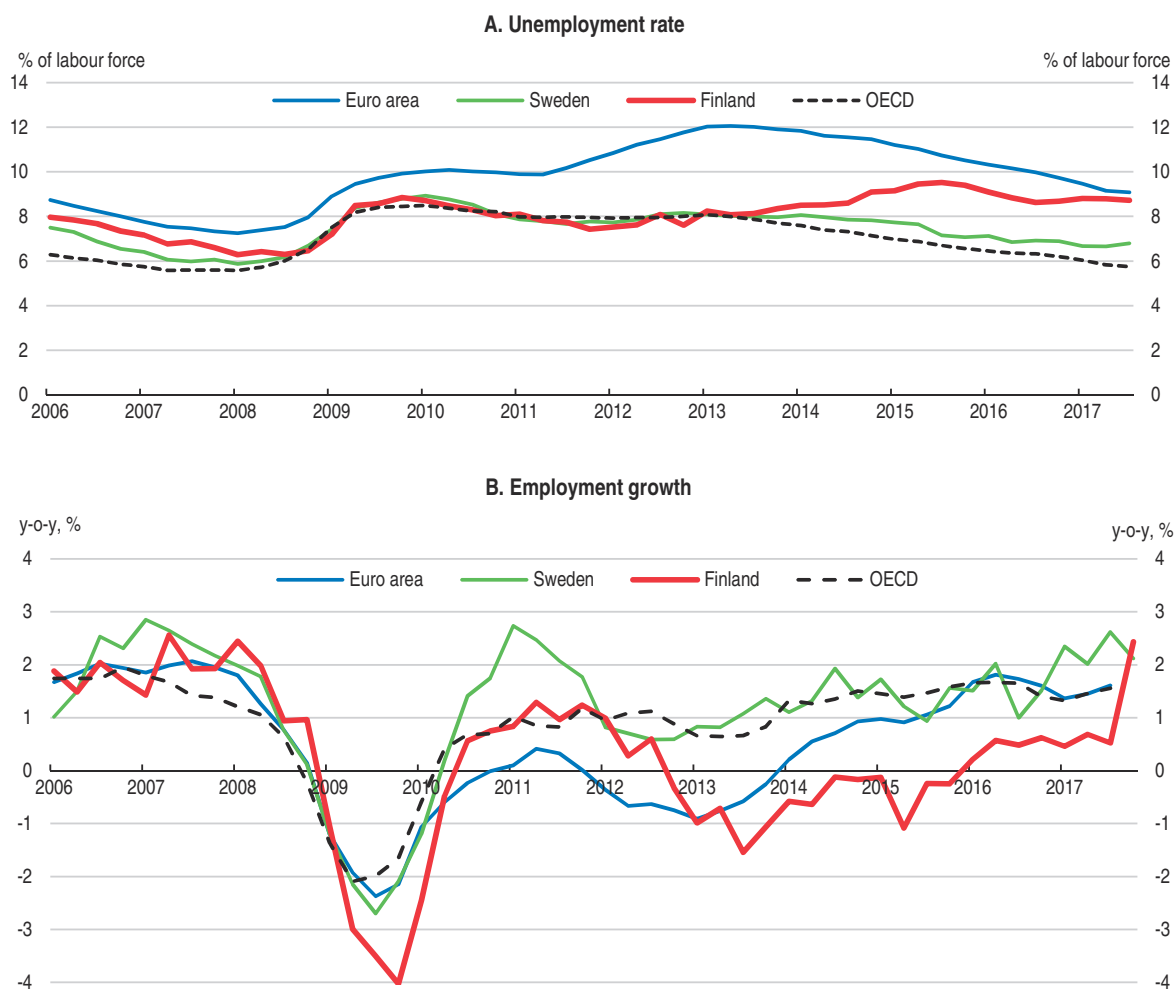
4. As a percentage of household disposable income.

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.

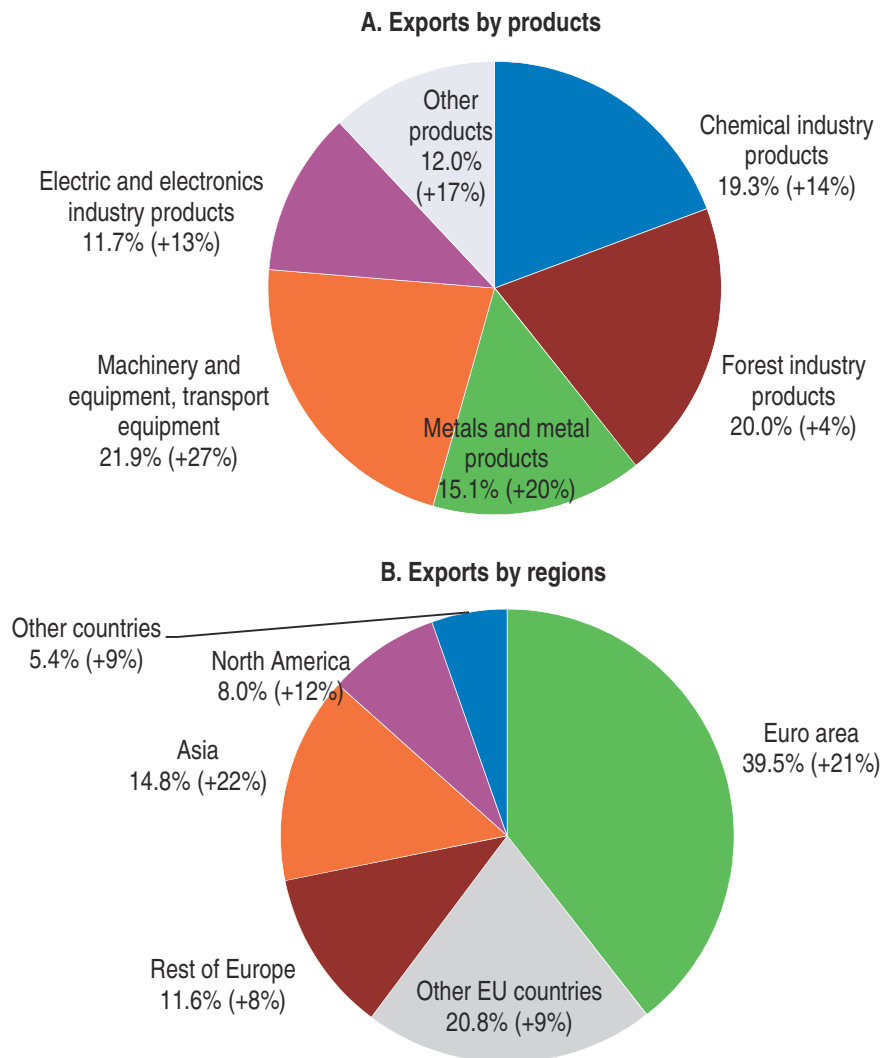
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education needs to be completed to create more centres of excellence in teaching and research. Notwithstanding a recent pick-up, total investment in R&D is now below 3% of GDP compared to close to 3.5% before the 2007 crisis – largely because of a 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**

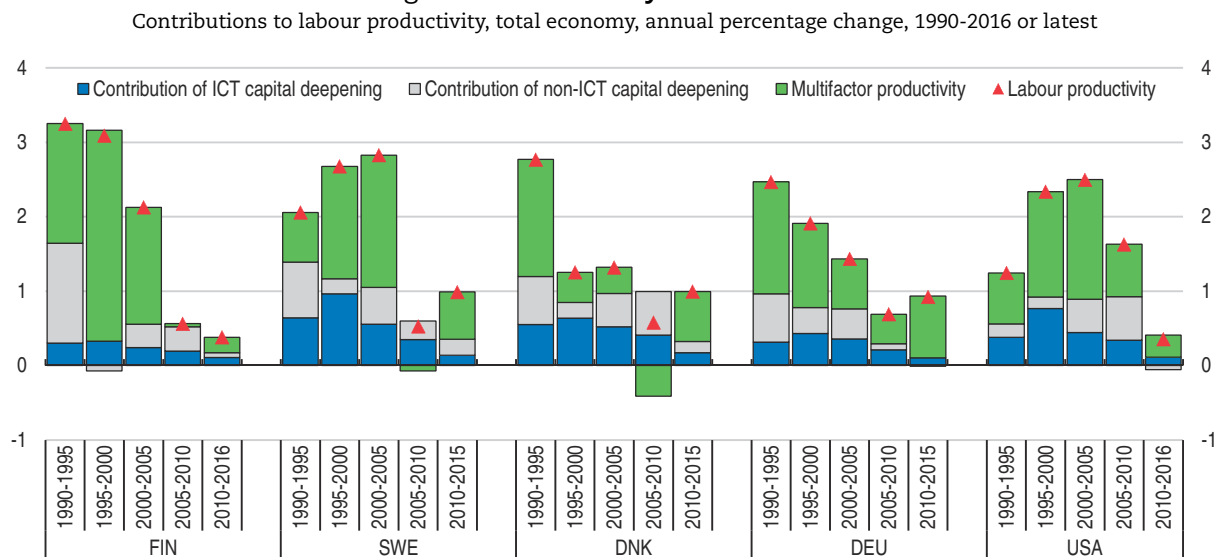
Share and change from previous year (%), 2017 Q1-Q3



Source: Finnish Customs.

StatLink  <http://dx.doi.org/10.1787/888933662388>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**

Source: OECD Productivity Statistics Database.

StatLink <http://dx.doi.org/10.1787/888933662407>

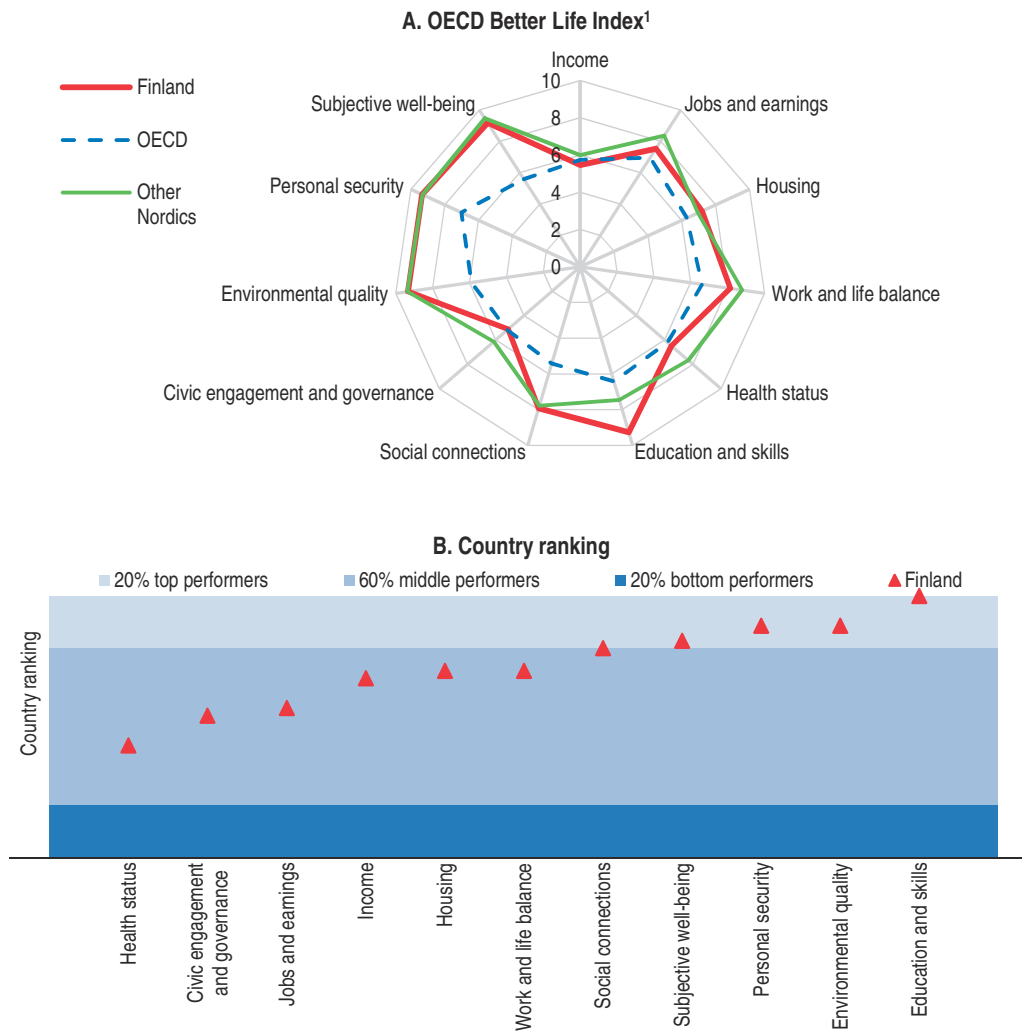
Table 3. **Past recommendations on productivity-enhancing reform**

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



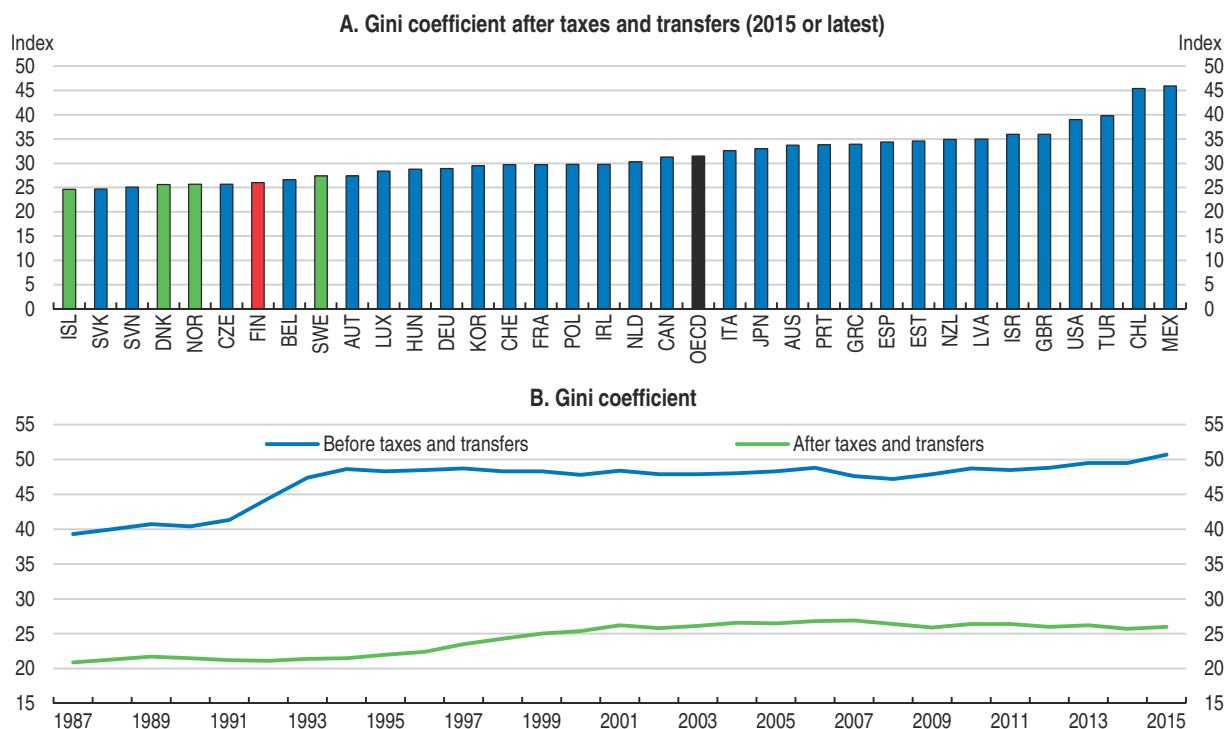
1. Each well-being dimension is measured by indicators from the OECD Better Life Indicator set. Indicators are normalised to range between 0 (worst) and 10 (best).

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**

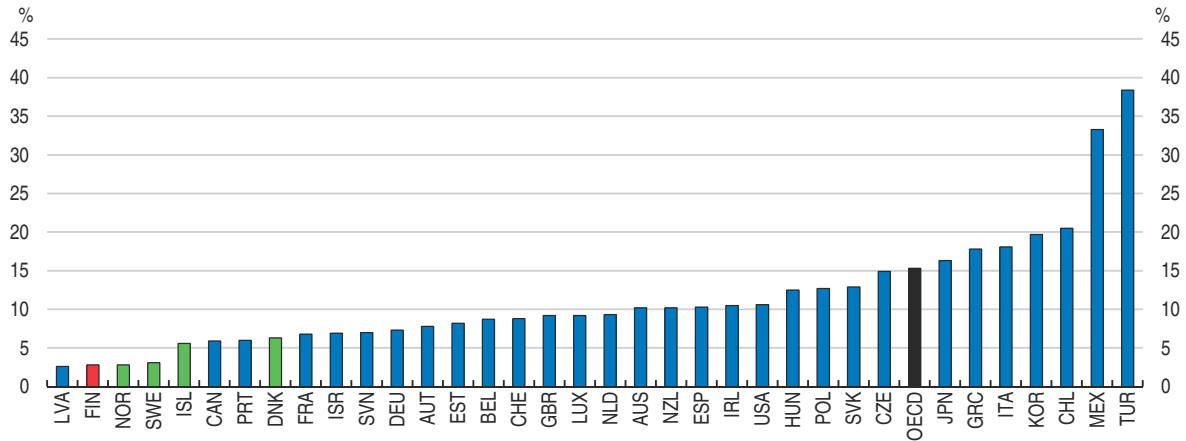
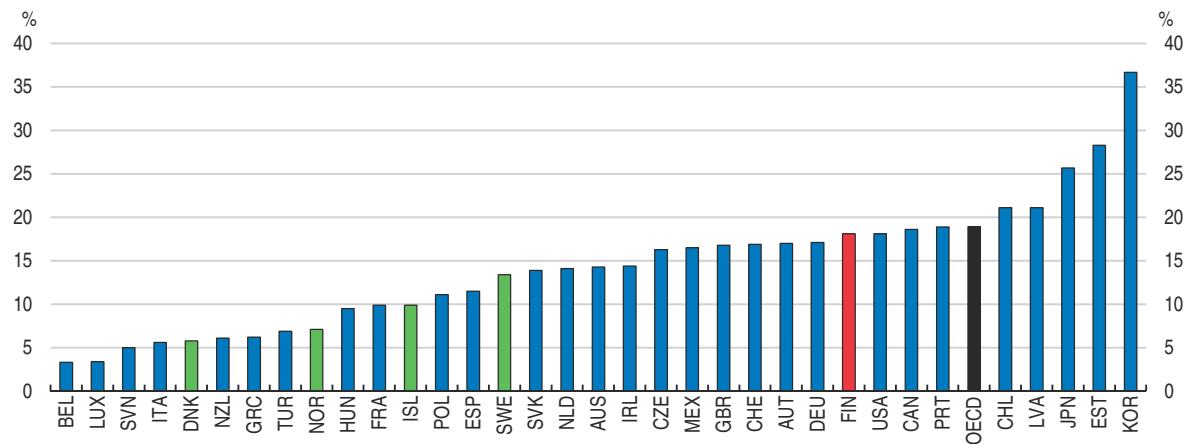
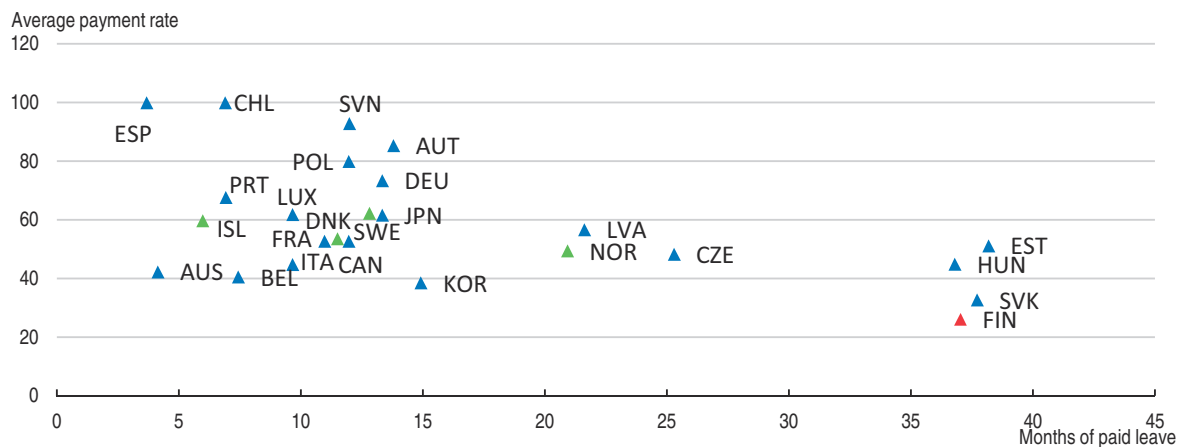
Source: OECD Income Distribution Database (IDD).

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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****A. Male-female employment rate gap, age 15-64, 2016Q4 or latest****B. Gender wage gap, 2016 or latest¹****C. Paid maternity, parental and home care leave to mothers, 2016²**

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 home care 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 CO₂-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).

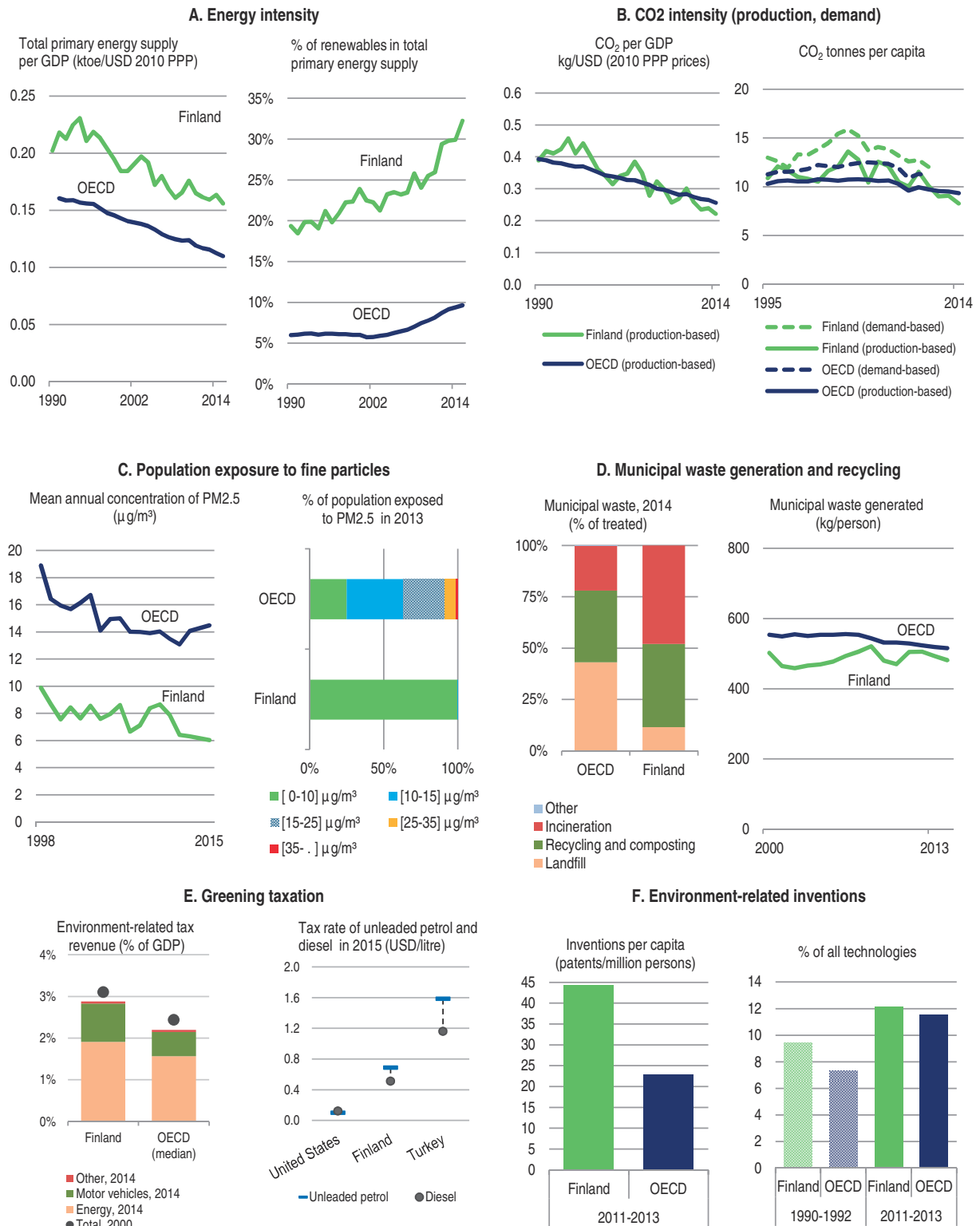
Overall air quality is among the best in the OECD and unlike nearly all other countries, good air quality is nearly uniform across the country (Panel C). Water quality is also generally good and all urban areas are well-served by sewage treatment; some rural areas have little or no collective treatment, 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).

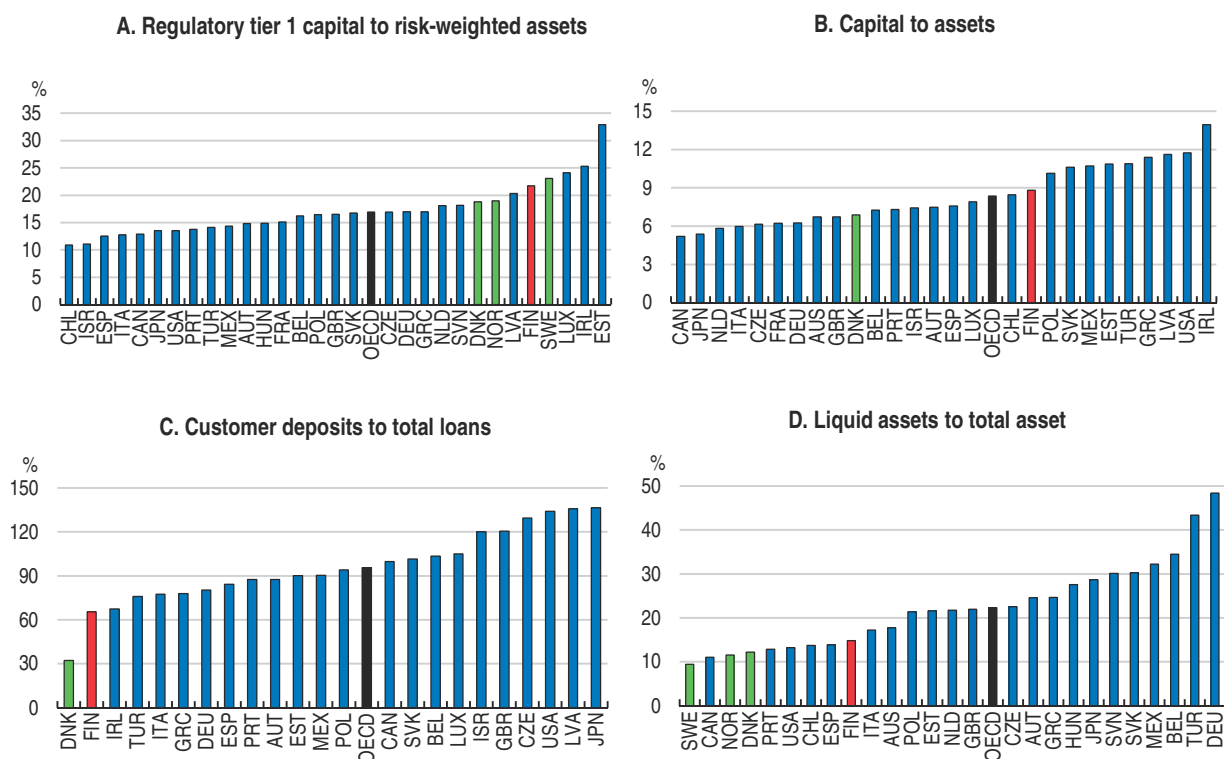
Table 5. Past recommendations on environmental sustainability

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 (Thedén, 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.

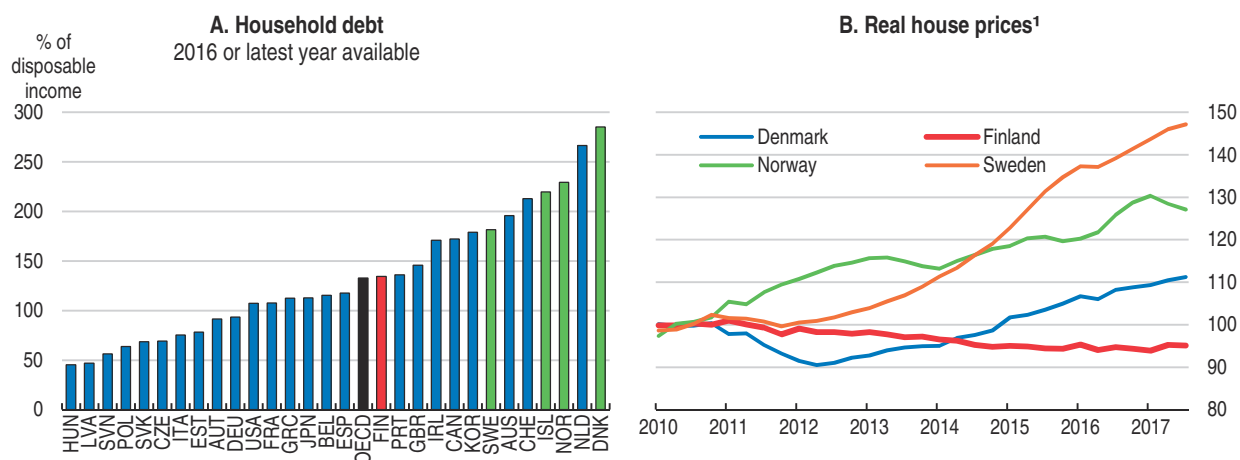
In Finland, the household debt-to-income ratio is relatively high in an OECD perspective, but much lower than in the other Nordic countries (Figure 12, Panel A). This partly reflects a more conservative behaviour of borrowers and financial institutions, in particular in terms of amortisation of loans. 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).

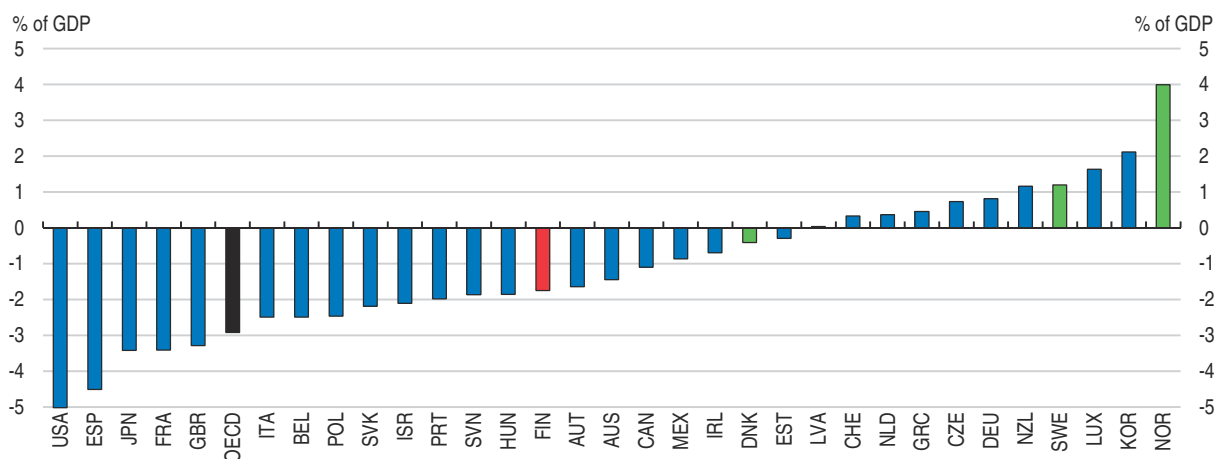
Table 7. **Impact of budget measures**

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

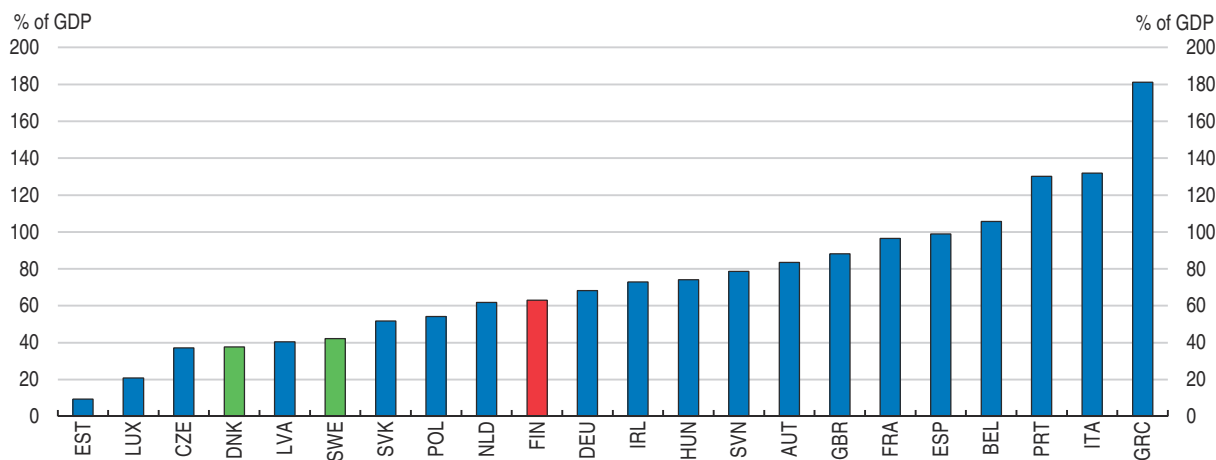
Source: Ministry of Finance.

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

A. Government financial balance (2016 or latest available)



B. Gross government debt, Maastricht definition (2016)



Source: OECD Economic Outlook Database.


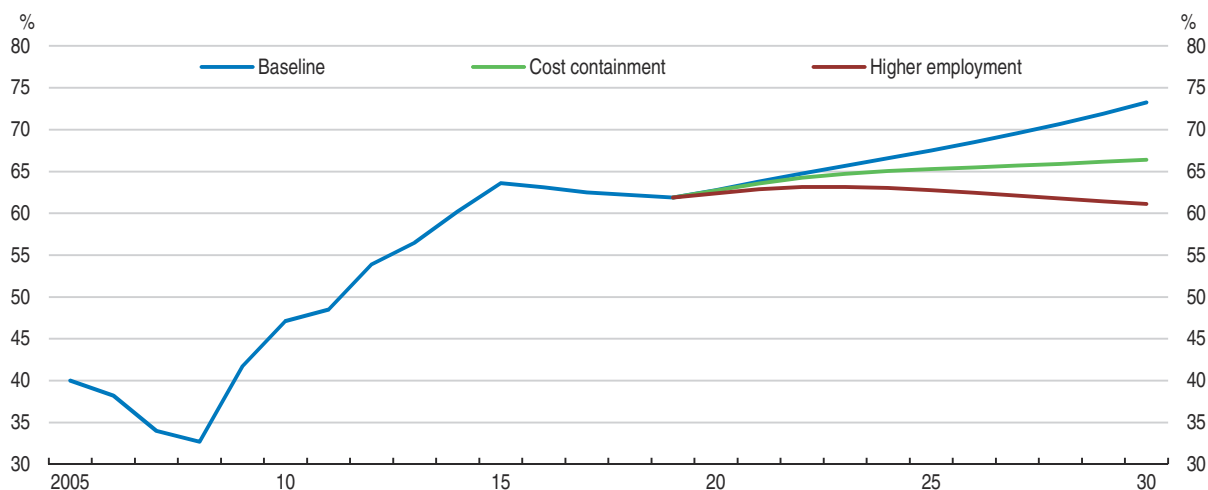
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Figure 14. **Health reform and higher employment would help stabilise debt**

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**

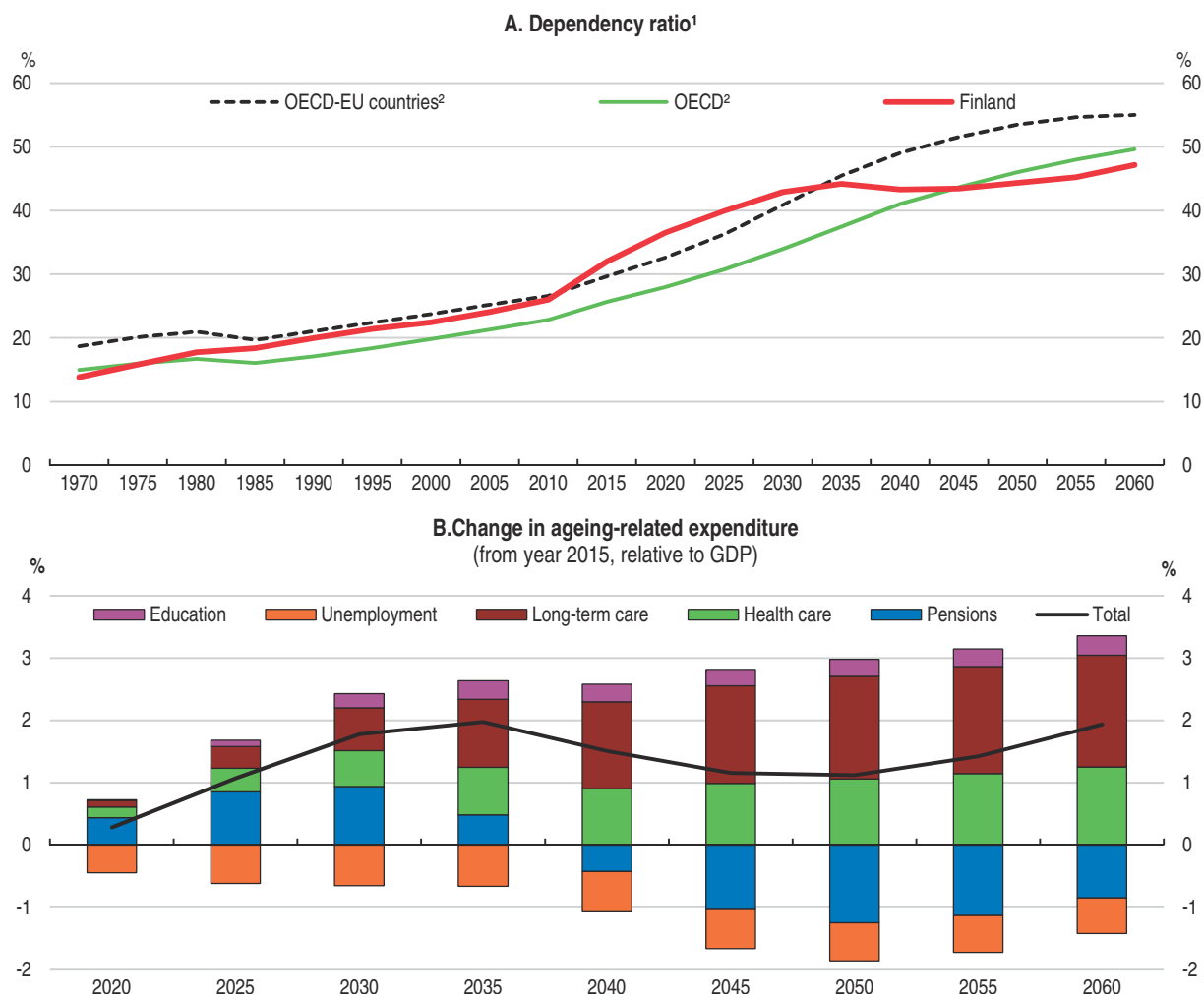
Main recent OECD recommendations	Action taken since the 2016 Survey or planned
Rationalise the organisation of health services to achieve a better balance between primary and specialised care. Drawing on existing experiences in some municipalities, a purchaser-provider split should be adopted in areas where the population base and the level of complexity of treatment allow meaningful competition.	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. 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.

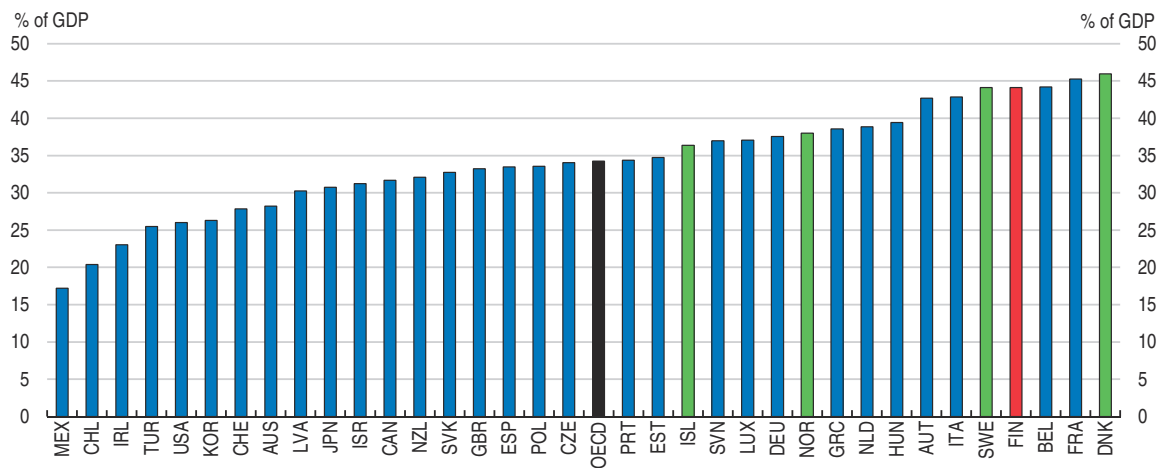
2. Weighted average.

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).

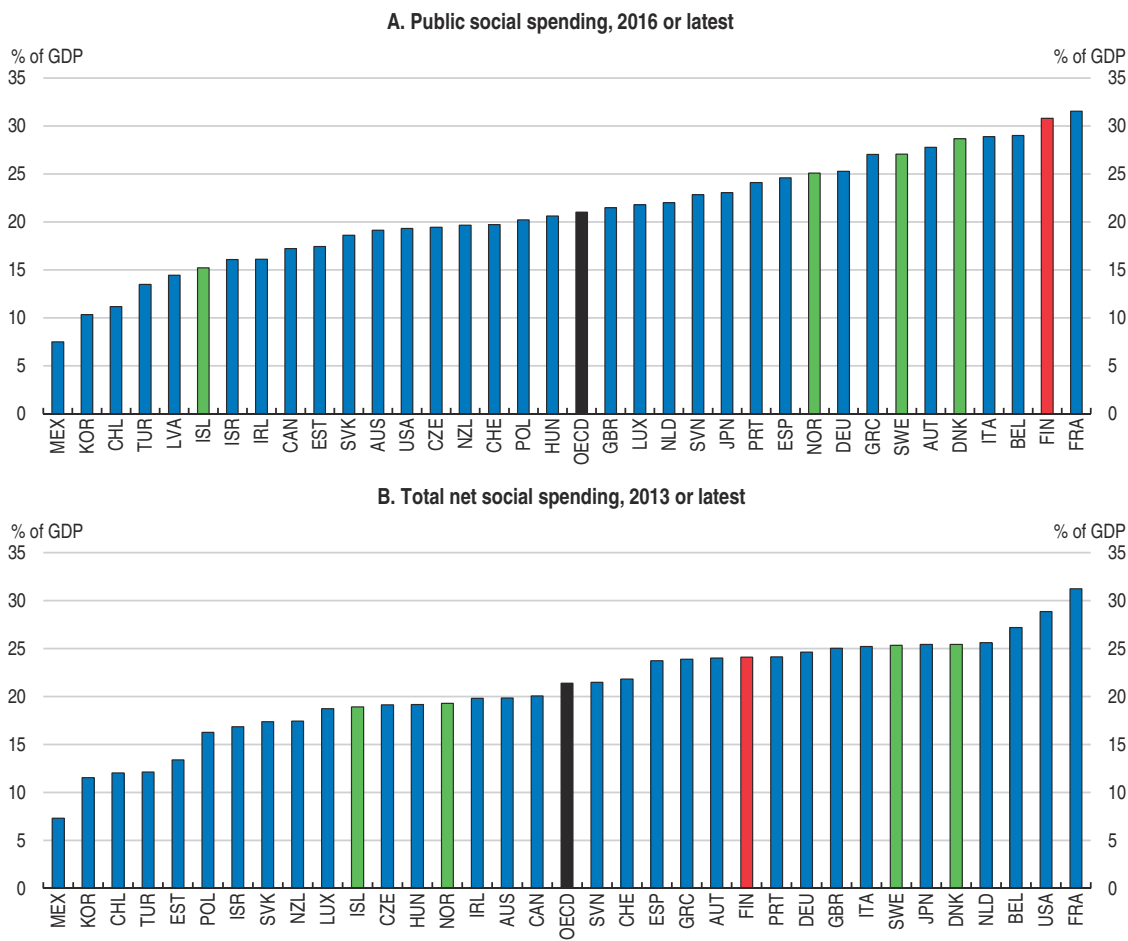
Figure 16. The tax burden is among the highest in the OECD
Taxes and social security contributions, 2016 or latest



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.

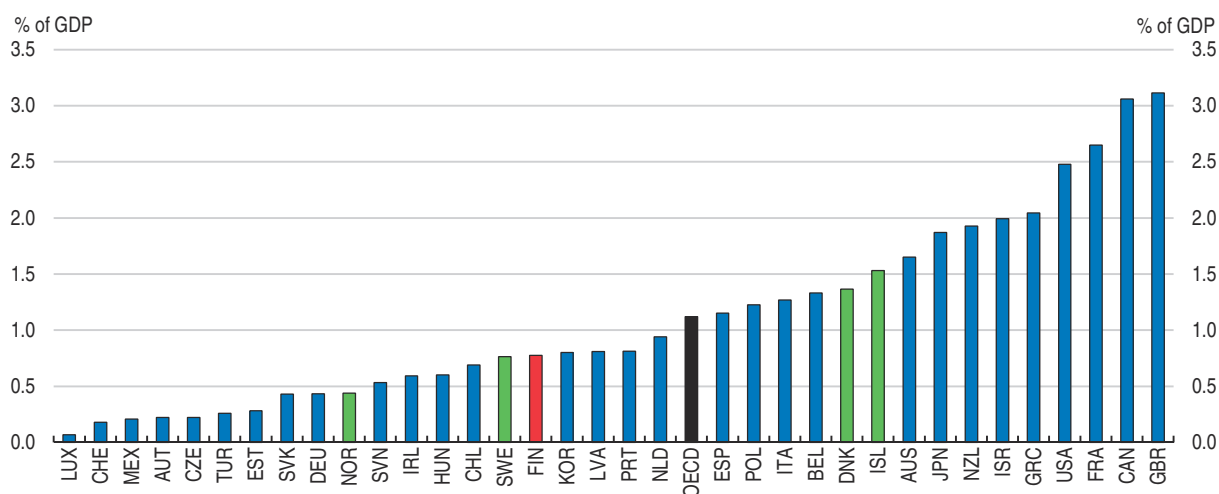
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Raising property taxes and moving further towards tenure-neutral taxation of housing


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.

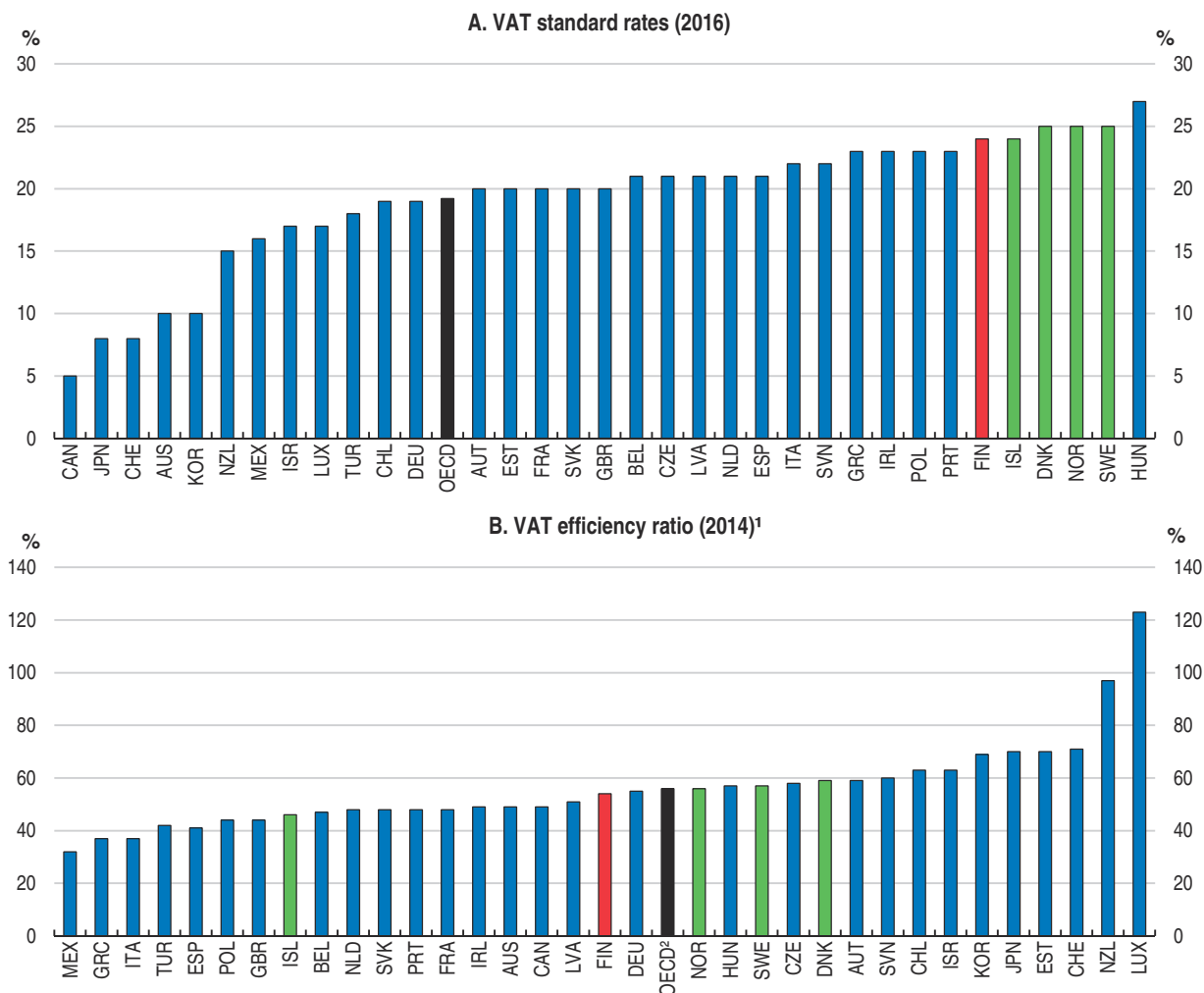
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Reducing the scope of reduced VAT rates

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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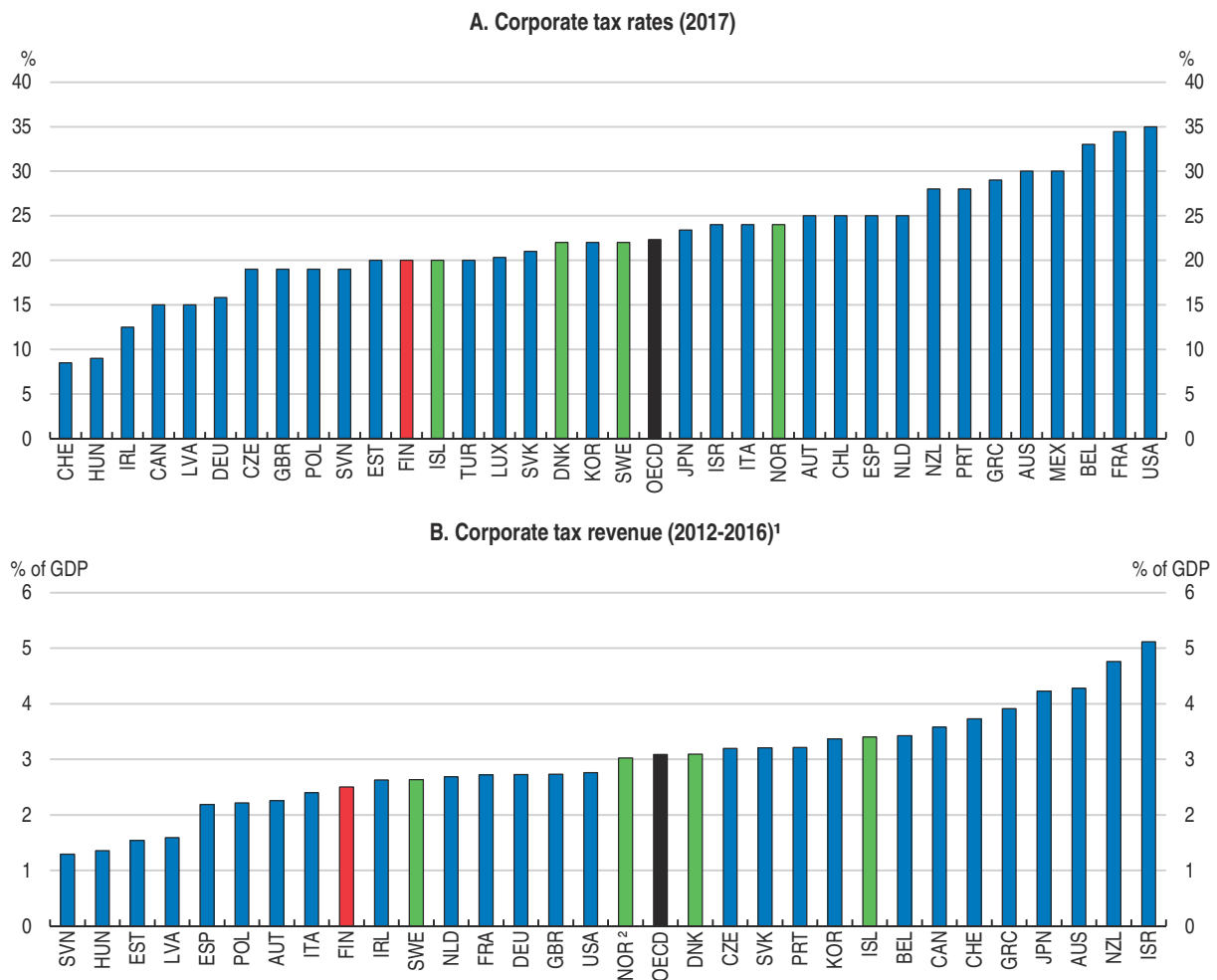
The relatively low efficiency of Finnish VAT is mainly related to exemptions and reduced rates, as compliance is high (Thackray et al., 2015; CASE, 2016). Reduced VAT rates cost about EUR 2 billion (1% of GDP) in 2014 and are the second largest tax expenditure after the total of deductions related to 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.

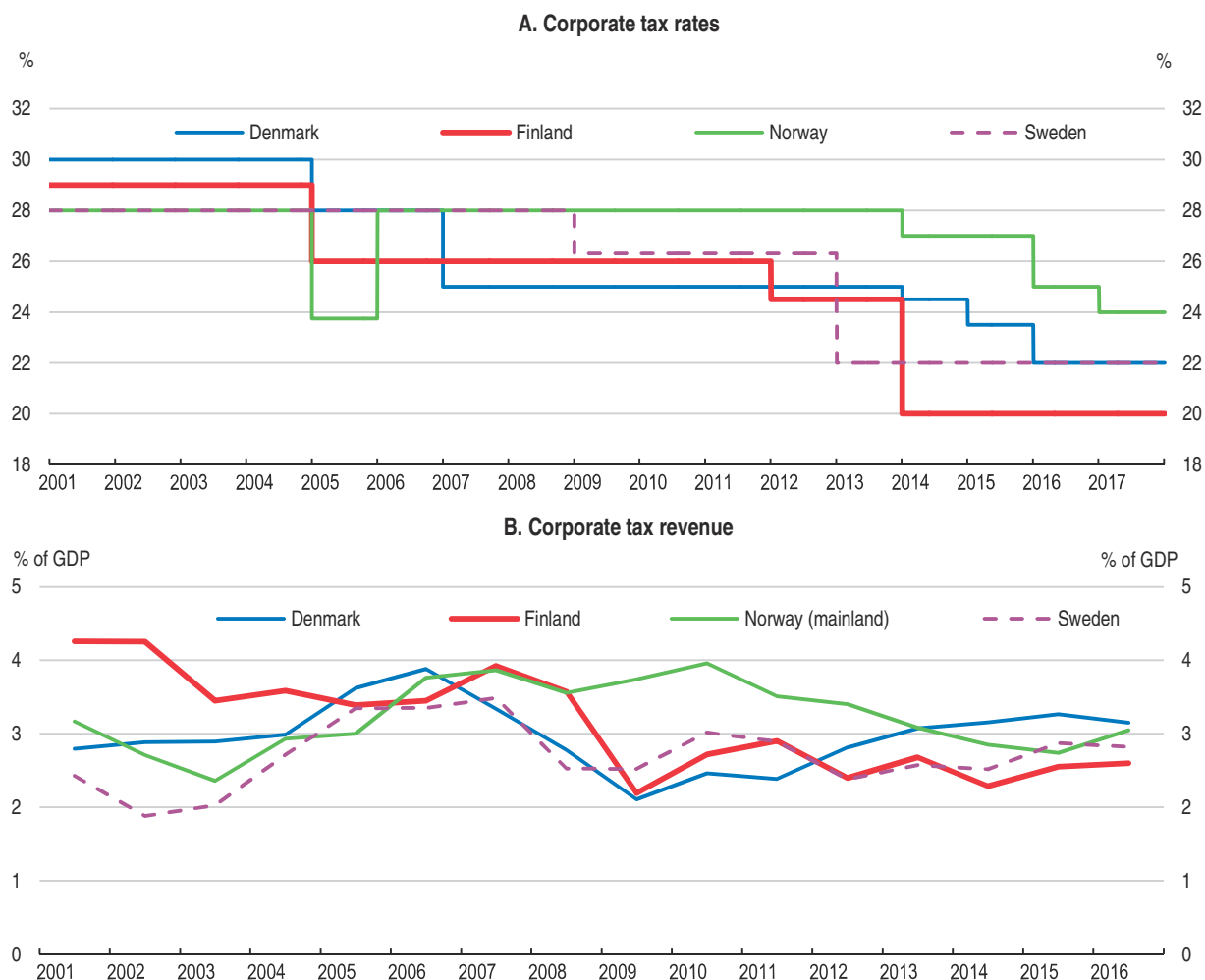
2. Mainland Norway.

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).

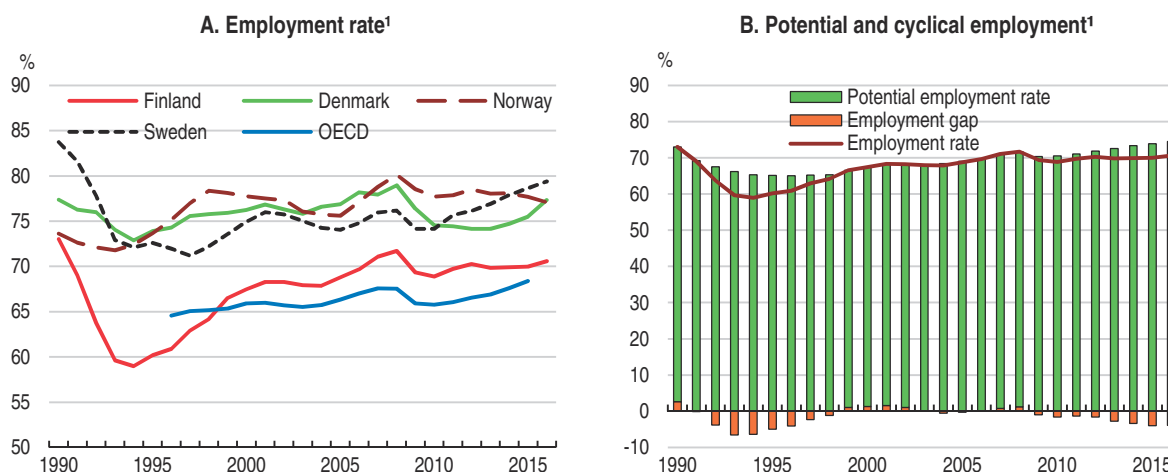
Table 10. **Past recommendations on tax reform**

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.


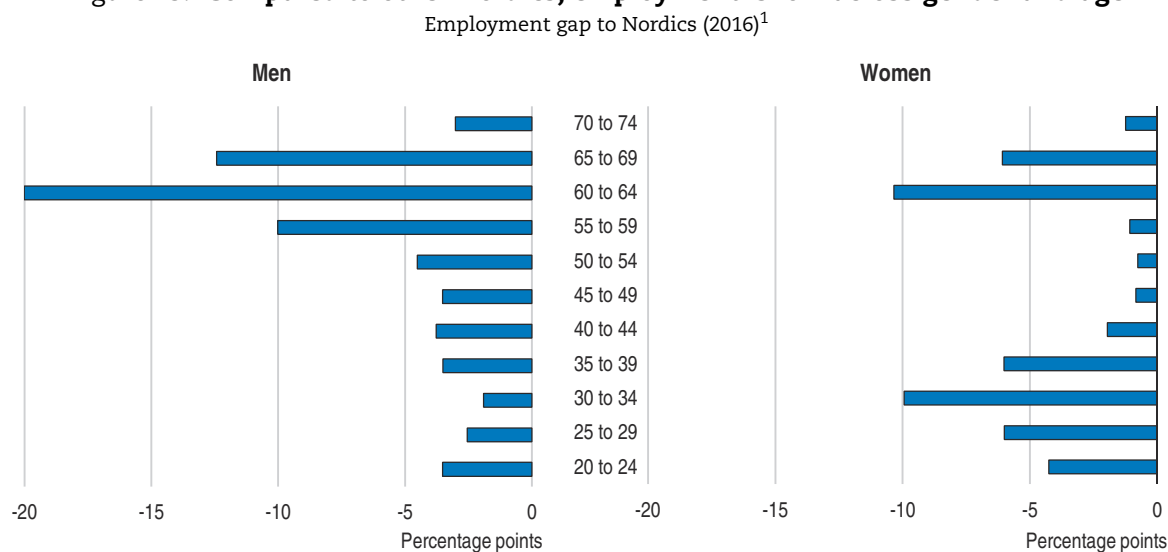

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Figure 23. **Compared to other Nordics, employment is low across gender and age**

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.

StatLink  <http://dx.doi.org/10.1787/888933662730>

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.

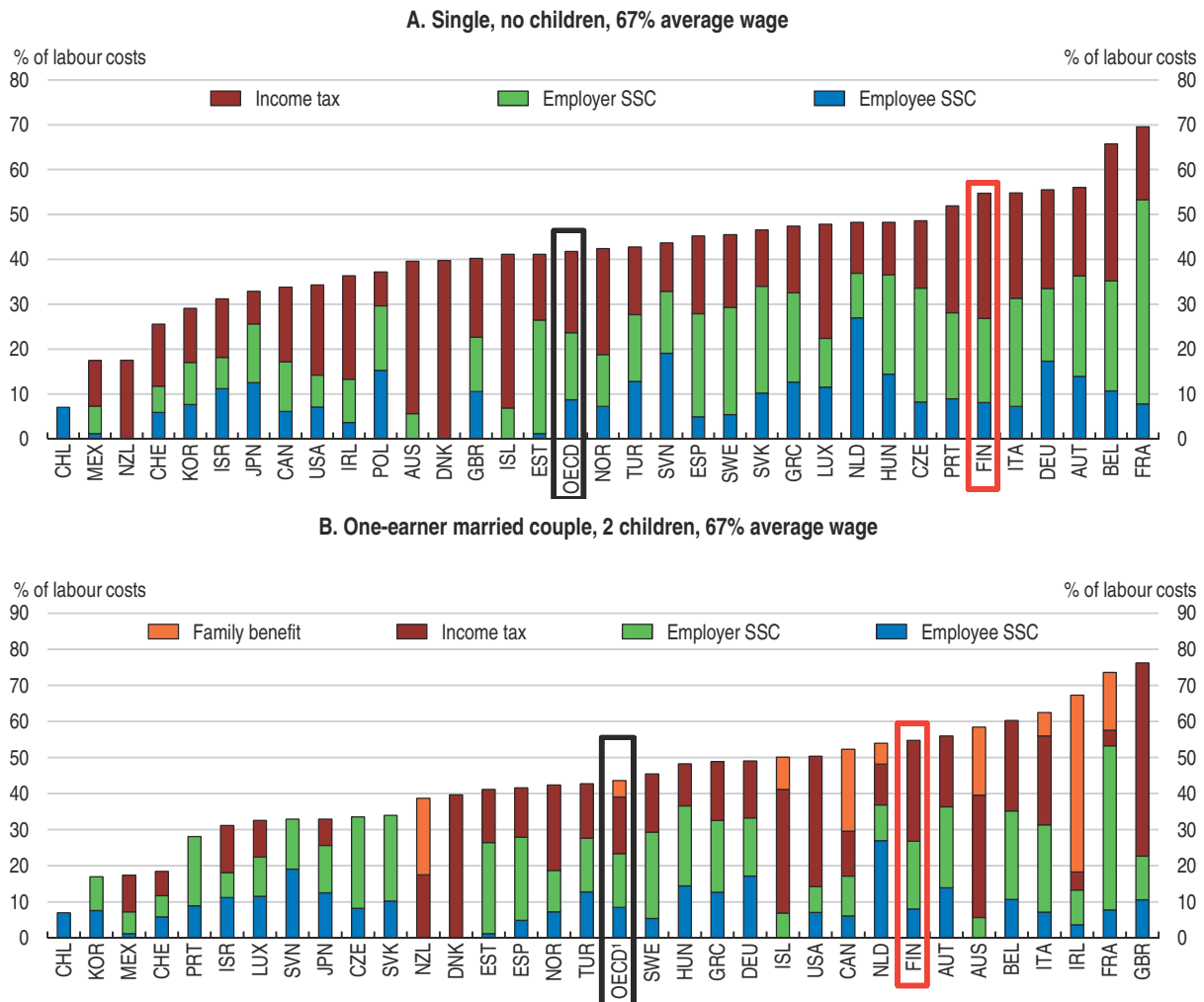
Incentive- and bureaucratic traps in the current system

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



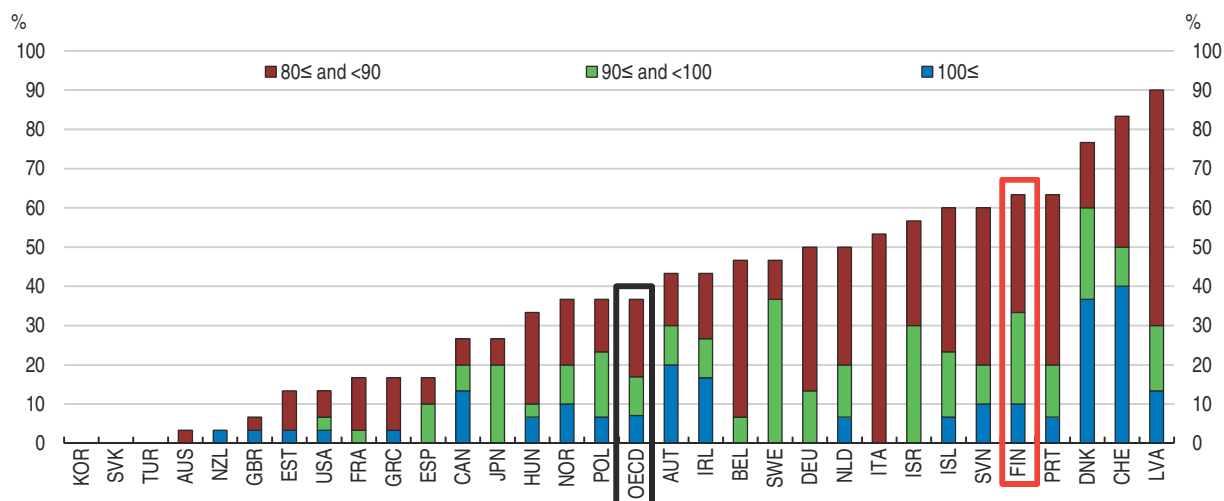
1. OECD average excludes Poland.

Source: OECD Taxation Database.

StatLink  <http://dx.doi.org/10.1787/888933662749>

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 traps¹



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.

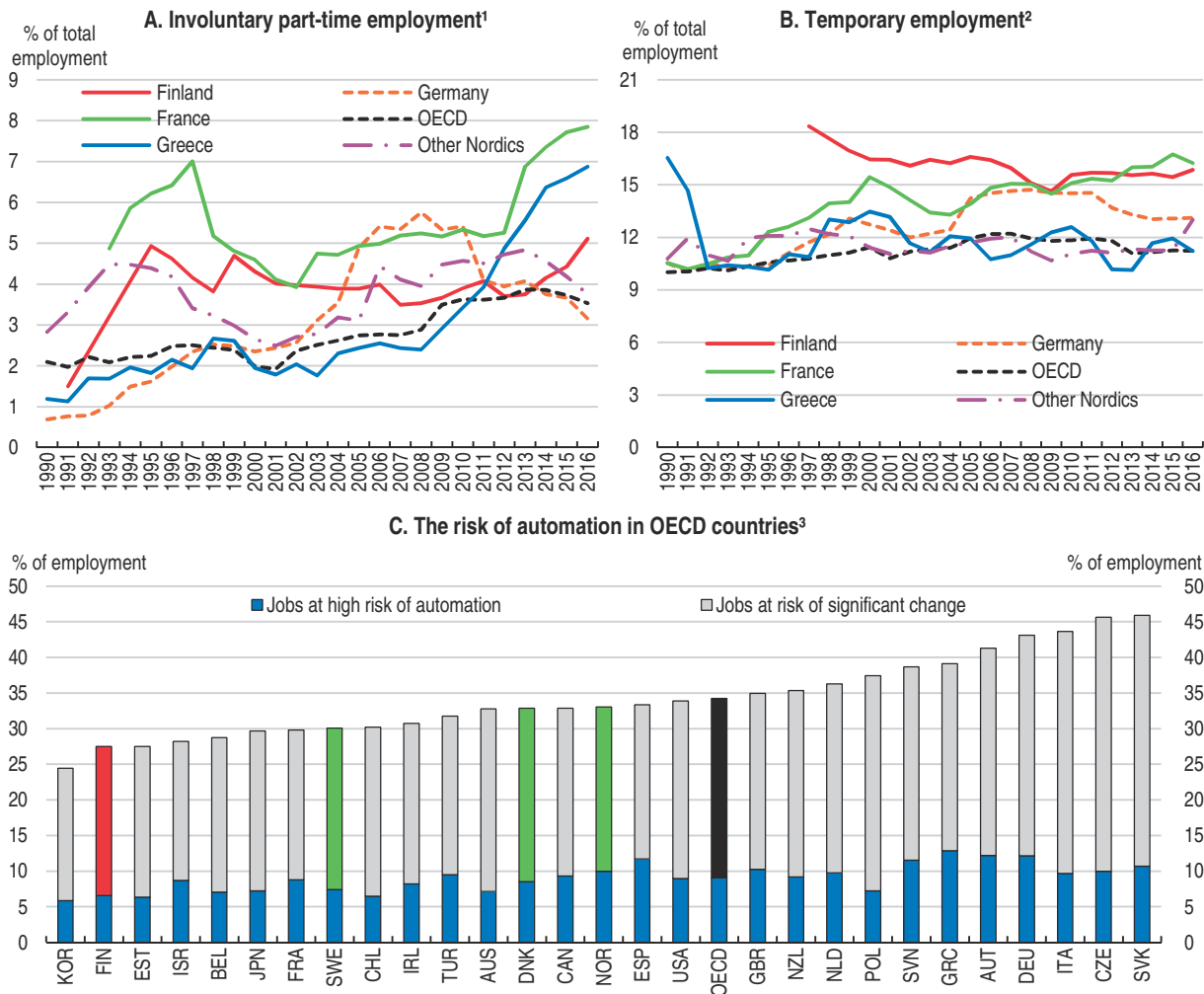
Source: Simulations with the OECD TaxBen model, in Pareliussen et al. (2018).

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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 ongoing 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 insurance¹

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 benefit²

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

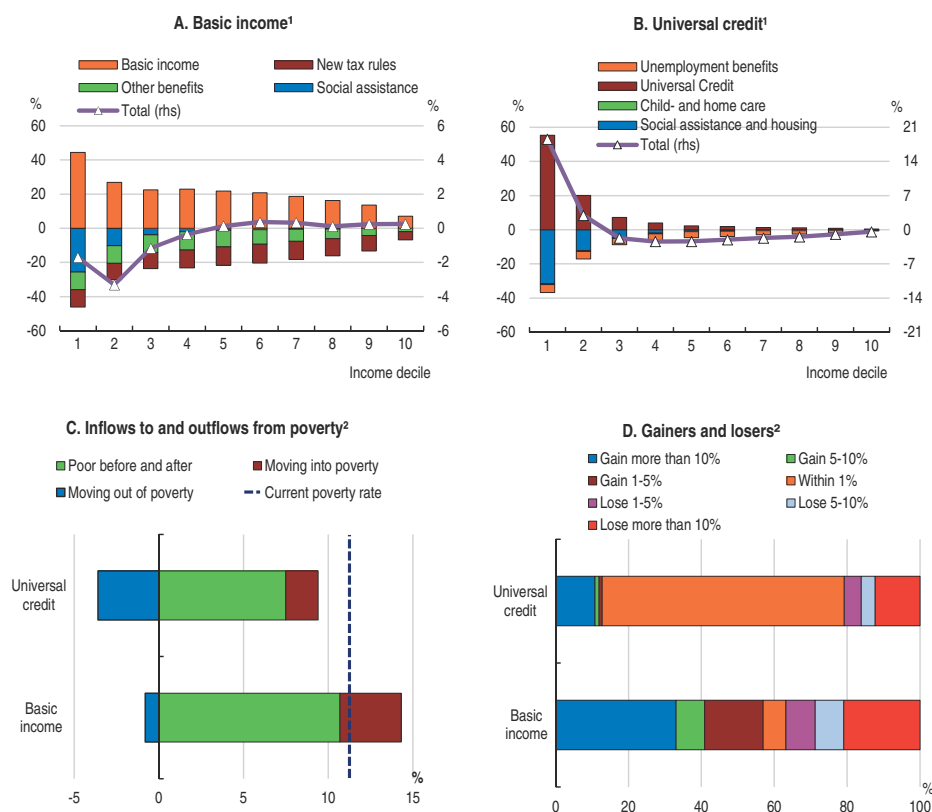
A basic income is a uniform benefit to all, regardless of their earnings or individual circumstances. The concept of a basic income is not new, and most OECD countries already include unconditional transfers to certain groups in the form of, for example, child benefits and basic old-age pensions. However, 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 Parelissen et al. (2018).

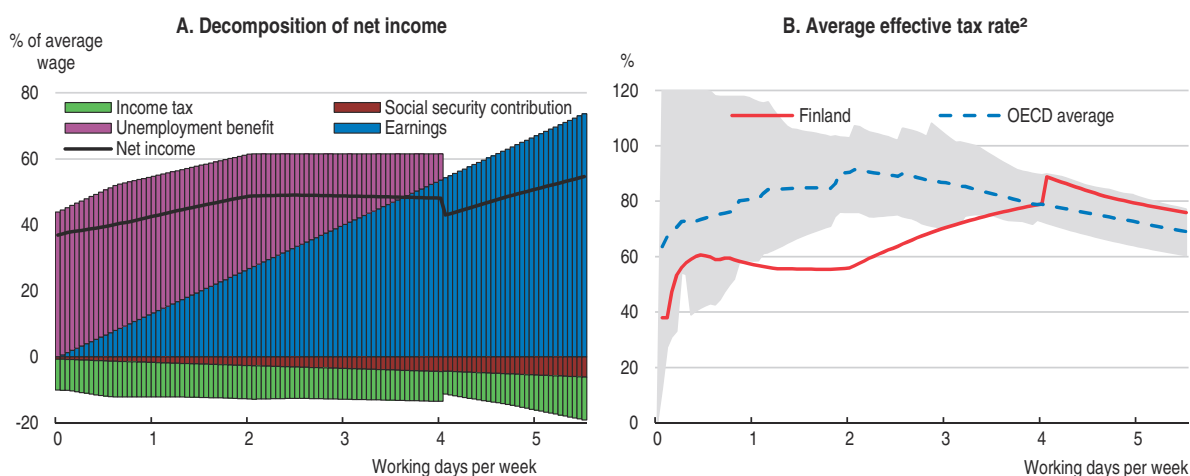
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Reform priorities within the current system

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.

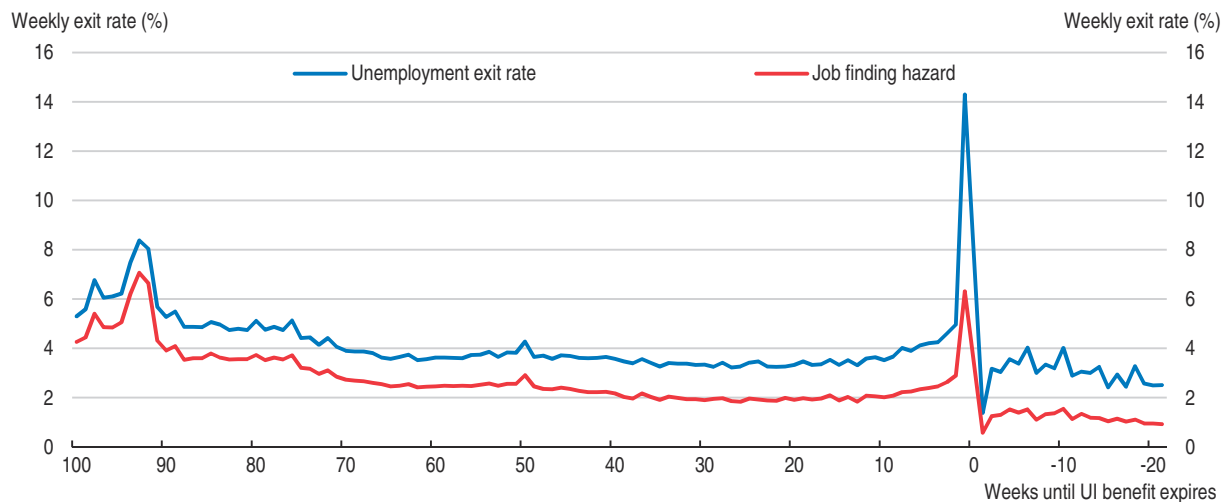
Source: Pareliussen et al. (2018).

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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

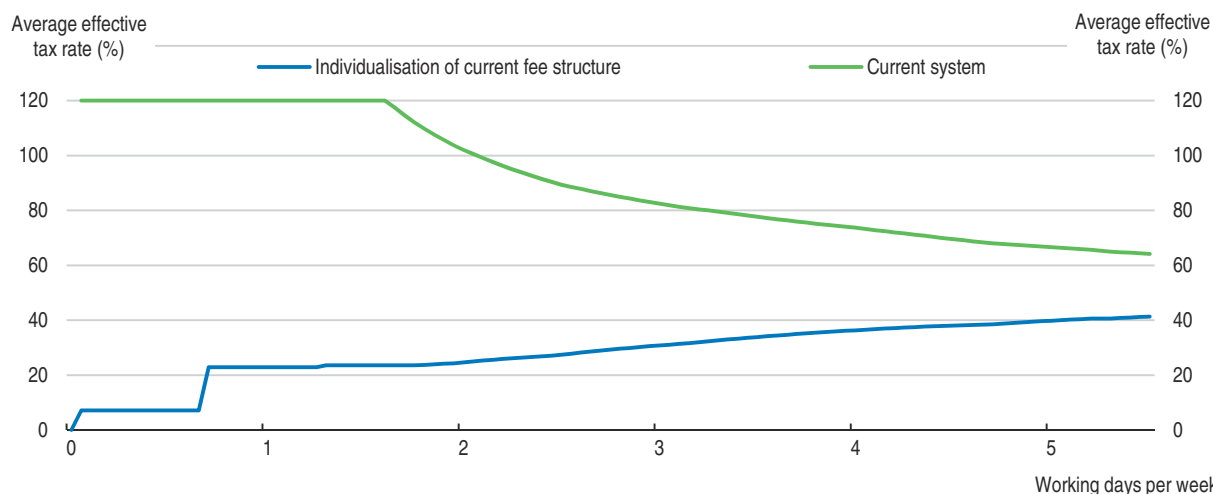
The homecare allowance is equivalent to a direct subsidy to stay out of the workforce for parents, notably second earners (OECD Economic Survey of Finland, 2016). To remove disincentives, the direct link to participation in childcare needs to be broken. Such a restructuring could be achieved by removing 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 earners¹**



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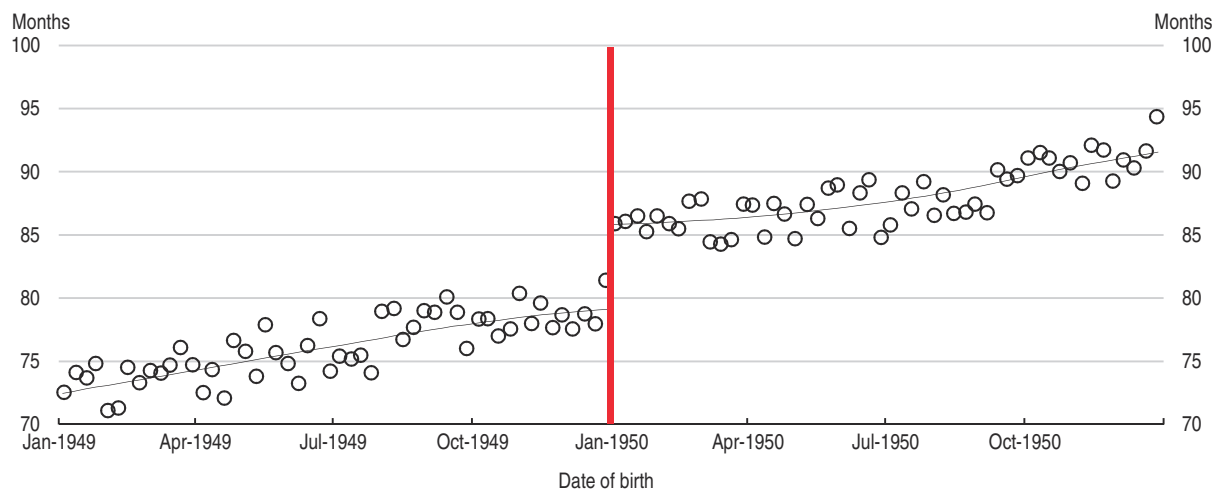
Finland, those aged above 61 on the day their unemployment insurance expires qualify for extended unemployment benefits until the statutory pension age – the “unemployment tunnel” (Kyyrä and Pesola, 2017; OECD *Economic Survey of Finland*, 2016).

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).

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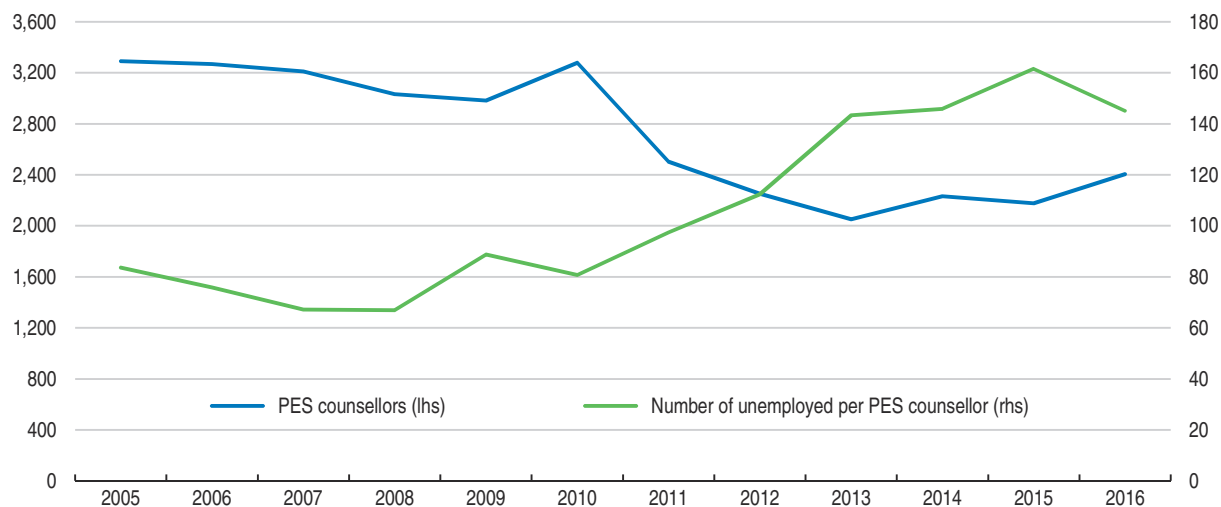
the tax treatment and income definitions of benefits could pave the way for restructuring benefits into their core functions: a personal basic amount, a child supplement, a housing supplement and an unemployment insurance supplement, with coordinated tapering as described in the universal credit scenario.

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 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.
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.