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1997-1998

FINLAND

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Pursuant to Article 1 of the Convention signed in Paris on 14th December 1960, and which came into force on 30th September 1961, the Organisation for Economic Co-operation and Development (OECD) shall promote policies designed:

– to achieve the highest sustainable economic growth and employment and a rising standard of living in Member countries, while maintaining financial stability, and thus to contribute to the development of the world economy;
– to contribute to sound economic expansion in Member as well as non-member countries in the process of economic development; and
– to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.

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Publié également en français.

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BASIC STATISTICS OF FINLAND (1997)

THE LAND

Area (1 000 km², 1995):	338.1	Major cities (thousand inhabitants, 31.12.96):	
of which:		Helsinki	532.1
Cultivated land	27.5	Espoo	196.3
Forests	230.0	Tampere	186.0
Lakes	33.6	Vantaa	168.8

THE PEOPLE

Population (thousands, 31.12.97)	5 147	Labour force (thousands)	2 537
Number of inhabitants per km²	15.2	Employment (thousands)	2 170
Net natural increase (thousands)	10.3	Employment (as a per cent of total):	
Net migration (thousands)	3.9	Agriculture, forestry and fishing	7.1
		Industry and construction	21.3
		Services	71.6

PARLIAMENT AND GOVERNMENT

Composition of Parliament (number of seats):		Government, number of ministers from:	
Social Democratic Party	63	Social Democratic Party	7
Centre Party	44	National Coalition (Conservatives)	5
National Coalition (Conservatives)	39	Swedish People's Party	2
Left-wing Alliance	22	Left-wing Alliance	2
Swedish People's Party	12	Green League	1
Green League	9	Independent	1
Christian League	7	Total	18
Other	4		
Total	200	Last general elections: 19.3.95	

PRODUCTION AND PUBLIC SECTOR

Gross domestic product (Mk billion)	618.0	Public consumption (per cent of GDP)	20.9
Gross domestic product per head (US$)	23 236		
Gross fixed capital investment:		General government (per cent of GDP):	
Per cent of GDP	16.9	Current and capital expenditure	54.2
Per head (US$)	3 933	Current revenue	53.2

FOREIGN TRADE

Exports of goods and services (per cent of GDP)	39.6	Imports of goods and services (per cent of GDP)	30.7
Main exports (per cent of total):		Main imports (per cent of total):	
Wood products	8.3	Raw materials	59.3
Pulp and paper	26.7	Fuels and lubricants	9.1
Chemical products	11.1	Investment goods	16.8
Metal products and machinery	49.2	Consumer goods	24.6

THE CURRENCY

Monetary unit: Markka		Currency units per US$, average of daily figures:	
		Year 1997	5.19
		April 1998	5.51

Note: An international comparison of certain basic statistics is given in an annex table.

This Survey is based on the Secretariat's study prepared for the annual review of Finland by the Economic and Development Review Committee on 4 June 1998.

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After revisions in the light of discussions during the review, final approval of the Survey for publication was given by the Committee on 23 June 1998.

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The previous Survey of Finland was issued in August 1997.

Assessment and recommendations

Recent performance has been very good, but deep-rooted structural problems remain

Since the recession bottomed out in 1993, the Finnish economy has performed very well. In the past four years, real GDP expanded by almost 5 per cent on average – more than double the OECD average – due to a significant easing of monetary conditions, incomes policy that delivered moderate wage and price developments, fiscal consolidation and important steps towards European integration. These actions served to enhance policy credibility and boosted household and business sentiment, thereby contributing to improving domestic demand conditions. In addition, successful innovation in high-technology exporting industries, together with industrial restructuring, have underpinned the expansion. However, there remain deep-rooted structural problems, which need to be tackled to sustain economic growth with low inflation while reducing the still high level of unemployment. These mainly concern insufficient mobility and other rigidities in the labour market as well as weak work incentives created by the interaction of taxation and social transfers, which manifest themselves in a high level of unemployment among low-skilled workers. Moreover, the high level of government expenditure leads to a heavy tax burden.

The strong economic upswing continues...

From the outset, the recovery was driven by soaring exports, but domestic demand has gradually been picking up, and is set to become the main engine of growth this year and next. Indeed, with surging asset prices in real estate and equity markets, both consumption and investment should remain buoyant, despite a completion of major investment projects in the paper industry. However, with export growth decelerating in the wake of the crisis in Asian and other emerging markets, GDP growth is projected to ease from almost 6 per cent in 1997 to just over 4 and 3 per cent in 1998 and 1999, respectively.

... with unemployment declining rapidly, while remaining at a high level

The unemployment rate fell from its 16½ per cent peak in 1994 to below 12 per cent in early 1998 – one of the steepest declines ever recorded in the OECD area over such a short period. Employment growth gathered further pace over the last year, reflecting the recovery in labour-intensive domestic activities, and was particularly pronounced in the construction and retail sectors. However, better job prospects still largely bypass older workers who have become redundant following industrial restructuring and have become trapped in relatively generous income support schemes. On the other hand, job opportunities for young, skilled workers have significantly improved. As demand is projected to remain strong, the unemployment rate is expected to decline further. While the official target of halving the unemployment rate by 1999 from its 1995 level may not be fully realised, unemployment in Finland is rapidly approaching the average of the European Union and is reaching a level where inflationary pressures could develop.

Although inflation has remained subdued, the economy risks overheating

Despite the advanced stage of the business cycle, inflation has remained subdued, although it edged up to 2 per cent in late 1997. The favourable inflation performance has been helped by moderate centralised wage agreements since late 1995, weak wage drift and the lowering of social security contribution rates. Inflation is projected to remain low over the next two years, reflecting the incomes policy pact in place and subdued import prices in the wake of the crisis in emerging markets. However, there is a risk that continued asset price inflation might boost already buoyant domestic demand to an unsustainable growth rate. This may lead to an overheating in parts of the economy as bottlenecks emerge and slack in the labour market is evaporating quickly. Indeed, output has been growing faster than its estimated potential and the number of unfilled vacancies has risen significantly in both the exposed and sheltered sectors of the economy. While the OECD Secretariat projects wage drift to remain moderate, historical experience shows that it may accelerate if labour market conditions become tight, and incomes policies have at times unravelled in Finland. Taking out insurance against the risk of overheating calls for a tight stance of macroeconomic policies.

With monetary policy easy before the start of monetary union...

Although price stability is the official goal of Finnish monetary policy, the approach of the single currency is constraining monetary policy because of the requirement to keep the exchange rate stable in the ERM. So far, the attainment of the twin objectives of price and exchange rate stability has been facilitated by the remaining slack in the economy and, more recently, by subdued international price developments following the crisis in emerging economies. In recent quarters, moreover, the monetary authorities have been able to utilise the available scope for raising short-term interest rates, and brought them into line with corresponding German rates. However, overall, financial conditions have eased since last year, as the short-term interest rate increases were only marginal, the effective exchange rate depreciated and long-term interest rates declined significantly. Next year, monetary policy – conducted by the European Central Bank and geared to conditions in the euro area as a whole – is likely to be too easy for the conjunctural requirements of the Finnish economy, given the earlier stage of the economic recovery in many European Union countries.

... the task of preventing an eventual overheating falls on structural as well as fiscal policies

Inflationary pressures could be eased by pursuing coherent structural reform aimed at raising the potential output of the economy. In fact, failing to implement such reform would strengthen the need to tighten fiscal policy significantly further in order to slow the economy to a sustainable pace. The strength of the upswing to date has been underpinned by the government's medium-term programme of fiscal consolidation, as it has inspired confidence in financial markets and led to a sizeable decline in the real interest rate since late 1995. Moreover, the consolidation programme reversed the build-up of public debt and practically eliminated the budget deficit. However, the programme is largely complete in 1998. The fiscal stance will be only moderately tight this year, and budgetary policy risks becoming insufficiently restrictive in 1999 unless additional expenditure cuts are implemented. This would be desirable for several reasons. In the short term, the momentum in the economy needs to be contained. From a longer-term perspective, moreover, the budget would need to be in significant surplus to preserve the sustainability of public finances in the face of an ageing population. This would also be important for the compliance with the EU's Stability and Growth Pact and to be able to rely on automatic stabilisers in a future downturn. It is, therefore, of crucial importance that the government use the window of opportunity provided by the ongoing upswing to bring forward budget consolidation efforts which are envisaged in the Convergence Programme over the medium term.

The emphasis should be on public expenditure restraint...

Fiscal restraint should take the form of cuts in public expenditure. At 54 per cent of GDP, Finland has one of the highest levels of expenditure in the OECD area, due to a generous welfare system and a high level of support to agriculture and public employment. This has resulted from the extension of public sector services in past decades, as Finland caught up to the Nordic standards of achieving far-reaching social objectives through government action. Generous entitlements set the stage for a surge in welfare outlays during the crisis in the early 1990s, which has proved difficult to reverse despite the very favourable economic developments.

... to reduce the very high tax burden

To sustain the high levels of government spending, the tax burden in Finland has risen to 47 per cent of GDP, one of the highest in the OECD area notwithstanding substantial interest income in the social security (pension) sector. While the taxation of labour, capital and sales are all high, personal income taxation stands out. The average marginal tax wedge on labour income amounts to 70 per cent, which strongly distorts incentives for workers to move up the income ladder and contributes to trap unemployed workers in social benefit dependency. In addition, such high tax rates jeopardise job creation for low-skilled workers. They also induce firms to relocate activities abroad, and discourage inflows of foreign direct investment. The government has somewhat reduced labour taxation recently, by cutting employers' social security contributions and personal income tax rates, and has also raised the municipal earned income tax credit for low-skilled workers. Nevertheless, major additional efforts are needed to reduce taxation. In combination with a leaner income transfer system, this could help sustain the virtuous circle of job creation, low inflation and economic growth.

Income transfers need to be curtailed to strengthen work incentives...

Since the dramatic decline in employment in the early 1990s, a quarter of the working age population has been on income support – unemployment benefits, early retirement and disability pensions, and various active labour market programmes. Initiatives by the government in early 1997 to reform the income support system have curtailed the possibility to re-qualify for unemployment insurance benefits through participation in subsidised job programmes and made the benefits less generous. At the same time, the benefit rules for the early retirement and disability pension schemes were changed to discourage entry. These measures have, however, not yet had a noticeable impact on the number of beneficiaries. As concluded in the previous *Economic Survey*, much remains to be done in this area, including the re-examination of the medical fitness of the disabled and a review of means-tested cash benefits which usually supplement other forms of income support.

... as part of a comprehensive reform of the labour market

Recent initiatives have focused on improving the effectiveness of active labour market policies, including training, in which over 5 per cent of the labour force participate. A reform of the Public Employment Service has strengthened job counselling and brokerage, while allowing private job broking to a greater extent. Although such measures are expected to improve the employability and job search of inactive persons, further efforts are needed to raise the scope for a flexible adjustment in the labour market to accelerate the absorption of the large pool of low-skilled unemployed workers. To this end, wage negotiations should increasingly be conducted at the firm level to improve the matching of labour demand and supply across firms, sectors, regions and skill groups. Moreover, an easing of employment protection and working time rules would favour employment creation by SMEs, especially in private services. Regional mobility of labour also needs to be enhanced by changing pension rules which penalise inter-firm mobility removing distortions in the housing market and enforcing existing rules for job mobility by the Public Employment Service.

Industrial and agricultural support needs to be lowered...

In the 1990s, industry has adjusted smoothly to the increased contestability of product markets resulting from Finland's participation in the European integration process and international agreements. For several product categories, such as telecommunication and forestry-related equipment, Finland has become a global market leader, with large companies expanding their production facilities both at home and abroad. To spur adjustment further, the government should keep the momentum of its privatisation programme of state-owned companies. At the same time, it should carefully review the effectiveness of industrial support and streamline the plethora of programmes, while focusing on creating a business-friendly environment for small and medium-sized enterprises, which would be conducive to physical and intangible investment and job creation. The introduction of the Common Agricultural Policy has implied a reduction of agricultural support from an extremely high level. While resulting in high transition costs, this has yielded significant permanent gains to consumers. Further reductions in support are, however, needed as agricultural subsidies remain substantial.

... and financial market reform should now turn to the pension insurance industry

Spurred by the European integration process, progress in rationalising the banking industry has outpaced developments in other EU countries. Moreover, in the wake of the banking crisis in the early 1990s, surveillance of the banking industry by the independent Financial Supervisory Authority has been strengthened and, more recently, support for distressed banks brought to a close. As in many other OECD countries, the strengthening of financial supervision is under discussion. In this context, current plans for maintaining a separate surveillance body for life and pension insurance firms under the Ministry of Social Affairs and Health should be reconsidered. Moreover, increased competition between insurance companies who manage statutory pension insurance should be allowed and investment rules eased in order to raise the return on capital invested by pension funds. This would reduce the cost of the pension system and hence limit a future rise in the tax burden. Increased competition between pension insurance providers would be facilitated by introducing employees' freedom of choice with regard to these providers.

The health care system delivers high-quality services...

The economic crisis and the need to consolidate public finances have marked the development of Finnish health care expenditure since the early 1990s. Nevertheless, the provision of high-quality services was preserved as savings were realised by a more effective use of existing capacity in both hospitals and municipal health centres. These results were obtained by: *i)* the introduction of block grant funding of municipalities in 1993 which increased local decision-making power while hardening the budget constraint; *ii)* a lower reimbursement of fees for services granted by the national health insurance, which prompted households to increase the use of the under-utilised public health care services; and *iii)* cuts in the number of hospital beds and increased reliance on outpatient services. As a result, health care expenditure in Finland has declined sharply since the early 1990s, and the system, at present, absorbs $7^1/_2$ per cent of GDP, slightly below the OECD average.

... but there is scope for efficiency gains

While the productivity of the Finnish health care system has improved significantly in recent years, the wide variation in health care costs per capita across regions suggests scope for further progress by adopting national best practice standards. While a major overhaul of the system is not on the political agenda, improvements in its functioning are indeed possible. In particular, managerial standards in hospitals and health centres could be raised, and the co-operation between the various layers of health service provision enhanced, to reduce overlap in the provision of these services. The competition between hospitals could be strengthened, even though this may be difficult to realise in sparsely populated regions. The market for hospital services could benefit from appropriate pricing based on modern cost accounting principles, such as the diagnostic related groups (DRG) system. Moreover, the introduction of a mix of basic salaries, capitation payments and fees for services for doctors employed by hospitals and municipal health centres could improve the cost-effectiveness of diagnosis and treatment. Finally, it could reduce incentives for physicians to maintain part-time private practices to top up their income which, in the past, have led to under-utilisation of public facilities.

Summary

In sum, economic policies have underpinned a surge in economic activity, with the unemployment rate falling rapidly. Although inflation has remained subdued, there are risks that the economy could overheat in the near future. Monetary policy in the euro area may be too easy for the cyclical requirements of the Finnish economy. In view of the overheating risks, timely structural reforms are called for to alleviate constraints on sustained high growth. Public expenditure should be cut further to allow a reduction of the very high tax burden. Income transfers need to be curtailed to strengthen work incentives, as part of a bolder and more coherent reform of the labour market, which should include more flexibility in wage setting. This should help to overcome labour shortages at what is still a high unemployment rate. In the absence of such structural reform, a tight stance of fiscal policy will be all the more needed to slow the economy to a sustainable pace. Indeed, the overall favourable economic outlook represents a window of opportunity to implement measures to prepare the ground for continuing strong non-inflationary growth and a further sizeable reduction of unemployment.

I. Recent developments and short-term prospects

The Finnish economy has comfortably recovered the 11 per cent fall in economic activity of the 1991-93 recession and has also been making up steadily the ground lost against other European economies. The upswing since 1994 has been mainly export driven, but domestic demand is gradually taking over as the engine of growth due to strong household and business sentiment and easy monetary conditions. The unemployment rate has shown a spectacular decline from its 1994 peak of 16½ per cent to below 12 per cent in early 1998, but the absorption of the remaining labour market slack may be less easy due to mismatch problems, the high tax wedge, and weak work incentives at the low end of the pay scale stemming from the interaction between taxation and social transfers. In fact, despite the still high unemployment rate, the economy now risks overheating.

A buoyant economy

GDP expanded by a robust 5.9 per cent in 1997 with few, if any, signs of a significant slowdown (Table 1 and Figure 1, Panel A). The appreciation of the dollar, the rapid development of eastern European economies, the boom in the international telecommunication equipment market and the upswing in the forestry cycle all boosted exports after the brief downturn in early 1996. At the same time, domestic demand conditions have remained favourable, with residential investment particularly buoyant (Figure 1, Panels B and C). As job creation accelerated, unemployment dropped below 12 per cent of the labour force in recent months, and may be approaching the Secretariat's gauge of the NAWRU (non-accelerating wage rate of unemployment). With the labour market thus rapidly becoming tighter, the output gap is estimated by the OECD Secretariat to

Table 1. **Demand and output**

Percentage changes from previous period, volume

	Current prices 1994 Mk billion	1995	1996	1997	Seasonally adjusted, annual rate 1996 2nd half	1997 1st half	1997 2nd half
Private consumption	284.4	4.6	3.8	3.0	3.3	2.4	3.9
of which: Durable goods	21.8	13.0	14.5	6.2	5.1	3.7	12.6
Government consumption	114.0	1.9	3.5	–0.3	2.8	–3.1	2.3
Gross fixed capital formation	74.2	11.3	8.4	11.2	14.6	3.7	23.9
Public sector	14.0	–5.5	10.5	4.6	9.5	4.5	0.2
Business sector	60.2	15.2	8.0	12.6	15.6	3.6	28.7
Residential	18.4	–3.4	–0.1	29.7	41.6	29.2	20.9
Non-residential	41.8	25.1	11.3	6.2	7.2	–5.8	32.5
Final domestic demand	472.6	5.1	4.6	3.8	5.2	1.4	7.4
Stockbuilding[1, 2]	5.9	–0.2	–1.8	0.6	–1.1	2.8	–2.1
Exports of goods and services	182.5	8.2	3.9	12.8	10.9	12.2	16.0
Imports of goods and services	150.0	6.9	4.3	9.3	2.1	13.7	7.9
Foreign balance[1]	32.5	0.9	0.2	1.9	3.1	0.5	3.4
GDP	511.0	5.1	3.6	5.9	6.8	4.6	7.8
of which: Manufacturing	112.7	9.6	3.4	9.2	8.1	7.3	14.3

1. Contribution to GDP growth.
2. Including statistical discrepancy.

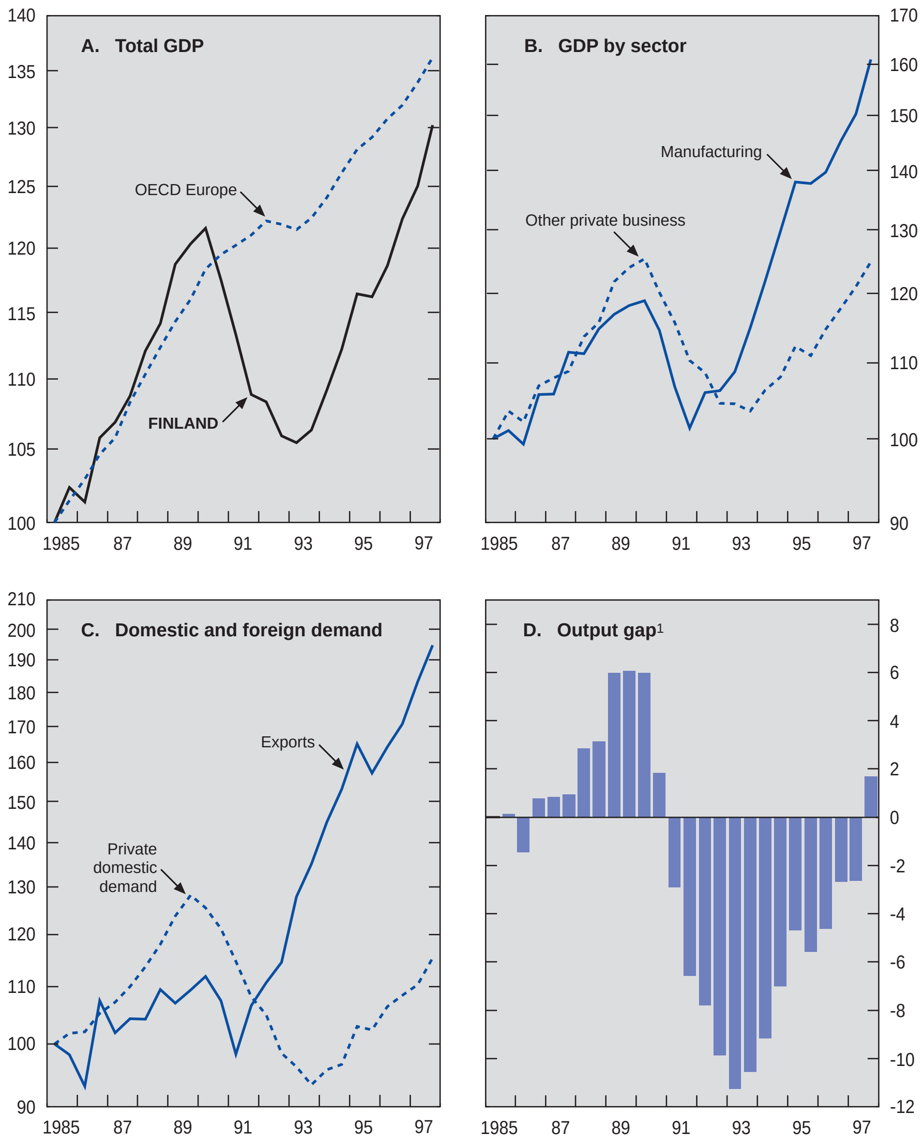
Source: OECD, *National Accounts* and OECD Secretariat.

have practically closed in 1997 (Figure 1, Panel D). This points to an increasing risk of economic overheating.

Exports are booming

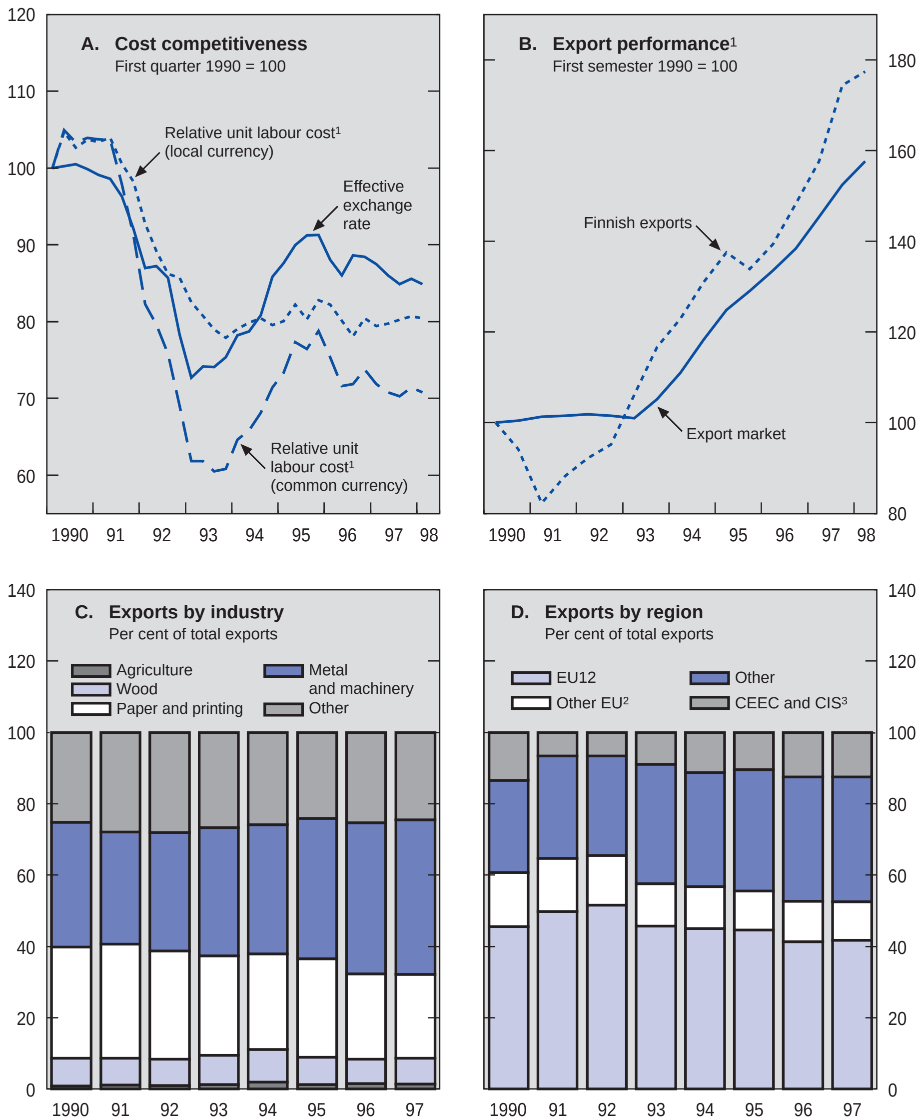
Following a short-lived downturn in late 1995 and early 1996 related to weak activity elsewhere in Europe, the boom in merchandise exports, which has been ongoing since 1991, resumed vigorously. The sales of goods abroad expanded by 15.3 per cent in volume in 1997, almost three times as fast as in the preceding year and exceeding the growth of Finnish export markets by over 6 percentage points. The gains in market share on the part of Finnish producers have been supported by strong increases in cost-competitiveness in recent years. Indeed, moderate wage developments and a weakening effective exchange rate together reduced unit labour cost in manufacturing relative to Finland's trading partners by almost 10 per cent since late 1995 (Figure 2, Panels A and B).

Figure 1. **GDP AND ITS MAIN COMPONENTS**
Semi-annual data, semi-log scale, 1st half 1985 = 100



1. Linear scale, per cent deviation from potential output.
Source: OECD, *Quarterly National Accounts* and OECD Secretariat.

Figure 2. **COST COMPETITIVENESS AND EXPORT PERFORMANCE**



1. Manufacturing.
2. Austria and Sweden.
3. Central and eastern European countries and Community of Independant States (former USSR up to 1991).

Source: Statistics Finland, *Statistical Yearbook;* OECD, *Foreign Trade Statistics* and OECD Secretariat.

Particularly striking is the sharp rebound in exports in the wood and paper industries – which account for around one-third of total merchandise exports (Table 2). This contrasts sharply with the weak development in 1995 and 1996, and is due to a combination of recovering demand in Europe and the United States and the coming on stream of large new paper production facilities in 1997. Although export growth in this product category has been less strong in early 1998, this reflects new capacity limits rather than weakening demand. The crisis in Asia and other emerging markets has, in fact, boosted demand for Finnish paper pulp as investment projects in Indonesia were scaled down.

Exports of metal products and the machinery industry – which at present cover around half of total merchandise exports (Figure 2, Panel C) – have been less affected by the slowdown in 1995 and 1996, and continued to perform extraordinarily well in 1997. Within this industry, notably the electronics and telecommunications sector has been booming, with one company – Nokia – contributing around one-fifth of the 13.5 per cent expansion of metal products and machinery exports in 1997. This strong performance continued unabated in early 1998, notwithstanding the crisis in Asia to which this sector is relatively exposed,[1] due to offsetting demand impulses from North America, the EU, Russia, Estonia and China. Of the remaining product groups, chemicals and food have also performed very well, underpinned in particular by robust demand from Russia. The share of total trade with the ex-Comecon countries in total Finnish

Table 2. **Exports by industry**

Percentage volume changes

	1990 Current prices Mk billion	1991	1992	1993	1994	1995	1996	1997
Manufacturing	100.0	–8.8	9.6	18.4	13.5	6.5	5.6	14.6
of which:								
Wood	7.8	–9.4	6.9	38.7	22.1	–2.9	0.0	15.0
Paper	31.7	–2.2	5.1	9.8	11.5	–2.3	–2.3	21.0
Metal products and machinery	35.5	–20.1	13.0	30.9	11.5	29.1	5.3	13.5
Total goods	101.3	–8.8	8.8	18.5	13.6	7.2	5.6	15.3

Source: Statistics Finland and ETLA.

exports has, accordingly, returned to its 1990 level (Figure 2, Panel D), although the composition is completely different.

Household demand remains robust

For the third year in succession private consumption has grown vigorously, with the decline in the period 1991-93 now entirely recovered (Table 3 and Figure 3, Panel A). The net asset position of households improved further in 1997, with the debt/earnings ratio having returned to its mid-1980s level and house prices soaring. The expansion of private consumption was, nevertheless, slightly slower in 1997 than in the two preceding years and also lagged real disposable income to some extent. In particular, household demand for consumer durables, including private cars, slowed significantly following the extraordinary rebound in 1995 and 1996 (Figure 3, Panel B). Apparently, pent-up demand for such goods has been satisfied, and households have progressively increased demand for housing.

Measures taken by the government as part of the 1995 *Employment Programme* to stimulate renovation activity and mortgage lending sparked a sharp

Table 3. **Household appropriation account**

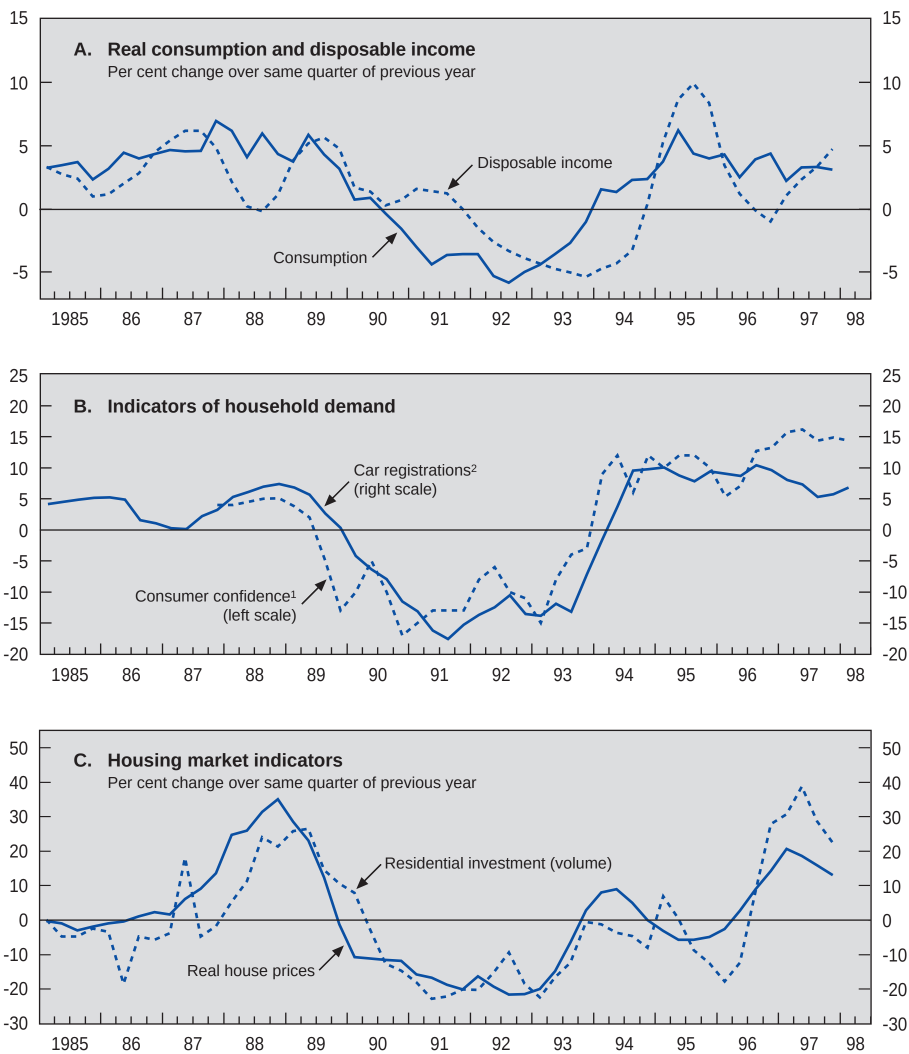
Percentage changes

	1991 Mk billion	1992	1993	1994	1995	1996	1997
Disposable income	289.3	1.2	–0.8	–1.6	8.3	2.5	6.5
Contributions from:							
Wages	301.3	–3.4	–4.2	3.8	5.4	4.4	4.4
Entrepreneurial and property income	77.9	0.9	–0.4	–0.6	1.5	–0.2	2.8
Transfers received	117.6	6.1	3.0	2.5	0.4	0.5	1.3
Transfers paid	–98.6	–3.6	–1.7	–5.0	0.4	–0.3	–1.4
Direct taxes[1, 2]	–78.3	1.4	0.6	–4.1	0.4	–3.0	–1.6
Interest on consumer debt[1]	–30.6	–0.1	1.8	1.7	0.2	1.1	1.0
Real disposable income	273.9	–2.8	–4.8	–3.0	8.1	0.9	5.0
Real consumption expenditure	260.0	–4.9	–2.9	1.9	4.6	3.8	3.0
Saving ratio (per cent)[3]	5.1	7.1	5.2	0.4	3.6	0.9	2.8

1. A positive number indicates that interest payments, transfers paid or direct taxes have fallen.
2. Direct tax payments in 1994 are heavily affected by a postponement of tax refunds to 1995.
3. Ratio of household saving to disposable household income (non-profit institutions are included in the household sector).

Source: OECD Secretariat.

Figure 3. **HOUSEHOLD SPENDING**
Per cent



1. The indicator reflects consumer perception of economic developments for the past and future twelve months and whether present conditions are conducive to larger purchases.
2. Per cent change over same quarter of previous year, four quarter moving average.

Source: Ministry of Finance; OECD, *Quarterly National Accounts* and *Main Economic Indicators.*

pick-up in residential investment in the second half of 1996, and strong confidence, the easing debt burden and low mortgage lending rates raised housing construction by 30 per cent in 1997 (Figure 3, Panels B and C). The construction boom has also been spurred by recovering prices of second-hand houses in major cities to levels that now well exceed the construction cost of newly-built accommodation. Indeed, while real prices of second-hand houses increased, on average, by around 15 per cent in 1997, they rose by some 25 per cent in the larger cities. Such price increases could develop into local speculative bubbles, although housing markets in rural areas and smaller cities remain relatively depressed.

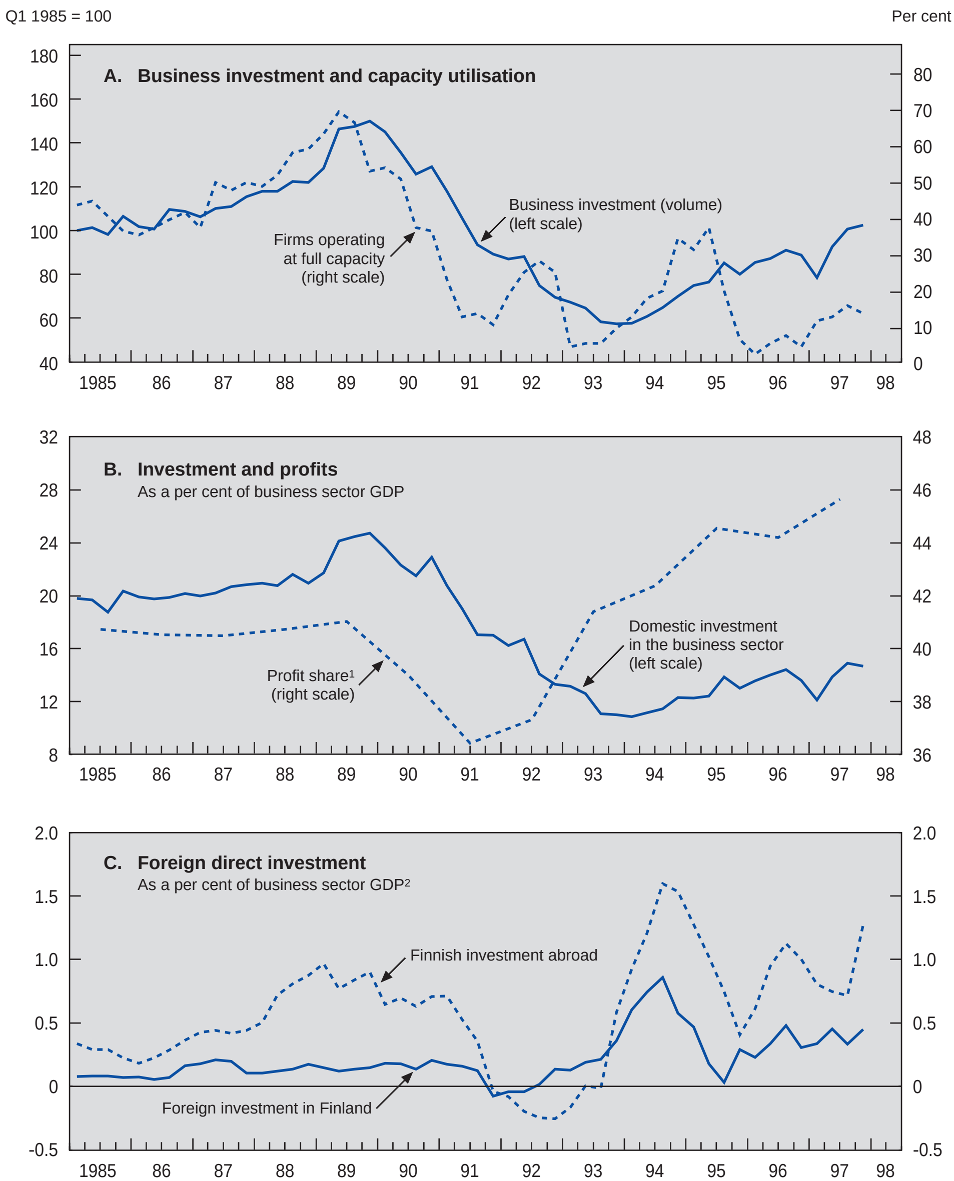
Asset prices soar

House prices have risen by one third since 1993, albeit from a low level, thereby significantly raising households' real wealth. Other major categories of asset prices (share prices, stumpage prices) have also risen sharply, reflecting the extraordinary performance of both forestry-related and high-technology exporting industries. Share prices on the Helsinki stock exchange have increased by 600 per cent since their 1993 trough, rising by 40 per cent in 1997 and by another 40 per cent in the first five months of 1998. The surge in equity prices has been underpinned by massive purchases of Finnish stocks by foreign institutional investors, which have amounted to over Mk 55 billion (10 per cent of GDP) since 1993. Stumpage prices, which affect Finnish household and business balance sheets through the valuation of forestry property, have increased by almost 60 per cent since their 1993 low, and have returned to their previous peak level in 1990. They rose by almost 10 per cent in 1997 but levelled off in early 1998.

Business investment expands at home and abroad

The pick-up in business fixed capital formation which started in 1994 continued in 1997, albeit at a somewhat lower rate than in previous years due to the winding down of major investment projects in the paper industry (Table 1 and Figure 4, Panel A). Growth in private investment accelerated through the year, however, due to strong profitability and the anticipation of a less generous tax treatment of investment projects which came into effect in January 1998. Moreover, capital formation progressively shifted from machinery and equipment to property. Although this still leaves investment as a share of business value added at a historically low level (Figure 4, Panel B), capital productivity has

Figure 4. **BUSINESS INVESTMENT**



1. Business sector GDP less compensation.
2. Four quarter moving average, right adjusted.

Source: Bank of Finland; OECD, *Quarterly National Accounts* and *Main Economic Indicators.*

Box 1. **Finnish foreign direct investment in nearby transition economies**

Because of geographical proximity, Estonia and the north-western part of Russia, more specifically greater St. Petersburg, which has a population of roughly the same size as Finland, are promising trading partners for Finland and, furthermore, a potential destination of foreign direct investment by Finnish companies. To date, however, such foreign direct investment has been rather limited, although growing, for a number of reasons.

The St. Petersburg urban area is characterised by a number of problems common to most Russian cities, such as a declining industry which is undergoing transformation from military to civil production, unemployment and wage arrears. Moreover, efforts by the local authorities to promote St. Petersburg as the ‘‘second Russian capital’’ seem to be failing while markets and property rights are poorly regulated (although the situation in this regard is somewhat better then in the rest of Russia). As a result, Finnish foreign direct investment to the St. Petersburg area is still small (only a fraction of the 1.4 per cent of total Finnish foreign direct investment that flows to Russia), even though production in St. Petersburg is growing faster than the Russian average and has more SME activity than, for instance, the greater Moscow area.

There are fewer impediments for Finnish investors in Estonia due to the linguistic and cultural ties, which add to advantages such as the low wage level (average production worker wages are around 15 per cent of the Finnish level), the high skill level of the labour force and the strategic location within the common Baltic market. Moreover, the Estonian economy is growing very rapidly, at a rate of around 11 per cent in 1997 and, probably, by 5 to 6 per cent in 1998. Finnish foreign direct investment to Estonia is on an upward trend, reaching 0.7 per cent of the total in 1997.

substantially increased since the early 1990s due to a shift from capital-intensive industries towards knowledge-intensive ‘‘high-tech’’ activities. While business capital formation lost some momentum in early 1998, the conditions for investment remain favourable, with profitability and capacity utilisation rising.

Supported by high profits, foreign direct investment by Finnish companies has been spectacular in recent years, almost tripling from Mk 5.2 billion in 1995, to Mk 13.7 billion in 1997 (Figure 4, Panel C). Foreign direct investment has been particularly strong in the forest and metal industries, where it was of roughly the same size as domestic investment. Foreign investment is motivated by the desire to expand capacity close to raw material sources, to expand distribution and service networks in growing markets, to exploit the potential of economies of scale and scope abroad, and to benefit from lower taxes and wages. In line with historical trends, the bulk of the foreign direct investment flows in 1997 went to the European Union and Switzerland (70 per cent) and most of the remainder (12 per cent) to North America. Foreign direct investment flows to Russia (St. Petersburg) and Estonia, although nearby economies and more rapidly developing than other parts of the ex-USSR, are still comparatively small due to specific local problems (see Box 1). The conditions for foreign direct investment in the EU could become even more favourable with the adoption of the euro in January 1999.

Unemployment falls rapidly

Buoyant economic activity boosted employment by 2 per cent in 1997, after expanding by about 1 per cent in 1996 (Table 4 and Figure 5, Panel A). Labour demand was particularly strong in the construction industry, while job growth in the services sector also picked up owing to export-related transportation activity, the flourishing tourism industry and the recovery of retail services (Figure 5, Panel B). Meanwhile, the decline in the number of workers in primary industries ceased due to strong logging activity. In manufacturing, in contrast, employment growth was sluggish as soaring export-related production was accompanied by a sharp rise in labour productivity. Aside from the rapid shift in the industrial structure towards ''high-tech'' activities, this reflects the increased utilisation of productive capacity set up in the past few years. In line with the trend in recent years, as many as two-thirds of new jobs created were either part-time, fixed term or temporary employment contracts.

Labour market participation increased only moderately in 1997 as stricter eligibility conditions for unemployment insurance reduced the number of registered young job seekers and more people were enrolled in labour market training programmes. Combined with the ongoing employment growth, this resulted in a sharp decline in the unemployment rate from 14.7 per cent in 1996 to 11.8 per cent in early 1998 (revised definition, Figure 5, Panel C).[2] Contrary to developments in recent years, unemployment fell for prime-age and older workers, while, by contrast, the fall in youth unemployment stalled. Apparently, the process of ''cream skimming'' of young high-skilled workers by high-tech companies is

Table 4. **Labour market developments**

	1980-90	1991	1992	1993	1994	1995	1996	1997[1]
	Percentage changes							
Real GDP	3.1	–7.1	–3.6	–1.2	4.5	5.1	3.6	5.9
Real GDP per worker	2.5	–2.0	3.8	5.3	5.4	2.8	2.3	3.9
Employment	0.6	–5.2	–7.1	–6.1	–0.8	2.2	1.3	2.0
Labour force	0.5	–0.9	–1.2	–0.7	–0.2	0.8	0.3	0.4
	Per cent of labour force							
Unemployment rate	4.8	7.4	12.7	17.3	17.9	16.7	15.8	14.5
of which:								
Males	5.1	9.3	15.5	19.8	19.9	17.6	16.1	14.0
Females	4.4	5.7	10.5	15.7	16.7	16.7	16.5	15.0
Persons aged under 25 years	8.4	14.5	25.2	33.3	33.6	29.9	27.4	26.8
Persons unemployed for more than 12 months (per cent of total)	9.3	2.5	8.0	17.8	27.0	30.1	30.1	30.5
Active labour market programmes[2]								
of which:								
Job creation	3.8	1.6	2.1	2.3	2.8	2.8	3.5	3.3
Labour market training	0.6	0.7	1.1	1.1	1.3	1.6	1.9	2.1
Memorandum item:								
Revised unemployment rate[3]	. .	6.4	11.5	16.1	16.4	15.6	14.7	12.6

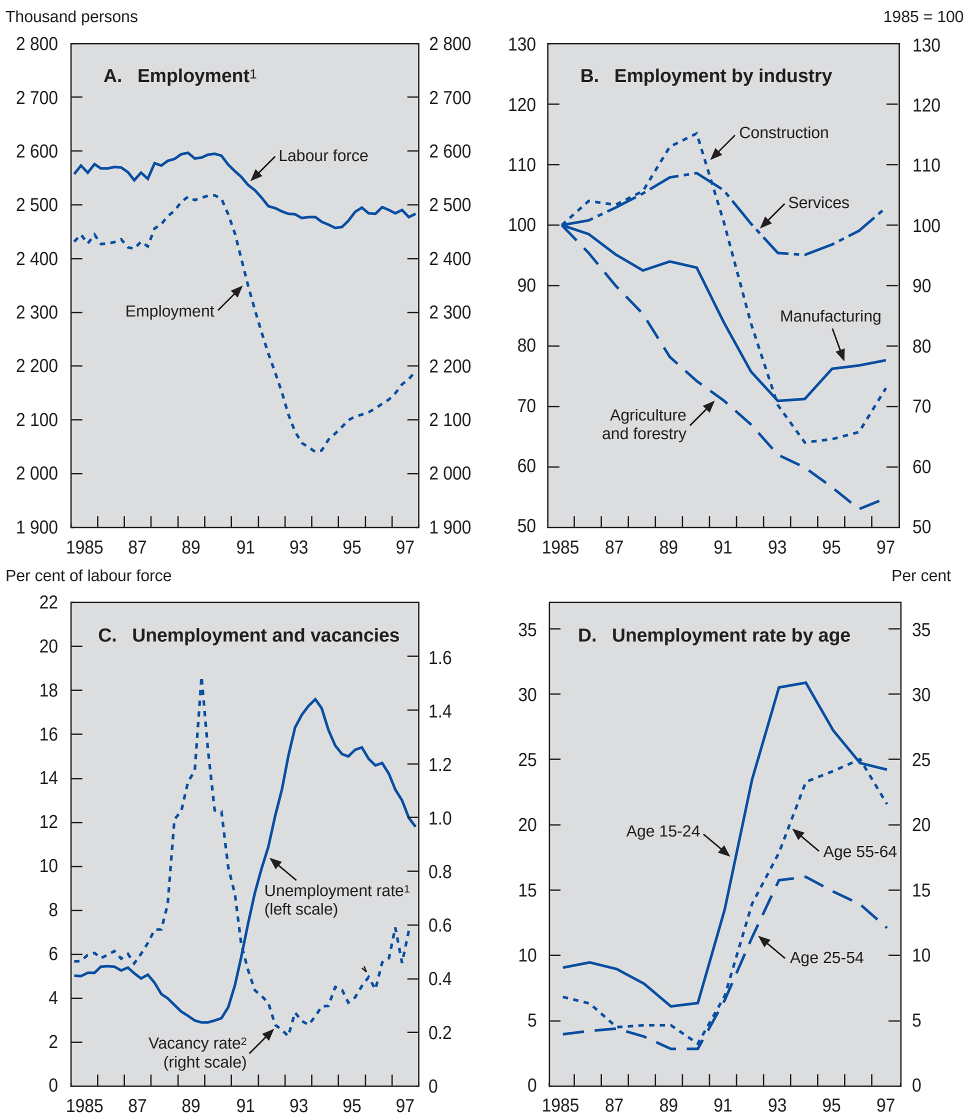
1. Break in series for revised Labour Force Survey data.
2. Includes persons participating in public works projects, ESF objective 3 programmes and LMS training.
3. The revised series refers to unemployed persons who have been actively seeking work in the last four weeks and is in line with the EU definition of harmonised unemployment. The previous series included unemployed persons seeking work in the last three months.

Source: Ministry of Labour, *Finnish Labour Review* and OECD Secretariat.

slowing, reflecting increasing shortages of graduates with appropriate competences, in particular in engineering. With, moreover, the share of long-term unemployment (more than twelve months) edging up to 30.5 per cent in 1997, the remaining unemployed may be more difficult to place, as they are more vulnerable to skill erosion and may lack the required skills associated with technological developments and industrial restructuring more broadly.

The current pace of unemployment declines may not be sustainable due to ‘‘speed limits’’, which could lead to stronger wage drift. Indeed, OECD Secretariat estimates suggest that, on current trends, the unemployment rate in Finland may soon reach the ‘‘NAWRU’’ – the non-accelerating wage rate of

Figure 5. **LABOUR MARKET**



1. Break in series in 1988. Revised series according to the new definition thereafter (see Table 4).
2. Break in series in 1988 due to a change in legislation forcing firms to declare vacant jobs.

Source: Statistics Finland, *Labour Force Statistics* and *Bulletin of Statistics;* OECD, *Main Economic Indicators* and *Labour Force Statistics* (Part III).

unemployment. The NAWRU is estimated by the Secretariat to have risen from 5½ per cent in the 1980s to 11 per cent in the mid-1990s.[3] Since then the NAWRU has probably been on a declining trend, based on, *inter alia*, a tightening of unemployment insurance rules (see Chapter III) and the entrance into the labour market of young graduates who have higher qualifications than the ''average'' worker. Nevertheless, the room for further non-inflationary job growth may be limited, notwithstanding the favourable employment and inflation performance to date. This is corroborated by the fact that the number of unfilled vacancies is rising quickly despite still very high unemployment, with employers reporting shortages of construction workers, electronic engineers, sales representatives, cleaners and welders.

Still subdued wage and price developments

Wage developments have significantly moderated in the past two years, with the annual rate of pay increases falling from 4.7 per cent in 1995 to 2.0 per cent in 1997 (Table 5 and Figure 6, Panels A and B). This has been the result of the incomes policy agreement concluded in the autumn of 1995 between the trade

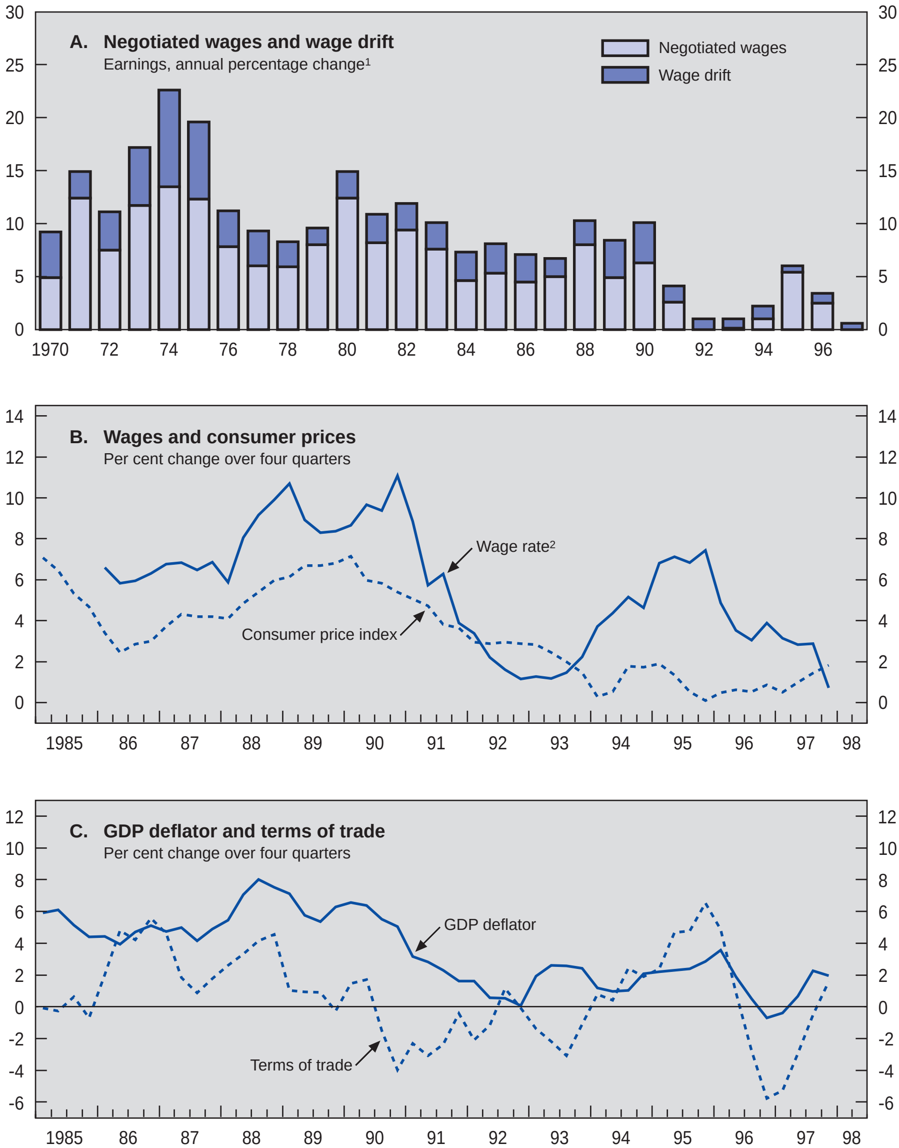
Table 5. **Wages, costs and prices**

Percentage changes

	1990	1991	1992	1993	1994	1995	1996	1997
Unit labour costs	**9.5**	**7.8**	**–2.6**	**–5.3**	**–2.5**	**1.8**	**1.8**	**–2.0**
Negotiated wages	5.5	4.0	0.9	0.0	0.7	3.6	3.2	1.5
Wage drift	3.7	2.4	1.0	0.8	1.3	1.1	0.7	0.5
Wage rate	9.2	6.4	1.9	0.8	2.0	4.7	3.9	2.0
Compensation rate	10.9	7.0	1.8	1.2	1.4	3.7	3.4	1.7
Consumer prices	**6.1**	**4.3**	**3.0**	**2.1**	**1.1**	**1.0**	**0.6**	**1.2**
At year end[1]	4.9	3.9	2.1	1.5	1.6	0.3	0.8	1.9
Contribution from:								
Labour cost and profit margins	2½	1½	–2	0	0	½	–¼	½
Import prices	1	½	3½	2	½	0	½	½
Housing costs	¼	–¼	–½	–¾	0	0	–¼	¾
Indirect taxes	1	2¼	1¼	¼	1	¾	½	¼
Food prices	¼	0	0	0	0	–1¼	0	0

1. Rates of change from December to December.
Source: Ministry of Finance and Bank of Finland.

Figure 6. **PRICE AND WAGE DEVELOPMENTS**



1. From fourth quarter to fourth quarter.
2. Hourly earnings of employees in manufacturing.

Source: Ministry of Finance; OECD, *Quarterly National Accounts* and *Main Economic Indicators.*

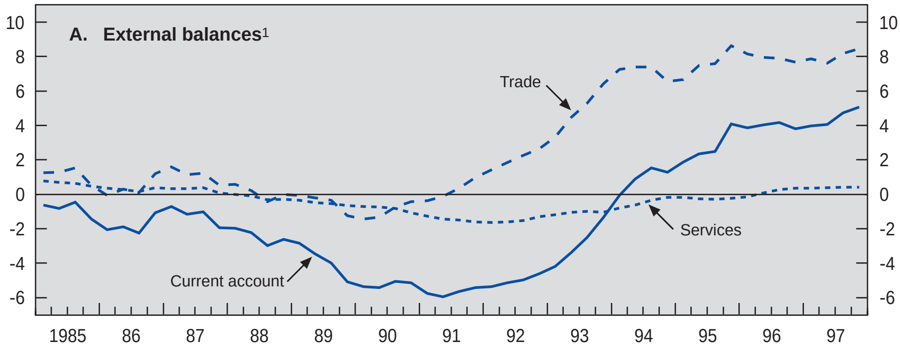
unions, the business association and the government. This agreement, which expired in January 1998, implied an initial pay rise of 2 per cent in November 1995, a second one of 1¾ per cent in October 1996 and no further increase in 1997. As a consequence, the annual rise in negotiated wages, including carry-over effects from previous wage agreements, fell from 3.2 per cent in 1996 to 1.5 per cent in 1997. Moreover, the modest effect of wage drift on labour cost was largely offset by a reduction in non-wage labour cost – in particular a cut in the employers' contributions for sickness and national pension insurance. In combination with the marked increase in labour productivity, this has helped to reduce unit labour cost by 2 per cent in 1997. As a new incomes policy agreement concluded in December 1997 calls for a 2.6 per cent pay increase in 1998 and a further 1.7 per cent in 1999, wage inflation should move slightly up this year and could edge down again in 1999, unless wage drift accelerates.

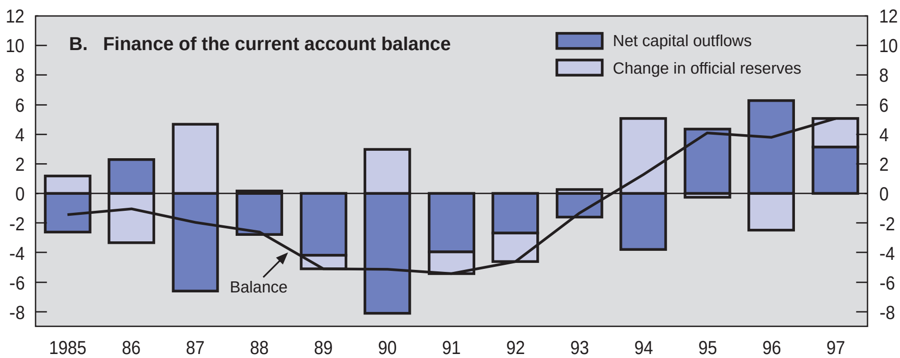
Reflecting low cost pressures, the consumer price index remained practically stable for the fourth year in a row, with the rate of change nevertheless slightly accelerating from 0.6 per cent in 1996 to 1.2 per cent in 1997. In fact, the inflation rate drifted up to 1.9 per cent by the end of the year, due to rising housing costs, higher import prices and widening profit margins. Despite an increase in petrol excises, it stabilised at this rate in the first quarter of 1998 as import prices subsided in the wake of the crisis in Asia and other emerging markets. The latter also served to lift the terms of trade further after it had been boosted by a recovery in export prices (notably in forestry and basic metal industries) in the course of 1997 (Figure 6, Panel C). The GDP deflator accordingly rebounded in 1997, even though the annual average increase was limited to just over 1 per cent.

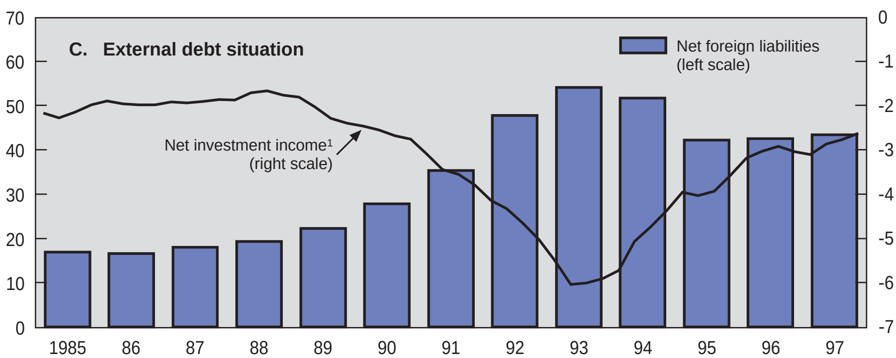
A strong external position

After having declined somewhat in 1996, the huge trade surplus built up since 1991 climbed further to 8¾ per cent of GDP in 1997, with soaring export volumes and rising terms of trade more than offsetting sharp increases in import volumes (of raw materials in particular) associated with buoyant industrial activity (Figure 7, Panel A). Moreover, with the services account showing a small surplus for the second consecutive year and the deficit on the investment income

Figure 7. **EXTERNAL POSITION**
Per cent of GDP







1. Four quarter moving average.
Source: Bank of Finland and OECD, *Main Economic Indicators.*

account widening to 2½ per cent of GDP, the current account surplus edged up to 5¼ per cent of GDP in 1997.

Despite the external surplus, net foreign liabilities remained broadly constant at 43 per cent of GDP, as the continued upswing in the market value of foreign-owned financial assets quoted on the Helsinki stock exchange almost exactly matched the sum of net capital exports and the increase in official reserves (Figure 7, Panel B). Around two-thirds of such net capital exports, which amounted to around 3½ per cent of GDP, reflected net foreign direct investment flows, although the purchases of securities issued in the (future) euro area by Finnish institutional investors also grew in anticipation of the reduced exchange rate risk. Official reserves increased in 1997 by an equivalent of 1¾ per cent of GDP, as substantial foreign exchange purchases – in response to speculative capital inflows at the beginning of the year – exceeded the repayment of foreign debt by the government.

Short-term outlook

The Secretariat's projections (Table 6), which are the same as those published in *Economic Outlook No. 63* (May 1998), assume that markets of Finnish manufacturing exports grow by 7½ and 6½ per cent in 1998 and 1999, respectively. Moreover, a slight tightening of monetary policy in Germany this year is assumed to be shadowed by Finland, while long-term interest rates would also show a modest increase reflecting a pick up in economic activity in Europe. Finland will be a founding member of the European Monetary Union in 1999, with the European Central Bank expected to tighten monetary policy slightly later in the year. Finally, in line with the budget presented to parliament last autumn, the general government primary surplus (excluding debt interest payments) is projected to rise by a cyclically-adjusted ¾ per cent of potential GDP in 1998, as a decline in public expenditure would exceed the reduction of the tax burden. Tax rates are assumed to remain unchanged in 1999, while expenditure restraint continues in line with the medium-term budgetary framework agreed last autumn.

Although both private consumption and residential investment should remain buoyant, economic growth is projected to ease to 4.2 per cent in 1998 and 3 per cent in 1999 due to slower export growth in the wake of the crisis in Asia and other emerging markets (in particular in the forestry equipment industry),

Table 6. **Short-term projections**

Percentage changes, volume

	1994 Current prices Mk billion	1995	1996	1997	1998	1999
Private consumption	284.4	4.6	3.8	3.0	3.2	3.1
Government consumption	114.0	1.9	3.5	–0.3	0.6	0.4
Gross fixed capital formation	74.2	11.3	8.4	11.2	10.3	9.0
Public sector	14.0	–5.5	10.5	4.6	–6.2	1.2
Business sector	60.2	15.2	8.0	12.6	13.2	10.1
Residential	18.4	–3.4	–0.1	29.7	25.5	15.7
Non-residential	41.8	25.1	11.3	6.2	7.7	7.2
Final domestic demand	472.6	5.1	4.6	3.8	4.1	3.8
Stockbuilding[1]	7.9	–0.2	–0.7	0.3	0.1	0.0
Total domestic demand	480.5	4.8	3.8	4.1	4.1	3.7
Exports of goods and services	182.5	8.2	3.9	12.8	7.5	3.8
Imports of goods and services	150.0	6.9	4.3	9.3	7.9	5.9
Foreign balance[1]	32.5	0.9	0.2	1.9	0.6	–0.3
GDP	511.0	5.1	3.6	5.9	4.2	3.0
Employment	2 024.1[2]	2.2	1.4	3.2	2.6	1.9
Unemployment rate (per cent)[3]	16.4	15.6	14.7	12.6	10.5	9.1
Household saving ratio[4]	0.4	3.6	0.9	2.8	2.5	2.2
Private consumption deflator	. .	0.3	1.6	1.4	1.9	2.0
GDP deflator	. .	2.4	1.3	1.1	1.9	2.3
Private sector wage rate	. .	5.5	4.4	2.6	3.8	2.6
Current account (per cent of GDP)	. .	4.1	3.8	5.4	5.8	5.7
Interest rates (per cent)						
Short-term (3 months)	. .	5.8	3.6	3.2	3.6	4.0
Long-term (5 years)	. .	7.9	6.0	4.9	4.6	4.9

1. Contribution to GDP growth.
2. Thousand persons.
3. New definition, see footnote 3 in Table 4.
4. Households and non-profit institutions, per cent of disposable income.

Source: OECD Secretariat.

capacity constraints in several industries and the unwinding of the construction boom (Table 6). Further robust employment growth should push the unemployment rate to 9 per cent by the end of the projection period, but wage and price increases are expected to remain moderate, at close to 3 and 2 per cent on average, respectively, supported by the two-year incomes policy agreement concluded in the fall of 1997.

Household demand risks turning out more buoyant than projected. Continued strong demand for owner-occupied housing, driven by low mortgage lending rates and improving households' net asset positions, could spark a boom in the real estate market and fuel asset price inflation – the more so since monetary policy will not be able to respond at the national level after Finland's adoption of the euro in January 1999. The associated wealth effects could spill over into household consumption and construction activity. As a result, while inflationary risks have eased with the recent incomes policy agreement, wages might increase faster than projected as emerging shortages in several trades (notably construction workers and professional engineers) could be exacerbated. An economy-wide acceleration of wages would jeopardise the desired reduction in unemployment, and risks breaking the ongoing virtuous circle of confidence building, job creation and fiscal consolidation. A possible downward correction in international stock markets, on the other hand, could spill over into weaker domestic business sentiment and investment, the more so if the crisis in Asia and other emerging economies turns out to have a stronger negative impact on Finnish export markets than currently expected.

II. Macroeconomic policies

In recent years, Finland has realised robust growth, with little inflationary pressure so far. In the early 1990s the currency was allowed to fall significantly, leading to a dramatic easing of monetary conditions and improved competitiveness, which was instrumental in boosting the economy out of recession. At the same time, a series of budget cuts aimed to re-establish policy credibility. The fiscal targets set out in the government's ''Convergence Programme'' have been met, with the general government balance estimated to reach a surplus in 1998 and the ratio of public debt to GDP below 60 per cent and falling. Even though the recession, the worst ever in the history of the OECD, was detrimental to market sentiment, the pursuit of sound policies contributed to lower interest rates – which have converged to German rates for all maturities. Finally, while easy monetary conditions have continued to provide strong impetus to the economic recovery, the official target of keeping underlying inflation at close to 2 per cent has been comfortably realised since 1995 – due, initially, to falling food prices following EU accession and helped, thereafter, by moderate central pay agreements.

Monetary union prompts new challenges

When entering the European Union in 1995 Finland became a signatory to the Maastricht Treaty. Finland has met the Maastricht criteria and will join the European single currency area in 1999, and thereby lose monetary policy as a domestic policy instrument. Finland has thus gone further than the neighbouring Scandinavian countries in anchoring its economy in the European Union. While Norway joined the European Economic Area and not the EU, both Denmark and Sweden are in the EU, but have chosen not to become founding members of the Economic and Monetary Union (EMU). Finland expects that it will gain from the single currency and has already benefited from the policy requirements of the convergence process. While the latter has fostered continued fiscal consolidation and wage moderation, the participation in the monetary union should further boost confidence of international financial markets, raise trade with EU partners and create a stable operating environment for Finnish businesses.

Monetary union will pose new challenges. Of immediate concern is the overall easy stance of macroeconomic policies when entering the Third Stage of EMU. Given the momentum of the economy compared with some major European countries – for instance, Germany and France – the risk of overheating calls for an appropriately tight stance of fiscal policy to offset the easy monetary conditions imported from the euro area. In a longer-term perspective, moreover, the loss of the monetary policy instrument may become problematic as soon as Finland is hit by either an adverse shock stemming from its specific product mix (for example, forestry products, telecommunication equipment) or geographical composition (Asia, eastern Europe), or by domestic wage inflation. Currency movements and interest rate changes will then not be available to smooth adjustment, and it is thus of crucial importance to have alternative ''shock absorbers'' available. Fiscal policy could play such a role at the macroeconomic level, but this would require a sustained accumulation of fiscal surpluses in the years to come to comply with the EU's Stability and Growth Pact (see Boxes 2 and 3), preferably through cuts in public spending in order to contain the high tax burden. Moreover, as discussed in Chapter III, microeconomic flexibility would need to be strengthened, *e.g.* by adopting structural reforms in both product and labour markets aimed at increasing the scope for non-inflationary growth and at avoiding further relocation of economic activities to other countries.

Against this backdrop, the remainder of this chapter examines the recent conduct of macroeconomic policies. It starts with a discussion of monetary management and recent financial market developments, both of which have been marked by the approach of monetary union. It then reviews the progress in budget consolidation, the current stance of fiscal policy and the long-run sustainability of public finances.

Box 2. **The EU's Stability and Growth Pact**

The Pact for Stability and Growth, finalised at the Amsterdam Summit in June 1997, consists of two Council regulations. One clarifies the Maastricht Treaty's provisions for an Excessive Deficit Procedure and the other strengthens the surveillance and co-ordination of economic policies. The Pact also calls on participants in the monetary union to commit themselves to aim at a medium-term budgetary balance or at a surplus.

Avoiding excessive government deficits (above 3 per cent of GDP) is considered essential for the success of Economic and Monetary Union. The Maastricht Treaty already included a procedure aimed at discouraging, and reducing when one occurs, excessive deficits. The 3 per cent reference value, however, can be exceeded if: *i)* the origin of the excess lies outside the normal range of situations (exceptionality); *ii)* the excess is limited in time (temporariness); and *iii)* the excess is small enough for the deficit to remain close to the 3 per cent reference value (closeness). These three conditions need to apply simultaneously. The Treaty, however, does not specify a precise interpretation of these constraints.

The Stability and Growth Pact gives a more specific interpretation of exceptionality and temporariness. For countries participating in monetary union, the Pact considers a general government deficit above 3 per cent as excessive unless the country is in economic recession. A recession is defined as an annual fall in real output (GDP) of at least 0.75 per cent. Implementation of the Excessive Deficit Procedure depends on the severity of the economic decline. If economic output in a Member State declines by 2 per cent or more, and provided the deficit is temporary, exemption from the Excessive Deficit Procedure is granted. In the event GDP falls by between 0.75 per cent and 2 per cent, exemption can be granted in special circumstances by the Council of Ministers. The country would need to convince the Council that the economic decline was ''exceptional'' in terms of its abruptness or in relation to past output trends.

Failure to adhere to the Pact could result in the imposition of sanctions. Initially, these would take the form of non-remunerated deposits, with a fixed component equal to 0.2 per cent of GDP and a variable component rising in line with the size of the excessive deficit. Such deposits are limited to a maximum of 0.5 per cent of GDP, but would accumulate each year until the excessive deficit is eliminated. Provided the excessive deficit is corrected within two years the deposits are returned to the country. Otherwise, the deposits could ultimately be converted into a fine.

Box 3. **How large a surplus to comply with the Stability and Growth Pact?**

The Stability and Growth Pact (see Box 2) is not explicit on the required budgetary position individual EMU Members should aim for in the medium run. That depends on the volatility of the economy in question as well as the sensitivity of fiscal outcomes to economic fluctuations. Finland has known three episodes of below-trend output since 1970: 1974-78, 1981-84 and 1990-93. The first two recessions were relatively mild and the budget surplus remained at 3 per cent of GDP or even more at the trough – helped by the financial surplus of the (partly) funded public pension system (Table 7, first two columns). The recent recession, however, was extremely severe, with the output gap bottoming in 1993 at almost 11 per cent of trend GDP and the deficit reaching 8 per cent of GDP (Table 7, third column). The calculations by the OECD Secretariat shown in the table indicate that three-quarters (6 percentage points) of the 1993 budget deficit was directly caused by the slump. This would suggest that, in order to respect the 3 per cent deficit ceiling during exceptionally severe recessions, Finland should maintain a (structural) budget surplus of 3 per cent of GDP in the medium run.

Although the past experience provides useful guidance for the formulation of medium-term fiscal objectives, smaller medium-term budget surpluses could suffice as the Finnish economy may become less volatile in the future - not least reflecting the more stable economic environment that may be created by monetary union. Moreover, the extent of the swings in economic activity in the early 1990s has resulted from a unique combination of exceptional circumstances which are unlikely to be repeated in the future. In fact, even if a similar recession were to hit Finland after it has adopted the euro, it

Table 7. **Estimated impact of past recessions on general government net lending**

	As a per cent of	1978	1984	1993	Average	
					1978 and 1984	All periods
Output gap at trough[1]	Potential GDP	–3.7	–0.5	–10.9	–2.1	–5.0
Net lending at trough	Actual GDP	3.9	3.0	–7.9	3.4	–0.3
of which:						
Structural[2]	Potential GDP	4.4	2.2	–1.9	3.3	1.6
Cyclical	Actual GDP	–1.8	–0.2	–6.1	–1.0	–2.7
Net interest receipts	Potential GDP	1.0	0.9	0.3	1.0	0.8

1. Difference between actual and potential GDP.
2. Primary cyclically-adjusted balance.
Source: OECD Secretariat.

(continued on next page)

(continued)

would probably qualify as ''resulting from an unusual event outside the control of the Member State'' as stipulated in the Stability and Growth Pact, and thus not lead to sanctions.* In this case, the benchmark for the medium-term budget surplus would be the ''average'' recession in the past three decades rather than the ''worst'' recession. In that case it would suffice to maintain a balanced budget in the medium run (the impact of an ''average'' recession on the budget deficit is almost 3 per cent of GDP, see Table 7, last column).

However, a medium-run balanced budget would leave little room for discretionary fiscal stimulus in future recessions, which may be desirable because fiscal policy needs to bear the brunt of macroeconomic stabilisation requirements once the monetary policy instrument is abandoned with the adoption of the euro. Therefore, the Finnish authorities would still need to aim for a budget surplus in the medium run if they wished to allow for the possibility of fiscal stimulus. This could be of the order of 2 per cent of GDP, in line with the target for 2001 announced in the Convergence Programme. Nevertheless, larger surpluses should be aimed for in years where economic activity is above trend. In any event, a structural budget surplus is called for to cope with the long-run fiscal implications of population ageing.

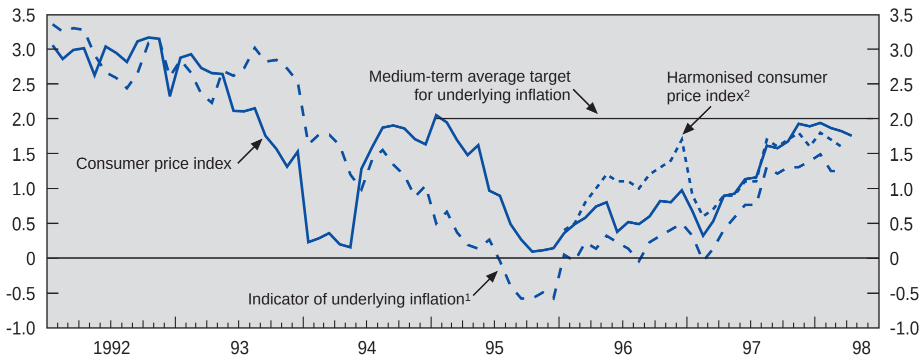
* As noted in Box 2, the Growth and Stability Pact reiterated the ''exceptionality'' clause included in the Maastricht Treaty, stipulating that a temporary overshooting of the 3 per cent reference value of the budget deficit could be accepted if it results from ''an unusual event outside the control of the Member State in question'' or from ''an exceptionally severe recession''. The Pact defines an ''exceptionally severe recession'' as one where real GDP declines by 2 per cent or more. It is noteworthy that if the Pact had applied in 1993 and been interpreted to the letter, this would not have qualified Finland as being in ''exceptionally severe'' recession: after real GDP had dropped by 7.6 and 3.6 in 1991 and 1992, respectively, it fell by ''only'' 1.2 per cent in 1993, which is the year when the deficit hit the bottom.

Monetary policy

Policy aims and institutional changes

Since early 1993, monetary policy has aimed at a medium-term inflation target (referring to the consumer price index adjusted for changes in indirect taxes, subsidies and capital costs of owner-occupied dwellings) of around 2 per cent from 1995 onwards. Although the short-term inflation outlook has improved in the euro area, partly reflecting the crisis in Asia and other emerging economies and a related weakening of commodity prices, inflation has edged up from a very low level in early 1997 (Figure 8). It now exceeds the EU-area average of around

Figure 8. **INFLATION PERFORMANCE**
Per cent change over 12 months



1. Consumer price index, net of indirect taxes and subsidies, adjusted for housing capital costs.
2. Inflation measure introduced by the European Union to improve EU-wide comparability between national consumer price indices, using 1996-based weighting schemes.

Source: Statistics Finland and OECD, *Main Economic Indicators.*

1½ per cent by a small margin (based on harmonised price indices). The slight acceleration of inflation and the weakening of the effective exchange rate in the course of 1997 prompted the monetary authorities to raise the official interest rate in March 1998, despite the recent moderate wage agreement. In addition to the inflation target, the monetary authorities have observed an exchange rate target since the Markka entered the European Exchange Rate Mechanism (ERM) in October 1996. Since entering the ERM, the Markka has remained close to its central rate.

Monetary union implies a series of institutional changes. EMU is scheduled to begin on 1 January 1999,[4] at which time Finland will adopt the euro, with monetary policy being conducted by the European Central Bank (ECB) and a single payments system (TARGET) for the European System of Central Banks being introduced. After the changeover to the single currency, monetary policy will be decided area-wide by the governors of the participating national central banks together with the executive board of the ECB.[5] While it has been agreed that the ECB will pursue price stability as the sole objective of monetary policy, its mode of implementation has yet to be decided.

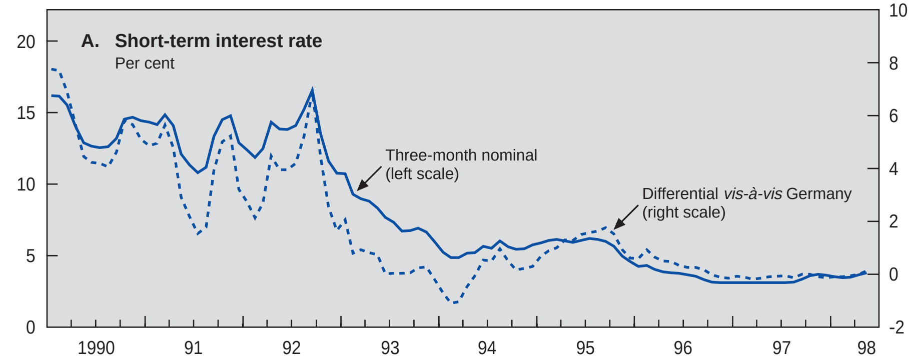
Finland has made steady progress in aligning national monetary and financial policies, institutions and instruments with the requirements of monetary union, as laid out in the Maastricht Treaty and implemented in consultation with the European Monetary Institute (EMI), the precursor to the ECB. A new Bank of Finland Act will fully enter into force at the start of 1999, with the objective of aligning Finnish central banking legislation with Maastricht requirements for Stage Three of EMU.[6] The existing Bank of Finland Act was amended already in March 1998 to enable the Bank to function as a part of the European System of Central Banks. Accordingly, once the single currency has been established, the market instruments available to the Bank will be identical to those in all other euro countries, with the Helsinki interbank offer rate, Helibor, to be replaced by a euro-equivalent ‘‘Euribor’’. However, aside from the implementation of the common monetary policy in Finland, the Bank will continue to play its role of supplying currency and maintaining the stability of the domestic payments system.

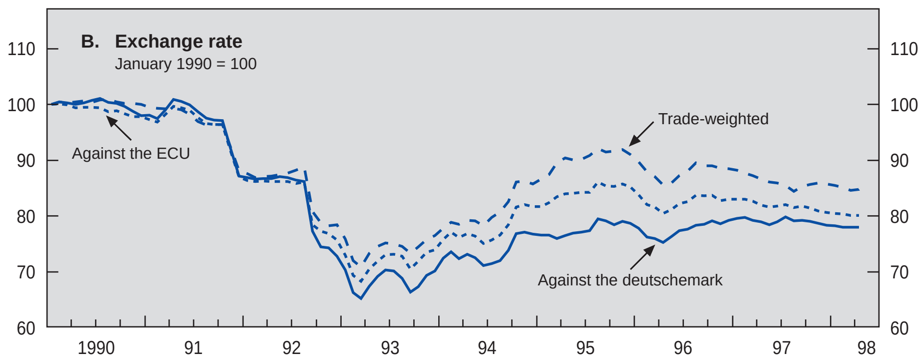
One prerequisite for Finland's participation in EMU was its entry into the ERM, a step which was taken on 6 October 1996. ERM membership requires that monetary policy aims at keeping the national currency within fluctuation bands against the currencies of the other ERM members (+/–15 per cent of the central rate, although a narrower band has been observed in practice). While the markka's central rate *vis-à-vis* the ECU has been technically devalued twice since entry to the ERM – when the lira entered the ERM in November 1996 above its market value and the Irish punt was revalued within the grid in March 1998 – the central parities *vis-à-vis* other ERM currencies have been unchanged and the currency has shown only minor fluctuations.[7] The requirement to keep the bilateral exchange rates of the markka *vis-à-vis* the other ERM currencies stable has come on top of the official inflation target observed since 1995. Since ERM membership, Finnish monetary policy has therefore aimed at attaining the twin objectives of exchange rate and inflation stability.

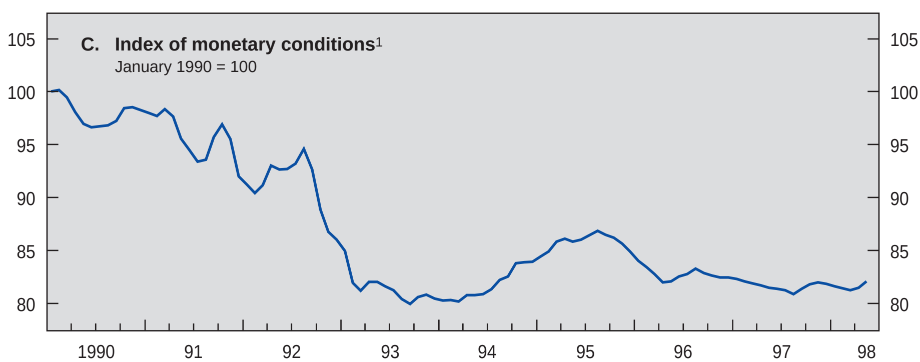
Exchange and interest rate developments

The value of the markka depreciated in effective terms in the course of the past twelve months by around 4 per cent, largely due to the strengthening of the dollar and sterling – although this trend was interrupted briefly as the crisis in Asia and other emerging economies unfolded (Figure 9, Panel B). The markka

Figure 9. **MONETARY CONDITIONS**







1. Index constructed by the Bank of Finland using a weighted average of changes in the three-month money market rate (0.70) and the effective exchange rate (0.30).

Source: Bank of Finland and OECD, *Main Economic Indicators.*

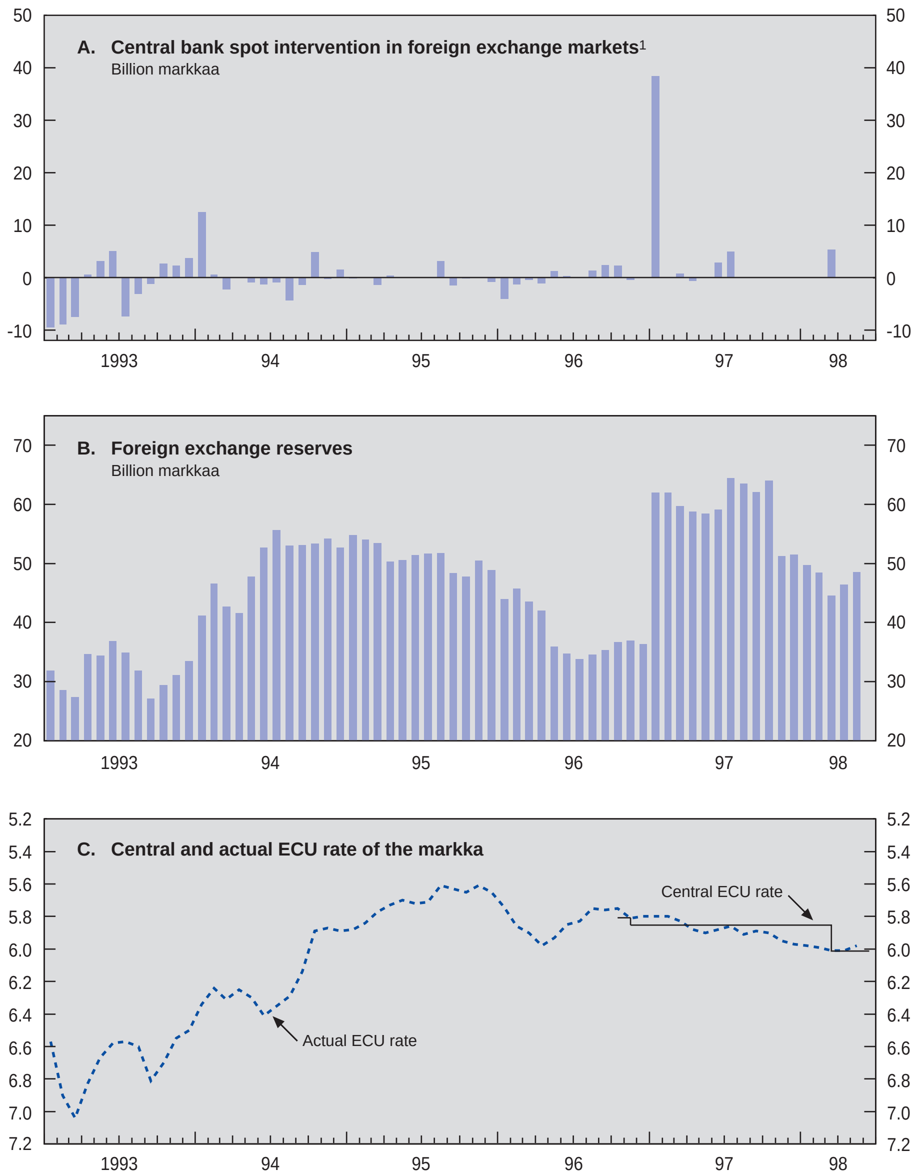
also trended down against the ECU from mid 1997 due to the appreciating punt, but has been almost exactly at its central rate since the Irish currency was revalued in March 1998 (Figure 10, Panel C). Speculation on an appreciation of the markka in early 1997, and to a lesser extent over the summer, was held in check by exchange market intervention; since then the markka has not been subject to further speculative pressure (Figure 10, Panel A). Reflecting intervention, official foreign exchange reserves rose in the first half of the year, but fell subsequently as the central government repaid foreign denominated public debt (Figure 10, Panel B).

With upward pressure on the markka fading in summer 1997, the Bank of Finland exploited the room to raise its tender rate – and increased it to 3.25 per cent in September 1997, up from 3.0 per cent. In March 1998, the Bank increased it further to 3.4 per cent, in view of the momentum of the economy, concerns over booming asset prices and imported inflation associated with the effective depreciation of the exchange rate. As a result, the market-determined Helibor rate remained very close to the equivalent German rate (Figure 9, Panel A). The Finnish long term interest rate (10 year bonds), which stood at 6.5 per cent upon the country's entry into the ERM in October 1996, has declined steadily since then, reflecting the favourable development in foreign trade and public finances (Figure 11, Panel A). By March 1998, it stood at 5.0 per cent, only slightly above German yields (Figure 11, Panel B). Reflecting the pronounced decline in long-term interest rates and the modest increase in short rates, the yield gap has halved in the past twelve months, to 1.6 percentage points in early 1998 (Figure 11, Panel C). Overall, monetary conditions have remained easy (Figure 9, Panel C).

Money and credit growth

The growth rates of the various money aggregates converged in 1997 and early 1998, as the impact of various structural changes waned. In 1997, the expansion of M1 (cash plus sight deposits) decelerated to just over 5 per cent after strong growth in prior years due to a shift from time to sight deposits as the former lost tax-exempt status (Table 8). On the other hand, M2 growth (M1 plus time deposits) resumed in 1997 as the acceleration in net foreign assets outweighed a contraction of domestic credit and other items. At the same time, an increase in certificates of deposit (CDs) held by the public boosted the broader money aggregate M3 (M2 plus CDs).

Figure 10. **RECENT FOREIGN EXCHANGE DEVELOPMENTS**

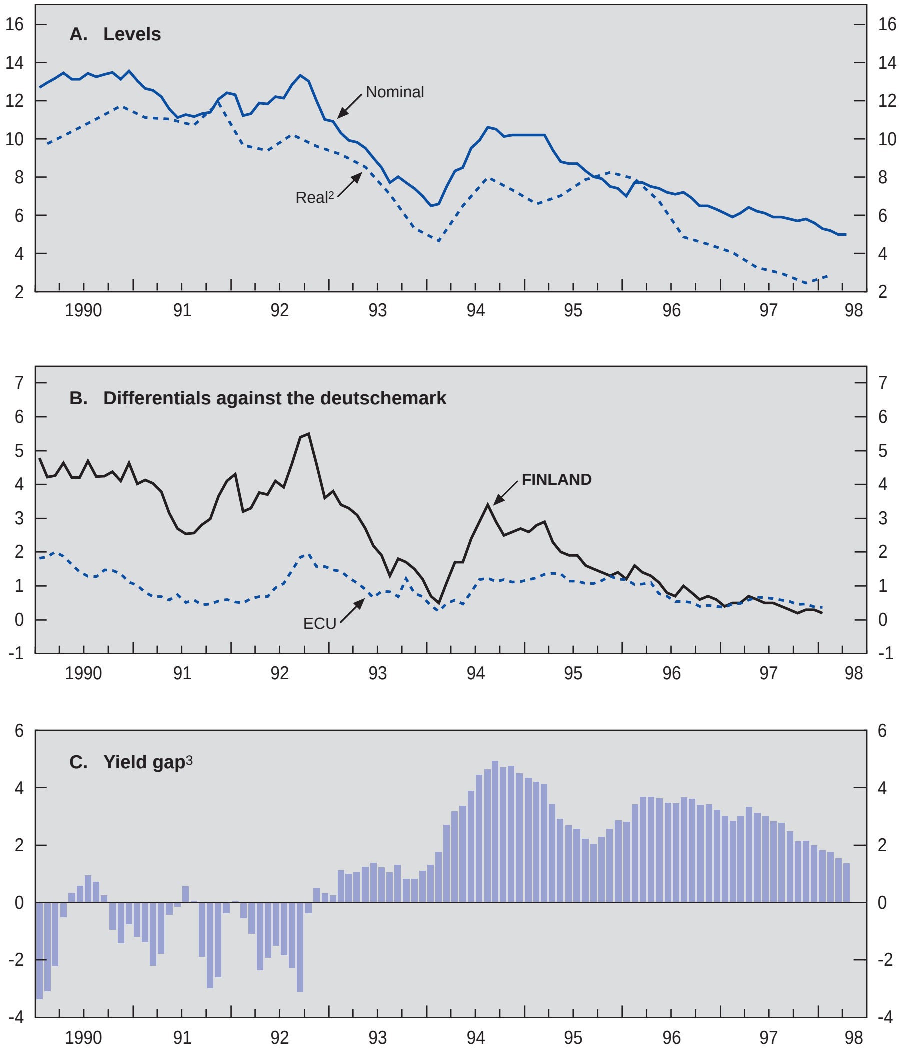


1. No interventions from August 1997 to February 1998.

Source: Bank of Finland.

Figure 11. **LONG-TERM INTEREST RATE DEVELOPMENTS**[1]

Per cent



1. For Finland, the long-term rates are for five-year taxable government bonds prior to November 1992 and ten-year bonds thereafter.
2. Long-term bond yield less the expected rate of inflation, the latter being measured by the percentage change on the GDP deflator over the four quarters following each observation.
3. Long-term bond yield less the three-month money market rate.

Source: Bank of Finland; OECD, *Financial Statistics Monthly* and OECD Secretariat.

Table 8. **Money growth**

Percentage change

	1990	1991	1992	1993	1994	1995	1996	1997	1998[1]
M1	13.9	–7.7	3.2	5.1	8.9	14.0	16.4	5.3	5.8
M2	5.9	3.3	–0.4	2.0	2.5	6.0	–2.1	2.8	3.5
M3	6.8	6.8	–0.1	3.8	1.9	0.4	–1.3	8.7	5.8
Contributions to M2 growth									
Foreign assets, net	–9.5	–1.4	6.7	15.4	13.9	4.4	5.0	9.8	. .
Domestic credit	17.9	11.1	–8.8	–12.6	–12.1	0.5	–3.3	–3.9	. .
Other items, net	–2.5	–6.4	1.7	–0.8	0.7	1.1	–3.8	–3.0	. .

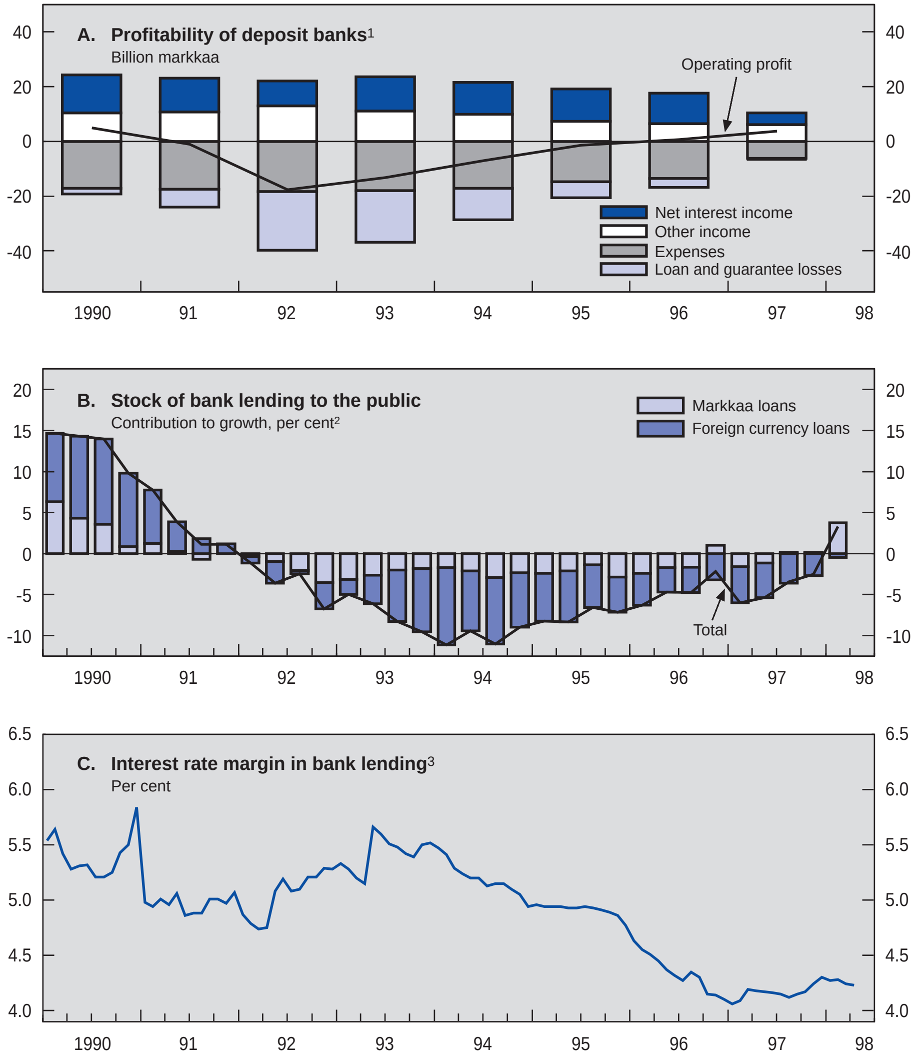
1. Growth from April 1997 to April 1998.
Source: Bank of Finland.

Liquidity conditions, which served as a brake on economic developments in the years following the banking crisis, have improved owing to the restored profitability of banks (Figure 12, Panel A).[8] Nevertheless, credit growth has remained sluggish (Figure 12, Panel B) due to declining demand for corporate loans, as soaring profits prompted many companies to finance investment with retained earnings. An increase in housing loans supported by the buoyant housing market, however, finally boosted new markka-denominated borrowing in the first quarter of 1998. Lending rates for households and interest margins on bank lending nevertheless remained low due to fierce competition between banks (Figure 12, Panel C). Indeed, several banks cut their prime rate to reflect the falling long-term interest rate and banks' lending rates continued to decline despite the September 1997 and March 1998 increases in the official tender rate.

Is monetary policy too loose?

While the relatively easy stance of monetary policy in recent years has been justified by the absence of inflationary pressure during the recovery from the deep recession, there are concerns that it may have become too easy given the momentum of the economy and the associated risk of accelerating inflation (see Chapter I). Inflationary pressures are already visible in emerging shortages in labour markets associated with pronounced skill mismatches and rising asset price inflation in both real estate and equity markets. Under ''normal'' circumstances, monetary policy would be tightened to avoid an overheating of the

Figure 12. **BANK PROFITABILITY AND CREDIT BEHAVIOUR**



1. Owing to the revision in 1995 of the regulations on annual accounting, the figures for 1995 onwards are not comparable with earlier years. Data for 1997 is an estimate.
2. Contribution to changes in total bank lending to the public (as a per cent of total bank lending to the public in the same quarter of the previous year). Break in the first quarter of 1997.
3. Average rate on markka lending minus average markka deposit rate.

Source: Bank of Finland and The Finnish Bankers' Association, *Finnish Financial Markets 1997.*

economy. Given the twin objectives of Finnish monetary policy, of exchange rate and price stability, the scope for further interest rate increases has become limited. So far, the simultaneous attainment of the twin objectives has been facilitated by the remaining slack in the economy, and inflation is likely to remain low until the adoption of the euro on 1 January 1999, when monetary policy will be determined by the ECB which will pursue the goal of area-wide price stability. However, slack is evaporating quickly; the appropriateness of area-wide monetary conditions for Finland is in doubt given that they are likely to remain easy due to the relatively weaker economic conditions in many euro countries. As a consequence, the burden of a timely macroeconomic policy adjustment to reduce domestic inflationary risks falls squarely on fiscal policy.

Fiscal policy

The strength of the economic recovery has benefited from the credibility effects associated with the intensive budget consolidation process. The public deficit has been practically eliminated and a downward trend in the ratio of public debt to GDP secured. Convergence towards the fiscal requirements of the Maastricht Treaty has been comfortably achieved. Meanwhile, public expenditure levels have remained high by international comparison. During the early 1990s, the economic crisis and the associated dramatic increase in the number of claimants of social transfers sparked a surge in general government social expenditure (including statutory occupational pensions) which, as a share of GDP, soared from 27 per cent in 1990 to 37 per cent in 1993 before declining to 34 per cent in 1997.[9] These increases came on top of a major expansion of the Finnish welfare system during the 1980s and, although important corrective measures have been taken in recent years, Finland remains, after Sweden, the country with the highest share of welfare expenditure in GDP in the OECD area. Moreover, the share of total public expenditure in GDP, at 54 per cent, is 10 percentage points above the level prevailing in the mid-1980s, notwithstanding a comparable cyclical position of the economy. The tax burden has increased unabated in past decades and, at 47 per cent of GDP, is also among the highest in the OECD area. The wide difference between spending and tax revenues largely reflects the sizeable interest income in the social security (pension) sector.

Fiscal consolidation has remained a priority

Since the crisis in the early 1990s the development of public finances in Finland has been marked by fiscal consolidation efforts, which were needed to offset the erosion of the tax base and the mounting welfare expenditure. After taking office in 1991 the previous government implemented a series of austerity packages which by the end of its term in 1995 had resulted in Mk 34½ billion of annual budget savings – corresponding to 6 per cent of GDP – compared with the initially projected expenditure levels. When entering office in the spring of 1995, the present government introduced an additional austerity package, which has generated further budget savings of Mk 23½ billion (4 per cent of GDP) per year. One third of these measures were included in the 1996 budget and the remainder in the 1997 budget.

Around one-third of the austerity measures since 1991 have taken the form of reductions in central government transfers to municipalities, which, in turn, has been reflected in sharp declines in real public spending on education and health care as well as public investment (Table 9).[10] The remainder of the austerity packages mainly affected social transfers to households, central government consumption and subsidies. The implementation of the austerity packages was facilitated by a combination of two fundamental changes in budgetary procedures: *i)* the adoption of new budget legislation in 1992 allowing cuts in welfare spending to be enacted on the basis of a simple rather than a qualified parliamentary majority; and *ii)* the introduction of a new funding method for municipalities in 1993, with the previous system of retrospective reimbursements replaced with prospective block grants based on a capitation formula (see Chapter IV).

The successive austerity packages, helped by the economic upturn which started in 1994, have achieved three main objectives: public expenditure growth has been restrained, the large public deficit reined in and the upward trend in the public debt/GDP ratio arrested (Figure 13). After peaking at 60¼ per cent of GDP in 1993, the share of general government expenditure in GDP fell to 54¼ per cent in 1997. This was accomplished despite the 2 per cent of GDP increase in public expenditure related to Finland’s accession to the EU in 1995 (including the adoption of a national agricultural support programme to mitigate the impact of the Common Agricultural Policy on farm incomes – see Chapter III) and the implementation of temporary fiscal stimulus measures in

Table 9. **Public finances in the 1990s**

Per cent of GDP

	1990	1991	1992	1993	1994	1995	1996	1997
Expenditure	**45.4**	**53.9**	**59.1**	**60.2**	**59.3**	**57.9**	**57.3**	**54.2**
Percentage volume change	6.5	7.5	3.8	1.0	2.5	2.8	1.9	0.5
of which:								
Health care	3.5	–0.4	–3.8	–5.9	–2.9	1.7	2.9	. .
Education	2.1	3.4	–2.4	–4.7	3.6	7.7	1.7	. .
Current transfers[1]	9.4	13.1	12.5	5.5	3.2	2.7	0.8	–0.1
Revenue	**50.7**	**52.5**	**53.4**	**52.3**	**53.2**	**52.7**	**53.9**	**53.2**
Tax[2]	46.2	47.1	47.1	45.7	47.9	46.1	47.8	47.2
Other revenue[3]	4.5	5.4	6.2	6.6	5.3	6.6	6.1	5.9
Net lending	**5.4**	**–1.5**	**–5.7**	**–7.9**	**–6.2**	**–5.2**	**–3.4**	**–1.0**
of which:								
Central government	1.2	–4.5	–7.6	–11.2	–11.3	–9.6	–7.4	–4.7
Local government	0.1	–0.9	–0.8	0.4	1.3	0.6	0.6	0.2
Social security funds	4.1	3.9	2.6	2.8	3.9	3.9	3.5	3.3
Gross debt[4]	**14.5**	**23.0**	**41.5**	**58.0**	**59.6**	**58.1**	**58.0**	**59.1**
of which: Central government	10.5	17.2	34.7	53.0	60.2	65.3	68.8	70.6
Government bond yields 8-10 years (per cent)	13.2	11.6	12.1	8.8	9.1	8.8	7.1	6.0

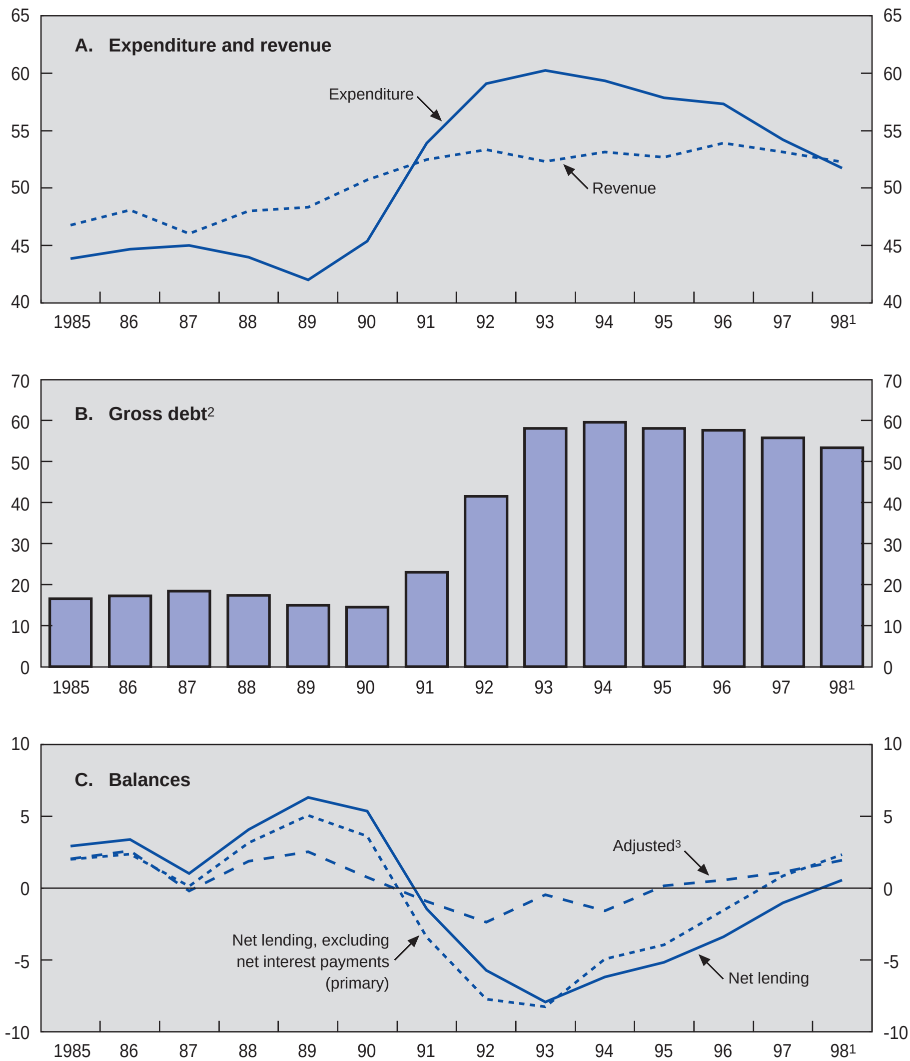
1. Deflated by the consumer price index.
2. Including social security contributions.
3. Property income and transfers received other than social security contributions.
4. EMU definition.

Source: Bank of Finland, *Bulletin*; Ministry of Finance and OECD Secretariat.

October 1995 as part of the government's 1995 Employment Programme. Moreover, with the recovery lifting general government revenues, the general government deficit shrank from almost 8 per cent of GDP in 1993 to around 1 per cent in 1997. Over this period, the municipal budgets were close to balance and the social security funds' surpluses maintained at around 3½ per cent of GDP, respectively, while the central government deficit declined from 11¼ to 4 per cent – with the 1997 outcome even better than planned (Table 10). Finally, the fiscal consolidation efforts, together with the ending of the banking crisis, the decline in interest rates, and the recovery of the exchange rate from its 1993 trough (which led to a lower level of foreign-currency denominated public debt), contributed to reducing the general government gross debt/GDP ratio from a 59½ per cent peak in 1994 to 55¾ per cent in 1997 (Figure 13, Panel B). Finland thus comfortably meets the Maastricht fiscal criteria for participation in

Figure 13. **GENERAL GOVERNMENT FINANCES**

Per cent of GDP



1. Projections.
2. According to the "Maastricht" definition.
3. Primary cyclically adjusted, corrected for tax refunds. Per cent of potential GDP.

Source: OECD, *National Accounts* and OECD Secretariat.

Table 10. **Initial budget proposals and outcomes**

Mk billion, national accounts basis

	Outcome			1997		1998	
	1994	1995	1996	Budget[1]	Estimate[2]	Budget[1]	Revised[2]
Central government							
Revenue	124.8	139.2	152.2	160.5	163.9	169.1	173.4
Expenditure	182.7	192.2	194.9	190.9	189.0	190.0	191.4
Balance	–57.9	–53.0	–42.7	–30.4	–25.1	–20.9	–18.0
Per cent of GDP	*–11.3*	*–9.6*	*–7.4*	*–4.9*	*–4.1*	*–3.2*	*–2.7*
Local government							
Revenue	98.5	100.2	100.8	97.6	99.5	94.5	96.5
Expenditure	91.9	96.9	97.1	97.2	100.5	96.5	98.5
Balance	6.6	3.3	3.7	0.4	–1.0	–2.0	–2.0
Per cent of GDP	*1.3*	*0.6*	*0.6*	*0.1*	*–0.2*	*–0.3*	*–0.3*
Social security							
Revenue	137.5	139.7	138.2	140.6	137.9	139.6	139.1
Expenditure	117.7	118.3	117.8	119.0	119.6	117.5	116.7
Balance	19.8	21.4	20.4	21.6	18.3	22.1	22.4
Per cent of GDP	*3.9*	*3.9*	*3.5*	*3.5*	*3.0*	*3.4*	*3.4*
General government balance							
Per cent of GDP	*–6.2*	*–5.2*	*–3.4*	*–1.4*	*–1.3*	*–0.1*	*0.4*
Underlying projections, per cent:							
GDP growth	4.5	5.1	3.6	3.9	5.9	3.5	4.0
Unemployment rate[3]	17.9	16.7	15.8	15.4	14.5	13.5	12.5

1. September of the preceding year.
2. February 1998.
3. Old definition, see footnote 3 in Table 4.

Source: Ministry of Finance.

monetary union, although it should be noted that the central government's gross debt still amounted to 70 per cent of GDP in 1997 (Table 9).[11]

Not surprisingly, the Secretariat's fiscal indicators suggest a tightening stance of fiscal policy since 1993. The general government's primary balance (*i.e.* net of interest payments) has displayed an improvement since 1993, and in 1997 turned positive for the first time since 1990 (Figure 13, Panel C). Moreover, the cyclically-adjusted primary balance (*i.e.* net of the effects of automatic stabilisers and corrected for changes in the timing of tax refunds) has been showing a modestly widening surplus since 1995, indicating that fiscal policy has acted to dampen domestic demand growth to some extent in the past three years.

The 1998 budget and 1999 deliberations

In order to limit the risk of economic overheating and to reduce the still high level of central government debt, the government included additional spending cuts of around Mk 2 billion ($^1/_2$ per cent of GDP) in the 1998 budget presented to the parliament in September 1997. The bulk of these cuts concerned infrastructure projects and construction subsidies, and served to reverse the stimulus package initiated in late 1995. Although these cuts were accompanied by a reduction in payroll taxes of around Mk 1 billion (following the two-year incomes policy agreement concluded in September 1997), the central government deficit was officially projected to decline further from 4.1 per cent of GDP in 1997 to 3.2 per cent in 1998. With the local government budgets likely to show a small deficit of 0.3 per cent and the social security funds maintaining a surplus of 3.4 per cent of GDP, the general government account was officially estimated to be practically in balance in 1998 (Table 10). The budget update released by the government in February 1998 suggests that fiscal outcomes this year may be even more favourable than envisaged initially, mostly due to higher than expected tax proceeds associated with the buoyant economy. The general government balance is now expected to post a surplus of 0.4 per cent of GDP, with the central government deficit likely to decline to 2.7 per cent of GDP. The Secretariat's fiscal indicators show that, based on these assumptions, the stance of budgetary policy would be moderately tight in 1998 (Figure 13, Panel C).

With the austerity packages now fully implemented, fiscal policy may turn to an easier stance in 1999, however, at a time when domestic demand is likely to remain strong and labour market conditions become tighter (see Chapter I). In view of these developments, the government has expressed its readiness to include further spending cuts in the 1999 budget. The authorities provisionally expect to reduce the central government deficit to $1^1/_2$ per cent of GDP and boost the general government surplus to almost 2 per cent of GDP in 1999. This would realise the September 1997 Convergence Programme target for the year 2001 already in 1999, helped by a stronger performance of the economy than that projected in the Programme.

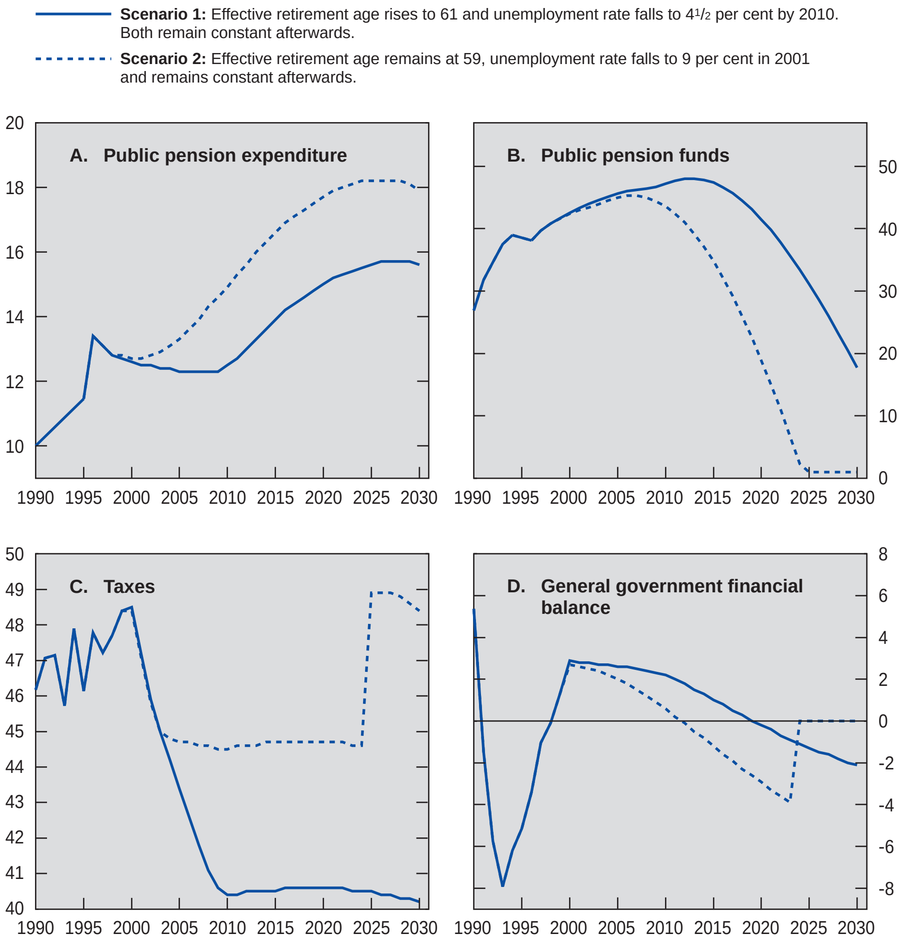
Longer-term challenges

The current and previous governments' efforts to rein in public expenditure have been motivated also by the need to ensure sustainable public finances in the long run, in view of the rapid ageing of the population, the low effective retirement age of workers and the rising tax burden in the wake of the slump of the early 1990s. The question thus arises whether the fiscal consolidation achieved to date is sufficient from a longer-term perspective, noting that Finland already stands out by its high level of government expenditure and taxation – reflecting the large share of public in total employment (at 23 per cent the fifth-highest in the OECD area after Sweden, Norway, Denmark and France), the sizeable regional, agricultural and industrial support programmes (subsidies as a share of GDP are the third-highest in the OECD area after Norway and Sweden) and the costly welfare system. These features combine not only to raise public expenditure levels but, as discussed in Chapter III, also create adjustment difficulties in the labour market through welfare traps and impediments to labour mobility.

A major future challenge stems from rising public pension expenditure in Finland, whose share in GDP, at 12 per cent, is already the highest in the OECD area after Greece, Italy and Sweden, while the tax burden, as noted, is also very high by international comparison. Although the public pension system in Finland has been subject to far-reaching reforms in recent years (see the special chapter in the 1997 *OECD Economic Survey of Finland*), the expected long-run increase in pension expenditure still risks being more pronounced than in most OECD countries. Recent official calculations suggest that – with current pension rules and entitlements to public services unchanged, pension contribution rates fixed at present levels, and tax rates of the local and central governments adjusted to balance their budgets – it would require very solid macroeconomic conditions to keep general government finances sustainable in the long run. For example, the favourable ''Scenario 1'' depicted in Figure 14 shows that, with the unemployment rate falling to 4½ per cent (old definition) by the year 2010 and the effective retirement age increasing from its present 59 years to 61 years in 2010, pension expenditure would rise to 16 per cent of GDP in the third decade of the next century. With the overall tax/GDP ratio dropping from 47 per cent in 1997 to 41 per cent in 2010 – in line with the fall in unemployment and the associated broadening of the tax base – the general government balance would turn into deficit from 2017, as the Employment Pension funds begin to deplete their assets.[12] However, the Employment Pension funds would not entirely run out of assets before 2030 and hence public finances would still be manageable.

Figure 14. **LONG-RUN SCENARIOS FOR PUBLIC FINANCES**[1]

Per cent of GDP



1. the general assumptions for the scenarios are as follows:
   i) in line with demographic projections by Statistics Finland, the proportion of the population aged over 60 increases from 20 per cent in 2000 to 25 per cent in 2010 and 31 per cent in 2030;
   ii) until 2001 economic developments are in line with the Convergence Programme and from 2002 onwards the labour participation rates per age bracket remain constant, labour productivity and the overall price level both increase by 2 per cent annually (and the price level of public consumption by 3 per cent), the real yield on financial assets and liabilities is 3 per cent;
   iii) the Employment Pension funds keep their contribution rates fixed until they have depleted their assets and they are subsequently run on a "Pay-As-You-Go" basis (this explains the hike of the tax/GDP ratio in 2025 in Scenario 2).

   For other assumptions, see main text.

Source: Tuukkanen (1998).

By contrast, if the unemployment rate remains at 9 per cent (old definition) from 2002 onwards and the effective retirement age remains at 59 years, pension expenditure would rise to 18 per cent of GDP in the 2020s (‘‘Scenario 2’’ in Figure 14). The initial decline in taxes would then be less pronounced – the ratio to GDP falls to 45 per cent by 2010 – and the Employment Pension funds' assets would already be depleted in the early 2020s. As a result, pension contributions would need to be raised, thereby boosting the tax/GDP ratio from 45 to 49 per cent of GDP in the second half of the 2020s. Although pension contribution rates would probably be raised earlier and more smoothly (current legislation would, in fact, oblige the Employment Pension funds to do so), the conclusion remains that reducing (structural) unemployment and limiting early retirement inflows are both key to ensuring sustainable public finances in the long run. Simulations with the Minilink model carried out recently by the OECD Secretariat point to the same conclusions (Turner *et al*., 1998). On the other hand, as highlighted in the previous OECD *Economic Survey*, raising the returns on the Employment Pension funds' assets – which are low by international standards due to restrictions on investment in shares – would considerably ease the financing requirements of public pensions in Finland.

III. Implementing structural reform: a review of progress

Overview

After four years of robust growth, there is evidence that bottlenecks are developing in the labour market despite the significant remaining unemployment. In addition, as Finland is in the process of giving up the domestic monetary policy instrument associated with the adoption of the euro, the burden of adjustment to changing economic situations will fall increasingly on fiscal policy which, however, is constrained by the requirements of Stability and Growth Pact and the rising costs associated with the ageing of the population. As a result, structural reform of labour, product and financial markets will have an increasingly important role to play to ensure continued high non-inflationary growth and a sustainable reduction in unemployment in the years to come.

Major structural change in product and financial markets has already resulted from Finland's participation in the European integration process and international agreements, with businesses and financial institutions adjusting well to the increased contestability of markets. As part of EU membership, the authorities have adopted the Common Agricultural Policy and reformed financial market regulation and supervision. Nevertheless, there is ample scope for increased economic efficiency in Finland. While in past decades labour productivity has been catching up, in particular in the manufacturing industry (Table 11), the level of per capita GDP is still well below the United States and low relative to the EU (Figure 15). This indicates that labour resources are under-utilised and also suggests that productivity developments in ''sheltered'' activities, including the public sector, continue to lag those in many OECD countries. As demonstrated in Chapter IV, for example, the scope for productivity gains in the health care sector is still considerable, and it is also clear that the efficiency of the heavily

Table 11. **Relative labour productivity levels in manufacturing**

Value added per unit, United States = 100

	1960		1973		1985		1995[1]	
	Person engaged	Hour worked	Person engaged	Hour worked	Person engaged	Hour worked	Person engaged	Hour worked
Finland[2]	**49.2**	**45.9**	**54.4**	**58.3**	**63.9**	**71.9**	**82.8**	**100.8**
Australia	52.9	50.5	50.2	49.9	54.2	56.5	50.3	51.7
Belgium[2]	45.3	45.6	60.7	70.9	83.1	106.4	81.1	104.7
Canada	69.1	68.5	81.3	82.5	82.0	84.3	68.4	69.6
France	47.5	45.9	66.0	70.0	72.3	85.8	70.1	85.1
Germany	60.6	56.0	72.5	76.1	75.6	86.4	63.1	81.4
Japan	25.1	19.2	55.4	48.5	78.2	68.8	74.8	72.8
Mexico[2]	26.6	24.7	34.2	32.4	34.3	31.4	..	..
Netherlands	52.8	50.8	76.8	88.2	85.8	107.1	73.7	96.5
Spain[2, 3]	15.4	20.4	29.2	37.8	48.8	79.8	40.1	67.6
Sweden	48.5	49.8	66.0	79.6	68.3	87.3	75.4	90.3
United Kingdom	48.6	45.0	52.0	53.6	54.7	59.7	59.6	69.7
United States	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

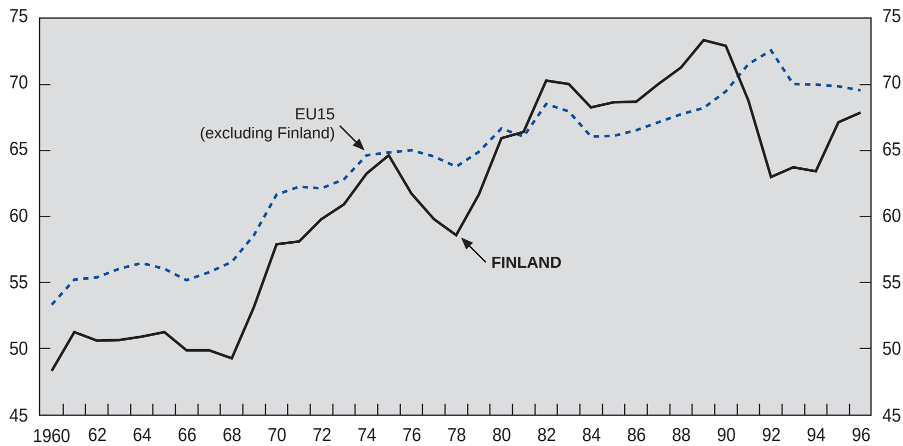
1. Or latest available year.
2. The productivity estimates for these countries are directly derived from industry-of-origin studies, and thus exclude PPPs from expenditure studies. They are therefore not strictly comparable to the estimates for the other countries.
3. Spain/USA is an inferential estimate, based on a benchmark study for Spain/UK that was linked to the other country by the UK/USA comparison.

Source: Pilat, D. (1997), ‘‘Competition, Productivity and Efficiency’’, OECD, *Economic Studies*, No. 27.

supported agricultural industry could improve significantly. Moreover, a recent survey (UNICE, 1997) found that the large size of the public sector and the resulting high tax burden are major constraints to operating a business in Finland.

A bold and coherent structural reform programme aimed at improving the functioning of the labour market is still to be developed. Due to the recession in the early 1990s, a significant part of a generation of older workers became redundant and the share of long-term unemployed rose. In order to speed up the reduction in unemployment, the government implemented the ‘‘Employment Programme’’ in 1995 and 1996 which, aside from a number of modifications to the public transfer system, relied heavily on measures to stimulate construction activity and active labour market programmes. As a positive spin-off of the Employment Programme, the central labour market organisations committed themselves to achieving further wage moderation while the government continued to use the generous transfer system to support the unemployed workers. In early 1998, the authorities introduced a comprehensive reform of active labour

Figure 15. **GDP PER CAPITA**
Current PPPs, United States = 100



Source: OECD, *National Accounts.*

market policies, with a view to raising their efficiency. While additional measures are not planned prior to the start of EMU and parliamentary elections in early 1999, the next government should move forward with implementing the needed comprehensive structural policy reform, aimed at raising factor inputs and productivity, and enhancing the ability of the labour market to respond flexibly to changing economic conditions within the single currency area.

This chapter reviews structural initiatives since the previous *Economic Survey* in the context of the above challenges. It starts with a discussion of labour market issues, with the recent progress in implementing the OECD *Jobs Strategy* receiving special attention, and subsequently briefly examines the tax system in view of the high tax burden in Finland. The chapter ends with a review of policies regarding product and financial markets.

The labour market

The country-specific recommendations for implementing the OECD *Jobs Strategy* (see the 1996 *Economic Survey* of Finland) highlighted the need to increase work incentives for people on public income support, raise flexibility in wage setting and employment practices, and reduce the high taxation of labour. In particular, it was recommended that the maximum duration of benefits be shortened; the income support for new entrants abolished; the social ''income norm'' for long-term benefit recipients, who rely on means-tested benefits, lowered; the waiting period before unemployment benefits can be claimed extended; the eligibility criteria for unemployment benefits tightened and enforced more strictly; and the use of subsidised jobs for unemployment insurance re-qualification ended. Moreover, it was suggested that early retirement be scaled back, employment protection legislation eased and the administrative extension of negotiated wage settlements abolished. A synopsis of the Jobs Strategy recommendations and their subsequent implementation is presented in Table 12.

While the 1995 Employment Programme contained measures that went in some of these directions, the 1997 OECD *Economic Survey* of Finland found progress to be largely insufficient. The measures adopted to weaken the incentives for early retirement and to reduce the practice of benefit renewal through participation in active labour market programmes were welcomed, but in virtually none of the other areas was major progress achieved. Accordingly, one in four persons of working age remains on social security benefits, as the pronounced rebound in employment in recent years has not sufficed to reduce significantly the dependency of workers on public income support (Figure 16). Indeed, a decline in the number of beneficiaries in the flat-rate Unemployment Assistance scheme has been entirely off-set by a rise in the number of people on the means-tested Labour Market Support programme. The number of beneficiaries in other income support schemes – *i.e.* the earnings-related Unemployment Insurance, Unemployment Pension, Disability Pension and various active labour market programmes, has remained broadly stable. While inflow into the disability pension scheme has been reduced significantly in recent years, the share of disability pension beneficiaries in the working age population remains among the highest in the OECD area. It is, therefore, advisable for the government to undertake a thorough medical re-evaluation to ensure that participation in this scheme follows the original intention of providing financial support for the disabled.

Further structural reform in the labour market should give priority to reducing the persistence of long-term unemployment among mostly older and lower-

Table 12. **Implementing the OECD Jobs Strategy – an overview**

Jobs Study proposal	Action taken since the previous *Survey*	Assessment/recommendation
I. Reform unemployment and related benefits		
a) End use of subsidised jobs for unemployment insurance benefit requalification	*a)* Limits on unemployment insurance benefit renewal through subsidised employment adopted in early 1997	Unemployment and related benefit reform is in right direction, but additional reforms are needed including the medical re-examination of the large number of persons on the generous disability pension scheme, and a reduction in the ''income norm'' to limit means-tested cash benefits
b) Shorten maximum unemployment benefit duration	*b)* No action	
c) Reduce benefit levels over time	*c)* Basic daily unemployment benefit increased from Mk 118 to 120 in early 1998. Reduction in benefit level for renewal of unemployment insurance adopted in early 1997	
d) Enforce and tighten unemployment benefit eligibility criteria	*d)* Comprehensive proposal for labour market policy reform provides enforcement of job search requirements and more frequent contact of job-seekers with the Public Employment Service adopted in early 1998	
e) Extend unemployment benefit waiting period	*e)* No action	
II. Increase employment and working time flexibility		
a) Reduce early withdrawal from labour force	*a)* New benefit rules implemented in early 1997 to discourage entry into early retirement and disability pension schemes	Need to fully liberalise store opening hours. More reform of employment protection and working time legislation needed to better encourage job creation, especially by SMEs
b) Reform employment protection legislation, for *e.g.* fixed-term contracts and part-time employment	*b)* Maximum allowable overtime reduced in aggregate, but with increased flexibility at local level. Job protection raised for atypical work forms	
c) Facilitate inter-firm job mobility by linking pension rights to career average earnings rather than to earnings at the end of every employment contract	*c)* No further action has been taken following measures in 1996 to extend the pensionable wage from the last four to the last ten years of every employment contract	Move towards pensionable wage based on career average earnings

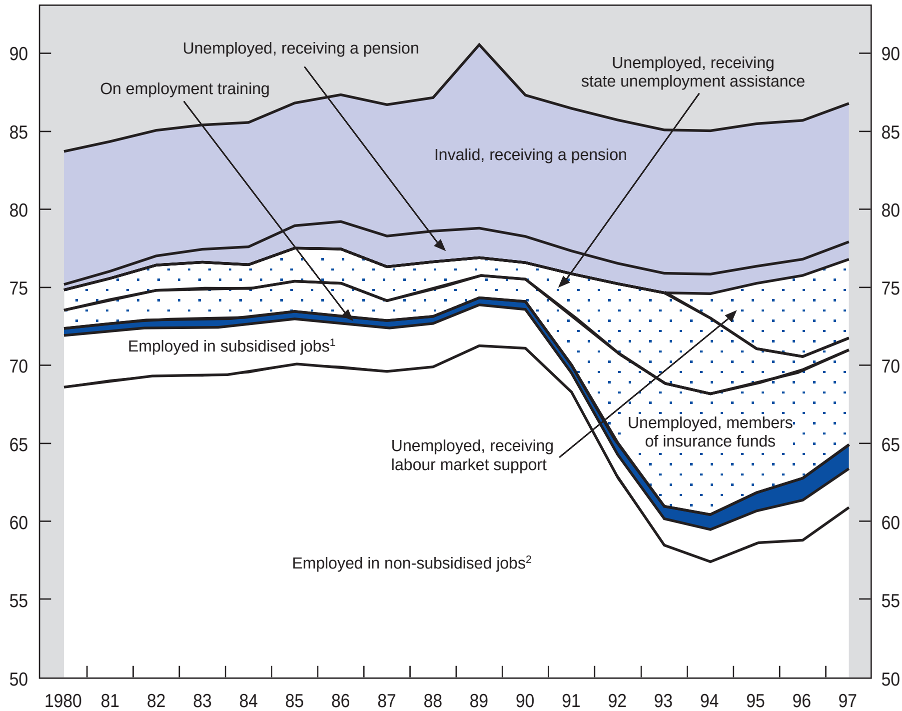
Table 12. **Implementing the OECD Jobs Strategy – an overview** *(cont.)*

Jobs Study proposal	Action taken since the previous *Survey*	Assessment/recommendation
III. Increase wage and labour cost flexibility		
a) Abolish administrative extension of negotiated wage settlements, including non-wage aspects, and replace it with a low universal minimum wage	*a)* No action	Review existing wage formation arrangements in order to enhance employability of low-skilled workers, in particular in private services
b) Government to disengage from wage formation process	*b)* No action	
IV. Enhance product market competition		
a) Continue privatisation of state-owned enterprises	*a)* Efforts continue, but pace limited by capacity of domestic stock market	Examine scope for completing privatisation of partially privatised state enterprises. Continue efforts to reduce industrial and agricultural support and streamline number of support programmes in industry
b) Liberalise professional services, *e.g.* prices and entry	*b)* Action taken in recent years	
c) Reduce income tax rates on low-income workers	*c)* A modest increase in municipal earned income tax credit to be implemented in 1998 and 1999	
d) Remove obstacles for the development of SMEs	*d)* Several reforms implemented. Financing conditions facing SMEs in rural areas being studied	
V. Improve labour force skills and competencies		
a) Promote industry-education co-operation for apprenticeship training	*a)* Comprehensive proposal to improve targeting of training programmes on emerging mis-matches	Monitor labour market developments by occupation and skill level
b) Bolster career planning in secondary schools and above	*b)* No action	

Source: OECD Secretariat.

Figure 16. **STRUCTURE OF THE LABOUR FORCE**

Per cent of population aged 15-64



1. Persons employed with selective measures or participating in other job programmes (*e.g.* public works, ESF objective 3).
2. Total employment less persons employed in subsidised jobs.

Source: Ministry of Labour, *Finnish Labour Review* and OECD Secretariat.

skilled workers who are most susceptible to becoming trapped in public income support schemes, resulting in a tremendous waste of human and financial resources.[13] While overall unemployment is declining rapidly, the share of long-term unemployment in total unemployment has tended to rise – indicating that unemployment, especially for older workers, is becoming an increasingly entrenched problem.[14] In fact, persons over 50 years of age frequently report encountering problems in finding employment, and these difficulties are even more pronounced for those over 55.[15] As a result, many older workers have become discouraged, and have effectively withdrawn from the labour market by entering interim arrangements leading to old age retirement, such as the special Unemployment Insurance benefit scheme which does not require job search for persons over 57, or the Unemployment Pension programme or other forms of early retirement after 60. Low-skilled young persons also appear to face increasing difficulties in the job market, despite the fact that youth unemployment has been falling rapidly in recent years (see Chapter I).[16]

There is also mounting evidence that labour mobility could be enhanced, in order to ease regional and occupational mismatches in the labour market.[17] A recent study (Böckerman, 1998) has demonstrated that out of three main regional factors accommodating labour demand shocks – the unemployment rate, the labour force participation rate and labour mobility – only unemployment responded to such shocks ''immediately and strongly''. There are several causes explaining the lack of labour mobility, including the pension system, generous public income replacement rates, housing subsidies, and the insufficient enforcement of job acceptance requirements across regions and occupations. As discussed in last year's *Survey*, employees who change employers during their working life risk facing lower pension entitlements than those who remain with one employer. Geographic mobility is also lowered for persons with low income in public housing who decide to move to another municipality as they risk losing their entitlement to public housing in the municipality they move to.[18] In addition, local Public Employment Service offices rarely enforce the pertinent rules concerning the requirement to take a job in another region or occupation after three months of unemployment. Labour mobility across regions and occupations could thus be enhanced by removing these distortions, although this would likely reduce the population of the northern regions further. Priority should be given to tightening the link between individual pension contributions and benefit entitlements and enforcement of existing rules by the Public Employment Service.

Initiatives since the last *Survey* have focused mainly on improving active labour market policies, which currently cover around 5 per cent of the labour force. Moreover, efforts have been made to enhance the flexibility of working hours and employment contracts, while macroeconomic flexibility of labour cost has been raised through the introduction of buffer funds in the social security system. The sections below review these policies in more detail.

Active labour market policies

Several initiatives took effect in January 1997 limiting the use of active labour market programmes to renew Unemployment Insurance benefit entitlements.[19] These measures did not cover all programmes, however, and have led to increasing inflows into ''last resort'' benefit schemes, in particular the Labour Market Support programme.[20] In May 1997, a working group of senior government advisors presented a *Comprehensive Proposal for Labour Market Policy Reform* (Räisänen and Skog, 1997), with the aim to improve the interaction between passive and active measures. These proposed measures, the majority of which were passed into law on 1 January 1998, limit the access to last resort benefit schemes. To this end, admittance to the Labour Market Support scheme – which has functioned as a passive unemployment support since its introduction – has, as originally intended, been made conditional on participation in some form of labour market training.

Key to the success of this reform strategy will be to increase the effectiveness of the existing active labour market programmes, which included over 5 per cent of the labour force in 1997.[21] In particular, an objective of the *Comprehensive Proposal* is to strengthen job counselling and the brokerage activity of the Public Employment Service and to re-emphasise the rights and obligations of unemployed persons in order to stimulate their job-search activity and acceptance. To this end, regular interviews of unemployed job-seekers have been introduced, based on a job-seeking plan structured around the ''skill mapping'' of each unemployed person, complemented by the distribution of a ''job-search manual''. Another initiative announced in the *Comprehensive Proposal* is to improve the targeting of labour market policies on categories of workers with a high incidence of long-term unemployment, or in areas with emerging bottlenecks.[22] Moreover, the ''education guarantee'', a special in-school benefit at a level equivalent to the Unemployment Assistance scheme which was previously available only to unemployed workers out of work for at least 6 of the previous 18 years has been opened up to all unemployed workers.[23] Finally, in order to improve the targeting of subsidised job creation, the *Comprehensive Proposal* introduced a ''combination support'' system, whereby service sector employers are paid the equivalent of the Labour Market Support benefit plus a special ''job-creation'' subsidy for each new job involving a long-term unemployed person, out of work for at least two years.[24]

Aside from the initiatives contained in the C*omprehensive Proposal,* efforts to liberalise the job brokerage function are expected to continue, in line with international trends, with the aim of improving the effectiveness of the Public Employment Service network. At present, the role of private job placement agencies is still very small in Finland – with the private job brokerage sector, comprising both ‘‘head-hunting’’ firms and temporary work agencies,[25] accounting for around ½ per cent of the job turnover – far below the European average of 2 to 3 per cent. Many of the placements by job brokerage firms are in part-time employment. One effect of greater private sector activity in this field has been to place pressure on the Public Employment Service to improve the quality of its service to job seekers, which in the past has focused on providing a job clearing service for employers. For example, a new computer system has been installed in the Public Employment Service offices for use by job seekers to help them to locate work faster.

While the *Comprehensive Proposal* represents a coherent approach to active labour market policies, it has not significantly affected the financial incentives for unemployed workers to stay inactive. The daily basic income support level to which most new benefit recipients are eligible is very high and rises quickly for families with children, based on supplementary cash benefits (housing allowance, etc.). As a result, the net replacement rate is one of the highest in the OECD area. In 1994, the net replacement rate of a Finnish couple with two children and receiving a single average production worker income was found to be 75 per cent in the first month of unemployment, 5 percentage points above the average for the OECD-Europe area excluding Finland and 14 percentage points above that in selected non-European OECD countries (OECD, 1996).[26] Moreover, by the 60th month of unemployment the Finnish net replacement rate had risen by 23 percentage points – compared with a 2 percentage point decline for OECD-Europe and a 6 percentage point decline for the other OECD countries. The financial incentives to seek work for older persons with limited vocational skills and receiving such benefits are especially low.[27]

Flexibility of employment and working time

Employment protection rules in Finland, although broadly in line with practices in other European countries, are restrictive relative to those found in non-European OECD countries. This may help to explain the rising incidence of long-term unemployment as firms are reluctant to take on workers with diminished skill levels. Reflecting the relatively limited use of atypical work forms (fixed-term, part-time and temporary work) in the economy, two sets of measures were implemented to increase the flexibility of employment and working time in early 1997.[28] *First*, a new Working Time Act entered into force on 1 January 1997, containing provisions permitting more flexible working time arrangements at the local level, although such arrangements are principally determined in collective agreements. The objective of the Act was to tailor flexible working time arrangements to local requirements, although the total amount of permissible overtime in the economy was reduced. *Second*, the Employment Contracts Act was amended on 1 February 1997, with the objective of enhancing the acceptability of atypical work. In particular, the amendment has granted atypical work equal status to that of permanent employment. The amendment has also been introduced to relieve pressure on permanent staff, by increasing the scope for atypical work to meet peak demand and for permanent staff to take leave associated with maternity, dependent care and sickness. While the amendment is intended to make it easier for Small and Medium-sized Enterprises (SMEs) to hire on a fixed-term basis, especially in the service sector, it may actually make it more difficult for people to enter the labour market, because stronger employment protection and higher social security coverage raise labour cost. A study (Grant Thornton International, 1997) found that the principal factor limiting recruitment by Finnish SMEs were ''hire and fire'' restrictions, which were significantly more pronounced than in other EU countries. Entrepreneurs are, however, mainly concerned about hiring restrictions associated with complex legislation for employment and working time, which impedes their ability to add workers flexibly when needed to expand existing operations or start up new ventures.[29]

The wage formation system

Finland has a long-standing tradition of centralised wage bargaining. Between 1968 and 1997, 20 central agreements on wages were concluded, each of them for a period of one or two years. The central agreements serve as a basis for negotiations at the industry and enterprise levels. As a result, wages are affected not only by increases agreed at the central level, but also by further upward adjustments negotiated at lower levels. In 1993 and 1994 this pattern was interrupted, as the government disengaged itself from the wage negotiation process in an effort to encourage labour unions and employers' organisations to seek a greater differentiation in wages across industries. This attempt, however, failed to bring sectoral variation in wages and, in fact, led to a temporary acceleration in wages at a time of very high unemployment. This is consistent with the finding that sectoral or branch level bargaining involves agents with considerable market power but does not take full account of economy-wide requirements, nor of those of individual firms, and as such tends to be the least desirable form of wage negotiation (Calmfors and Driffil, 1988). Since 1995, the social partners and the government have worked together to reach moderate wage agreements, as they felt that ensuring moderate wage outcomes remained an overriding priority, and that this was possible only in a centralised framework.

In past economic downturns, aggregate real wage flexibility was achieved with incomes policies, with price inflation exceeding wage increases for sustained periods – often in the context of exchange rate depreciation – but this option cannot be exercised when Finland joins the single currency area. In order to introduce more flexibility in aggregate real labour costs in view of monetary union, a proposal by the Federation of Labour Unions (SAK) to create a ''buffer fund'' in the Unemployment Insurance scheme was accepted by the government and employers as part of the two-year incomes policy agreement in December 1997.[30] At the same time, it was agreed to use the existing buffer fund of the Employment Pension scheme (occupational earnings-related pensions) in a similar way. The purpose of these funds – the assets of which are expected to reach several percentage points of the wage bill by 2003 – is to allow the Unemployment Insurance and Employment Pension schemes to run deficits during downturns and surpluses during upturns, which would help dampen the business cycle and smooth the development of social security contributions, an important element of labour taxation. In fact, the requirement to keep the social security system in balance, through an annual revision of contribution rates, has made such labour taxation pro-cyclical, as contribution rates declined in an upturn, but rose in a downturn. In return for the buffer fund arrangement, the unions agreed to change the basis on which individual social security contribution rates are calculated. Accordingly, the share of employees' social security contributions was raised from 5 to 20 per cent of total contributions as of 1 January 1999 – a rise from 1½ to 6 per cent of the wage bill – with a corresponding reduction in the employer's share from 50 to 40 per cent and the state's share from 45 to 40 per cent. While tax smoothing through buffer funds may prove helpful in a future downturn, its impact on aggregate labour cost developments is expected to be relatively small. Moreover, the creation of buffer funds risks jeopardising expenditure discipline due to softer budget constraints.

In view of the limited relative wage flexibility and the compressed wage structure, the 1996 *Economic Survey* recommended that wage negotiations be increasingly conducted at the firm level to improve the matching of labour demand and supply across firms, sectors, regions and skill groups.[31] To this end, it was also recommended that the administrative extension of central wage contracts to non-unionised employees be abolished in order to improve the scope for flexible wage setting. Administrative extensions are particularly problematic for SMEs. While labour demand by larger companies is fairly wage inelastic, explained partly by their greater possibilities of seeking labour cost flexibility through adjustments in in-house career-lines, SME labour demand has been found to be more wage elastic (Piekkola, 1998). Reforms to wage setting are, therefore, likely to encourage job creation by SMEs, especially in the service sector where, as noted in the previous *Survey*, Finland has a relatively large scope for employment gains.

Taxation

Due to the very high tax rates on labour – which have risen dramatically since 1985 – as well as the substantial value-added tax rate, Finland's overall share of taxes in GDP, at 46 per cent in 1995, was at the high end in the OECD area (Table 13). Such high tax rates are reflected in production costs and wage levels which, in turn, distort investment and employment decisions in the economy.[32] High taxation may also lead to tax avoidance in the form of lower (reported) economic activity – although Finland has scored relatively favourably to date in this respect[33] – and the relocation of activity abroad.[34] Indeed, as discussed in the 1996 *Economic Survey*, in the past decade employment by Finnish manufacturing companies has been growing mostly abroad, due to a need to be close to consumer markets, but also to avoid high taxes in Finland. There is, indeed, some empirical evidence that foreign direct investment flows from Finland are in part explained by the high level of taxation (Leibfritz *et al.*, 1997).

Table 13. **Tax burden**

Per cent

	Capital[1]			Labour[2]			Sales[3]			Total taxes as a per cent of GDP		
	1975	1985	1995	1975	1985	1995	1975	1985	1995	1975	1985	1994
Finland	**29**	**34**	**33**	**30**	**34**	**44**	**18**	**21**	**21**	**38**	**41**	**46**
Australia	43	42	45	18	19	19	9	10	8	30	31	31
Austria	16[4]	22	21	33[4]	41	44	17	19	16	38	42	42
Belgium	32	34	35	35	41	41	14	13	14	42	47	46
Canada	43	34	47	20	23	29	10	11	11	33	33	36
Denmark	. .	43	41[5]	. .	40	43[5]	20	26	25	40	48	49
France	19	26	24	31	41	45	18	18	16	37	44	45
Germany	. .	. .	24	. .	. .	38	13	13	14	36	38	39
Italy	. .	23	30	. .	29	36	10	10	13	26	35	41
Japan	28	40	43	13	19	22	4	5	6	22	28	29
Netherlands	31[4]	25	27	40[4]	46	44	14	15	16	43	44	44
Norway	28[4]	39	29	33[4]	32	36	22	26	25	40	43	42
Spain	. .	12	19[5]	. .	24	32[5]	5	9	12	20	29	34
Sweden	. .	46	40	. .	47	47	15	19	19	44	50	50
United Kingdom	69	61	45	24	23	21	11	15	14	35	38	35
United States	42	34	40	19	22	23	5	5	5	25	26	28

1. Average effective tax rate on capital defined as household income taxes paid on operating surplus of private, unincorporated enterprises and on household property and entrepreneurial income; plus tax on income, profit and capital gains of corporations; plus recurrent taxes on immovable property; plus taxes on financial and capital transactions; all divided by total operating surplus of the economy.
2. Average effective tax rate on labour defined as household income tax paid on wages plus payroll or manpower taxes, divided by wages and salaries (including income of self-employed) plus employers' contribution to social security and to private pension schemes.
3. Average effective tax rate on sales of goods and services defined as general tax on goods and services plus excise taxes, divided by private and government non-wage consumption.
4. Data for 1976 for Austria, 1977 for Netherlands and 1978 for Norway.
5. Data for 1994 for Denmark and Spain.

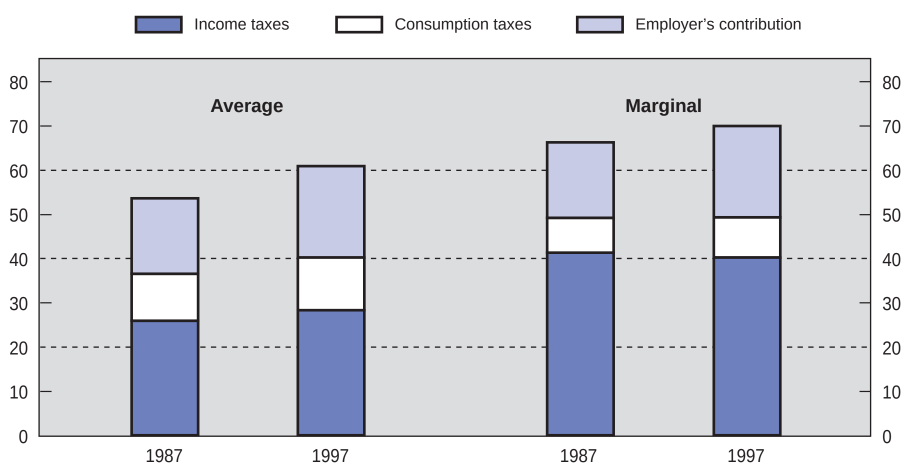
Source: OECD, *Revenue Statistics* and *National Accounts*; OECD (1997), ''Taxation and Economic Performance'', *Economics Department Working Paper,* No. 176.

In view of this, it is clear that the tax burden in Finland needs to be reduced to foster both continued domestic investment and attract inward foreign direct investment and to raise employment (OECD, 1997*a*).[35]

Rates of labour taxation – as measured by the marginal and average tax rates – are among the highest in the OECD area. Labour taxation increased sharply during the recession (Figure 17), as social security contributions were raised to match the surge in welfare outlays during the crisis, from 28 per cent of GDP in 1990 to 39 per cent in 1993. The envisaged reversal in the upward trend in the labour tax wedge back to its pre-1990s level, which was one of the measures proposed in the government's 1995 Employment Programme, has not been achieved, as public debt reduction was given a higher priority. In order to secure a modest wage deal, the government agreed to reduce taxes by Mk 5 billion (1 per cent of GDP) – partly through increases in the municipal earned income tax credit – to be spread over 1998 and 1999 and financed by increased property and corporate taxes. Given existing public finance objectives, larger tax concessions were not deemed possible.[36] Nevertheless, further reductions of

Figure 17. **AVERAGE AND MARGINAL TAX RATES**

For an average employee, per cent



Source: Ministry of Finance.

labour taxation are urgently needed, especially for low-paid work, in order to encourage more job creation for low-skilled workers (Leibfritz *et al.*, *ibid.*). Moreover, given the very narrow after-tax earnings distribution in Finland, caused by the compressed wage structure and a progressive tax schedule, it is important that reductions in marginal labour tax rates for low-skilled workers be accompanied by some reductions in the marginal tax rates of higher-skilled workers in order to avoid intensifying adverse incentive effects.

Moreover, as in many other OECD countries, the Finnish tax system imposes double taxation on retained earnings – which occurs when the retained earnings are taxed first as corporate income and then as a capital gain for an investor. This probably reduces efficiency of investment decisions. Parts of Finland's corporate and personal tax system already closely resemble the Norwegian and New Zealand tax systems, which are among the most neutral in the OECD area (Gordon and Tchilinguirian, 1998). All three systems impose the same rates of corporate and (top) personal income tax and allow full imputation of dividend income, thereby eliminating double taxation of dividends. Norway and New Zealand have, moreover, also eliminated the double taxation of retained earnings. Norway has done this by allowing investors to reduce their capital gains by the amount of retained earnings that is attributable to their shares – an approach which has, however, been criticised for entailing high administrative and compliance costs. New Zealand adopted the simpler solution of setting the capital gains tax rate to zero.[37] This means that taxes on retained earnings are limited to the corporate tax rate of 33 per cent (as compared to 28 per cent in Finland), the same as on dividends and interest income. A side effect of this solution is that it gives some scope for re-labelling interest income as capital gains for tax-avoidance purposes. Nevertheless, the elimination of the double taxation of retained earnings remains a desirable reform, as it will reduce the distortion in the choice of financing investment.

The Finnish tax system is also not neutral with respect to asset portfolios. Most prominently, imputed rent of owner-occupied housing is not taxed, while mortgage interest is tax-deductible against the personal income tax at a rate of 28 per cent (the same as the rate on capital income). The associated incentive to buy a home has been found to reduce the geographical mobility of labour due to high transaction costs. Moreover, until recently, the stamp duty for re-financing of mortgage debt tended to lock house-owners into a relationship with one bank, thus limiting competition in the housing loan market. The stamp duty, however, was abolished in May 1998.

Product markets

Subsidies to industry

Industrial support policies

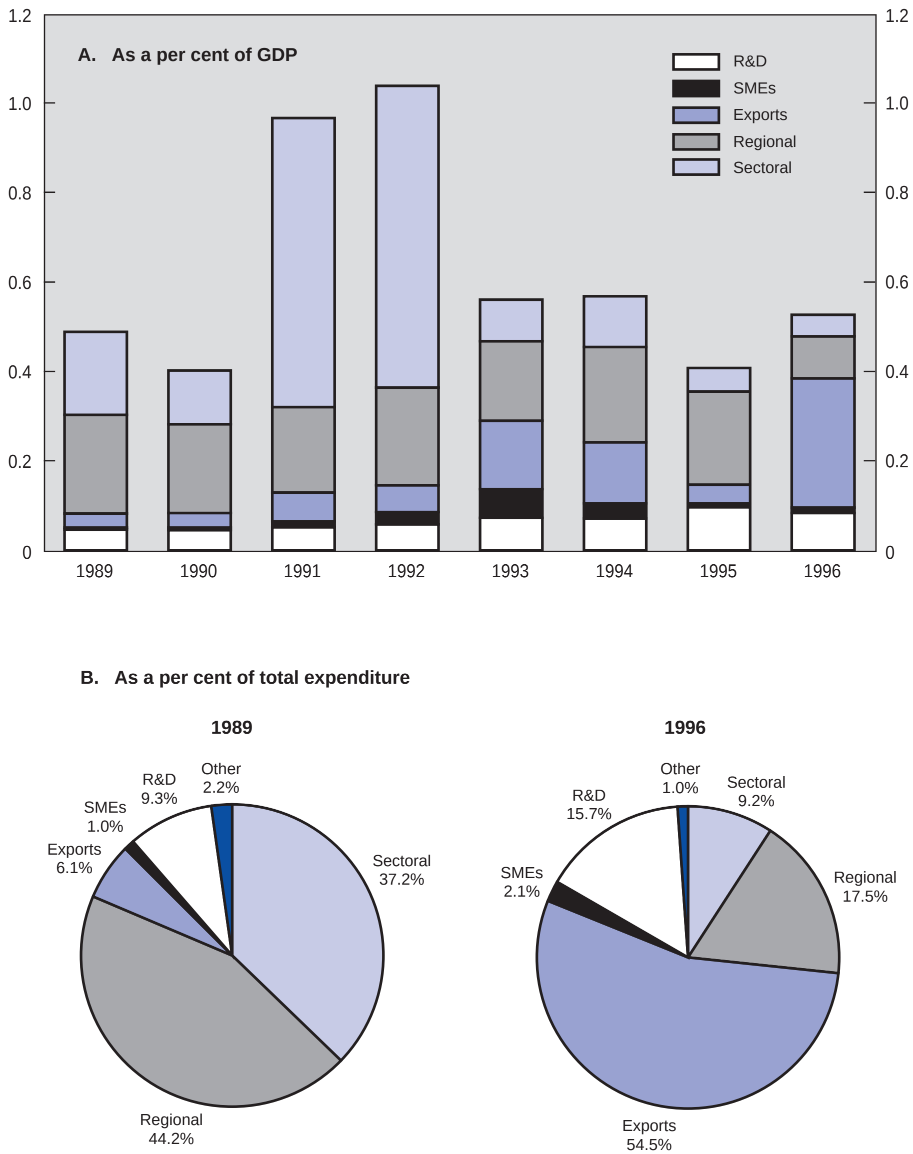
Until the 1980s, Finnish product market policies relied on a combination of industrial support and market regulation that tended to reduce competition in sectors where the authorities wanted to develop capital-intensive, primary industries in order to exploit the country's natural resources. Over time, grants and guarantees became the dominant support instrument, benefiting mostly State-owned enterprises in the manufacturing sector, while tax expenditure programmes played a negligible role (OECD, 1997*a*).[38] By 1995, grants and guarantees accounted for over 60 per cent of total support to the manufacturing industry. The economic crisis of the early 1990s shattered any remaining doubts about the shortcomings of the old strategy, while creating the impetus for a fundamental re-orientation of industrial policy in Finland.[39] Accordingly, the ''National Industrial Strategy for Finland'' developed by the Ministry of Trade and Industry in 1993 emphasised the need to improve the conditions for businesses through better functioning markets, lowering of the tax burden, enhancing technological development, promoting the development of SMEs and participation in international agreements such as the EEA, EU and Uruguay Round. At the same time, the Strategy identified important industrial clusters and underlined their significance for developing competitive advantages (OECD, 1997*a*). In the spring of 1996, the Ministry of Trade and Industry published *A New Outlook on Industrial Policies* which may be considered as a continuation of the 1993 strategy by defining more carefully the role of government, while also addressing the major economic and social adjustment challenges stemming from the deep technological and structural changes taking place in the world economy. This document promotes ''an efficiency driven growth strategy'' where industrial policy is focused on the reduction of market failures.

Reflecting trend developments in other OECD countries, Finnish industrial policy has, since the adoption of the 1993 strategy, been shifting towards the subsidisation of ‘‘intangible’’ investment.[40] While previously physical investment was seen as the key factor in expanding output and generating productivity gains, acquiring new technology and intangible investment (R&D, education and training, acquisition of entrepreneurial and organisational skills, marketing and advertising, and software used in firms) have become increasingly important.[41] Accordingly, the new legislation on general conditions for the provision of industrial subsidies, which entered into force in January 1998, states that support schemes shall be primarily targeted on research, product development, training or on some other form of immaterial corporate development, or on long-term enhancement of the competitiveness of SMEs. Public support for physical investments should be granted only on special grounds.[42]

In recent years, the Ministry of Trade and Industry has devoted a part of the proceeds from the privatisation of state-owned enterprises to foster R&D activities. In 1997, Mk 3 billion was allocated to universities, research institutes and private companies, mostly through programmes by the Technology Development Centre of the Ministry of Trade and Industry (TEKES). In 1997, total R&D spending rose to 2.7 per cent of GDP in Finland – comparable to the levels of the United States, Japan and Sweden – of which about 40 per cent was publicly financed, with the remainder coming from private industry.[43] Financial support, which constitutes the predominant type of government policies for technological innovation in Finland – including participation in EU projects, such as EUREKA – is rapidly increasing. This has contributed to an increasing share of high-tech products in exports. However, the insufficient availability of suitably skilled people in the areas of electronics, data processing and computer science has become a major bottleneck. Even though additional graduation and PhD programmes have been set up and the number of university graduates has doubled during the 1990s, the number of graduates in engineering – although high by international standards – is still not sufficient to meet the demand.[44]

Figure 18 highlights that during the 1990s industrial support policies have undergone considerable change, with sectoral aid and public support to regional development, excluding agriculture, falling from 81 per cent of total expenditure in 1989 to 27 per cent in 1996, whereas support to R&D, SMEs and export-oriented activities rose from 16 per cent to 72 per cent of total support over the same period.[45] The dramatic increase of support for exports in 1996 resulted from several large claims in the export credit guarantee scheme. Despite the official

Figure 18. **INDUSTRIAL SUPPORT**



Source: OECD (1997*a*).

target to halve industrial support from its 1996 level, to Mk 2 billion in 1999, support to SMEs is expected to increase. In addition, shipbuilding subsidies are to be re-introduced following the non-ratification of the OECD Shipbuilding Agreement.

Promoting the development of SMEs

Support for SMEs falls into three main categories. First, ECU 211 million has been co-financed by EU Structural Funds – of which ECU 86.1 million has been financed directly by the EU. This is estimated to have created 14 000 jobs and saved 31 000 jobs in this sector – though at unknown cost to other sectors.[46] Second, administrative procedures, including the notification and payment practices for VAT, have been simplified. Third, fifteen so-called business service points opened in September 1997. Their management is co-ordinated by the ministries of Agriculture, Labour and Trade and Industry. Wherever possible these centres are physically located in the same building as the Public Employment Service. The centres cover support from EU funds, education and consultation for entrepreneurs and aid by the State Guarantee Fund and TEKES. A start-up grant has been introduced with the aim of motivating workers to become entrepreneurs. Entrepreneurs may also receive labour market training, as well as small loans if they are operating in the service sector. An experiment was conducted in 1997 with work at home, financed with subsidies and tax deductions. Moreover, social security contributions of small companies were reduced, primarily in rural areas, in order to help them cope with problems associated with the adoption of the Common Agricultural Policy (see below). In all these programmes, support given to SMEs is to be of limited duration, and will be carefully assessed and evaluated.[47]

Towards a more rational support policy

While spill-over effects of industrial R&D activities can create substantial positive externalities for firms and the business environment in general, there are questions about what role governments should play in influencing technical progress. While it is commonly accepted that government can stimulate technical progress indirectly through the provision of a stable macroeconomic environment, non-distortive and low taxation and good regulatory frameworks, there is less consensus about direct measures. In particular, when a government decides on a mix of financial support measures – aiming to improve the capability and incentives of firms to innovate and to accelerate the diffusion of new technologies – it is assumed that government action enhances welfare overall. This may not always be a realistic assumption. First, direct financial support implies that the government is capable of identifying the market failure necessitating intervention. Moreover, even if it could do so, it is not clear that the benefits would exceed the potential costs of government failure in solving the market failure. In particular, it is doubtful whether the government can design the right mix of financial support, due to its lack of knowledge of the associated synergies and externalities. At the same time, it is hard to control dead-weight losses, where firms would have gone ahead with investment in technological development irrespective of direct government support. These problems suggest that it might be better for the government to focus on creating a stable operating environment for firms, one that is conducive to long-term investment, including R&D.

Moreover, while the overall decline and the improved targeting of industrial support is welcome, there is scope to streamline the plethora of support programmes.[48] With only 24 per cent of all programmes terminating within an eight year period, turnover in the stock of programmes does not appear to be very dynamic. Almost 60 per cent of the programmes have a duration of eight years and more. Apparently, the shift in policy focus of public support in Finland is reflected in modified financial flows in on-going programmes, rather than in the implementation of new or the phasing out of existing programmes.

Privatisation

The government's privatisation programme of State-owned enterprises is still operating within the mandate set by the Parliament in 1992 (see 1997 *Economic Survey* for Finland) and concerns twelve large multinational companies. These will not be fully privatised, but the state plans to dilute its majority holding. State-owned enterprises (with the exception of the railroads) are run like private companies and no longer receive government support, with some smaller State-owned enterprises having been allowed to go bankrupt. Moreover, most State-owned enterprises are export oriented and, thus, exposed to foreign competition. The government, however, attaches some strategic importance to keeping them, if only partially, in public hands. Two major initiatives were taken in April 1997, when shares in Kemijoki Oy (an electricity distribution company) were sold to regional electricity companies and an international equity offering was initiated for Rautaruuki Oy (a steel manufacturing company). Privatisation proceeds are used to strengthen the capital structure of privatised companies, stimulate R&D, increase education programmes, provide risk financing for SMEs, and reduce public debt. Currently, the capital raised by privatised state companies represents 20 per cent of the total capitalisation on the Helsinki stock exchange.[49] The government argues that the privatisation process needs to be slow and piecemeal because of the small size of the Finnish stock market, with a capitalisation of Mk 400 billion (66 per cent of GDP) and, more recently, the increased uncertainty related to the crisis in Asia and other emerging markets, which reduced share prices of some larger firms. However, international capital markets would easily absorb a greater volume of share offers associated with an accelerated and comprehensive privatisation process. Moreover, although Finnish Employment Pension funds have, since 1997, been legally permitted to invest in shares, including those of privatised companies, they have only done so to a limited extent, perhaps reflecting institutional habits. They could increasingly take advantage of such opportunities for adequately diversifying their investment portfolios in the future to include shares also.

Agricultural policy

A significant reform of the Finnish agricultural sector was brought about in recent years by the adoption of the EU's Common Agricultural Policy (Agricultural Economic Research Institute, 1997). With EU membership, food prices were virtually slashed in half, due to the high initial price level and exposure to international competition.[50] With limited leeway for the agricultural co-operatives to narrow operating margins in response to the price shock, the incidence of foreign competition fell entirely on farmers. Although direct EU support was equivalent to the existing national subsidies, to compensate for the loss in indirect support as a result of lower prices, a ''transitional'' national support programme was implemented to stem the fall in farm incomes and stabilise them at a lower level.[51] Moreover, the government plans to scale down this temporary support in coming years. Following the reform, many farmers have been going out of business. Since 1995 the number of farms has dropped from 90 000 to 80 000 and a further decline to the range of 53 000 to 60 000 is projected. Around 25 000 persons have already left agricultural employment since EU membership. Young skilled farmers are expected to increasingly exit these activities, while older farmers will manage to stay in business as they are typically not indebted. Overall, these changes have represented a substantial permanent gain for consumers, but also a shift in production patterns with substantial transition costs. Agricultural activity, for instance, has declined by over 4 per cent between 1995 and 1997. The EU's Agenda 2000 – aimed *inter alia* at reducing costs associated with new accessions – is, moreover, expected to further undermine the viability of agricultural activities in Finland. Combined national and EU support to Finnish agriculture, at 69 per cent in terms of a total producer subsidy equivalent in 1995, was among the highest in Europe – exceeding the already high EU average by 20 percentage points. While national expenditure on agriculture was reduced by 45 per cent between 1995 and 1997, it was still more than six times higher than in Sweden and Denmark (OECD, 1998). Although Finland, due to its northerly location, is considered a ''low yield-high cost'' agricultural region, there is clearly scope for further reductions in the level of overall support to the agricultural sector.[52] At the same time, the government could seek to shift the emphasis from general income support towards aid for firm start-ups and training, in order to help farm households diversify their earnings through other rural activities, including forestry (OECD, 1995*a*). It should be noted, however, that from an economic point of view, continued support does not represent a first best policy option.

Competition policy

With the opening of Finnish markets in recent years, their contestability has largely been achieved – with the major exception of postal services, railways and alcoholic beverage distribution – and remaining competition problems relate mostly to firm behaviour.[53] As in most other OECD countries, the ''prohibition'' principle has been adopted as the basis of Finnish competition laws aimed at ensuring an adequate level of competition in most sectors of the economy. Since EU membership, the jurisdiction of EU competition law extends to cross-border trade and merger control issues, with the Office of Free Competition acting as the domestic competition authority. The functioning of the Office of Free Competition is, however, hampered by a relatively small staff to handle competition violations compared with competition authorities in neighbouring countries. Moreover, while the Office of Free Competition has a mandate to investigate infringements, and is operationally independent of its supervising body – the

Ministry of Trade and Industry – it lacks power to initiate corrective action or assess penalties. This role has been assigned to the Competition Council, with a third entity, the Supreme Administrative Court, serving as an appeals court for alleged violations. The functioning of the Competition Council is not fully satisfactory as it is mostly staffed by high ranking public officials on a part-time basis, who have their main professional obligations elsewhere. A proposal was made by a working party appointed by the Ministry of Trade and Industry to amend the competition law to give the Office of Free Competition the power to initiate corrective action or assess penalties and to reform the Council into a court of appeals, as is the practice in most neighbouring countries and in line with OECD recommendations in this regard. The proposal was rejected by the government, however, based on the argument that such an accumulation of power in one body would create uncertainty in the operating environment of firms.

Deregulation

Deregulation has progressed rapidly in recent years. Following earlier reforms to deregulate the telecommunications sector, the Postal Service and Telecommunication Service have been separated, and shares in the latter floated on the Helsinki stock exchange this year. The Postal Service will remain in public hands for the time being, while a working party determines if and how it may also be privatised. In the electricity market, the national electricity grid management activity has been separated from the major State-owned electricity producer (IVO). There are currently two grid systems for the distribution of electricity, a national grid and local grids – the latter being managed by municipalities, associations of municipalities and private companies. The supply of electricity has been fully liberalised, with every household, in principle, able to choose between electricity suppliers. In turn, the local grid operator will be able to buy in bulk from suppliers for each period at a reduced rate. In this way the required amount of electricity can be provided to households at the cheapest rate, thus lowering the electricity prices from their already low level by international comparison.[54] There is still scope, however, to improve competition in the local supply of electricity. Some local electricity suppliers have acquired local electricity grids. Due to the currently high distribution tariffs (which account for around half of the retail price of electricity), there is concern that such vertical integration, although potentially efficiency enhancing, risks weakening competition.[55] A working group was formed in 1997 to investigate the degree of vertical integration between producers and distributors and it proposed to amend competition legislation to limit the ownership share of electricity suppliers to 25 per cent of local grids. The Office of Free Competition will have responsibility for investigating whether vertical integration in the electricity market impedes competition in the framework of new domestic merger legislation to be introduced in 1998.

Financial markets

Finland's accession to the EEA and EU allowed for the free flow of capital and the right for banks in the area to establish branches in Finland and *vice versa.* As a result, competition in domestic financial markets has increased strongly, in particular in the banking industry. The number of foreign credit institutions has increased rapidly, but their market share is still rather small (Table 14 and Figure 19). The impact of foreign banks, which were at the outset mainly targeting the lending market for large companies and the retail banking market in the major urban areas, is increasingly felt throughout the banking industry.

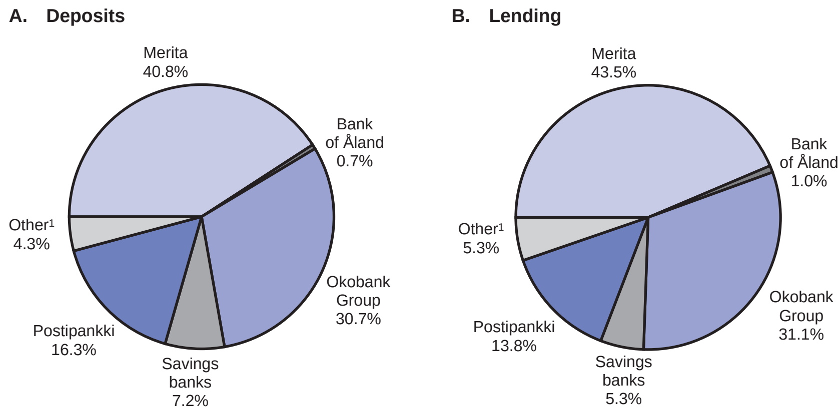
With competition in the banking sector increasingly shifting from network density and quality of services to pricing, lending margins have shown a steady decline (see Chapter II). This has sparked further reductions in banks' operating

Table 14. **Developments in the banking sector**

	1989	1990	1991	1992	1993	1994	1995	1996	1997
Institutions	553	523	438	370	358	357	351	350[1]	348
Commercial banks	14	14	17	14	14	14	11	12	15
of which: Foreign	4	4	5	4	4	4	4	4	6
Savings banks	178	150	86	39	41	41	40	40	40
Co-operative banks	361	359	335	317	303	302	300	298	293
Branches	2 977	2 821	2 662	2 393	2 200	1 828	1 612	1 745[1]	1 644
Automatic teller machines (ATMs)									
Cash dispensing	2 634	2 838	2 908	2 914	2 994	2 833	2 421	2 298	2 285
Giro	85	505	718	984	1 477	1 984	2 153	2 363	2 482
Employees	48 600	46 080	42 800	38 890	35 970	34 070	30 250	28 462[1]	26 717

1. Including domestic banks' foreign branches and foreign banks' branches in Finland.
Source: OECD (1997), *Bank Profitability*, Bank of Finland and Finnish Bankers Association.

Figure 19. **MARKET SHARES OF DEPOSIT BANKS**
End of June 1997



1. Interbank Ltd., Skopbank, local co-operative banks and foreign bank branches in Finland.
Source: Finnish Bankers Association.

cost, branch networks and staff numbers through merger activity (Table 14), with the progress in Finland in this regard faster than in other European countries (Table 15). As a result, there are only three major domestic bank groups left: *Merita* (formed by KOP Bank and the Union Bank of Finland in 1995), *OKO* (the umbrella institution of the co-operative banks), and *Leonia* (formed through a recent merger between *Postipankki* and the Finnish Export Credit Ltd.). Moreover, since 1997, Merita is part of the Swedish-Finnish *Merita-Nordbanken* Holding company. With the scope for domestic mergers thus practically exhausted, future merger activity is also likely to be of a cross-border nature.

In November 1997, a study carried out by a special Committee commissioned by the Bank of Finland recommended combining the surveillance of the insurance and banking sectors in one independent agency, in line with developments in some other OECD countries. Such combined supervision is motivated by the blurring of lines of activity between banks and life insurance companies, the high degree of concentration in these sectors due to mergers, the increasing practice of creating holding companies including banks and life insurance companies, the need to increase information sharing in surveillance activities, and to

Table 15. **Banking resources in selected OECD countries**

Per 10 000 inhabitants

	Finland	Norway	Sweden	Germany	France	Italy	United Kingdom
Branches							
1985	5.99	4.82	1.72	6.37	. .	2.04	2.40
1990	5.66	4.23	1.57	6.26	4.60	2.60	2.26
1995	3.16	3.58	2.53	5.39	4.58	3.64	1.81
Employees							
1985	75	72	27	89	. .	55	60
1990	92	74	29	105	78	58	71
1995	59	63	44	89	70	59	65
Profits before tax[1]							
1985	0.39	0.55	0.34	0.72	. .	0.97	1.09
1990	0.40	–0.66	0.22	0.48	0.36	1.00	0.70
1995	–0.37	1.36	1.33	0.56	0.15	0.36	1.17
1996[2]	0.41	1.23	1.30	0.53	0.18	0.50	. .

1. As a per cent of the average balance sheet total.
2. Estimates.

Source: OECD (1997), *Bank Profitability* and OECD Secretariat.

reduce cartelisation behaviour that can arise when an individual agency is supervising a specific industry. The proposal was generally well received in the financial industry, but met opposition from the Ministry of Social Affairs and Health, the current supervisory body for the insurance industry. A new proposal is being considered, whereby the supervision of the insurance industry – in particular life and pension insurance – would be performed by a separate entity.

As regards the pension insurance industry, the special Committee welcomed the change in pension fund management implemented in early 1997, in particular the reform enabling the Employment Pension funds to undertake portfolio diversification towards assets with higher risk. By raising the rate of return on pension fund assets while properly managing the higher risk, such an investment strategy would contribute to enhance the sustainability of a pension system faced with an ageing population. It noted, however, in line with previous OECD recommendations, that more needs to be done to increase the rate of return on pension fund assets. By reducing the cost of the system, this would help to contain the expected increase in the contribution rates as the population ages (see Chapter II). As suggested in the previous *Survey*, a more ambitious portfolio-management of pension insurers, who currently invest mostly in Finnish government bonds, could be encouraged by allowing them to compete for clients on the basis of investment performance – although that might call for heavier regulation to avoid excessive risk taking. The admission of foreign entrants in the Finnish market for statutory pension insurance could help reinforce such competition,[56] as would the removal of penalties on employers who switch institutions (for instance, they lose the right to take out loans against contributions paid in the past and have to pay a stamp duty). In this regard, the Ministry of Finance is currently preparing a proposal to permit employees to switch pension insurer if they wish, and to allow the insurers to compete freely on the basis of contribution rates.

Assessment

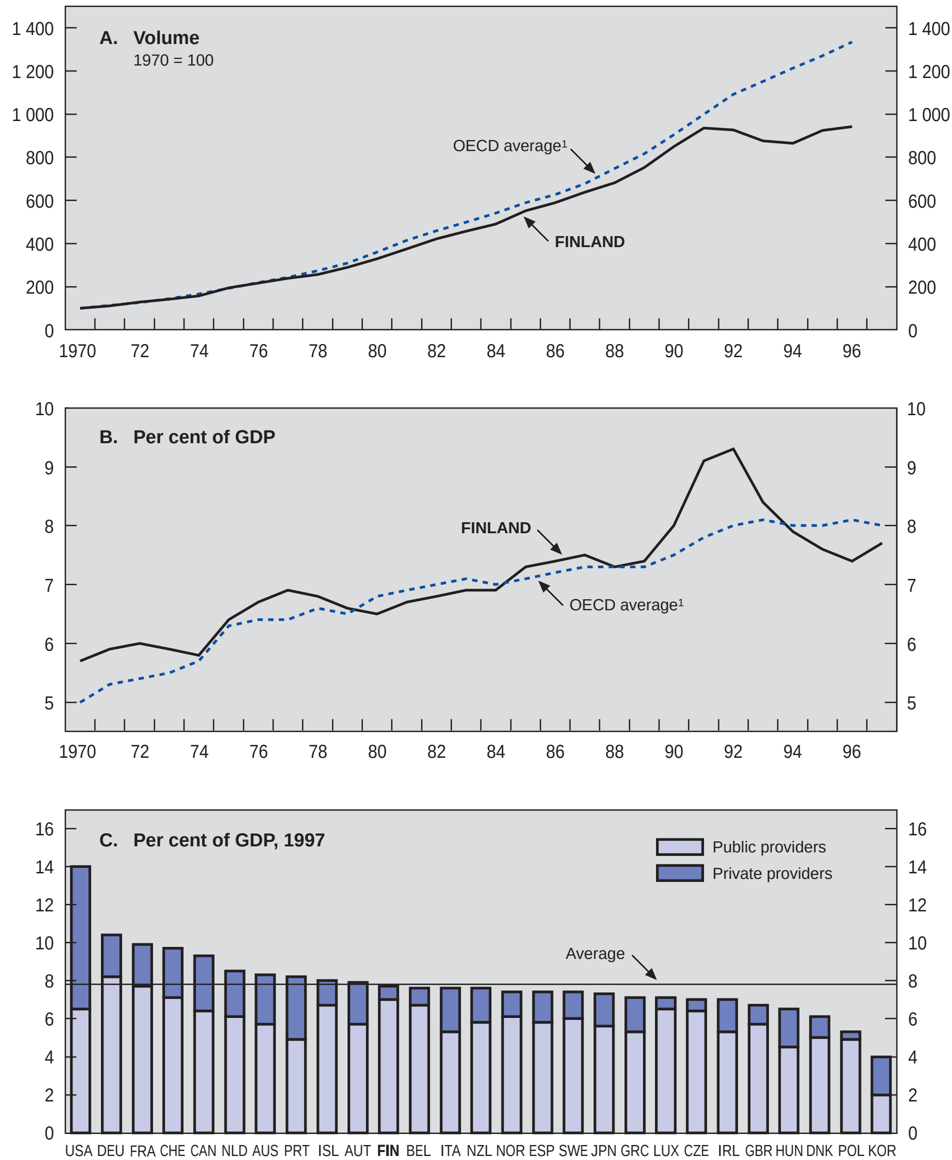
All considered, the Finnish economy could benefit from further wide-ranging structural initiatives. While major structural change in product and financial markets has resulted in increased contestability of these markets, there is remaining scope for increased efficiency and a reduction in the constraints on business operation associated with the large public sector and resulting high tax burden. At the same time, while Finland has increasingly directed industrial support towards intangible investment and SME development, overall support levels to industry and agriculture remain relatively high. It would, therefore, be preferable for the government to continue reducing direct support and focus on creating a stable operating environment for firms, in order to foster investment activity, including in R&D. Moreover, although representing steps in the right direction, the measures taken to improve the functioning of the labour market to date fall short of the comprehensive reform advocated by the OECD's *Jobs Strategy*. In order to reduce the still high unemployment levels and ensure continued robust economic growth while preventing inflation pressure from building up, reforms need to focus on enhancing the work incentives of people on public income support. At the same time, labour costs could be reduced by lowering the high taxation, of low-paid labour in particular, and increasing the flexibility of employment practices and wage setting – including the elimination of the administrative extension of negotiated wage settlements. Lower taxes and increased labour market flexibility would increase the scope for employment creation, in particular by SMEs in the private services sector, and are also required to enhance the ability of the economy to adjust to changing economic situations in the single currency area.

IV. The health care system

The Finnish health care system is dominated by the public provision of both primary and specialised services for all residents and is largely tax financed. As in the other Nordic and some other European countries (and unlike *e.g.* the United States, Canada and Japan), the public sector acts as both the purchaser and provider of health care (OECD, 1994). Moreover, physicians are mostly paid regular salaries, rather than fees for service, and the contracting of private providers is only marginal. As a result, private health insurance has hardly developed.

The system expanded rapidly in the 1970s and 1980s, with the central government playing a crucial role in the financing, planning and supervision of the system, while the provision was assured by the municipal authorities. Since 1993 the system has been almost entirely managed at the municipal level due to a major budget reform which fundamentally changed the financial relationship between central and local governments. At the same time, the economic crisis induced sharp reductions in the central government resources devoted to public health care. As a result, total health care expenditure in Finland has shown a sharp decline in volume terms between 1991 and 1994 (Figure 20, Panel A) – a development which is exceptional in the OECD area, although Sweden has achieved even larger reductions. The scope and quality of care provision was nonetheless preserved as the increased budget rigour led to better management and improved allocation of resources. At present, health care expenditure in Finland absorbs around 7½ per cent of GDP, which is slightly below the average for the OECD area (Figure 20, Panels B and C). There is, nevertheless, scope for raising efficiency further, in particular through better co-ordination of service provision and the introduction of financial incentives to stimulate cost-effective solutions.

Figure 20. **HEALTH CARE EXPENDITURE**



1. Unweighted average. The Czech Republic, Hungary, Mexico, Poland and Turkey are excluded.
Source: OECD Health Data 98.

This chapter is the third one in a series of special chapters providing an in-depth assessment of the Finnish public sector. The previous two chapters covered, respectively, the education and pension systems.[57] The present chapter first gives an overview of the institutional set-up of the health care system, followed by a discussion of its performance and cost. It then examines major policy issues associated with the system. These mainly concern the regional variation in work practices and treatments, the lack of co-ordination between the various care providers and the weak bargaining power of municipalities *vis-à-vis* providers of hospital care. The chapter concludes with a review of recent reform initiatives and some suggestions for further change.

The institutional set-up changed significantly in 1993

Service provision

A major characteristic of the health care system in Finland is the key role of the municipalities, who not only deliver part of health care directly, but are also its main funder and exert major decision-making power on the allocation of health care resources. Until the late 1980s the national authorities still played an important role in determining the allocation of resources on the basis of five-year rolling plans. Since then, however, the municipalities have received greater autonomy as central planning was gradually diminished. The municipal authorities reached almost full discretion regarding the scope, content and organisation of services when a block grant funding system was introduced in 1993: the central government transfers an annual lump sum to each municipality which can spend it in ways it considers appropriate – even though legislation still defines standards for health services that must be provided. National plans are still being produced (covering four rather than five years), but their role has been limited to providing general guidelines and information on financing, operating costs and investment policy.

Primary health care is largely provided by municipal ‘‘health centres’’, which cover a wide range of services.[58] Health centres may be involved in occupational health care (see below). In early 1998 there were 254 health centres. Most of these provide services exclusively to the residents of the municipality in which they are located, but the smallest municipalities have established joint health centres with neighbouring municipalities (municipalities differ greatly in size, from fewer than 1 000 to over 500 000 inhabitants). Health centres also maintain inpatient wards, whose number of bed days sharply increased until 1992 due to a rising admittance of elderly patients (over 75 years of age) with chronic diseases who demand less specialised care (Table 16). At present, over 50 per cent of the available beds in health centres are occupied by such patients (see Terveydenhuollon kehittämisprojekti, 1998).

The 1979 Occupational Health Care Act requires employers to provide occupational health services mostly for prevention purposes, including workplace inspections, prevention of health hazards at work and periodic health examinations. However, employers may also arrange treatment for their employees, and are free to purchase the necessary services from authorised external providers (usually the local health centre) or organise these services themselves – either independently or jointly with other employers. Since the mid-1980s, around 80 per cent of workers are covered by this programme, mostly in larger companies. The national health insurance reimburses 50 per cent of the running costs.

All licensed physicians in Finland are allowed to set up a private practice, but in most cases such services are provided on a part-time basis by physicians who hold full-time posts in a public hospital. Hence the vast majority of privately practising physicians are specialists. As a result, while the visits to private practitioners account for around one-fifth of all doctors' consultations, one-third of the visits to specialists is to private practitioners.[59] As the fees for service paid to private physicians are only partly reimbursed by the national health insurance (up to a maximum of 60 per cent of a standardised agreed rate; see below), these mostly attract patients in the relatively prosperous urban areas: in the Helsinki

Table 16. **Bed-days and length of stay in hospitals**

	1980	1985	1990	1991	1992	1993	1994	1995
Bed days (per 1 000 inhabitants)								
Hospitals	2 679	2 266	1 751	1 748	1 315	1 243	1 281	1 218
Health centres	1 118	1 482	1 725	1 759	1 761	1 473	1 512	1 532
Average length of stay (days)								
Hospitals	17.1	13.6	10.4	10.0	7.7	7.2	6.9	6.6

Source: Social Protection in Finland 1995.

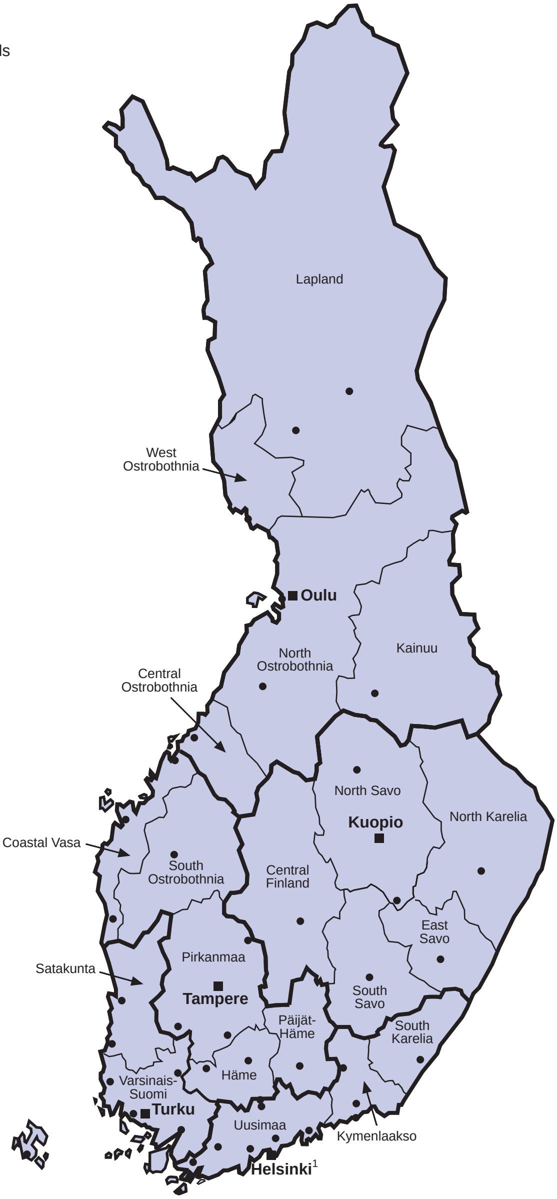
metropolitan area there is 1.0 visit per capita per year to private physicians compared with only 0.3 in Northeast Finland (Terveydenhuollon kehittämis-projekti, 1998). Around 70 per cent of the adult population obtains dental care from dentists working in private practice, also mainly in the Helsinki area and other major cities.

Since many municipalities are too small to maintain a hospital, so-called Federations of Municipalities have been formed to co-ordinate hospital care within hospital districts.[60] Moreover, the number of districts has been reduced from 99 to 21 in 1991 in order to streamline co-ordination (Figure 21). All municipalities have been legally obliged to be a member of such a district, which owns the public hospitals in its area. A hospital district is governed by a council, whose members are elected by the member-municipalities. The council, in turn, names a board who appoints a management team. Normally a hospital district comprises one to three general hospitals and one or two psychiatric hospitals. At present there are 51 municipal hospitals, of which five are university hospitals, 16 other central hospitals and 30 local hospitals. Municipalities usually purchase hospital care (both inpatient and outpatient) from their hospital district, although since 1993 they have been allowed to purchase services from other districts or private providers. Less-specialised hospital services are also provided by the municipal health centres, which may compete with the hospitals run by the hospital districts.

Finally, the retail distribution of drugs is managed exclusively by privately-owned pharmacies. As in the other Nordic countries (except Iceland where the retail market for medicines has been liberalised), pharmacies are subject to strict licensing and other statutory limitations, and prices are regulated. As there are around 800 pharmacies (including subsidiaries), the density of the pharmacy network is the highest in the Nordic area. Pharmacies have agreed a financial settlement arrangement with the national health insurance, which allows the refundable costs of prescribed drugs to be directly paid to the pharmacy at the time of purchase. At the wholesale level, the distribution of drugs is based on exclusive sales agreements between producers or their agents and the two whole-sale companies in Finland, Tamro and Oriola. These agreements prompted Finn-ish pharmacies to file a complaint with the Office of Free Competition (OFC) several years ago. However, while acknowledging that exclusive sale agreements complicate the entry of new wholesalers into the Finnish drugs market, the OFC

Figure 21. **HOSPITAL DISTRICTS AND MAIN HOSPITAL LOCATIONS**

■ Teaching hospitals
● Central or district hospitals



1. Also a hospital district.
Source: STAKES.

ruled in April 1997 that the cost-effectiveness of this arrangement outweighs its potentially harmful effects on competition.

Funding arrangements

The municipalities account for over 60 per cent of total health expenditure, with out-of-pocket payments and the national health insurance covering around 22 per cent and 13 per cent, respectively (Table 17). The remainder is covered by employers (occupational care) and private insurers. Only around two-thirds of the municipal share in health care expenditure is, however, financed by local tax proceeds, as the remainder is covered by block grants from the central government and user charges.[61] The health-care related block grants from the central government are determined as a fixed amount per capita, with some adjustment for the local age structure and the remoteness of the municipality.[62] These annual grants are not strictly earmarked for health care purposes, as the municipal council is free to decide on the budget for individual spending programmes. Indeed, the council may wish to use part of the block grants for welfare spending or basic education – which are funded by different capitation formulae – for health care purposes, or *vice versa*.

This block grant system was introduced in 1993. In the previous system grants were strictly earmarked for specific purposes and paid via provincial

Table 17. **Funding of health care expenditure**

Per cent shares

	1980	1985	1990	1992	1993	1994	1995	1996
Public funding	79.6	78.9	80.9	79.5	76.3	74.8	74.7	74.7
Central government grants	38.2	34.0	35.6	35.2	32.0	30.4	28.7	24.3
Municipal taxes	28.9	34.7	34.7	33.3	32.0	31.3	32.5	36.8
National health insurance	12.4	10.2	10.6	11.1	12.3	13.1	13.5	13.6
Private funding	20.4	21.1	19.2	20.5	23.7	25.2	25.3	25.3
Employers	1.2	1.3	1.4	1.5	1.3	1.6	1.4	1.4
Relief fund	0.6	0.7	0.5	0.4	0.5	0.4	0.4	0.5
Private insurance	0.8	1.2	1.7	2.0	2.1	2.1	2.0	1.9
Out-of-pocket payments	17.8	18.0	15.6	16.6	19.8	21.1	21.5	21.5
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

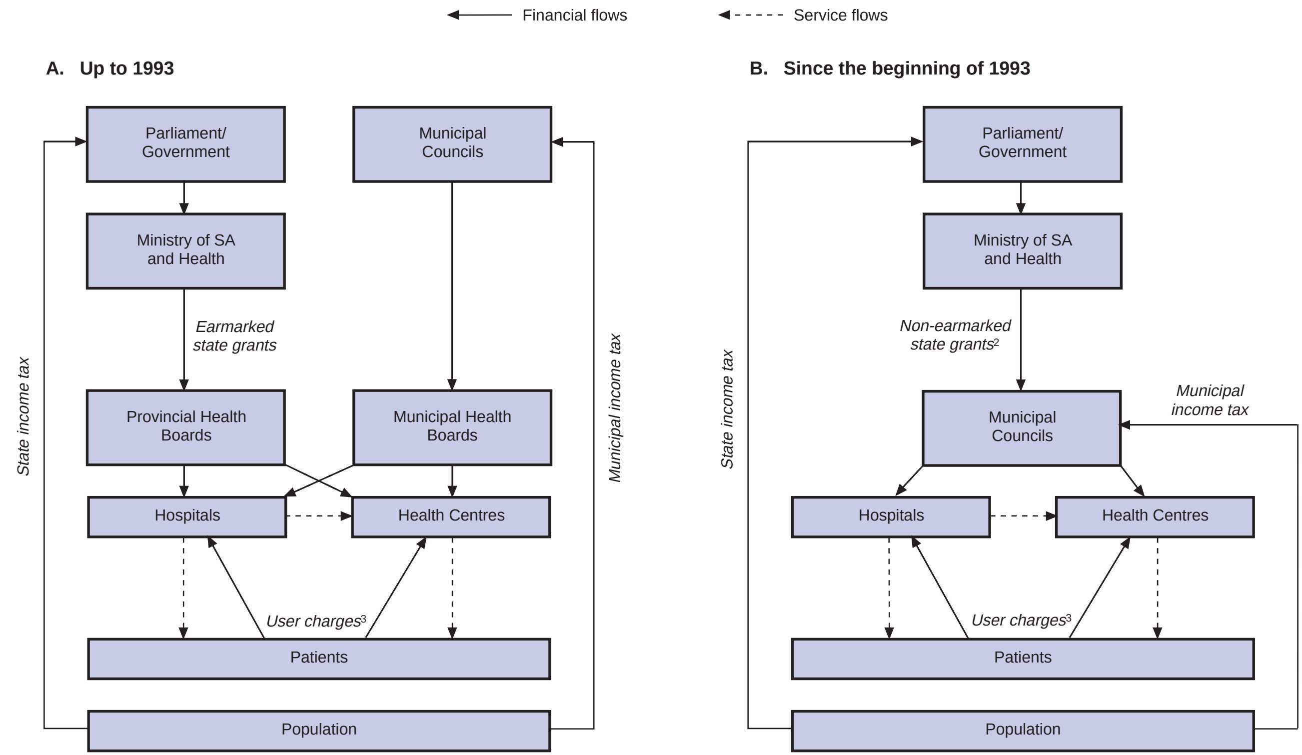
Source: Social Insurance Institute (1997), *Health Care Expenditure and Financing in Finland 1960-95*, T9:54 and Ministry of Social Affairs and Labour.

boards to the providers (*e.g.* hospitals, health centres, welfare services, schools, etc.) as a fixed proportion of the incurred costs (Figure 22). The government also set annual quota for investment envelopes and overall staffing which were subsequently allocated to the provincial boards by the Ministry of Social Affairs and Health. These, in turn, were distributed among the municipalities and municipal federations. With the 1993 reform the municipalities received full autonomy as regards the use of funds, which radically changed the financial relationship between the central and the municipal authorities and had a significant impact on the financial incentives and constraints facing the local decision makers and providers.

The earmarking of funds for capital expenditure by the central government has, however, continued. Whereas municipalities are expected to finance the purchases of smaller items (less than Mk 2 million) from their own resources, medium-sized (between Mk 2 and Mk 25 million) and major (over Mk 25 million) projects need to be submitted to provincial boards. These boards, in turn, receive annual quotas from the central government for the allocation of funds with respect to medium-sized projects. Major capital investments, by contrast, require *ad hoc* approval by the central government. The central government subsidises both medium-sized and major capital investments at a rate which varies between 25 and 50 per cent, depending on the per-capita income of the municipality. The Finnish Slot Machine Association, moreover, co-funds capital outlays of non-profit private health care providers. This source is estimated to amount to roughly one third of total investment outlays in the health care sector (Häkkinen, 1997).

Although the five university hospitals still receive earmarked grants from the central government for teaching and research activities, subsequent to the 1993 grant reform hospitals receive the bulk of their funding (90 per cent) by charging the municipalities in their district for services delivered, with the remainder of their budgets financed through patient co-payments (*e.g.* patients pay Mk 125 per day for inpatient care). While hospital districts have thus been prompted to define and price their products, there are no national guidelines for the pricing of hospital services, and consequently there is a wide variety of pricing methods. In some hospitals, prices are based on an average cost per bed-day, while so-called ‘‘service-package pricing’’ for surgical interventions has become common in many others.[63] Two hospital districts and the Helsinki

Figure 22. **FINANCE AND PROVISION OF PUBLIC HEALTH CARE**[1]



1. Does not include care funded by National Health Insurance and/or employers (private sector and occupational health care).
2. Based on capitation formula.
3. User charges decided by municipalities with a ceiling fixed by government.

Source: OECD (1994).

University hospital have adopted the Diagnostic Related Groups (DRG) approach for billing purposes, with the amounts paid by the municipalities based on the number of patients treated, their diagnosed medical conditions and a standardised cost per treatment. Several other districts are also considering the adoption of this system. In recent years, municipalities have begun to question hospitals' pricing policies and have increasingly negotiated contracts with hospitals to obtain better terms.

Unlike hospitals, the municipal health centres are not being funded through unit-cost pricing, but are financed directly from the municipalities' budget. The staff receives a salary, although since the late 1980s some health centres have adopted a system whereby doctors receive a capitation payment based on the number of listed patients (adjusted for the age profile and other characteristics). This system was introduced as a means to establish durable relationships between patients and doctors in order to avoid ''shopping around'' as well as to give doctors incentives to undertake preventive treatment.

As indicated above, the share of the national health insurance in total health care funding is relatively small, even though it has increased somewhat from 10 per cent in 1990 to 13.5 per cent in 1995. The national health insurance is managed by the Social Insurance Institution which is a public agency under parliamentary supervision. It derives its funding from contributions paid by wage earners, pensioners and employers, as well as returns on financial assets and transfers from the government.[64] Two-thirds of its expenditure concern the refunding of prescribed medicines. Of every prescription the first Mk 50 is paid out of pocket, while a certain percentage of additional expenses is reimbursed by the national health insurance, based on a reference price system for drugs. Refunds include a basic rate of 50 per cent for most prescriptions and a special rate of 75 or 100 per cent for severe chronic illnesses. A list of such illnesses and the associated medicines is approved by the government.[65] Patients' out-of-pocket payments for prescribed drugs can never exceed a specified annual limit. Non-prescribed drugs or the cost of spectacles do not qualify for reimbursement. The national health insurance, in addition, reimburses the fees for service of private sector physicians and dentists (for persons born after 1955) up to a maximum of 60 per cent of an agreed basic tariff. However, since the actual fees typically exceed the levels agreed by the national health insurance, the share of out-of-pocket payments in private doctors' total income is on average 61 per cent (Klavus and Häkkinen, 1997).[66]

A striking development since the early 1990s has been the declining share of public funding of health care, including the co-financing by the national health insurance, due to a substantial increase in patients' out-of-pocket payments (Table 17). For patients with chronic illness out-of-pocket payments may be considerable – notably if the illness requires the frequent use of services and prolonged hospital stays – due to the absence of an upper limit on annual expenses except for drugs. This development has fuelled a public debate on the risks of reduced access to health care. On the other hand, given that higher income groups pay proportionately more taxes and tend to make most use of private sector health care provision where co-payments are most pronounced, the funding of the Finnish health care system gives rise to substantial income redistribution (Klavus and Häkkinen, 1996).

Performance remained strong despite budget austerity

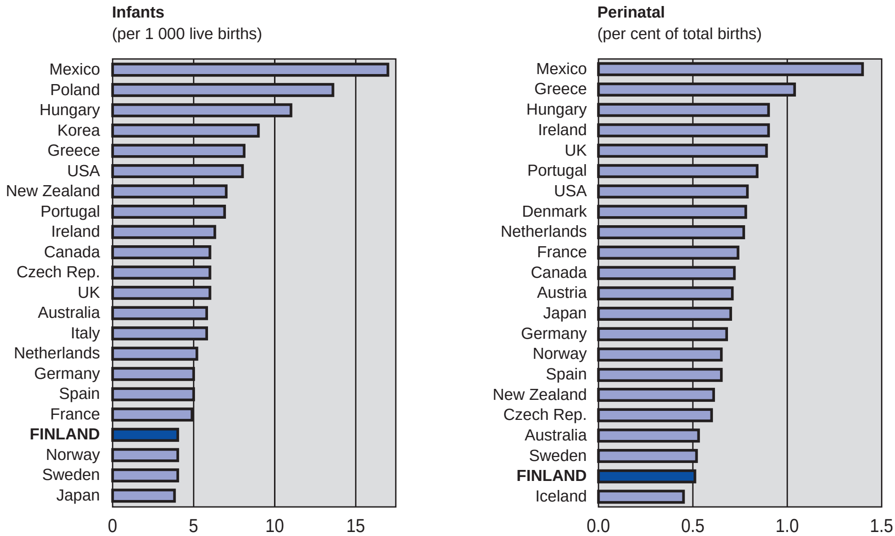
Health status of the population

Finland's health care system has an excellent international reputation, with the available facilities and the skills of health care staff matching global best practice. Not surprisingly, the overall health status of the Finnish population is currently among the best in the OECD area, following a considerable improvement in recent decades. Due to a long-standing tradition of health centres providing wide-ranging maternal child care and school care services, infant and perinatal mortality are among the lowest in the OECD (Figure 23, Panels A and B). The level of immunisation achieved for many diseases is among the highest in western Europe. In addition, helped by a strong emphasis in health education on issues like nutrition, physical exercise and reproductive health, the dietary habits of Finns have improved considerably. Moreover, the daily intake of calories has been reduced by a tenth in the last fifteen years, and regular anti-smoking campaigns and legislation have helped to reduce the consumption of tobacco and related diseases markedly.

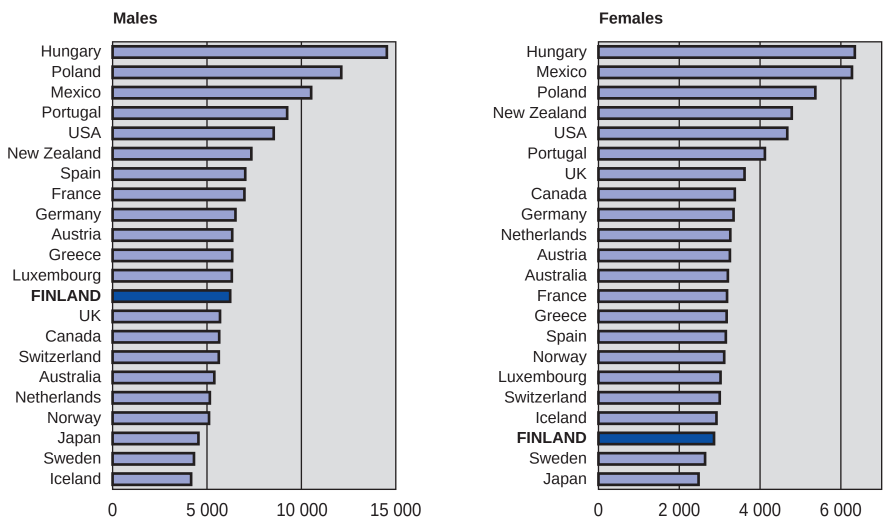
Apart from preventive measures, the results obtained for diagnosis and treatment are favourable by international comparison. For instance, the five year

Figure 23. **INTERNATIONAL COMPARISON OF HEALTH OUTCOMES**

A. **Child mortality rates,** 1996[1]



B. **Potential years of lives lost,** 1995[1] (per 100 000 persons aged under 70)



1. Or previous year where data is not available.
Source: OECD Health Data 98.

survival rates of patients with cancer, the most frequent cause of death in the OECD area, are the highest in Finland, Switzerland and the Netherlands, and are still improving. Similarly, mortality due to cardiovascular diseases has substantially declined in past decades, although this has resulted not only from improved intervention in acute heart situations, but also from preventive treatment of hypertension, healthier eating habits, and a decline in smoking among men (Ministry of Social Affairs and Health, 1997).

While the health status of the population is thus further improving, there are important gaps in life expectancy between older and younger generations: as late as in 1960 the life expectancy of Finns was still the second-lowest in the OECD after Portugal. As a result, despite a sharp increase in life expectancy at birth, the life expectancy of old people in Finland has remained relatively low, with the chance of dying from diseases of the circulatory system still one of the highest in Europe (Statistics Finland, 1996). Similarly, dental problems like oral infections are common among the elderly, notwithstanding a remarkable improvement in oral health status overall. In addition, the gap in life expectancy between the sexes is also relatively wide, with the potential lives lost considerably higher for men than for women (Figure 23, Panels C and D). This gender inequality has been attributed to the high rates of cardiovascular diseases, unintentional injuries and, most importantly, suicides among young and middle-aged Finnish men.[67]

Patients' satisfaction

The Finnish population's judgement of the quality of health care is generally very good. Recent evidence from a cross national survey in the European Union (Mossialos, 1997) indicates that the overwhelming majority of the Finnish population is satisfied with their health system (86 per cent) – the second highest score in the EU after Denmark (92 per cent) and well above the area average of 50 per cent. Not surprisingly, in Finland, as in Denmark, the vast majority of the population is of the opinion that fundamental changes in the health care system are not needed.

Such findings confirm the outcomes of national opinion polls carried out by the National Research and Development Centre for Welfare and Health in 1992 and 1996, which show that the quality of health services is considered adequate by a large majority of respondents (Sihvo, 1997). In particular, for services like maternity care, physician services, home nursing, rehabilitation and polyclinic special examinations, the proportion of respondents who were dissatisfied with the quality of services had remained stable at a very low level. However, the proportion of those who considered the quality of long-term institutional care of the elderly and mental health care to be unsatisfactory was relatively large and had, moreover, considerably risen between 1992 and 1996. In addition, the proportion of respondents who were dissatisfied with the quality of hospital care have slightly increased in recent years as well.

Input of resources

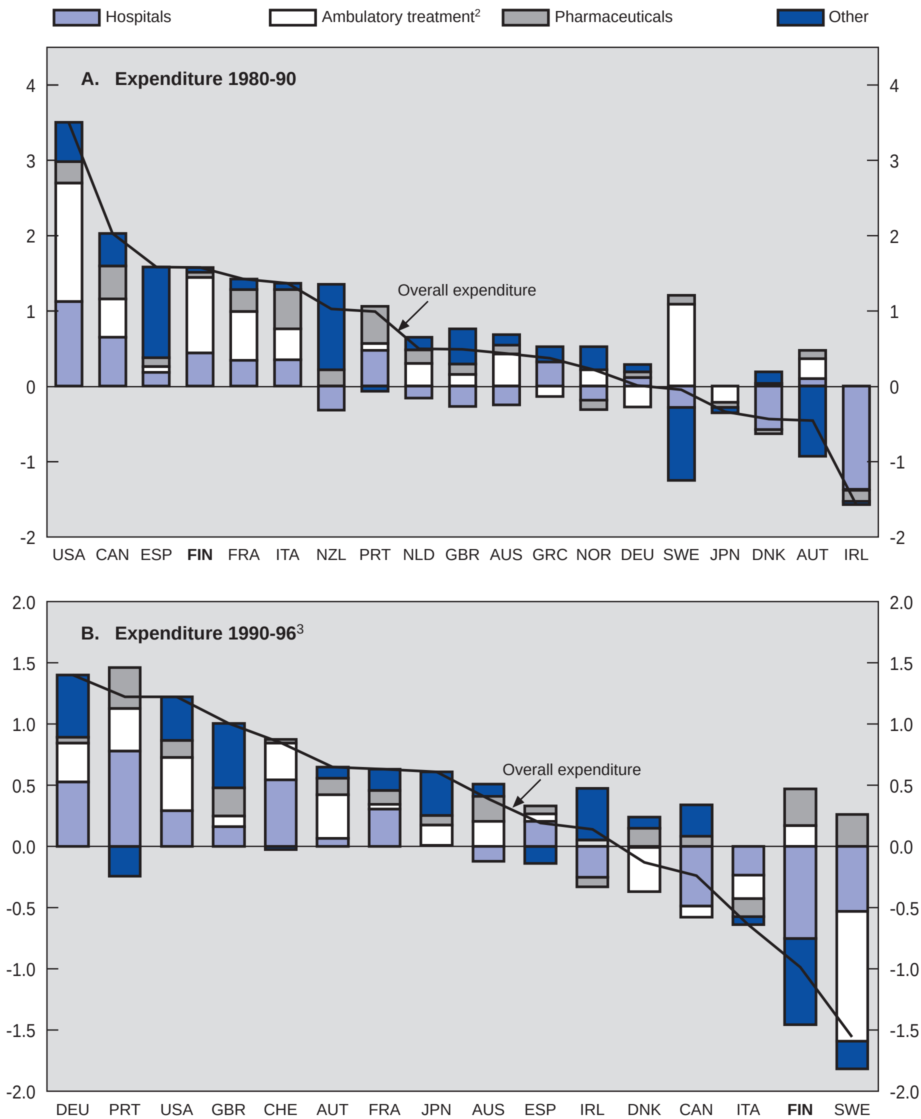
The resources allocated to health care markedly increased in Finland during the 1980s (Figure 24, Panel A). Indeed, the annual increase in health care expenditure exceeded that of trend GDP by 2 percentage points, surpassed only by the United States and Canada (Oxley and MacFarlan, 1995). The bulk of this increase was due to the expansion of ambulatory care, while the number of hospital beds per capita has remained roughly stable since the early 1980s, at a high level in international comparison.

The development of health care expenditure radically changed, however, after the onset of the economic crisis in the early 1990s. Due to fiscal austerity measures, health care expenditure fell by more than 10 per cent in real terms between 1991 and 1993 (Figure 20, Panel A). Although some of this decline has been reversed since then, Finland has recorded the second most rapid reduction in health care expenditure relative to trend GDP in the 1990s, after Sweden (Figure 24, Panel B). The decline in resource inputs has not been uniform across health spending categories. In fact, expenditure on drugs has continued to increase in the 1990s, despite cuts in reimbursement rates by the national health insurance and the abolition of tax credits for out-of-pocket health expenses. The share of inpatient care in total expenditure, on the other hand, declined further in the 1990s, as the number of hospital beds was cut by more than 10 per cent. Capital outlays also dropped in the 1990s, partly due to fiscal austerity measures, but also reflecting the trend shift from inpatient to (less capital intensive) ambulatory care.

Total health care expenditure in Finland is currently around 7½ per cent of GDP and, on a per-capita basis, broadly the same as in Sweden and Denmark – in line with what might be expected given the level of Finnish per capita GDP (Figure 25). It is striking that such a moderate cost level is achieved despite a

Figure 24. **GROWTH IN HEALTH SPENDING BY CATEGORY**[1]

Change in ratio to trend GDP, percentage points

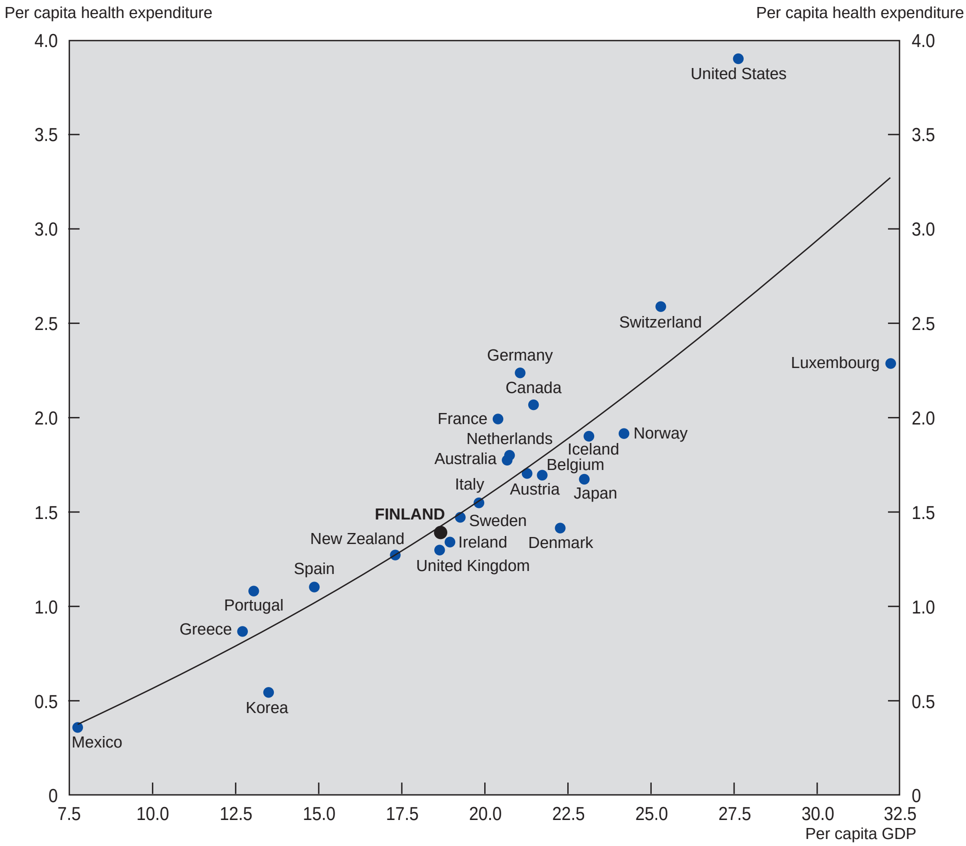


1. Current expenditure.
2. Public expenditure for Greece, Ireland, Portugal, Sweden and United Kingdom.
3. Or latest year available.

Source: OECD Health Data 98.

Figure 25. **HEALTH EXPENDITURE AND GDP PER CAPITA**[1]

1996, in thousand US$ PPP



1. Total expenditure on health care. The equation of the regression line is the following:
LN (health expenditure per capita) = -4.11 + 1.52 * LN (GDP per capita)
R squared = 0.84 T : (-9.92) (10.94)

Source: OECD Health Data 98.

relatively high input of labour resources in health care compared to most OECD countries. This largely reflects the relative wage level of health care workers in Finland which has traditionally been low by international comparison, even though it has risen during the 1990s (Häkkinen, 1997). As the number of physicians per capita in Finland is close to the European average, the high level of health care employment is fully explained by the large number of nurses (Figure 26). This partly reflects the extensive system of maternal and child care, but may also be a remnant from past decades when physicians were scarce and nurses were recruited to perform a wide variety of tasks (WHO, 1996). Even during most of the 1990s, however, the number of certified nurses has been increasing further.

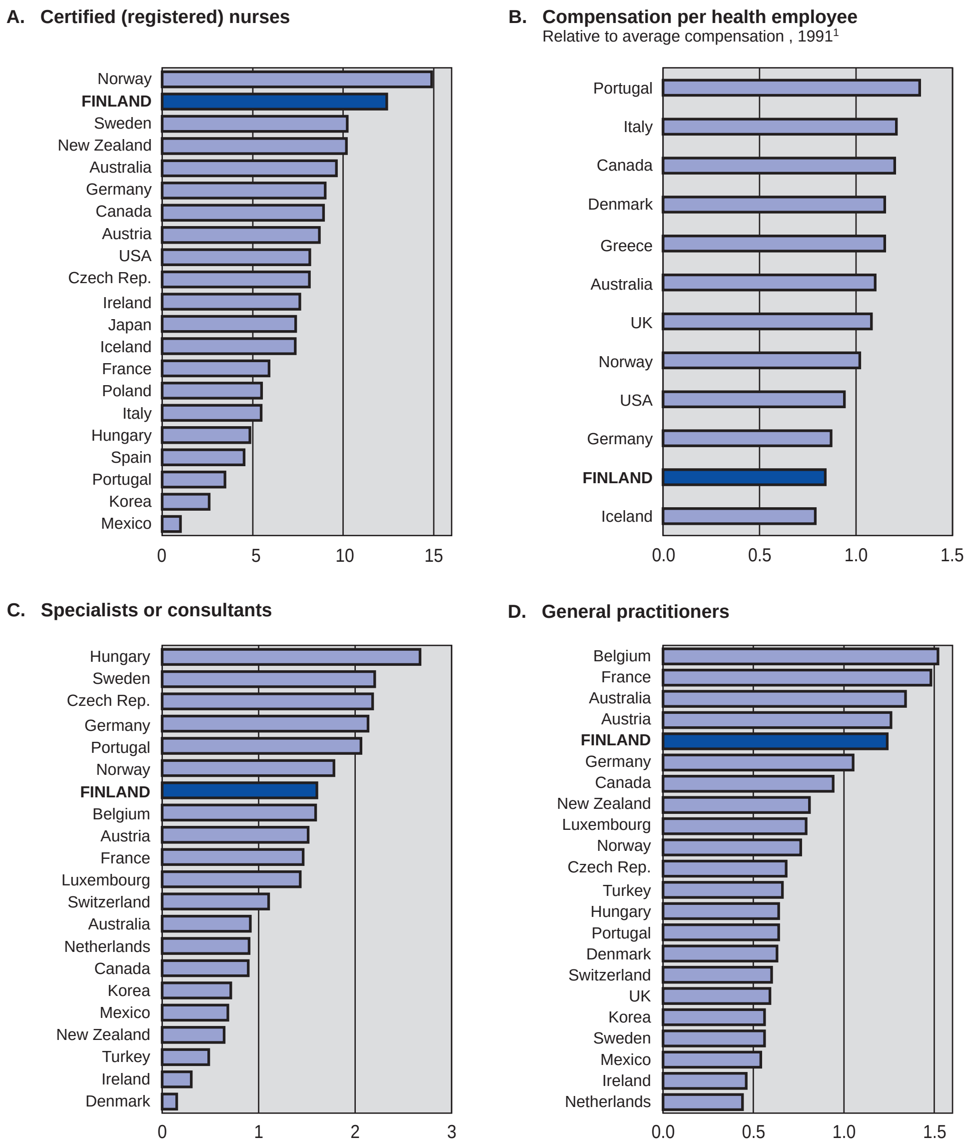
Productivity trends

While health expenditure declined sharply during the 1990s, the level of service provision has been broadly maintained, with the number of doctors' consultations, bed-days, hospital discharges, services of health centres and other output measures remaining stable or increasing (Linna, 1998). The bed-occupancy rate of general hospitals rose between 1991 and 1995, from 69 per cent to 71 per cent (Häkkinen, 1997). The number of visits to physicians in primary care and outpatient care has grown rapidly, by 8 per cent and by 37 per cent, respectively, between 1990 and 1995. Most of the increase occurred in health centres, as the economic crisis forced many patients to substitute private ambulatory care for public care to reduce out-of-pocket payments. Dental care visits have risen as well (Uusitalo and Staff, 1997), with the increase, in contrast, entirely due to a rising number of visits to private dentists. The increase in both the number of admissions to inpatient wards in health centres and visits to psychiatric out-patient care may, however, reflect a decline in psychiatric inpatient health care (nevertheless, the number of bed-days in psychiatric care in Finland has remained the highest in the Nordic area) (Uusitalo and Staff, 1997).

These output developments indicate that the productivity of total factor inputs in Finnish health care has substantially increased in recent years. This overall impression is confirmed by several detailed empirical studies showing that a trend decline in productivity in health care services during the 1980s was totally reversed in the 1990s.[68] Such a striking turn-around in productivity trends is exceptional in the OECD area, although a similar development has been reported in Sweden.[69] The productivity increases were particularly pronounced in hospitals, by 3 to 4 per cent on average per year between 1992 and 1994, but the evidence of sharp rises in productivity in health centres is also strong.[70] As discussed below, however, there remains scope for further productivity growth.

Figure 26. **LABOUR RESOURCES IN HEALTH CARE**

Per 1 000 population, 1996[1]



1. Or latest year of data available.

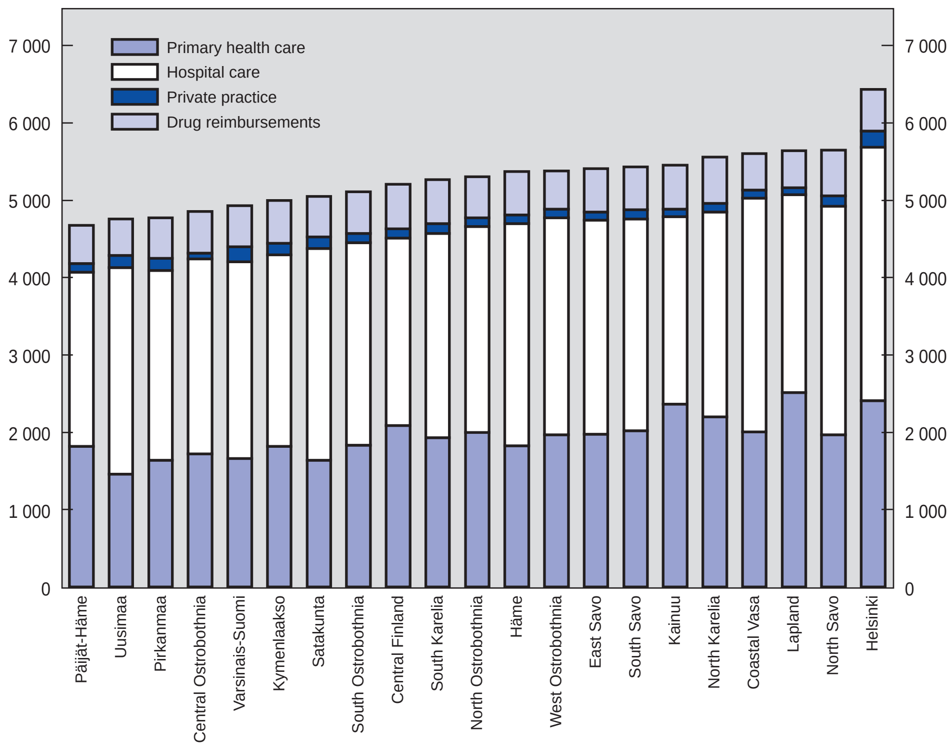
Source: OECD Health Data 98.

Some problem areas have remained

Regional variations in cost and productivity

While the productivity performance of the Finnish health care system substantially improved in the 1990s, there is a significant variation in the health care costs per capita across the 21 hospital districts (Figure 27). While not an unusual phenomenon in countries with a small and unevenly distributed population, such

Figure 27. **REGIONAL VARIATION IN PUBLIC HEALTH EXPENDITURE**
Markkaa per capita, 1995



Source: Terveydenhuollon kehittämisprojekti (1998).

cost differentials seem to be only weakly related to the demographic characteristics or the remoteness of districts. For example, the relatively densely populated Helsinki district is 20 per cent more expensive than the national average.

Efficiency levels are, indeed, found to vary markedly across hospitals. Estimates for 1994 indicated that these institutions could, by adopting the best practice standards attained in the country, reduce their cost considerably (Linna and Häkkinen, 1996). While, as noted above, important productivity gains have been realised in recent years on aggregate, inefficiencies have persisted in some regions, in part reflecting the entrenchment of historically developed organisational cultures. Moreover, many hospital managers in Finland appear to lack the necessary skills or incentives to modernise business strategies, to favour the adoption of new work practices and to provide leadership, as these abilities carry less weight in selecting people for top positions (Karvonen *et al.*, 1994 and Terveydenhuollon kehittämisprojekti, 1998). Although information systems for hospitals have improved considerably in recent years, there are still serious shortcomings in information flows, which contribute to haphazard priority setting in hospitals. For example, the variation in treatment mix across hospitals – controlled for differences in location or epidemiological characteristics of the population – is marked.[71] There is also some regional variation in waiting lists for hospital admission for several treatments (Table 18), even though the overall situation is not alarming, noting that waiting lists are not unusual in health care systems where patient co-payments are low and the prices of health services hence do not act as a rationing device.

A recent survey suggests that there is also considerable variation in cost levels across health centres (Luoma *et al.*, 1996). Specifically, various researchers have found substantial differences in productivity of dental and radiology examinations in health centres, and a substantial potential for cost saving (Vesala *et al.*, 1998). Cost variations between health centres are generally reflected in their personnel mix, with the ratio of total staff to physicians typically being the highest in the least efficient health centres, due to an excessive employment of administrative and non-medical support staff. The efficiency score of health centres (controlled for demographic and case-mix factors) appears to be strongly, negatively correlated with the size of the state grant per capita received prior to the 1993 reform. This indicates that health centres have been subject to a soft budget constraint – *i.e.* easy finance leading to high resource use. Whereas in

Table 18. **Waiting time by hospital district**

Number of months, in 1996[1]

	Surgery			Replacements		Coronary bypass	Total
	Cataract	Hernia	Varicose veins	Hip	Knee		
Uusimaa	5.7	3.7	3.3	2.9	2.7	0.9	2.8
Helsinki	2.3	3.6	2.8	0.9	1.0	1.3	1.5
Varsinais-Suomi	3.1	1.3	2.2	2.9	2.6	1.5	1.6
Satakunta	5.1	2.9	3.5	3.4	4.1	1.0	2.7
Häme	3.0	3.3	3.5	4.7	3.8	0.7	2.3
Pirkanmaa	5.4	1.3	1.1	3.3	2.2	1.2	2.7
Päijät-Häme	5.9	3.8	1.8	1.2	0.9	1.0	2.7
Kymenlaakso	0.5	3.3	3.1	3.6	3.7	0.6	1.8
South Karelia	1.4	2.4	3.4	3.2	3.1	0.0	1.5
South Savo	1.5	2.2	1.5	1.8	1.3	0.0	1.1
East Savo	2.7	3.7	4.4	3.7	2.9	0.0	2.3
North Karelia	7.5	2.9	2.9	2.1	1.4	0.0	3.0
North Savo	0.0	1.3	1.8	2.0	1.0	0.1	1.1
Central Finland	4.5	2.0	1.2	1.8	1.8	0.2	1.7
South Ostrobothnia	5.5	3.7	3.2	4.4	4.0	0.7	2.9
Coastal Vasa	7.5	2.4	3.8	3.4	2.7	0.7	3.5
Central Ostrobothnia	..	0.9	0.2	3.2	2.6	0.6	0.6
North Ostrobothnia	3.2	1.2	1.2	1.3	1.1	1.1	1.3
Kainuu	3.2	3.9	2.1	2.5	2.6	0.5	1.8
West Ostrobothnia	3.0	1.0	0.8	0.9	1.3	1.1	1.0
Lapland	5.1	0.2	0.5	1.7	1.3	0.8	1.6

1. Age and sex standardised average waiting time.

Source: Rasilainen, J., A. Palmu and M.Nenonen (1997), *Aluevaihtelut kirurgisissa toimenpiteissä (pl. ortopedia ja urologia) vuonna 1995,* Stakes tilastotiedote 13/1997, Helsinki.

hospitals the incentives for efficiency enhancement have become more pronounced with the abolition of the earmarked state grant system and the subsequent introduction of activity-based financing, such moral hazard may still be relevant in municipal health centres.

Lack of co-ordination between care providers

The co-existence of several parallel systems of funding and service provision in both primary care (health centres, private practices and occupational health care) and secondary care (hospitals, health centres) has been an important source of inefficiencies. The central authorities traditionally lacked instruments to reduce such overlaps. The multi-tiered structure of the Finnish health care system has become even more difficult to manage, however, with the increasing autonomy of municipalities and hospital districts. This is reflected in a variety of problems:

- *First*, where overlap exists, guidelines as to which service should assume primary responsibility for which patients during the treatment period are lacking (Terveydenhuollon kehittämisprojekti, 1998). Health centre doctors reportedly see the poor information feedback they receive after they have referred their patients to a hospital for examination or treatment as one of the most important problems in this regard.[72] Not only is this deemed to affect the quality of care but it may also lead to unnecessary duplication of laboratory tests and other examinations;
- *Second*, ‘‘gate keeping’’ is not well organised, as a clear policy for referrals to specialised medical care is lacking. This is illustrated by the wide variation in referral rates among doctors, while there is also evidence that a significant proportion of patients admitted into hospitals could have been treated equally well by primary providers. The double role of specialists as full-time hospital doctors and part-time private practitioners, moreover, makes it particularly difficult to establish an effective referral and gate-keeping system;
- *Third*, as there is only limited specialisation across institutions which provide inpatient care (university hospitals, central hospitals, local hospitals and health centres), treatment units tend to be too small (Rissanen, 1996). As a result, economies of scale are not fully exploited, which contributes to sub-optimal medical treatments as well as higher cost levels.

Despite past efforts by the authorities to achieve a more rational service structure, the Finnish ‘‘care culture’’ tends to favour an institutional rather than a patient-oriented approach. In the current set-up, the central authorities have only limited possibilities to change the structure of health care provision in this regard. The main instrument they have available is the programme of state co-funding of investment outlays (including the allocation of funds raised by the Slot Machine Association, which is channelled to the small private non-profit health care sector) and the state subsidies to university hospitals. While these may be effective tools for steering health care developments in the very long run, they may not yield visible results immediately. It was expected that the block grant system introduced in 1993 would provide sufficient incentives to municipalities to take appropriate action, as they would reap the financial benefits from greater efficiency and the associated cost reductions. The record to date, however, indicates room for further improvement.

Uneven bargaining power of purchasers and providers of hospital care

The abolition of grants earmarked for hospital funding in 1993 and the associated greater autonomy of municipalities in terms of arranging these services, has prompted municipalities to buy hospital services from the hospital districts. The beginnings of a market for hospital services thus developed even though this was not the motivation behind the 1993 grant reform *per se*. The efficient functioning of this ''market'' to date, however, has been impeded by an imbalance in the relative market power of purchasers on the one hand and providers on the other. While this problem is common to hospital systems in most OECD countries, several country-specific factors play a role in Finland. First of all, the hospital districts represent a natural monopoly in the sparsely populated areas of the country. Moreover, although municipalities are free to buy services from any hospital district, they are inclined to favour their own district in order to reduce the risk of financial losses (municipalities are the funder of last resort of their district). This weakens the budget constraints facing hospitals and effectively puts the hospital districts in a monopoly position also in the more densely populated areas. Finally, hospital districts are in a position to exploit the information advantage *vis-à-vis* their member municipalities, many of which are, as noted, very small.

Another complication is that the hospital districts lack data to gauge the true marginal cost per bed-day or treatment, due to mediocre cost accounting practices and information systems in many hospitals, and hence resort to simplistic average cost measures to determine their fees. Since many hospitals still have excess capacity, municipalities tend to be over-charged, as the marginal cost of admissions and treatment are clearly below the average cost. As an important side effect, municipalities favour inpatient treatment in health centres over hospital treatment, even if there is sufficient capacity in hospitals, on the ground that this is ''cheaper''.

Sub-optimal pricing policies, soft budget constraints and monopoly behaviour of hospital districts have various adverse effects. Most prominently, it distorts the priority setting by hospitals, who are inclined to favour the development of the most ''profitable'' activities rather than those which are most needed. Moreover, the system discourages a more rational spread of resources across municipalities, for example, from increased specialisation, thus contributing to exacerbate excess capacity in a wide range of medical disciplines. There may even be a tendency towards ''bed-day inflation'' as billing is mostly based on a fixed bed-day tariff, although this is difficult to demonstrate due to the underlying trend towards shorter hospital stays associated with technological developments – albeit the average length of stay is still somewhat longer than generally observed in the OECD. Finally, the limited scope for competition between hospital districts removes an important element of quality and cost control, and discourages progress with the elimination of regional differences in cost and treatment practices.

Reform strategies

Like in most OECD countries, the Finnish health care system is prone to increasing cost pressure in the decades ahead. Rising income and education levels are likely to contribute to such cost pressure, and so will the ever faster diffusion of new medical intervention and diagnostic procedures – even though some technological developments, in particular neurology and surgery, may also result in cost saving. Moreover, the ageing of the population will be more pronounced in Finland than in most OECD countries (see Chapter II and the special chapter on pension reform in the 1997 *OECD Economic Survey of Finland*), which may raise health care expenditure relative to the OECD average, even though ageing has not been a dominant factor in overall health expenditure growth over the past three decades (OECD, 1995*b*). Recent estimates for Finland (which assume unchanged technology and health status of the population), suggest that demographic developments would require a 12 per cent increase in the number of somatic hospital beds, a 5 per cent increase in the number of psychiatric beds and a 26 per cent increase in the number of beds in health centre inpatient wards in the period 1995-2010 (Muuri *et al.*, 1997). Such estimates, however, may prove to be too pessimistic as the average health status of the Finnish population, as noted, is still improving.

While fiscal concerns will force the government to keep a tight rein on health care expenditure in the future, several strengths of the system are worth preserving. The infrastructure (*i.e*. buildings, facilities and equipment) is modern, the skills of health care personnel are excellent and health outcomes very good overall. The system, moreover, has been ensuring continued universal access and high quality of health care – qualities which the overwhelming majority of the Finnish population sees as very important. Future action should therefore be focused on lifting the performance of institutions to the best-practice standards achieved in many areas of care, while leaving the institutional set-up, where possible, unchanged.

Past initiatives

The introduction of block grant funding of municipalities in 1993 has been a far-reaching reform. It increased the decision making power of municipalities radically and broadened, therefore, the range of options open to them in arranging social and health care services for their residents – the more so since detailed regulations issued by central authorities were reduced by a considerable extent. After the grant reform was implemented, moreover, state grants for municipal health care were cut by over 35 per cent, from Mk 11 billion in 1993 to Mk 7 billion in 1997. Other changes since 1993 have aimed mostly at fine-tuning the capitation rules for block grant funding.

This grant reform has been complemented by several initiatives. Most prominently, a group of experts was appointed to prepare proposals for dismantling overlapping service provision and fostering an efficient regional allocation of specialised health care facilities. The thrust of the experts' approach is to persuade hospital managers to press for new work practices or aim for a better division of tasks between health care institutions on a consensual basis. Moreover, the local authorities have been encouraged to reduce long-term hospital stays of elderly people in order to free up beds for other purposes, while increasing the supply of sheltered housing. While this initiative has been successful, it may, according to some analysts, have gone too far in terms of reducing long-term hospital care (Vaarama and Noro, 1997).

Major efforts have also been made in recent years to train and inform health care managers and to monitor their institutions' performances. One of the main tools that has been developed for this purpose is ''benchmarking'', *e.g.* comparing an institution's performance on treatment practices and outcomes with results obtained in the best performing institutions and regions. This approach is thought to result in a learning process which could help lagging institutions to catch up. To this end, the National Research and Development Centre for Welfare and Health (STAKES) collects vast amounts of health care data on a regular basis, which it has made available to the health care institutions via the Internet. In addition, the Ministry of Social Affairs and Health and the Finnish Association of Municipalities have jointly issued proposals in February 1998 to strengthen the patients' position and to enhance the efficiency of Finnish health care. The proposals emerged from an extensive national research programme, and will be further assessed by experts in the public administration in order to prepare action in the years ahead.

Suggestions for further change

A major overhaul of the Finnish health care system is not on the political agenda in view of the overall satisfactory performance of the system. The system will remain largely tax financed and dominated by public provision while a more rigorous purchaser-provider split and large-scale private health insurance are unlikely to develop. However, a series of shortcomings have been identified, not all of which can be resolved with the current policies in place. These include the overlap of health care services supplied by the various health care institutions and the insufficient managerial skills in these institutions, the lack of steering mechanisms available to the central authorities, the inadequate functioning of the market for hospital services, the weak financial incentives for doctors to raise productivity within the municipal health services and the soft budget constraints facing health care providers due *inter alia* to the information asymmetry between the providers and the municipalities and the possibility of cost shifting between parallel funding sources.

Reforms in the organisation of health care provision should focus on eliminating overlapping services and improving management. In particular, there is scope for improving the flow of patient information after a referral has been issued. The possibilities for exploiting modern information technology for this purpose should be carefully scrutinised. Moreover, managerial standards in hospitals and health centres need to be raised, not only through training but also by changes in staff appraisal procedures, qualification requirements and reward systems. Indeed, the benchmarking approach will not be fruitful if managers are not endowed with the skills needed to analyse and interpret statistical and financial information.

The financial instruments available to the national planners for steering health care developments in a desired direction could be enhanced, which requires that the extent of state funding not be reduced further. A suitable steering instrument in this regard could be to create a special state grant for the design of cost-effective solutions. Such grants could be financed by reducing the existing state co-funding of capital outlays by health care providers, as these tend to favour capital-intensive and hence more expensive care facilities. Moreover, some shift of state funding from academic medical research to the development and introduction of better diagnostic and therapeutic practices may also be justified. More generally, the current approach whereby the central government co-finances the provision of health care but delegates all responsibility to the local authorities risks generating excess supply of health care facilities in the longer run, since providers are important local employers and hence are susceptible to intensive lobbying.

A more immediate reform appears to be called for in the domain of hospital funding. At present the municipalities have limited negotiating power as a purchaser of hospital services. Training of municipal officials could help reduce the informational asymmetry between producers and purchasers. However, a more fundamental change in the purchaser-provider split for hospital care may prove useful. A possible solution would be to revamp the role of the hospital districts to become the municipalities' buying agents for hospital care. They would thus negotiate prices and other conditions for delivery with the hospitals. In order for such an arrangement to be effective, however, hospitals would need to be subject to a hard budget constraint. At the same time, the number of hospital districts could be scaled down in order to strengthen their position *vis-à-vis* the providers and to enhance competition between hospitals where possible notably in the more densely populated areas. In addition, there is a need for clear rules concerning the pricing of hospital services. In particular, the current system of tariffs based on average cost needs to be replaced with a combination of: *i)* capitation payments to cover hospitals' long-term expenditure commitments, which are weakly related to actual activity levels; and *ii)* prospective payments based on DRGs per case to cover the short-run marginal cost of inpatient care. This, in turn, requires that all hospitals adopt modern cost accounting procedures in order to generate the information needed to price services appropriately.

Finally, a change in the way physicians in public employment are paid is worth considering. The current system whereby doctors receive a standard salary (with some individual-based adjustments) is likely to contribute to under-provision of services (to ease workloads) and excessive referrals (OECD, 1995*b*), and it also has stimulated the creation of part-time private practices by hospital doctors even though public facilities are under-utilised. The introduction of a mix of basic salaries, capitation payments (with doctors receiving a fixed annual payment per patient with adjustment for age and gender) and fees-for-service could reduce such drawbacks. Maintaining a significant salary component should allow the authorities to control care costs directly, while the introduction of fees-for-service would give doctors an incentive to expand the care provision inside hospitals or health centres. Capitation payments could complement these sources of remuneration, as they would encourage doctors to establish durable contacts with their patients. A balanced combination of salaries, service fees and capitation payments could also avoid ''treatment'' inflation.

Notes

1. The share of Asia in Finnish exports in this industry is around 20 per cent, compared with just over 10 per cent for total merchandise exports.
2. The new definition of unemployment includes unemployed workers who have been actively seeking work in the last four weeks and is in line with the EU definition of harmonised unemployment. The previous definition included unemployed persons seeking work in the last three months. The numbers according to the old definition are 15.8 and 12.7 per cent, respectively.
3. Such estimates are, however, fraught with uncertainties. A recent attempt to estimate the NAIRU (non-accelerating inflation rate of unemployment – a concept which is related to the NAWRU) on the basis of a co-integration model, pointed to a significantly lower level of structural unemployment, but these results are sensitive to the assumed stochastic properties of the unemployment series (see Rasie and Viikari, 1998). Based on the old definition of unemployment the Secretariat's NAWRU estimate is 13 per cent.
4. EMU countries are currently in Phase A of the Third Stage of EMU. Phase B will start on 1 January 1999 with the introduction of the euro and run until 31 December 2001, when it will be followed by Phase C with the euro completely replacing existing national currencies.
5. The Bank of Finland, which was founded in 1811, operates under the supervision of the Parliamentary Bank Supervisory Council. The Council acts mainly as a supervisory body with limited decision-making power with respect to the management of the Bank. All matters that have not been entrusted to the Council are decided upon by the Board of Directors. The Governor and up to five members of the Board are appointed by the President of the Republic on the proposal of the Council.
6. The new Bank of Finland Act, certain elements of which already entered into force on 1 May 1998, emphasises the independent status of the central bank, prohibiting it from taking instructions from (but not excluding co-operation with) the Council of State and other official bodies. According to the new Act, the primary commitment of the bank is to maintain price stability.
7. On the entry of Finland to the ERM, on 14 October 1996, the central rate was set at Mk 5.80661 per ECU. This rate was raised on 25 November 1996 to Mk 5.85424, reflecting the entry of the Italian Lira into the ERM at a central rate above its market rate. On 16 March 1998 it was decided to adjust the central rates to account for the appreciation of the Irish Punt, resulting in a rise in the central rate of the Markka, to 6.01125. The central rate against the Deutschemark – Mk 3.04 – has remained unaltered since the markka's entry into the ERM.

8. Although liquidity conditions have hampered economic developments in the years following the crisis – manifested as a pronounced reduction in bank lending, due both to the high indebtedness of borrowers and reduced willingness of banks to lend – this trend is being reversed (see Pazarbasioglu, 1996).
9. See the special chapter in the 1995 *OECD Economic Survey of Finland*.
10. Local government expenditure has somewhat recovered in recent years, based on increased proceeds from local taxes and user charges (municipalities have tax autonomy, but are subject to the ‘‘golden rule’’ that current revenues and expenditure should balance), but they have continued to lag GDP growth.
11. In fact, the debt/GDP ratios of the central and general government have been diverging. The decline in the general government debt/GDP ratio has benefited from the purchases of state bonds by the social security funds, in particular the Employment Pension funds which manage the statutory pension insurance in Finland and whose financial assets amount to some 45 per cent of GDP. As discussed in the 1997 *Economic Survey*, these pension funds, which run substantial financial surpluses of the order of 4 per cent of GDP, have consistently raised the share of state bonds in their investment portfolios since 1993, due to measures making direct lending to employers less attractive.
12. The Finnish public pension system consists of two tiers, with the national pension scheme providing basic pensions for all citizens and the Employment Pension schemes granting earnings-related pensions. As participation in the Employment Pension schemes is compulsory for all workers, these provide virtually universal coverage. Unlike the national pension schemes, the management of the Employment Pension schemes is in the hands of private pension insurers and these schemes have accumulated substantial financial assets – although in an actuarial sense the system is far from fully funded – which are included in the general government balance sheet.
13. According to official estimates, the high unemployment in the 1990s has cost Finland an estimated Mk 224 billion – equivalent to 60 per cent of the central government debt – in lost tax revenues and unemployment benefit payments. The accumulated annual cost is estimated to average around Mk 50 billion per year, or almost one tenth of GDP.
14. In 1997, 120 000 persons were unemployed between one and two years and the number of those unemployed for over two years stabilised at around 40 000 at the end of 1997.
15. Apart from skill mismatches associated with the rapid change of the industrial structure following the economic crisis, this ‘‘lost generation’’ of older workers is tending to be rejected for employment due to their age, in conjunction with the expectation that they may retire early, and a comparatively low level of education.
16. Youth unemployment has fallen primarily due to the stronger financial incentives for young people to seek work and fundamental reforms in the education system, including a job apprenticeship training programme.
17. The report of an Expert Group, appointed by the Economic Council, emphasised the need for improving regional mobility of labour (Economic Council, 1998).
18. Temporary impediments to geographic mobility are the acute shortage of social housing in the booming Helsinki area and the tendency for homeowners in areas where housing prices have declined, not to sell and move to another area, so as not to realise the equity loss.

19. As discussed in the previous OECD *Economic Survey* for Finland, measures to limit the use of subsidised employment – especially by municipal governments – as a vehicle for Unemployment Insurance entitlement renewal have proved effective, with participation in this programme declining considerably. Part of this decline has, moreover, been associated with the change to make the employment subsidy payable to private employers after the subsidised employment was converted to a permanent employment relationship, which has reduced their use of this scheme. The decline in the number of persons in subsidised employment by private employers has not, however, led to a reduction in the number of people in job-related labour market measures, due to the more frequent use of apprenticeships and job-sharing schemes by companies, reflecting the greater resources being devoted to such measures in recent years.

20. The Labour Market Support scheme is increasingly being used in place of the Unemployment Assistance scheme, which is being phased out.

21. The Employment Programme target of placing 5 per cent of the labour force in labour market policies by 1997 was exceeded. By October 1997, the equivalent of 52 000 man year places had been created – through 22 000 training and education places and 30 000 ''demand'' places, *e.g.* in subsidised employment, public construction and leave measures. In 1997, 122 000 persons participated in such measures on average and the target for 1998 is 118 000 persons.

22. The programmes reported under the Labour and Training Policy Objective are: Employment Subsidy Scheme; Subsidy for Worsened Employment Situation; Structural Change Scheme; Investment Aid to Promote Employment; Vocational Training Scheme; Compensation to Employers.

23. The education guarantee benefit, which equals the basic daily allowance, exceeds the level of financial support available to ''normal'' students.

24. To further motivate long-term unemployed persons to participate in this programme, compensation is offered for travel and maintenance during the job training period.

25. In 1997, there were around 30 head-hunting firms and 150 temporary work agencies operating in Finland. The head-hunting firms were, moreover, primarily concentrating on the placement of professionals, such as managers and experts.

26. The selected OECD countries are the United States, Canada, Japan, Australia and New Zealand.

27. According to the Federation of Industrial Companies (TT), the lower range of hourly earnings in Finland in 1997 was Mk 35 for men and Mk 28 for women. Public income received by low-skilled prime-age and older workers in the Unemployment Insurance or Unemployment Pension schemes – including supplementary cash benefits – easily exceeds these hourly earnings.

28. In 1997, 28 per cent of the service sector employees were in permanent part-time employment, while 15 per cent were in fixed-term employment (on a full or part-time basis). The comparable figures for the economy as a whole, were 6 and 18 per cent, respectively. An official report indicates that the growth in the number of fixed-term contracts has been levelling off as they have progressively been converted into permanent employment relationships.

29. Small employers in Finland are relatively unencumbered in terms of firing restrictions, being allowed to issue dismissal notices after a few days of negotiation. Lay-offs for economic reasons, however, require the employer to give priority to the affected workers when re-hiring.

30. The Unemployment Insurance buffer fund will probably be included in the next budget.

31. Real wage flexibility, different from relative wage flexibility, ensures that the aggregate real wage level is consistent with low unemployment.

32. It has been found that labour cost changes have a greater tendency to be shifted to the producer in countries where collective wage bargaining is strong (Leibfritz *et al,* 1997).

33. A recent study suggests that the black market economy is around 2 to 4 per cent of GDP – among the smallest in the EU.

34. OECD *Economic Outlook* No. 63, pp. 157-170.

35. The same report concluded that a reduction in public support to manufacturing industry in Finland should be combined with a shift to a broader tax base and lower tax rates on capital and labour to promote industrial development.

36. The commitment to implement an increase in the municipal earned-income tax credit appears, however, to be only weak, as the municipalities implementing it have full tax autonomy.

37. In many OECD countries, capital gains tax for investors is zero for shares that have been held for a certain time. However, this does not necessarily imply neutral taxation.

38. Part of the industrial support takes the form of soft loans by KERA (the Industrial Investment Fund; directed towards SMEs), the Finnish Guarantee Board (export guarantees) and Finfund (development aid). These three institutions will be merged in order to improve their operations.

39. International treaties also played an important role in the design of a new industrial support strategy, in particular the WTO Agreement on Subsidies and Countervailing Measures and Procurement and the Articles 92 and 94 of the Treaty of Rome regarding Government Support.

40. A 1996 White Paper outlines the government's programme for technology policy between 1997 and 1999.

41. In a ''knowledge-based economy'' physical and intangible investment are complementary forces of economic and employment growth, and their interaction plays a crucial role in determining the competitiveness of business in the long term. Government policies, recognising the complementary role of investment in physical and intangible assets, have evolved to accommodate both.

42. The ''Advisory Committee on Business Subsidies'', to be established to prepare an appraisal statement on each new scheme prior to its formal approval, is expected to improve the effectiveness of future support programmes, while limiting public support to manufacturing industry. In principle, government support measures should only be allowed if they enhance welfare by correcting market failure.

43. A feature of industrial globalisation has been the internationalisation of industrial R&D activities. Even though R&D activities are less internationalised than production itself, they have grown significantly over the past fifteen years. This process has resulted primarily from a

growing number of Finnish R&D laboratories locating abroad and the proliferation of co-operation agreements or alliances, either between firms or between firms and government or university R&D institutions.

44. In specific sectors, such as biotechnology, there is some indication that highly-skilled workers are being attracted abroad by better salaries.

45. By 1996, public support had returned to around the same share of GDP seen prior to the recession. The shift from sector-specific and enterprise-specific supports towards horizontal policy areas was particularly marked in Finland: support to the former category declined from 38 per cent in 1989 to 12 per cent in 1995, while support to horizontal activities (*i.e.* regional development, R&D, SMEs, energy efficiency, environmental protection, and investment incentives) expanded from 55.4 to 77.1 per cent of total support.

46. A small part of regional support has been used to subsidise transportation cost of SME products from remote areas.

47. The legislation, in force since 1 January 1998, applies to around two-thirds of the Ministries' programmes.

48. In 1997, there were 42 industrial support programmes in Finland: Equity Capital Injections to State-Owned Enterprises; Subsidies to the Press; The Ship Guarantee Scheme of the Finnish Guarantee Board (FGB); Export Credit Guarantee Scheme (Shipping) of the FGB; Interest Rate Subsidies for Ship Deliveries; Aid for Investments and Adaptation of Food Industry; State Aid for Shipbuilding; Support to Certain Enterprises in Difficulty; Firm Specific Loans; Grants for Industrial R&D; Soft Loans for Industrial R&D; Aid for the Promotion of Energy Research; The Fund for Investments in Industrial R&D; R&D Co-operation Grants; Regional Transport Subsidy; Regional Development Aid for Enterprises; Relocation Aid for SMEs; Small Business Aid; Regional development activities of KERA Ltd; Accelerated Regional Depreciation; Regional Stamp Duty Exemption; Provincial Development Grants; State Aid for Improvement of the Operational Conditions of Undertakings; Accelerated Depreciation Scheme for Investment in Industrial Production; Transfer to State Investment Fund; Industry Guarantee Scheme of FGB; Interest Rate Subsidy for Investments of SMEs; Interest Rate Subsidy for SMEs; Regional Business Service Offices; Consolidation Guarantee Scheme of the FGB; Venture Capital Guarantee Scheme of the FGB; Internationalisation of SMEs; Soft Loans for the Internationalisation of Businesses; Promotion of Industrial Performance; Export Credit Guarantee Scheme of FGB; Interest Rate Subsidies to the FEC Ltd.; Energy Grants; Interest Rate Subsidy for Energy Investments; Environmental Protection Guarantee Scheme of FGB; Interest Rate Subsidy for Waste Management and Air Pollution Control; Interest Rate Subsidy for Water Protection Investments by Industry; Promotion of Environmental Protection.

49. All Finnish State-owned enterprises operating in the manufacturing sector are quoted on the Helsinki stock exchange.

50. The fact that Finnish agricultural activities take place in a northerly ''low yield-high cost'' region, implies they are inherently less competitive than similar activities no further away than *e.g.* Denmark and the lower half of Sweden.

51. From 1994 to 1995, agricultural market proceeds dropped from Mk 23.0 billion to Mk 13.0 billion and local subsidies of Mk 4.3 billion in 1995 were replaced by higher

national income support of Mk 5.6 billion. Although the decline in market proceeds was also partly offset by EU support of Mk 5.1 billion, the total agricultural income dropped from Mk 27.3 billion to Mk 23.7 billion between the two years.

52. Since 1996, data concerning overall agriculture support including, for instance, price support under the Common Agricultural Policy are not available for Finland.

53. An example of a case lodged with the Office of Free Competition concerned the practice of credit card firms to prohibit commercial users, like travel agents, from charging service fees, on top of advertised prices, *e.g.* on travel arrangements listed on the Internet. The Office of Free Competition agreed that this practice violated their ''freedom of pricing'' and was, therefore, injurious to the travel agencies. The Competition Council is now deliberating on the matter.

54. Electricity prices in Finland were in 1996 the lowest in Europe, after Sweden. Source: Electricity Association, International Electricity Price Survey, January 1996.

55. Concerning the supply of energy itself, there seems to be adequate competition.

56. The Treaty of Accession of Finland to the EU comprised a derogation from the EU Insurance Directive, barring insurers from the other EU countries from entering the Finnish market for statutory pension insurance.

57. See the 1996 and 1997 *OECD Economic Surveys* of Finland.

58. Pursuant to the 1972 Primary Health Care Act, health centres must be set up by the local authorities to provide general care, health counselling, maternity, infant and school health care, ambulance transport and dental care for people born after 1955 (people born before depend on private dental care).

59. The share of consultations with private specialists in the total number of consultations varies considerably across disciplines. It is the highest for psychiatrists (80 per cent), and also considerable (around 50 per cent) for ophthalmology, gynaecology, obstetrics, paediatrics and otolaryngology.

60. The private provision of hospital services is very limited, comprising only a few hospitals owned by non-profit foundations, which supply around 5 per cent of the total number of hospital beds in the country.

61. Local taxes are levied as a flat rate on income and vary from municipality to municipality due to the local tax autonomy; the national average rate is 17.5 per cent.

62. In addition, adjustments are made for the number of invalidity pensions for those under 55 years of age, and the so-called ''archipelago factor'' favouring municipalities which are not located on the mainland.

63. A service package typically includes all services associated with a specific surgical intervention.

64. The health insurance contribution rates are fixed by the government on an annual basis as a percentage of earnings or benefits.

65. Patients must apply for the right to receive special refunds by presenting a medical certificate indicating the presence of a severe illness at a local office of the Social Insurance Institution. The certificate has to be based on an examination performed in a hospital or issued by a specialist.

66. Hospitals and health centres also require co-payments for outpatient services, which are not reimbursed by the national health insurance, but these cover only around 10 per cent of the total cost.

67. Forty per cent of deaths of men in the 15-34 year age bracket are due to suicide.

68. Studies by Hjerppe (1982), Häkkinen and Luoma (1989), Luoma and Järviö (1992) and Alander *et al*. (1990) estimate the average annual decline in public health care productivity in Finland to have been around 3 to 4 per cent per year. Recent studies on productivity developments in health care (Luoma and Järviö, 1998; Linna, 1998), applying a so-called Malmquist index approach, suggest that productivity has increased during the 1990s.

69. Sweden also experienced a negative productivity development in public health care in the 1980s, which was reversed in the 1990s as well.

70. Such productivity improvements have been the combined effect of low productivity institutions catching up and a shift in the productivity frontier. See Luoma and Järviö (1998) and Linna (1998).

71. For example, the age and sex adjusted indexes for inguinal hernia repair (national average = 100) by hospital district vary from 37 (Jyväskylä) to 137 (Pirkanmaa, excluding the city of Tampere). Similarly, the indexes for varicose vein operations range between 23 (Jyväskylä) and 151 (Kotka), for coronary bypass operations between 56 (Turku) and 175 (Oulu) and for appendectomy between 66 (Jyväskylä) and 167 (Oulu).

72. Doctors issuing a referral to a hospital receive feedback information only in 30 to 60 per cent of the cases and often with a considerable delay.

Glossary of acronyms

CEEC	Central and eastern European Countries
CIS	Community of Independent States
DRG	Diagnostic Related Groups
EEA	European Economic Area
ECB	European Central Bank
EMI	European Monetary Institute
EMU	Economic and Monetary Union
ERM	Exchange Rate Mechanism
ETLA	Research Institute of the Finnish Economy
FGB	Finnish Guarantee Board
KERA	Industrial investment fund
NAIRU	Non-Accelerating Inflation Rate of Unemployment
NAWRU	Non-Accelerating Wage Rate of Unemployment
OFC	Office of Free Competition
R&D	Research and Development
SAK	Federation of labour unions
SMEs	Small and Medium-sized Enterprises
STAKES	National research and development centre for welfare and health
TEKES	Technology development centre of the Ministry of Trade and Industry
TT	Federation of industrial companies
VAT	Value Added Tax
WTO	World Trade Organisation

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Annex

Calendar of main economic events

1997

January

The State Budget for 1997 is adopted by Parliament. Expenditure totals Mk 190.3 billion and revenue, excluding borrowing, Mk 162.0 billion. Relative to the 1996 Budget, expenditure will decline by 1.7 per cent, whereas revenue will grow by 2.4 per cent. New saving measures will cut expenditure by Mk 6 billion. Saving measures effective in 1995, are to be extended. Of the saving measures undertaken in 1995-97, Mk 23.5 billion will be realised in 1997.

In 1997, the rate of the employers' average employment pension TEL contribution (long-term employment) will be 16.7 per cent, that of the LEL contribution (short-term employment) 17.7 per cent, and those of the YEL (self-employed persons) and the MYEL (farmers) contribution 20.7 per cent. The average rate of the local government employers' pension contribution will be 20.8 per cent of the payroll, and that of the State pension contribution 19.0 per cent. The rate of the employees' pension insurance contribution will be 4.5 per cent of wages.

In 1997, the rate of employers' unemployment insurance contribution will be 1 per cent for the first Mk 5 million of the payroll and 4 per cent for the amount in excess of that. The rate of the employees' unemployment insurance contribution will be 1.5 per cent of wages. The shares of contribution to earnings-related daily allowances are temporarily revised so that the share of the State will be 54.5 per cent, that of employers' 40 per cent and that of insured 5.5 per cent.

In the private sector, the rate of the employers' old age insurance contribution will be 2.40, 4.00 or 4.90 per cent of the payroll, depending on the capital-intensity of the company, and 3.95 per cent in the public sector; in the private sector, the rate of sickness insurance contribution will be 1.60 per cent of the payroll, and in the public sector 2.85 per cent. Old age insurance contributions of the insured will be abolished. The rate of the sickness insurance contribution of the insured will be 1.90 per cent of the taxable income up to Mk 80 000 per annum and 2.35 per cent in excess of that. An additional sickness insurance contribution of 3 per cent of pension income will be collected from pension recipients.

The maximum amount of earned income deduction in local government taxation is raised.

Wealth tax relief for owner-entrepreneurs is reduced from 20 to 10 per cent of share holdings in a company.

The energy tax system is revised to eliminate taxation of electrical power generation sources and a shift is made to taxation of electricity. The electricity tax is graduated so that industry and commercial greenhouse operators pay a lower rate. Small generating plants are provided with support from State funds.

Stamp duty on securities and real estate transactions is replaced with an asset transfer tax of 1.6 and 4 per cent, respectively.

An inflation adjustment, corresponding to the 4 per cent rise in the price level, is made to income tax scales. The marginal tax rates in these scales are lowered by 1 percentage point. Wealth tax scales remain unchanged.

The period of prior employment for entitlement to the earnings-related unemployment benefit is extended from six to ten months and the pay forming the basis for earnings-related daily allowances is to be calculated from the date when the employment requirement is fulfilled. New allowances shall be at least 80 per cent of the previous allowances. The incentive for earning additional income while benefiting from unemployment insurance is improved. The period of unemployment benefit for the long-term unemployed over 53 years of age is shortened by two years.

Persons aged 20 to 24 years lacking any vocational training will not be entitled to labour market support if, without any acceptable reason, they refuse a job offer, studying or vocational training.

The index freeze of unemployment benefits will continue in 1997-99.

The State's contribution to the Social Insurance Institution is to increase by Mk 2.4 billion mainly due to payment agreements (housing support to people receiving national pension and reductions in municipalities' social security contributions). The additional and basic national pension are abolished.

The tax rate rose in ten municipalities and fell in 45 municipalities; according to preliminary data, the tax rate averaged 17.43, *i.e.* 0.08 per cent less than in 1996.

February

The government agrees on a new four-year budgetary framework, with overall expenditure ceilings for each year, aiming for a decline in the central government debt-to-GDP ratio by 1999 – to meet the government's programme manifesto of Spring 1995 – and at the same time staying within the limits for public deficits and debt prescribed in the Maastricht Treaty.

March

A tax border concerning value-added tax and excise duty required by European Community legislation is established between Åland and the rest of Finland. As a result, the sale and transfer of goods and services between Åland and the rest of Finland is subject to the same regulations governing trade between Finland and countries outside the European Community.

April

The Council of State gives approval for the Ministry of Trade and Industry to sell shares of the State-owned company Rautaruukki Oy; leaving the State with at least 41 per cent of the shares.

May

The Council of the European Union approves the abrogation of its decision on the ‘‘existence of an excessive deficit’’ in Finland, as the share of general government deficit and debt in Finnish GDP were 2.6 and 58.7 per cent, respectively, in 1996 and are expected to attain 1.9 and 59.1 per cent in 1997.

The Council of State decides to present the Report of the Council of State on ‘‘Economic and Monetary Union – Finnish Options and National Decision Making’’ to the Parliament.

June

The Labour Contract Law is to be revised so that the obligation to pay wages during periods of illness is extended in a limited form to include employment lasting less than one month. The annual holiday law is revised (as of 1 April 1997), considerably broadening employee rights to annual holiday compensation, including for short-term employment.

July

The Parliament passes the Act on the Bank of Finland and certain related acts to take effect on 1 January 1998. The primary aim of the new legislation is to safeguard the value of money. The role of the Parliamentary Supervisory Board changes to a supervisory and administrative role, while monetary policy decisions and implementation are concentrated with the Board of Directors of the Central Bank. The new law also makes the Central Bank more independent of public financing needs, a requirement of the second stage of the EMU. The Currency Act, however, continues in its present form, until the European System of Central Banks is set up in accordance with Article 1091 of the Treaty establishing the European Community.

As of 1 October 1997, household employment in 1997-99 is made tax deductible, up to Mk 5 000 per annum, if the work performed is housework, nursing or care activities and carried out within the home. The deduction may also be granted for home improvement work, if no other support is received for this purpose. The employer's obligatory social security contributions can be deducted from income tax, or 40 per cent of payment can be made to an individual marked in the withholding tax register as engaged in taxable activities. Trial areas are municipalities belonging to the provinces of South Finland, Oulu and Lapland.

August

Unemployed persons are allowed to make short, occasional trips abroad without losing the right to daily unemployment benefits. The condition is that advance notice is made of the trip, and that the individual can be immediately contacted during the trip and is able to accept work offered during a normal span of time.

A regulation is added to the Income Tax Law to ease the progressive effect which some pension payments from abroad have had on the taxation of wage and salary income from Finland. The law is applied for the first time in 1997.

Long-term unemployed persons who have been active in the labour market in paid employment or as entrepreneurs for at least 12 years and registered as unemployed job seekers with the employment office for at least 12 of the preceding 24 months, have the right to daily unemployment benefits or to Labour Market Support benefits during a period of voluntary training aimed at promoting professional skills, for a period not exceeding two years.

September

Changes in Corporate Law are implemented concerning the division of companies into private and public stock companies, the broadening of the definition of what comprises a corporate group, an increase in the financial instruments employed by companies, increasingly stringent regulations concerning share capital payment, and capital assets, and the easing of changes in company structure. The central goal of the revisions is to promote the ability of companies to decide on operational arrangements as well as to improve equality among shareholders and the position of creditors.

An update of the national Convergence Programme is approved by the government. Under the programme the public sector deficit falls below the threshold value for 1997, and public debt eases after 1997.

The 1998 central government budget proposal is presented. Expenditure totals Mk 186.9 billion and revenues excluding borrowing Mk 171.4 billion. The budget deficit of Mk 15.4 billion is to be covered by equivalent net borrowing. Budgeted expenditure shows a decline in real terms of close to 3 per cent as compared to projected 1997 spending. The impact of previously decided cuts in spending will reduce government expenditure in 1998 by approximately Mk 3 billion, and savings and deferred expenditure by Mk 2 billion.

The Bank of Finland raises its tender rate from 3.00 per cent to 3.25 per cent. In addition, the interest rate on banks' excess reserves is raised from 1.00 per cent to 1.25 per cent.

October

The net effect of the supplementary budget on central government expenditure is a reduction of Mk 1.6 billion in costs. This figure includes a Mk 3.6 billion increase in the yield on bond issue premiums as a factor reducing costs. With a net increase in income, primarily due to growth in corporate tax receipts, estimated at Mk 7 billion, central government net borrowing is reduced by Mk 8.6 billion. Net borrowing for 1997 within the scope of the supplementary budget remains at Mk 19.7 billion.

November

The Bank of Finland shortens the maturity applied in its money market tenders from one month to two weeks. The normal settlement day for these tenders will be the banking day following the trade day. The maturity applied in its liquidity credit is shortened from seven days to one day and the limits are abolished on collateralised liquidity credit.

The government and the labour market organisations reach an agreement on the establishment of two buffer funds associated with the employment pension and the unemployment insurance schemes, to provide scope for adjustment in labour costs in the single currency area. The total sum amounts to nearly Mk 7 billion.

December

The central labour market organisations ratify an incomes policy agreement for 1998-99. The new wage settlement period is from 1 January 1998 to 15 January 2000. At the beginning of 1998 there will be a general increase in wages and salaries, Mk 0.85 per hour or Mk 142 per month, but no less than 1.6 per cent. As from the same date, an amount equal to 0.5 per cent of the wage bill in each branch will be used to correct distortions within the branches with a high incidence of female and low-paid employees. From the beginning of 1999 wages and salaries will be raised by the same amount again and, should the rise in the consumer price index (1995 = 100) from December 1997 to October 1998 exceed 2.6 per cent, wages and salaries will also be increased by an equivalent sum, excluding rises of 0.4 per cent or less.

The government approves the formation of a new energy corporation, by combining Imatran Voima Limited and Neste Limited in a holding company, which is later to be quoted on the Helsinki Stock Exchange.

The Bank of Finland reaches a decision in principle to terminate the quotation of the Helibor interest rates, excluding rates with a maturity of three-years which are to be abolished in 1998, when a final decision on the outcome of Finnish participation in stage three of Economic and Monetary Union is to be made.

1998

January

The State Budget for 1998 is adopted by the Parliament. Expenditure amounts to Mk 188.6 billion and income excluding borrowing to Mk 173.2 billion. Relative to the Budget for 1997, expenditure will decline by 0.9 per cent, while revenue will grow by 6.9 per cent. The net borrowing requirement is Mk 15.4 billion.

The Finnish deposit guarantee scheme is revised by an amendment and an extension of the Act on Credit Institutions (1229/97). All deposit banks must now belong to a common deposit guarantee fund. Instead of the previous full coverage, the guarantee is now limited to a maximum of Mk 150 000 per depositor/bank.

The rate of employers' average employment pension TEL contribution (long-term employment) in 1998 will be 16.8 per cent, the LEL contribution (short-term employment) 17.5 per cent, and the TaEL contribution (freelance employees) 11.3 per cent of the payroll. The average rate of local government employers' pension contributions is 20.9 per cent of the payroll and State pension contributions 18.8 per cent. The rate of employees' pension contributions, in turn, amounts to 4.7 per cent of wages.

Employers' unemployment insurance contributions in 1998 amount to 0.9 per cent of the first Mk 5 million of the payroll and to 3.9 per cent of sums exceeding that limit. The unemployment insurance contribution of the employed is 1.4 per cent of wages. For any amount exceeding Mk 80 million of the yield on the contributions, 54 per cent will be used to reduce the earnings-related unemployment *per diem* payments incurred by the State, and 46 per cent to finance employment pension supplements. The shares of contributions to earnings-related daily allowances will be temporarily revised in 1998 so that the share of the State will total 52.5 per cent while that of the central unemployment insurance funds, *i.e.* the share of employers, amounts to 42 per cent. The final State share is estimated at 35 per cent, when taking into account the reducing effect of the unemployment insurance contributions of wage earners on the State share. The employers' share of daily allowances during periods of redundancy is 67.5 per cent, while that of the State is 27 per cent. Both private and public employers' old age and sickness insurance contribution rates remain unchanged.

The income thresholds of the income tax scales are raised by 2 per cent. The wealth tax scale and the community wealth tax percentage remain unchanged. Retention for travel expenses between home and work is raised to Mk 3 000 and the maximum amount of tax-deductible travel expenses to Mk 20 000.

The tax structure of value-added tax is modified to correspond to European Union legislation so that only two reduced tax rates will be effective.

Tax exemption on income earned abroad, governed by the so-called ''six-month tax rule on income'', is revised so that all income subject to this rule is tax exempt. Sickness insurance contributions are still levied on the exempt income.

Legislation pertaining to energy taxation changes. The current 50 per cent tax concession on natural gas becomes permanent. Electricity generated by wood and wood-based fuels are granted a subsidy equivalent to the electricity tax. At the same time electric power distribution is granted exemption from electricity taxation. Losses in tax revenue derived from electricity generated by natural gas, wood and wood-based fuels is compensated for by raising the additional tax based on the carbon content of all fuels and the electricity tax. The equivalent subsidy granted to industry is offset by raising the electricity tax charges of industry. The excise duty on petrol is raised by Mk 0.20 per litre and diesel fuel by Mk 0.15 per litre.

The excise duty on wines and intermediate products is lowered by an average of 17 per cent and the concept of wine is broadened. The restrictions are relaxed on the amount of alcoholic beverages that passengers arriving in Finland from other EU countries may bring.

The basic daily Unemployment Assistance benefit is raised by Mk 2. The change is also reflected in the level of the earnings-related daily Unemployment Insurance, the vocational training support for adults, the Labour Market Support and certain labour market policy subsidies. Revisions in the Unemployment Assistance and child cash benefits are determined annually on the basis of cost of living developments instead of changes in the wage level.

A daily allowance is granted to unemployed persons – who have been wage earners or entrepreneurs on the labour markets for a minimum of 10 years during the past 15 years – for full-time vocational training intended for the promotion of occupational skills, for a period not exceeding 500 days. The recipients must, moreover, have been unemployed for at least 4 of the 12 months prior to the training period.

February

The depreciation schedule of small and medium-sized enterprises is raised to 50 per cent on the basis of capital assets acquired in 1998 and may be applied for the year of acquisition and the following two tax years. The tax relief applies not only to new production plants and travel agencies but also to the expansion of production plants and travel agencies in operation, and to the renewal of machinery and equipment in these units.

The Cabinet presents Parliament with a Statement on Finnish participation in the euro area, for the Parliament to express its position. The effects of the different alternatives have been carefully examined and it is the belief of the government that the interests of the Finnish nation can be best secured by participation in the euro area from the outset.

March

The Bank of Finland raises its tender rate from 3.25 to 3.40 per cent. In addition, the interest rate on banks' excess reserves is raised from 1.25 to 1.40 per cent.

April

The Parliament votes on the government's Statement on Finnish participation in the euro area with 135 votes in favour, and 61 against.

STATISTICAL ANNEX AND STRUCTURAL INDICATORS

Table A. **Selected background statistics**

	Average 1988-97	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
A. Percentage changes[1]											
Private consumption	1.1	5.1	4.3	0.0	–3.6	–4.9	–2.9	1.9	4.6	3.8	3.0
Gross fixed capital formation	–1.4	9.8	14.8	–4.1	–20.3	–16.9	–19.2	0.2	11.3	8.4	11.2
Public investment	–0.6	5.2	–12.3	14.1	–0.2	–2.0	–17.8	1.6	–5.5	10.5	4.6
Private investment	–1.5	10.6	19.1	–6.2	–23.1	–19.6	–19.5	–0.2	15.2	8.0	12.6
GDP	1.7	4.9	5.7	0.0	–7.1	–3.6	–1.2	4.5	5.1	3.6	5.9
GDP price deflator	3.0	7.0	6.1	5.8	2.5	0.7	2.4	1.3	2.4	1.3	1.1
Industrial production	3.7	4.0	3.8	–0.4	–9.7	1.7	5.2	11.9	8.6	3.8	8.5
Employment	–1.0	0.3	1.6	–0.1	–5.2	–7.1	–6.1	–0.8	2.2	1.4	3.5
Compensation of employees (current prices)	3.8	10.6	11.8	9.1	0.3	–5.6	–5.7	2.2	6.7	4.7	3.8
Productivity (real GDP/employment)	2.9	4.6	4.0	0.1	–2.0	3.8	5.3	5.4	2.8	2.2	2.3
Unit labour costs (compensation/real GDP)	1.8	5.8	5.9	8.4	7.8	–2.6	–5.3	–2.6	2.0	1.0	–2.1
B. Percentage ratios											
Gross fixed capital formation as a per cent of GDP[1]	20.8	25.9	28.1	27.0	23.2	20.0	16.3	15.6	16.6	17.3	18.2
Stockbuilding as a per cent of GDP[1]	0.3	0.6	1.5	0.6	–2.0	–1.3	–0.8	1.6	1.3	0.6	0.8
Foreign balance as a per cent of GDP[1]	3.5	–0.2	–2.0	–1.5	–0.2	2.0	6.3	6.9	7.4	7.3	8.7
Compensation of employees as a per cent of GDP	53.8	54.5	54.4	56.1	59.1	57.4	53.5	51.6	51.2	51.1	49.5
Direct taxes as a per cent of household income	16.2	17.5	17.2	17.2	15.8	14.7	14.5	16.3	15.5	16.7	16.8
Household saving as a per cent of disposable income	2.4	–1.2	–0.6	0.4	5.1	7.1	5.2	0.4	3.6	0.9	2.8
Unemployment rate (revised series)	10.4	4.2	3.1	3.1	6.4	11.5	16.1	16.4	15.6	14.7	12.6
C. Other indicator											
Current balance (billion dollars)	–1.0	–2.6	–5.1	–5.1	–5.5	–4.6	–1.3	1.3	4.1	3.8	5.1

1. At constant 1990 prices.

Source: OECD, *National accounts*, OECD Secretariat and Ministry of Finance.

Table B. **Supply and use of resources, current prices**[1]

Mk million

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Private consumption	232 580	254 588	269 754	274 709	272 114	275 252	284 425	298 201	314 451	328 346
Public consumption	87 199	96 019	108 535	118 719	118 453	112 190	114 001	119 795	126 579	128 886
Gross fixed investment	109 258	136 148	139 144	110 061	87 953	71 194	74 186	85 089	92 532	104 623
Final domestic demand	429 037	486 755	517 433	503 489	478 520	458 636	472 612	503 085	533 562	561 855
	(11.7)	(13.5)	(6.3)	(–2.7)	(–5.0)	(–4.2)	(3.1)	(6.5)	(6.1)	(5.3)
Stockbuilding	3 006	6 424	2 924	–9 498	–5 833	–3 880	7 892	5 396	2 971	5 305
	(1.0)	(0.8)	(–0.7)	(–2.4)	(0.8)	(0.4)	(2.4)	(–0.5)	(–0.4)	(0.4)
Total domestic demand	432 043	493 179	520 357	493 991	472 687	454 756	480 504	508 481	536 533	567 160
	(12.7)	(14.2)	(5.5)	(–5.1)	(–4.3)	(–3.8)	(5.7)	(5.8)	(5.5)	(5.7)
Exports	108 750	116 702	118 828	109 289	128 272	159 438	182 530	207 242	217 493	244 985
Imports	109 866	125 996	126 600	112 422	121 878	133 450	150 043	161 080	171 115	190 030
Foreign balance	–1 116	–9 294	–7 772	–3 133	6 394	25 988	32 487	46 162	46 378	54 955
	(–0.9)	(–1.9)	(0.3)	(0.9)	(1.9)	(4.1)	(1.4)	(2.7)	(0.0)	(1.5)
Statistical discrepancy	3 414	3 113	2 845	10	–2 303	1 653	–1 999	–4 780	–5 989	–4 073
GDP (market prices)	434 341	486 998	515 430	490 868	476 778	482 397	510 992	549 863	576 922	618 042
	(12.3)	(12.1)	(5.8)	(–4.8)	(–2.9)	(1.2)	(5.9)	(7.6)	(4.9)	(7.1)

1. Figures in parentheses are percentage annual growth rates; for stockbuilding and the foreign balance they are percentage contributions to GDP growth.

Source: OECD, *National Accounts* and Ministry of Finance.

Table C. **Supply and use of resources, 1990 prices**[1]

Mk million

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Private consumption	258 821	269 879	269 754	260 031	247 363	240 177	244 761	255 968	265 673	273 638
Public consumption	102 132	104 526	108 535	111 256	108 799	103 028	102 728	104 645	108 272	107 926
Gross fixed investment	126 370	145 054	139 144	110 965	92 237	74 528	74 650	83 056	90 004	100 128
Final domestic demand	487 323	519 459	517 433	482 252	448 399	417 733	422 139	443 669	463 949	481 692
	(5.7)	(6.6)	(–0.4)	(–6.8)	(–7.0)	(–6.8)	(1.1)	(5.1)	(4.6)	(3.8)
Stockbuilding	2 967	7 978	2 924	–9 567	–6 071	–3 694	7 491	6 542	2 818	4 585
	(0.9)	(1.0)	(–1.0)	(–2.4)	(0.7)	(0.5)	(2.5)	(–0.2)	(–0.7)	(0.3)
Total domestic demand	490 290	527 437	520 357	472 685	442 328	414 039	429 630	450 211	466 767	486 277
	(6.6)	(7.6)	(–1.3)	(–9.2)	(–6.4)	(–6.4)	(3.8)	(4.8)	(3.7)	(4.2)
Exports	115 761	117 241	118 828	110 965	122 059	142 459	161 376	174 580	181 447	204 736
Imports	116 898	127 311	126 600	111 755	112 989	113 842	128 411	137 327	143 300	156 625
Foreign balance	–1 137	–10 070	–7 772	–790	9 070	28 617	32 965	37 253	38 147	48 111
	(–1.6)	(–1.8)	(0.5)	(1.4)	(2.1)	(4.2)	(1.0)	(0.9)	(0.2)	(1.9)
Statistical discrepancy	–1 434	–2 003	2 845	7 116	10 605	13 915	14 745	14 026	14 581	15 959
GDP (market prices)	487 719	515 364	515 430	479 011	462 003	456 571	477 340	501 490	519 495	550 347
	(4.9)	(5.7)	(0.0)	(–7.1)	(–3.6)	(–1.2)	(4.6)	(5.1)	(3.6)	(5.9)

1. Figures in parentheses are percentage annual growth rates; for stockbuilding and the foreign balance they are percentage contributions to GDP growth.

Source: OECD, *National Accounts* and Ministry of Finance.

Table D. **Gross domestic product by industry of origin**

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
	Mk million									
At current prices										
Agriculture, forestry and fishing	22 612	24 739	28 077	29 043	24 073	21 468	22 081	25 264	21 920	20 389
Industry[1]	98 409	107 640	116 507	116 620	102 455	105 229	114 837	126 954	143 773	144 804
of which:										
Manufacturing	87 145	95 972	105 225	105 383	89 667	92 426	101 816	112 737	128 831	129 211
Electricity, gas and water	10 018	10 065	9 245	9 504	11 059	11 003	11 334	12 281	12 984	13 641
Construction	27 461	32 940	42 035	43 467	36 962	26 041	20 998	23 303	28 329	29 220
Services	202 210	224 058	250 860	275 982	279 615	273 487	277 531	286 047	302 087	320 482
Market services	141 977	157 967	177 645	193 834	188 832	182 692	191 056	199 014	210 450	224 305
Public administration	60 233	66 091	73 215	82 148	90 783	90 795	86 475	87 033	91 637	96 177
GDP (at factor cost)	350 692	389 377	437 479	465 112	443 105	426 225	435 447	461 568	496 109	514 895
	Percentage change									
At 1990 prices										
Agriculture, forestry and fishing	–8.0	5.5	7.5	2.5	–11.1	–1.1	4.4	9.7	–4.2	–4.4
Industry[1]	6.0	4.0	3.8	–0.4	–9.7	1.7	5.2	11.9	8.6	3.8
of which:										
Manufacturing	5.9	4.1	4.0	–0.7	–10.9	2.0	5.4	12.5	9.6	3.4
Electricity, gas and water	7.2	2.7	0.0	1.9	3.1	–0.5	4.2	5.8	–1.5	9.4
Construction	1.3	9.2	14.1	–2.3	–11.6	–14.9	–14.4	–2.0	4.2	4.5
Services	5.0	4.2	5.4	1.5	–4.1	–4.4	–0.9	1.8	3.4	4.4
Market services	5.6	4.9	6.9	1.5	–6.3	–5.4	0.8	2.8	4.2	5.4
Public administration	3.5	2.6	2.0	1.5	1.2	–2.2	–4.5	–0.2	1.5	1.9
GDP (at factor cost)	4.0	4.7	5.9	0.7	–6.6	–3.7	–0.1	4.8	4.4	3.7

1. Including mining and quarrying.

Source: OECD, *National Accounts,* Statistics Finland and Ministry of Finance.

Table E. **General government account**

Mk million

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Current receipts	208 584	235 301	261 450	257 561	254 382	252 392	271 629	289 793	311 837	326 587
Direct taxes	74 454	82 179	92 741	88 138	82 270	74 900	87 815	94 555	109 489	116 516
Social security contributions	50 329	56 673	67 243	68 137	70 882	74 097	82 721	83 499	83 846	84 907
Indirect taxes	66 667	75 595	78 025	74 730	71 643	71 556	74 200	75 649	82 227	89 513
Other current receipts	17 134	20 854	23 441	26 556	29 587	31 839	26 893	36 090	36 275	35 651
Current expenditure	176 535	194 731	221 029	251 973	271 327	283 740	294 592	310 935	322 796	328 168
Expenditure on goods and services	87 199	96 019	108 535	118 719	118 453	112 190	114 001	119 795	126 579	128 886
Subsidies	11 271	13 717	14 756	17 174	17 028	16 376	15 856	18 177	16 643	14 526
Interest paid	7 201	7 260	7 511	9 598	12 608	22 335	26 153	29 240	33 024	35 388
Social benefits	64 044	69 930	81 195	96 396	112 924	121 690	128 178	129 335	130 562	131 336
Other current transfers	6 820	7 805	9 032	10 086	10 314	11 149	10 404	14 388	15 988	18 032
Saving	32 049	40 570	40 421	5 588	–16 945	–31 348	–22 963	–21 142	–10 959	–1 581
Fixed investment	15 046	14 295	17 286	17 067	15 897	12 811	13 994	14 296	15 451	16 727
Capital transfers, net	–3 277	–870	–757	–1 202	–896	–544	–1 357	–421	–1 615	1 681
Consumption of fixed capital	5 696	6 294	7 383	7 481	7 401	7 391	7 948	8 611	8 736	9 082
Net lending	17 634	30 756	27 663	–7 178	–27 353	–38 214	–31 617	–28 360	–19 905	–7 818
(as a percentage of GDP)	4.1	6.3	5.4	–1.5	–5.7	–7.9	–6.2	–5.2	–3.4	–1.3

Source: OECD, *National Accounts* and Ministry of Finance.

Table F. **Balance of payments**[1]

Million US$

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Current account	–2 706	–5 800	–6 936	–6 603	–4 912	–1 109	1 269	5 159	4 797	6 097
Trade balance	1 172	–231	701	2 273	3 773	6 253	7 514	12 322	11 104	11 627
Merchandise exports	22 163	23 244	26 489	22 945	23 914	23 441	29 500	40 442	40 571	40 941
Merchandise imports	20 991	23 475	25 789	20 671	20 141	17 188	21 986	28 119	29 467	29 314
Non-factor services, net	–1 671	–2 140	–2 960	–3 228	–2 455	–1 990	–1 409	–2 101	–1 465	–1 362
Credit	3 832	4 058	4 633	4 303	4 919	4 483	5 717	7 543	7 305	6 889
Debit	5 504	6 198	7 592	7 531	7 374	6 473	7 126	9 643	8 770	8 251
Factor income, net	–1 713	–2 681	–3 726	–4 685	–5 447	–4 943	–4 372	–4 462	–3 746	–3 177
Credit	2 365	2 511	3 496	2 523	1 456	1 094	1 744	2 828	2 759	3 166
Debit	4 078	5 192	7 222	7 208	6 903	6 036	6 116	7 291	6 505	6 343
Transfers, net	–494	–749	–951	–964	–783	–428	–463	–599	–1 096	–991
Official	–421	–511	–636	–682	–528	–350	–362	–404	–664	–799
Private	–73	–238	–315	–282	–255	–78	–101	–195	–432	–192
Capital account	0	0	0	–74	0	0	0	64	56	250
Financial account	1 842	4 528	8 569	6 123	4 977	50	–492	–3 929	–4 974	–5 326
Finnish investment abroad	–4 954	–3 758	–6 895	–602	–1 186	–4 107	–8 898	–3 859	–9 313	–13 840
Direct	–2 608	–2 965	–2 708	124	752	–1 407	–4 298	–1 497	–3 596	–4 411
Portfolio	–483	–62	–457	–279	–694	–624	956	248	–4 115	–4 716
Other	–1 726	–1 788	303	–2 271	–3 291	–1 863	–673	–2 949	–4 667	–2 633
International reserves	–137	1 057	–4 033	1 824	2 047	–213	–4 883	339	3 065	–2 080
Foreign investment in Finland	6 795	8 287	15 464	6 725	6 164	4 157	8 406	–71	4 340	8 513
Direct	530	489	787	–247	406	864	1 578	1 063	1 109	1 544
Portfolio	3 520	3 751	5 685	8 480	8 452	6 768	6 376	–1 174	1 488	3 819
Other	2 745	4 047	8 992	–1 508	–2 694	–3 475	452	40	1 743	3 150
Errors and omissions, net	865	1 273	–1 632	554	–65	1 058	–777	–1 294	120	–1 021

1. BPM5 classification.

Source: Bank of Finland and OECD Secretariat.

Table G. **Labour market**

Thousands

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Labour force surveys[1]										
Labour force	2 546	2 559	2 555	2 533	2 502	2 484	2 480	2 497	2 503	2 537
Employment	2 431	2 470	2 467	2 340	2 174	2 041	2 024	2 068	2 096	2 170
Unemployment rate (per cent)	4.5	3.5	3.4	7.6	13.1	17.9	18.4	17.2	16.3	14.5
Labour force surveys, revised series[2]										
Labour force	2 575	2 587	2 585	2 538	2 492	2 468	2 459	2 487	2 493	2 484
Employment	2 467	2 507	2 504	2 375	2 206	2 071	2 054	2 099	2 127	2 170
Unemployment rate (per cent)	4.2	3.1	3.1	6.4	11.5	16.1	16.4	15.6	14.7	12.6
Employment exchange services										
Unemployed persons seeking work	127.6	103.4	103.2	213.2	363.1	482.2	494.2	466.0	448.0	409.0
of which: Insured	56.9	46.9	47.5	109.5	194.4	268.2	264.0	238.7	237.1	208.5
Unfilled vacancies	17.4	30.4	26.9	13.4	7.1	5.9	7.4	8.3	10.1	13.7

1. Break in series in 1997.
2. Labour force statistics revised in line with EU regulations and practices (May 1998).

Source: Ministry of Labour, *Finnish Labour Review* and Statistics Finland.

Table H. **Foreign trade by commodity group**

Million Mk

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Imports, total	88 227	105 518	103 026	87 744	94 947	103 167	120 547	128 555	141 720	159 192
Food and live animals	4 362	4 700	4 277	4 446	4 948	5 831	7 249	6 291	7 917	9 009
Beverages and tobacco	360	471	507	536	583	653	683	841	949	1 095
Crude materials, inedible, except fuels	5 549	5 900	5 407	4 944	7 075	7 264	7 995	9 474	9 628	10 936
Mineral fuels, lubricants and related materials	8 447	10 365	12 055	11 698	12 227	13 156	13 918	11 288	14 937	15 080
Animal and vegetable oils, fats and waxes	104	118	101	85	125	168	204	236	270	277
Chemicals and related products, n.e.s.	9 530	11 039	11 081	10 138	11 600	13 740	15 414	15 727	16 102	18 659
Manufactured goods	13 998	17 313	16 064	12 976	13 573	14 618	17 756	19 687	18 865	21 552
Machinery and transport equipment	34 627	42 290	39 802	30 440	31 457	35 010	43 318	49 766	55 636	62 418
Miscellaneous manufactured articles	11 219	13 284	13 696	12 444	13 331	12 683	13 957	13 087	15 295	17 595
Commodities and transactions, n.e.s.	32	39	36	38	29	45	52	2 158	2 121	2 571
Exports, total	90 854	99 782	101 327	92 841	107 463	134 112	154 163	176 021	186 334	211 695
Food and live animals	1 503	1 779	2 196	2 043	2 381	3 709	4 634	3 566	4 471	5 175
Beverages and tobacco	179	195	203	224	292	461	577	503	697	679
Crude materials, inedible, except fuels	11 213	11 987	10 199	8 597	9 551	11 718	15 256	15 718	14 241	17 045
Mineral fuels, lubricants and related materials	1 549	936	1 488	2 827	3 503	3 659	3 478	3 328	5 711	4 729
Animal and vegetable oils, fats and waxes	100	93	84	81	87	82	95	136	151	227
Chemicals and related products, n.e.s.	5 175	6 324	6 450	6 398	7 186	8 698	10 194	10 485	11 509	13 615
Manufactured goods	38 677	42 114	41 780	40 591	46 030	54 409	59 937	67 703	65 600	73 371
Machinery and transport equipment	24 931	28 820	31 264	25 491	31 285	42 175	49 148	62 309	71 546	82 444
Miscellaneous manufactured articles	7 443	7 445	7 573	6 499	7 090	9 133	10 765	10 560	11 091	12 981
Commodities and transactions, n.e.s.	84	89	90	91	57	67	78	1 713	1 317	1 429

Source: OECD, *Foreign Trade Statistics, Series C* and Ministry of Finance.

Table I. **Foreign trade by area**

Million US$

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Imports, total	20 918	24 620	27 108	21 717	20 748	18 033	23 345	29 520	30 860	29 500
OECD (29)	16 719	19 867	22 247	17 687	16 707	14 602	18 609	23 963	24 911	24 256
EU (15)	12 204	14 661	16 393	12 765	12 220	10 282	12 782	17 015	18 089	17 390
of which: France	829	1 005	1 152	870	857	708	924	1 193	1 381	1 433
Germany	3 630	4 373	4 706	3 667	3 450	2 939	3 425	4 585	4 634	4 289
Netherlands	667	790	861	731	736	649	801	1 091	1 104	1 193
Sweden	2 787	3 339	3 512	2 612	2 359	1 839	2 435	3 415	3 681	3 537
United Kingdom	1 403	1 608	2 055	1 654	1 792	1 590	1 925	2 421	2 729	2 254
Norway	470	541	893	968	818	863	1 109	1 216	1 227	1 093
United States	1 325	1 551	1 828	1 480	1 262	1 311	1 766	2 128	2 258	2 172
Non-OECD countries	4 199	4 753	4 860	4 030	4 041	3 430	4 736	5 557	5 949	5 244
of which: CEEC and CIS	2 824	3 226	3 117	2 316	2 051	1 946	2 742	3 141	3 188	3 172
OPEC	120	149	235	311	314	86	96	68	136	183
Exports, total	20 813	23 285	26 742	23 103	23 527	23 502	29 761	40 409	40 562	40 400
OECD (29)	15 648	17 685	20 475	18 971	19 530	18 330	23 018	30 268	29 829	29 606
EU (15)	12 183	13 668	16 234	14 954	15 406	13 537	16 897	22 417	21 380	21 427
of which: France	1 083	1 241	1 601	1 323	1 534	1 208	1 450	1 771	1 663	1 691
Germany	2 263	2 555	3 317	3 460	3 577	2 992	3 883	5 307	4 796	4 432
Netherlands	746	904	1 119	1 119	1 189	1 149	1 476	1 662	1 559	1 656
Sweden	2 907	3 299	3 755	3 147	2 964	2 556	3 178	4 036	4 264	3 975
United Kingdom	2 683	2 747	2 777	2 332	2 454	2 394	2 997	4 110	4 053	4 028
Norway	712	675	802	754	814	736	917	1 181	1 130	1 211
United States	1 190	1 480	1 540	1 394	1 377	1 801	2 092	2 658	3 190	2 812
Non-OECD countries	5 165	5 600	6 267	4 132	3 997	5 172	6 743	10 141	10 733	10 794
of which: CEEC and CIS	3 273	3 595	3 607	1 525	1 555	2 108	3 361	4 187	5 050	3 829
OPEC	320	351	426	463	404	541	439	941	1 157	733

Source: OECD, *Foreign Trade Statistics, Series C* and Ministry of Finance.

Table J. **Prices and wages**

1995 = 100

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Consumer prices										
Total	79.0	84.2	89.3	93.1	95.9	97.9	99.0	100.0	100.6	101.8
Food	98.0	101.5	105.5	108.5	108.4	107.7	107.9	100.0	98.2	99.6
Rent and energy	80.6	91.9	99.4	101.3	101.9	99.5	98.2	100.0	100.3	102.5
Wholesale prices										
Total	84.1	88.3	91.2	91.4	93.9	98.3	99.8	100.0	100.6	102.2
Domestic goods	85.9	90.5	94.2	94.4	95.2	97.6	99.6	100.0	100.4	102.1
Imported goods	80.8	84.0	85.1	85.6	91.1	99.7	100.2	100.0	101.0	102.1
Building costs	83.6	90.1	96.6	98.7	97.0	97.3	98.7	100.0	98.9	101.3
Wage and salary earnings										
Total	72.1	78.5	85.8	91.3	93.0	93.7	95.5	100.0	103.9	105.9
Manufacturing	67.9	74.0	81.2	86.2	88.0	89.4	93.4	100.0	103.8	106.2
Hourly paid employees	72.2	78.9	86.7	91.8	92.7	92.8	95.0	100.0	103.8	105.7
Private	71.3	78.1	85.2	90.6	92.1	92.7	95.1	100.0	103.9	105.9
Central government	77.5	82.6	90.1	95.0	96.5	96.5	97.7	100.0	103.9	106.1
Local government	72.2	78.2	85.7	91.7	94.3	95.7	96.4	100.0	104.0	106.3

Source: Statistics Finland, *Bulletin of Statistics.*

Table K. **Interest rates, money and credit**

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
	Per cent									
Interest rates										
Bank of Finland base rate[1]	7.6	7.7	8.5	8.5	9.2	6.9	5.3	5.2	4.4	4.0
Call money rate[1]	11.5	13.4	15.0	15.5	14.9	9.0	7.1	7.6	5.6	5.1
Average lending rate of commercial banks[2]	9.9	10.6	11.8	12.1	12.5	10.2	8.2	8.0	6.5	5.6
	Million Mk, end of year									
Bank of Finland net claims on:										
Foreign sector	30 263	22 752	35 960	33 204	26 519	32 148	51 629	46 783	34 571	49 886
Public sector	–775	–4 188	–7	1 372	2 356	1 004	1 713	1 807	1 906	2 015
Financial institutions	–4 864	12 751	–2 664	4 846	–5 405	476	–5 392	–7 945	5 169	–7 730
Corporate sector	–3 756	–8 604	–8 247	–5 768	–1 904	1 216	1 601	1 891	1 692	1 730
Banks' credit to the public	251 546	278 688	285 720	285 609[3]	286 570	281 070	271 670	263 452	270 301[3]	270 691
Money										
Money supply M1	111 259	124 295	141 524	130 644	134 829	141 759	154 357	175 921	204 834	215 763
M1 plus quasi money	234 268	251 519	266 383	275 241	274 011	279 595	286 696	303 788	297 291	305 596

1. Average of daily observations.
2. Aveage for period.
3. Break in series.

Source: Bank of Finland, *Bulletin.*

Table L. **Production and employment structures**

As a per cent of total

	GDP at factor cost (current prices)					Employment				
	1980	1985	1990	1995	1996	1980	1985	1990	1995	1996
Agriculture, forestry and fishing	8.8	7.3	5.6	4.0	3.6	13.2	11.8	8.8	8.1	..
Mining, crude petroleum and natural gas	0.5	0.4	0.3	0.4	0.3	0.4	0.3	0.2	0.2	..
Manufacturing	25.4	22.8	20.4	23.4	22.5	24.9	22.7	20.2	20.3	..
of which:										
Food, beverages and tobacco	2.7	2.6	2.4	2.4	..	2.8	2.7	2.4	2.3	..
Textiles, clothing, leather	2.1	1.6	0.8	0.6	..	3.2	2.5	1.5	1.0	..
Wood and wood products	2.2	1.1	1.3	1.2	..	2.3	1.8	1.5	1.4	..
Paper and paper products, printing and publishing	5.5	5.0	4.3	6.1	..	4.2	3.9	3.7	3.5	..
Chemicals and products of petroleum, coal, rubber, etc.	3.0	2.5	2.3	2.3	..	1.8	1.7	1.7	1.9	..
Fabricated metal products, machinery and equipment	6.6	7.2	6.8	8.2	..	7.5	7.4	6.8	7.9	..
Electricity, gas and water	2.6	2.5	1.8	2.4	2.4	1.2	1.2	1.2	1.1	..
Construction	7.2	7.0	8.4	5.2	5.1	7.8	7.9	8.8	6.3	..
Services	55.6	59.9	63.3	64.7	66.1	52.5	56.2	60.8	63.9	..
of which:										
Wholesale and retail trade, restaurants and hotels	11.6	11.8	11.2	9.6	9.7	15.7	16.0	16.7	15.6	..
Transport, storage and communication	7.1	7.1	7.1	7.6	7.7	7.1	7.1	7.5	7.6	..
Finance, insurance, real estate and business services	12.1	13.1	15.2	16.8	17.1	5.7	6.9	8.7	9.1	..
Other private services	24.7	28.0	29.8	30.7	31.7	23.9	26.1	27.8	31.6	..
Producers of government services	13.3	15.2	15.9	16.7	16.6	17.9	20.1	21.9	25.2	..

Source: OECD, *National Accounts* and Ministry of Finance.

Table M. **Productivity and investment structure**

Per cent

	Productivity growth (GDP/employment)					Share of total investment (current prices)				
	1980-84	1985-89	1990-94	1995	1996	1980	1985	1990	1995	1996
Agriculture, forestry and fishing	0.7	5.4	5.4	4.2	..	9.4	8.0	5.1	4.6	4.8
Mining, crude petroleum and natural gas	7.5	15.9	5.2	–0.1	..	0.4	0.4	0.2	0.5	0.4
Manufacturing	4.3	6.4	8.2	3.9	..	17.9	16.7	15.6	22.1	23.3
of which:										
Food, beverages and tobacco	3.1	4.1	7.4	–0.4	..	2.3	1.7	1.7	2.1	..
Textiles, clothing, leather	3.4	2.4	10.6	–10.0	..	0.8	0.3	0.3	0.4	..
Wood and wood products	4.4	9.1	8.9	–4.1	..	1.6	0.8	1.0	1.3	..
Paper and paper products, printing and publishing	5.2	5.2	7.2	6.6	..	5.2	5.8	5.9	5.2	..
Chemicals and products of petroleum, coal, rubber, etc.	3.5	5.8	6.0	–3.5	..	2.1	2.0	2.0	3.4	..
Fabricated metal products, machinery and equipment	4.3	7.0	8.6	9.3	..	3.7	4.0	3.0	5.8	..
Electricity, gas and water	2.5	3.5	9.5	–2.7	..	4.6	5.3	3.9	5.7	5.2
Construction	–0.2	3.8	2.9	–0.6	..	2.0	1.3	2.1	1.1	1.3
Services	1.1	2.3	1.2	2.4	..	65.6	68.3	73.1	66.0	65.0
of which:										
Wholesale and retail trade, restaurants and hotels	1.6	4.6	0.2	1.6	..	6.3	7.9	8.9	6.5	6.6
Transport, storage and communication	1.1	4.2	5.4	4.4	..	9.8	7.5	7.3	10.5	10.6
Finance, insurance, real estate and business services	0.7	–0.1	2.9	2.8	..	33.0	36.0	40.9	28.4	27.8
Other private services	0.3	1.4	–1.1	2.4	..	16.6	16.9	16.0	20.6	20.0
Producers of government services	0.2	0.2	0.2	–0.6	..	13.3	13.7	12.4	16.8	16.4

Source: OECD, *National Accounts* and Ministry of Finance.

Table N. **Public sector**
General government income and expenditure structures

As a percentage of GDP

	1975	1980	1985	1990	1995	1996	1997
Current receipts	43.4	40.9	46.8	50.7	52.7	53.9	53.2
Indirect taxes	12.5	13.4	14.4	15.1	13.8	14.3	14.0
Social security contributions	11.8	10.2	11.6	13.0	15.2	14.6	14.0
Direct taxes	16.5	14.5	16.8	18.0	17.2	19.0	19.2
Capital income	2.3	2.5	3.4	3.8	4.9	4.7	4.5
Other current receipts	0.3	0.4	0.6	0.7	1.6	1.4	1.4
Current expenditure	33.9	35.3	41.3	42.9	56.5	55.9	52.9
Expenditure on goods and services	17.0	18.0	20.2	21.1	21.8	21.9	20.9
Defence	1.3	1.4	1.6	1.5	1.6	1.7	. .
Education	4.8	4.9	5.1	5.3	5.9	5.9	. .
Health	3.6	3.9	4.6	4.8	4.6	4.7	. .
Social security and welfare	1.9	2.2	2.9	3.4	3.4	3.4	. .
Economic services	1.5	1.3	1.4	1.6	1.9	. .	. .
Other	3.9	4.2	4.6	4.5	4.3	. .	. .
Subsidies	3.8	3.3	3.1	2.9	3.3	2.9	2.5
Property income paid	0.7	1.1	1.9	1.5	5.3	5.8	5.6
Current transfers	1.3	1.1	1.4	1.8	2.6	2.7	2.7
Transfers to households	11.0	11.9	14.8	15.8	23.5	22.6	21.2
Net saving	9.5	5.6	5.5	7.8	–3.8	–1.9	0.3
Consumption of fixed capital	1.0	1.2	1.2	1.4	1.6	1.5	1.5
Gross saving	10.6	6.8	6.7	9.3	–2.3	–0.4	1.8
Gross fixed capital formation	3.7	3.4	3.3	3.4	2.6	2.7	2.7
Net lending	5.7	2.8	2.9	5.4	–5.2	–3.4	–1.0

Source: OECD, *National Accounts;* Ministry of Finance and OECD Secretariat.

BASIC STATISTICS:

INTERNATIONAL COMPARISONS

BASIC STATISTICS: INTERNATIONAL COMPARISONS

	Units	Reference period[1]	Australia	Austria	Belgium	Canada	Czech Republic	Denmark	Finland	France	Germany	Greece
Population												
Total	Thousands	1996	18 289	8 060	10 157	29 964	10 316	5 262	5 125	58 380	81 877	10 465
Inhabitants per sq. km	Number	1996	2	96	333	3	131	122	15	106	229	79
Net average annual increase over previous 10 years	%	1996	1.3	0.6	0.3	1.3	0	0.3	0.4	0.5	3	0.5
Employment												
Total civilian employment (TCE)[2]	Thousands	1996	8 344	3 737 (94)	3 675 (95)	13 676	4 918	2 593	2 087	21 951	35 360	3 824 (95)
of which: Agriculture	% of TCE	1996	5.1	7.2 (94)	2.5 (95)	4.1	6.3	4	7.1	4.6	3.3	20.4 (95)
Industry	% of TCE	1996	22.5	33.2 (94)	26.7 (95)	22.8	42	27	27.6	25.9	37.5	23.2 (95)
Services	% of TCE	1996	72.4	59.6 (94)	71.4 (95)	73.1	51.7	69	65.3	69.5	59.1	56.4 (95)
Gross domestic product (GDP)												
At current prices and current exchange rates	Bill. US$	1996	398.9	228.7	268.2	579.2	56.2	174.9	125.1	1 536.6	2 353.5	91.2 (95)
Per capita	US$	1996	21 812	28 384	26 409	19 330	5 445	33 230	24 420	26 323	28 738	8 722 (95)
At current prices using current PPPs[3]	Bill. US$	1996	372.7	172.4	222	645.1	..	118	96.7	1 198.6	1 736.1	133.5
Per capita	US$	1996	20 376	21 395	21 856	21 529	..	22 418	18 871	20 533	21 200	12 743
Average annual volume growth over previous 5 years	%	1996	3.9	1.6	1.2	2.2	2	2.2	1.6	1.2	1.4	1.3 (95)
Gross fixed capital formation (GFCF)	% of GDP	1996	20.3	23.8	17.3	17.7	33	16.7	16.1	17.4	20.6	17 (95)
of which: Machinery and equipment	% of GDP	1996	10.2 (95)	8.8 (95)	7.5 (95)	6.6	..	7.9 (95)	6.4 (95)	7.8	7.6	7.7 (95)
Residential construction	% of GDP	1996	4.6 (95)	5.9 (95)	4.6 (95)	5.4	..	3.2 (95)	3.5 (95)	4.4	7.3	3.3 (95)
Average annual volume growth over previous 5 years	%	1996	5.6	2.1	0.3	2.2	9.4	2	–4.1	–1.5	0.2	0.5 (95)
Gross saving ratio[4]	% of GDP	1996	18	21.9	22.2	17.8	..	17.6	19.6	18.7	20	16 (95)
General government												
Current expenditure on goods and services	% of GDP	1996	17	19.8	14.5	18.7	21.5	25.2	21.9	19.4	19.8	20.8 (95)
Current disbursements[5]	% of GDP	1995	35.6	48.6	52.2	45.8	..	59.6	55.9	50.9	46.6	52.1
Current receipts	% of GDP	1995	34.9	47.4	49.9	42.7	..	58.1	52.8	46.9	45.9	45
Net official development assistance	% of GNP	1995	0.36	0.33	0.38	0.38	..	0.96	0.32	0.55	0.31	0.13
Indicators of living standards												
Private consumption per capita using current PPPs[3]	US$	1996	12 596	12 152	13 793	12 959	..	12 027	10 282	12 506	12 244	9 473
Passenger cars, per 1 000 inhabitants	Number	1994	460	433	416	466	282	312	368	430	488	199
Telephones, per 1 000 inhabitants	Number	1994	496	466	449	576	209	604	551	547	483[8]	478
Television sets, per 1 000 inhabitants	Number	1993	489	479	453	618	476	538	504	412	559	202
Doctors, per 1 000 inhabitants	Number	1995	2.2 (91)	2.7	3.7 (94)	2.2	2.9	2.9 (94)	2.8	2.9	3.4	3.9 (94)
Infant mortality per 1 000 live births	Number	1995	5.7	5.4	7.6 (94)	6.3 (94)	7.7	5.5	4	5.8 (94)	5.3	8.1
Wages and prices (average annual increase over previous 5 years)												
Wages (earnings or rates according to availability)	%	1996	1.7	5.2	2.7	2.4	..	3.2	3.8	2.6	4.2	11.8
Consumer prices	%	1996	2.4	2.9	2.2	1.4	11.9	1.9	1.5	2	3.1	11.6
Foreign trade												
Exports of goods, fob*	Mill. US$	1996	60 288	57 870	170 223[7]	202 320	21 910	51 030	40 576	288 450	521 263	11 501
As % of GDP	%	1996	15.1	25.3	63.5	34.9	39	29.2	32.4	18.8	22.1	12.9 (95)
Average annual increase over previous 5 years	%	1996	7.5	7.1	7.6	9.7	..	6.2	12.1	6.3	5.4	5.8
Imports of goods, cif*	Mill. US$	1996	61 374	67 376	160 917[7]	170 931	27 721	44 987	30 911	271 348	455 741	27 402
As % of GDP	%	1996	15.4	29.5	60	29.5	49.3	25.7	24.7	17.7	19.4	30.4 (95)
Average annual increase over previous 5 years	%	1996	9.7	5.9	5.9	7.7	..	5.6	7.3	3.9	3.3	6.6
Total official reserves[6]	Mill. SDRs	1996	10 107	15 901	11 789[7]	14 202	8 590	9 834	4 810	18 635	57 844	12 171
As ratio of average monthly imports of goods	Ratio	1996	2	2.8	0.9	1	..	2.6	1.9	0.8	1.5	5.3

* At current prices and exchange rates.
1. Unless otherwise stated.
2. According to the definitions used in OECD *Labour Force Statistics*.
3. PPPs = Purchasing Power Parities.
4. Gross saving = Gross national disposable income minus private and government consumption.
5. Current disbursements = Current expenditure on goods and services plus current transfers and payments of property income.
6. End of year.
7. Data refer to the Belgo-Luxembourg Economic Union.
8. Data refer to western Germany.
9. Including non-residential construction.
10. Refers to the public sector including public enterprises.

Sources: Population and Employment: OECD, *Labour Force Statistics.* GDP, GFCF and General Government: OECD, *National Accounts*, Vol. I and *OECD Economic Outlook*, Historical Statistics. Indicators of living standards: Miscellaneous national publications. Wages and Prices: OECD, *Main Economic Indicators.* Foreign trade: OECD, *Monthly Foreign Trade Statistics*, Series A. Total official reserves: IMF, *International Financial Statistics.*

BASIC STATISTICS: INTERNATIONAL COMPARISONS *(cont'd)*

	Units	Reference period [1]	Hungary	Iceland	Ireland	Italy	Japan	Korea	Luxembourg	Mexico	Netherlands	New Zealand
Population												
Total	Thousands	1996	10 193	270	3 621	57 473	125 864	45 545	418	96 582	15 494	3 640
Inhabitants per sq. km	Number	1996	77	3	52	191	333	458	161	48	380	14
Net average annual increase over previous 10 years	%	1996	–0.3	1.1	0.2	0	0.4	1	1.3	2	0.6	1.1
Employment												
Total civilian employment (TCE)[2]	Thousands	1996	3 605	142	1 307	20 036	64 860	20 764	212 (95)	32 385 (95)	6 983	1 688
of which: Agriculture	% of TCE	1996	8.4	9.2	10.7	7	5.5	11.6	2.8 (95)	23.5 (95)	3.9	9.5
Industry	% of TCE	1996	33	23.9	27.2	32.1	33.3	32.5	30.7 (90)	21.7 (95)	22.4	24.6
Services	% of TCE	1996	58.6	66.2	62.3	60.9	61.2	55.9	66.1 (90)	54.8 (95)	73.8	65.9
Gross domestic product (GDP)												
At current prices and current exchange rates	Bill. US$	1996	43.7 (95)	7.3	70.7	1 214.2	4 595.2	484.8	17	329.4	396	65.9
Per capita	US$	1996	4 273 (95)	27 076	19 525	21 127	36 509	10 644	40 791	3 411	25 511	18 093
At current prices using current PPPs[3]	Bill. US$	1996	..	6.3	68.8	1 148	2 924.5	618.5	13.5	751.1	324.5	63.6
Per capita	US$	1996	..	23 242	18 988	19 974	23 235	13 580	32 416	7 776	20 905	17 473
Average annual volume growth over previous 5 years	%	1996	–2.4 (95)	1.5	7.1	1	1.5	7.1	4.8	1.7	2.3	3.7
Gross fixed capital formation (GFCF)	% of GDP	1996	19.3 (95)	17.5	17.2	17	29.7	36.8	20.8	18	19.7	20.9
of which: Machinery and equipment	% of GDP	1996	..	6.7	5.5 (95)	8.8	10.1 (95)	13	..	8.8	9.4	10
Residential construction	% of GDP	1996	. .	3.9	4.9 (95)	4.5	5.3 (95)	7.6	..	4.7	5	5.6
Average annual volume growth over previous 5 years	%	1996	–0.9 (95)	–1.4	6	–1.4	1.3	6.9	0.2	–0.7	2.2	9.6
Gross saving ratio[4]	% of GDP	1996	..	15.6	21.7	20.5	31.4	34.2	37.5	22.7	25.7	16
General government												
Current expenditure on goods and services	% of GDP	1996	24.9 (95)	20.8	14.1	16.4	9.7	10.6	13.6	9.7[10]	14	14.4
Current disbursements[5]	% of GDP	1995	..	35.1	39.2 (94)	49.5	28.5	15.1	..	..	51.8	..
Current receipts	% of GDP	1995	..	36	39.3 (94)	44.5	32	25.1	..	..	50	..
Net official development assistance	% of GNP	1995	..	..	0.29	0.15	0.28	0.03	0.36	..	0.81	0.23
Indicators of living standards												
Private consumption per capita using current PPPs[3]	US$	1996	..	14 244	10 020	12 224	13 912	7 354	17 811	5 045	12 477	10 895
Passenger cars, per 1 000 inhabitants	Number	1994	212	434	264	517	342	115	544	91	383	457
Telephones, per 1 000 inhabitants	Number	1994	170	557	350	429	480	397	564	93	509	470
Television sets, per 1 000 inhabitants	Number	1993	427	335	301	429	618	215	261	150	491	
Doctors, per 1 000 inhabitants	Number	1995	3.4	3.9 (94)	3.4	3.0 (94)	1.7	1.6 (92)	1.8 (94)	1.1	2.2 (93)	1.6
Infant mortality per 1 000 live births	Number	1995	11	6.1	6.3	6.6 (94)	4.3	9	5.3 (94)	17 (94)	5.5	7.2 (94)
Wages and prices (average annual increase over previous 5 years)												
Wages (earnings or rates according to availability)	%	1996	..	..	3.7	3.5	1.8	..	..	–1.6	2.4	1.5
Consumer prices	%	1996	23.2	2.6	2.2	4.5	0.7	5.3	2.4	19.7	2.5	2
Foreign trade												
Exports of goods, fob*	Mill. US$	1996	15 674	1 891	48 416	250 842	411 067	129 715	..	96 000	203 953	14 316
As % of GDP	%	1996	35.9	26	68.5	20.7	8.9	26.8	..	29.1	51.5	21.7
Average annual increase over previous 5 years	%	1996	8.9	4	14.8	8.2	5.5	12.5	..	17.6	8.9	8.2
Imports of goods, cif*	Mill. US$	1996	18 105	2 032	35 763	206 904	349 149	150 340	..	89 469	184 389	14 682
As % of GDP	%	1996	41.4	27.9	50.6	17	7.6	31	..	27.2	46.6	22.3
Average annual increase over previous 5 years	%	1996	9.6	3.4	11.5	2.5	8	13.9	..	12.4	7.8	11.8
Total official reserves[6]	Mill. SDRs	1996	6 812	316	5 706	31 954	150 663	23 670	..	13 514	18 615	4 140
As ratio of average monthly imports of goods	Ratio	1996	..	1.9	1.9	1.9	5.2	..	..	1.8	1.2	3.4

* At current prices and exchange rates.
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5. Current disbursements = Current expenditure on goods and services plus current transfers and payments of property income.
6. End of year.
7. Data refer to the Belgo-Luxembourg Economic Union.
8. Data refer to western Germany.
9. Including non-residential construction.
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Sources: Population and Employment: OECD, *Labour Force Statistics.* GDP, GFCF and General Government: OECD, *National Accounts*, Vol. I and *OECD Economic Outlook*, Historical Statistics. Indicators of living standards: Miscellaneous national publications. Wages and Prices: OECD, *Main Economic Indicators.* Foreign trade: OECD, *Monthly Foreign Trade Statistics*, Series A. Total official reserves: IMF, *International Financial Statistics.*

BASIC STATISTICS: INTERNATIONAL COMPARISONS *(cont'd)*

	Units	Reference period[1]	Norway	Poland	Portugal	Spain	Sweden	Switzerland	Turkey	United Kingdom	United States
Population											
Total	Thousands	1996	4 370	38 618	9 935	39 270	8 901	7 085	62 695	58 782	265 557
Inhabitants per sq. km	Number	1996	13	123	108	78	20	172	80	240	28
Net average annual increase over previous 10 years	%	1996	0.5	0.3	–0.1	0.2	0.6	0.8	2	0.3	1
Employment											
Total civilian employment (TCE)[2]	Thousands	1996	2 110	14 977	4 475	12 394	3 963	3 803	20 895	26 088	126 708
of which: Agriculture	% of TCE	1996	5.2	22.1	12.2	8.7	2.9	4.5	44.9	2	2.8
Industry	% of TCE	1996	23.4 (95)	31.7	31.4	29.7	26.1	27.7	22	27.4	23.8
Services	% of TCE	1996	71.5 (95)	46.2	56.4	61.6	71	67.4	33.1	71	73.3
Gross domestic product (GDP)											
At current prices and current exchange rates	Bill. US$	1996	157.8	117.9 (95)	103.6	584.9	251.7	294.3	181.5	1 153.4	7 388.1
Per capita	US$	1996	36 020	3 057 (95)	10 425	14 894	28 283	41 411	2 894	19 621	27 821
At current prices using current PPPs[3]	Bill. US$	1996	106.7	..	130.1	587.2	171.4	180.6	383.3	1 095.5	7 388.1
Per capita	US$	1996	24 364	..	13 100	14 954	19 258	25 402	6 114	18 636	27 821
Average annual volume growth over previous 5 years	%	1996	4.1	2.2 (95)	1.5	1.3	1	0.1	4.4	2.2	2.8
Gross fixed capital formation (GFCF)	% of GDP	1996	20.5	17.1 (95)	24.1	20.1	14.8	20.2	25	15.5	17.6
of which: Machinery and equipment	% of GDP	1996	8.4	..	11.7 (93)	6.1 (95)	7.9	9.3	11.9	7.6	8.3 (95)
Residential construction	% of GDP	1996	2.6 (94)	..	5.2 (93)	4.3 (95)	1.9	11[9]	8.4 (95)	3	4.1 (95)
Average annual volume growth over previous 5 years	%	1996	2.8	5.4 (95)	2.2	–1	–2.6	–0.8	6.9	1.3	6.9
Gross saving ratio[4]	% of GDP	1996	29.9	..	21.6	20.7	16	27.1	22.3	14.6	16.6
General government											
Current expenditure on goods and services	% of GDP	1996	20.5	16.9 (95)	18.5	16.3	26.2	14.3	11.6	21.1	15.6
Current disbursements[5]	% of GDP	1995	45.8	..	42.5 (93)	41.2	63.8	47.7	..	42.3 (94)	34.3
Current receipts	% of GDP	1995	50.9	..	39.8 (93)	37.9	57.5	53.8	..	37.2 (94)	32.1
Net official development assistance	% of GNP	1995	0.87	..	0.27	0.24	0.77	0.34	0.07	0.28	0.1
Indicators of living standards											
Private consumption per capita using current PPPs[3]	US$	1996	11 593	..	8 522	9 339	10 096	15 632	4 130	11 865	18 908
Passenger cars, per 1 000 inhabitants	Number	1994	381	186	357	351	406 (93)	451	47	372	565
Telephones, per 1 000 inhabitants	Number	1994	554	131	350	371	683	597	201	489	602
Television sets, per 1 000 inhabitants	Number	1993	427	298	190	400	470	400	176	435	816
Doctors, per 1 000 inhabitants	Number	1995	2.8	2.3	3	4.1 (93)	3.1	3.1 (94)	1.2	1.6 (94)	2.6 (94)
Infant mortality per 1 000 live births	Number	1995	4	13.6	7.4	6 (94)	4	5	46.8 (94)	6.2 (94)	8 (94)
Wages and prices (average annual increase over previous 5 years)											
Wages (earnings or rates according to availability)	%	1996	3.2	..	..	5.8	4.8	..	..	4.9	2.7
Consumer prices	%	1996	1.9	..	5.6	4.7	2.7	2.2	81.6	2.7	2.9
Foreign trade											
Exports of goods, fob*	Mill. US$	1996	49 576	24 417	24 614	102 067	84 836	79 581	23 301	259 941	625 075
As % of GDP	%	1996	31.4	20.7	23.8	17.5	33.7	27	12.8	22.5	8.5
Average annual increase over previous 5 years	%	1996	7.8	..	8.6	11.2	9	5.3	11.1	7	8.2
Imports of goods, cif*	Mill. US$	1996	35 575	37 185	35 192	121 838	66 825	78 052	43 094	287 033	795 289
As % of GDP	%	1996	22.5	31.5	34	20.8	26.5	26.5	23.7	24.9	10.8
Average annual increase over previous 5 years	%	1996	6.9	..	6.1	5.5	6	3.2	15.1	6.5	10.3
Total official reserves[6]	Mill. SDRs	1996	18 441	12 409	11 070	40 284	13 288	26 727	11 430	27 745	44 536
As ratio of average monthly imports of goods	Ratio	1996	6.2	..	3.8	4	2.4	4.1	3.2	1.2	0.7

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