

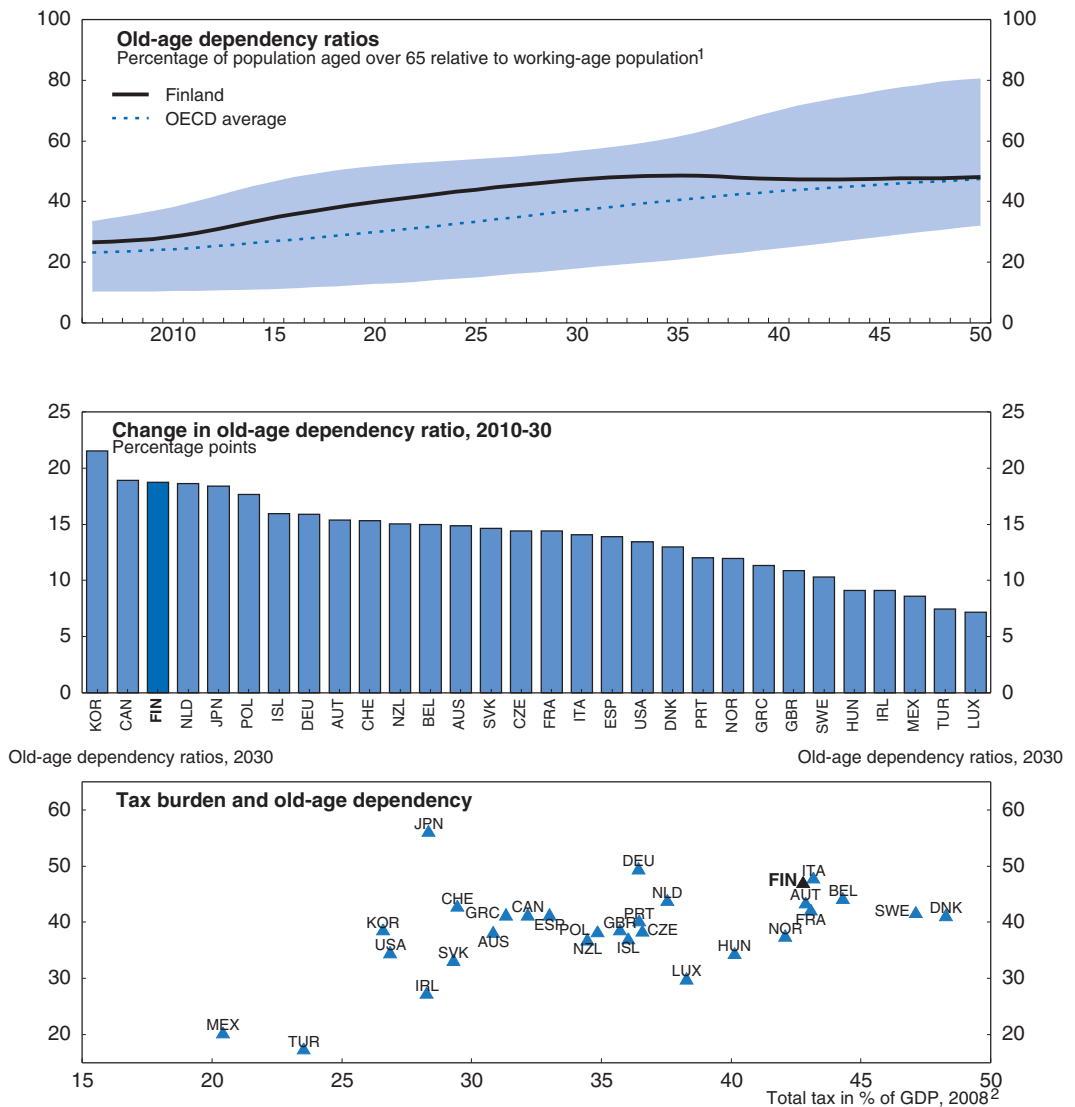
Chapter 2

Paving the way for sustainable public finances

The costs of the recession and ageing are a challenge to fiscal sustainability. The estimated fiscal sustainability gap has increased from 3 to 8% of GDP due to a sizeable permanent stimulus and lower potential output. A consolidation plan should be articulated now to ensure a smooth exit from stimulus once the recovery firms. Consolidation should encompass efficiency-enhancing tax measures such as an upward harmonisation of the value added tax (VAT) and higher property taxes, and constrain rising expenditures in municipalities. As discussed in Chapter 3, sustainability would also benefit from pension reforms that include tightening of benefits and eligibility conditions which would lower overall spending and boost labour supply. Tuition fees and a switch from grants to loans in tertiary education would also alleviate expenditure pressures (Chapter 1). A major overhaul of the municipal system could increase efficiency in service provision. Consolidation would be facilitated by revising the currently over-targeted fiscal framework and linking it more to long-term sustainability targets. This should include a lengthening in the fiscal planning horizon and linking structural annual deficit targets to long-term sustainability targets as well as setting up a fiscal council to monitor fiscal policies.

Finland's fiscal outlook has significantly worsened during the recession. The rise in the old-age dependency ratio in the next 20 years is expected to be among the fastest in the OECD (Figure 2.1). Furthermore, the working-age population is set to start contracting already in 2010. The tax-to-GDP ratio is high and leaves little room for tax hikes in rectifying the fiscal position. The strains from ageing on Finland's public finances have

Figure 2.1. **Dependency ratios are increasing**



1. The shaded area indicates the maximum and the minimum dependency ratios among OECD countries.
2. Or latest available year.

Source: OECD, Revenue Statistics and Population Databases.

StatLink <http://dx.doi.org/10.1787/827656134605>

been pointed out in previous *Surveys*, but the fiscal stimulus and weaker potential output following the current recession have worsened the fiscal outlook substantially. This chapter presents simulations of Finland's longer term fiscal outlook. It then discusses the need for a clear consolidation strategy within a revised fiscal framework, together with measures both on the tax and expenditure side that can help Finland reach sustainability once the recovery is on a firm footing.

Fiscal policy is on an unsustainable path

Fiscal sustainability can be defined in different ways, but most commonly it relates to the ability of governments to finance interest payments on current debt and cover future costs of programmes (Box 2.1). The analysis in this chapter is based on the so-called S2 indicator, which defines the immediate permanent improvement in the cyclically-adjusted primary balance (CAPB) that is needed to ensure that the discounted value of future surpluses is equal to the current level of debt. Assumptions and detailed results of three different long-term scenarios until 2050 are presented in Annex 2.A1.

The recession has substantially widened the fiscal sustainability gap, i.e. the difference between the estimated CAPB and the CAPB needed to achieve sustainable public finances. As discussed in Chapter 1, the CAPB is expected to worsen by roughly 6% of GDP between 2008 and 2011, mainly due to losses in potential output (2.2%) and permanent fiscal stimulus measures (3.2%). In the baseline scenario, where fiscal policy is assumed to remain unchanged,¹ the primary balance would stabilise at close to -8% of GDP from 2030, while the general government financial balance and government net financial liabilities would worsen continuously after 2015 (Figure 2.2). According to the S2 indicator, the CAPB would need to improve permanently by almost 8% of GDP from 2012 onwards to ensure sustainability. The "consolidation scenario" illustrates how the sustainability gap can be closed from 2012 and onwards, with fiscal consolidation equivalent to 1.5% of GDP per annum during 2012-15 and further consolidation amounting to roughly 2.5% of GDP in total during 2016-18.

Box 2.1. Measuring sustainability

Sustainable public finances can loosely be defined as a set of policy paths that ensure the ability of a government to finance interest payments on current debt and cover future costs of programmes. There is no unique definition of a sustainable fiscal position, nor is there a unique indicator of sustainability. Different indicators have different purposes and horizons and may therefore end up with different estimates.

Two widely used measures are the S1 and S2 indicators that are being used by the European Commission to evaluate the sustainability of public finances in EU member countries (European Commission, 2009). The S1 indicator shows the permanent adjustment to the cyclically-adjusted primary balance (CAPB) that is needed to reach a gross debt ratio of 60% of GDP (i.e. the threshold in the Stability and Growth Pact) in 2060. The S2 indicator shows the permanent adjustment to the CAPB that is required to fulfil the intertemporal budget constraint, i.e. ensuring that the present value of future fiscal surpluses will be equal to the current stock of government gross debt. This is the sustainability measure that is used in this *Survey*. In Finland the two indicators point to roughly the same amount of needed consolidation. The S2 indicator shows a need for a permanent improvement in the CAPB of 8% of GDP, while the S1 indicator points to 7.5%.

While Finland's fiscal challenges are substantial, significant uncertainties surround estimates of the sustainability gap. In the government's Stability Programme Update 2009 (Ministry of Finance, 2010), the gap is estimated to roughly 5½ per cent of GDP. The difference between the two estimates can largely be attributed to the government estimating a smaller impact from the crisis on potential GDP and assuming a higher rate of return on pension fund assets.² Sensitivity analysis illustrates that much of the projected worsening in public finances is explained by growing age-related spending, which is projected to increase by 5.4 percentage points in relation to GDP.³ This is apparent in the difference between the baseline and "unchanged age-related spending" scenario, where age-related expenditures are assumed to be constant as a share of GDP (Figure 2.2). However, even without the increase in age-related expenditures, fiscal consolidation would be required due to the large initial structural fiscal deficit (the difference between "unchanged age-related expenditures" and "consolidation"). All scenarios above are stylised in the sense that there are no feedbacks from the fiscal position to other parts of the economy, for example, in terms of interest rates or labour supply.

Two key assumptions in the analysis can be used to illustrate the sensitivity of the results. First, employment rates are assumed to increase from 71% in 2008 to more than 73% in 2030. As analysed in Chapter 3, there is a clear risk that this increase in employment rates may not be achieved on current policies. For example, if the average retirement age were to be one year lower in 2030, the sustainability gap would increase by roughly 1.4 percentage points (Kinnunen, 2009). Another key assumption is the rate of return earned on government assets. With gross government financial assets worth close to 100% of GDP, a 1 percentage point increase in the rate of return would lower the sustainability gap by 1% of GDP.

Planning for consolidation should start early to facilitate a smooth exit from the stimulus

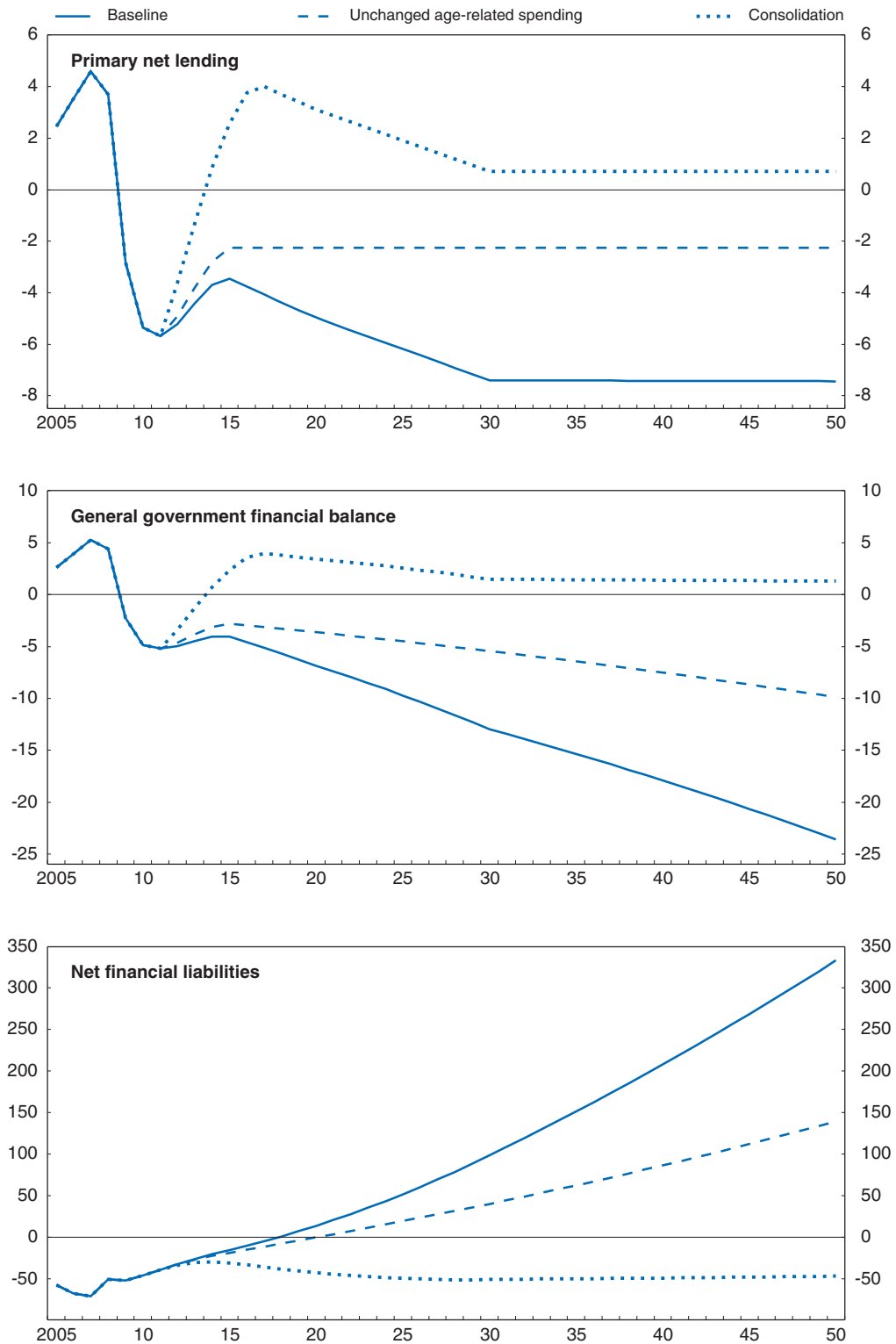
Given the large sustainability gap, the fiscal stance needs to be tightened as the recovery takes hold. While the timing and extent of fiscal consolidation must be contingent on the pace of the recovery, a consolidation programme should be presented and enacted as early as possible to maintain confidence and ensure that appropriate actions are taken. Successful fiscal consolidation tends to be accompanied by clear prior commitments (Guichard *et al.*, 2007). By being clear about its intentions to consolidate, the government can reassure households and financial markets that corrective action will be taken in due time. This ensures trust in the fiscal position. Furthermore, early action would also be beneficial from a political economy perspective, as the willingness to accept consolidation is likely to be greater during a crisis (Henriksson, 2007).

It is also cheaper to consolidate earlier than later. The risk of a "snowballing" effect from interest payments on debt favours early action. For example, if consolidation were to start in 2015 rather than 2012, it would need to be 0.4% of GDP larger in order to achieve sustainability.

Intergenerational fairness also favours immediate action. The costs of the recession in terms of lost output and fiscal deficits should be shared between current and future generations (Box 2.2). Without rapid consolidation, the fiscal burden of the recession increasingly falls on future generations through high underlying deficits and large projected increases in debt and interest payments. While there are arguments in favour of not letting the current generations of retirees bear the full costs, as their ability to respond to changed conditions is more limited, other currently living generations should contribute fully.

Figure 2.2. **Fiscal sustainability requires extensive consolidation**

As a percentage of GDP



Source: OECD, Economic Outlook 86 Database and OECD calculations.

StatLink  <http://dx.doi.org/10.1787/827660334103>

Box 2.2. Strategies for tackling fiscal sustainability – pre-funding in Finland

Two different paths are available to meet future fiscal obligations. Firstly, governments and individuals can decide to *pre-fund* to cover future obligations by building up assets today that will allow future primary deficits and net borrowing. This can be done within the pension system or by household savings outside the pension system. Secondly, governments can strive to increase *resilience* to future developments and shocks by improving the future primary fiscal position, for example, by raising future labour supply, reforming the pension system or credibly cutting back on future expenditures (See Chapter 3 for recommendations on these issues). Fiscal consolidation to improve sustainability needs to address both channels. From a welfare perspective, different shocks should typically be tackled with different tools. For example, an increase in future longevity could lead to further expenditure pressures but also benefits future generations in terms of longer lives. Consequently, it is logical that future generations that would benefit from the increase in longevity bear the costs, for example, by raising future retirement ages (Andersen, 2008). On the other hand, if current generations want to benefit from a higher quality old-age care when they are old, pre-funding would be a natural response.

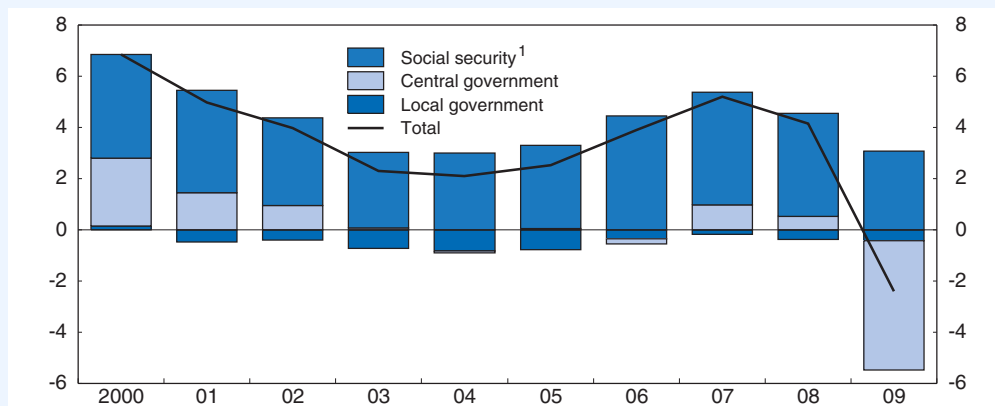
In practice, the choice of tools is more complex. Intergenerational fairness can be defined in many ways, and other considerations need to be taken into account. Factors pointing in the direction of more focus on pre-funding include issues of time-inconsistency in political-economy processes and overly optimistic assessments of the long-term impact of reforms. A factor suggesting less focus on pre-funding (as opposed to resilience) is the difficulty for governments to maintain large positive asset positions over long periods.

Pre-funding for ageing in Finland

Finland has been preparing for ageing by pre-funding through fiscal surpluses for a relatively long period, although the fiscal position worsened dramatically in 2009 (Figure 2.3). The general government surplus in Finland has to a large extent been reflected in the surplus in the social security funds (which include the employment pension funds), with lower surpluses in the central government sector and deficits in the local government sector.

Figure 2.3. **Government financial balances by sector**

In per cent of GDP



1. Including employment pension funds.

Source: Statistics Finland.

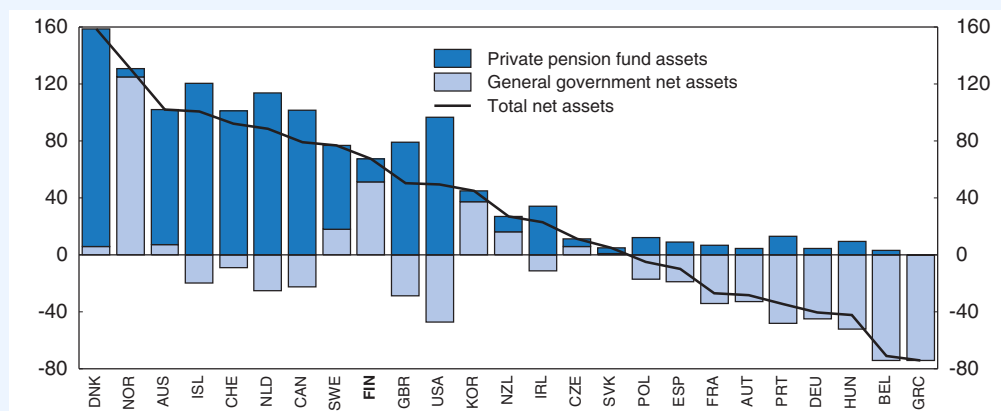
StatLink  <http://dx.doi.org/10.1787/827660731332>

Box 2.2. Strategies for tackling fiscal sustainability – pre-funding in Finland (cont.)

As a consequence of a national decision in 1993 and confirmation by the European Commission in 1997, Finnish employment pension institutions are classified in the general government sector. This means that contributions to mandatory pension schemes for private sector employees that are administered by private pension institutes are recorded as government receipts. Similarly, the assets of the pension funds are included as general government net assets, which inflate Finland's fiscal position compared to other countries. One way of more accurately gauging pre-funding across countries is to add together government net financial assets and private pension assets. Private pension assets are important in a number of countries (Figure 2.4), and their inclusion changes the relative fiscal position of Finland significantly. It should be stressed that there is no obvious “correct” way of treating pension funds in this regard. However, it is important that evaluations of pre-funding capture the differences. By fully including future pension liabilities in the government's balance sheet, the classification issue would be less important. The sustainability indicators presented in this Survey as well as by the Finnish government incorporate future spending on pensions and are thus not sensitive to those classification issues.

Figure 2.4. **Government and private pension net financial assets**

In per cent of GDP, 2008¹



1. Or latest available year.

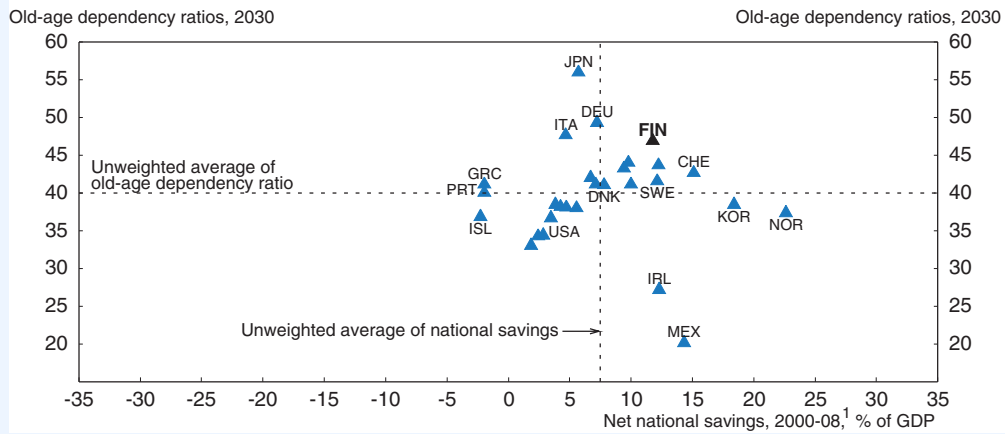
Source: OECD, Global Pension Statistics and OECD Economic Outlook Database.

StatLink  <http://dx.doi.org/10.1787/827684502008>

While adding together government assets and private pension assets gives one measure of pre-funding and preparation for future costs related to ageing societies, these measures have clear limitations. Societies may accumulate real and financial assets outside the pension system. In this context total domestic savings, which is equal to net capital formation and the current account surplus, may be a better indicator of a country's accumulation of resources (Figure 2.5). While net national savings in Finland are higher than the OECD average, ageing is also a more pressing concern and therefore Finland should save more than the average OECD country.


Box 2.2. **Strategies for tackling fiscal sustainability – pre-funding in Finland**
(cont.)

Figure 2.5. **Net national savings and old-age dependency**



1. Or latest available year.

Source: OECD, Annual National Accounts and Population Databases.

StatLink  <http://dx.doi.org/10.1787/827707527583>

However, fiscal consolidation should wait until recovery becomes established as the economic outlook for Finland remains uncertain and the output gap is wide. On current OECD projections a firmer recovery is expected during the course of 2011, suggesting that fiscal consolidation should take place from 2012 onwards, preferably starting with reforms to extend working lives, tax increases and restraints on general government spending, while elevated levels of labour market programmes should be kept in place longer.

The composition of consolidation matters

Apart from directly improving sustainability, a consolidation plan may yield additional indirect benefits or costs. Lowering replacement rates in unemployment insurance and further pension reform as outlined in Chapter 3 are, for example, likely to stimulate employment and growth which would further strengthen public finances. Consolidation through tax hikes that decrease incentives to work and invest may instead be self-defeating, as tax bases deteriorate and expenditures increase (see Box 2.3). This avenue should, therefore, be avoided if possible. The already high tax burden in Finland also leaves little room for further tax increases (Figure 2.1, third panel). International evidence also suggests that spending-focused consolidation tends to be more successful than tax increases, as the former typically is associated with higher GDP growth (Ardagna, 2004).

The successful fiscal consolidation in Finland after the 1992 crisis took place without significantly increasing the overall tax burden.⁴ However, expenditure restraints and cuts were accompanied by substantial increases in the tax wedge on labour. The income tax rate for an average earner increased from 32% in 1991 to 38% in 1995 (Grönqvist and Kinnunen, 2009). While such tax hikes tend to have detrimental effects on incentives to work and invest in human capital, the scale of the required consolidation at that time meant that expenditure cuts needed to be accompanied by tax increases.

Box 2.3. Two different consolidation scenarios

The composition of reforms is important for the efficiency of fiscal consolidation in a general equilibrium context. While policymakers have to consider political, distributional and regional concerns apart from the pure public finance aspects of reforms, this analysis highlights the role of labour supply and output in consolidation.

In the first scenario, income taxes and social security contributions are assumed to be raised by 4% of GDP each, amounting to a fiscal tightening of 8% of GDP. Such an increase would raise the tax wedge on labour income by roughly 15 percentage points, which in turn would increase unemployment by roughly 4.5 percentage points according to OECD estimates. If the higher unemployment rate then fully transforms into lower employment and GDP, primary net lending would deteriorate by a further 2.3% of GDP.* Thus under this scenario, significant further consolidation would be needed. These estimates are likely to err on the conservative side, as labour market participation may also decline and the compressed wage structure in Finland may prevent tax shifting to workers, which may exacerbate employment effects.

An alternative consolidation scenario consists of a combination of measures. Firstly, increases in less growth-hurting taxes such as the property tax (yielding 1% of GDP), and a uniform VAT of 23% (yielding 1-1.5% of GDP) could be implemented. Lowering excessive accrual rates in the pension system (see Chapter 3) could add savings to the pension system equivalent to roughly 2% of GDP (OECD, 2006). Containing real municipal expenditure growth through a tax ceiling, and freezing transfers to municipalities so that the recent 10% productivity loss is recovered, could shrink government expenditures by almost 1.5% of GDP relative to the baseline. Further savings could be made through the proposed changes to the financing of tertiary education (Chapter 1), lowering replacement rates and restricting access to early retirement pathways (Chapter 3). Raising returns on government assets would also help shrink the sustainability gap. All in all, such a fiscal package could achieve the required savings without negative repercussion on labour supply and growth. Indeed, if combined with employment-enhancing reforms as suggested in Chapter 3, the need for fiscal consolidation could be lessened substantially.

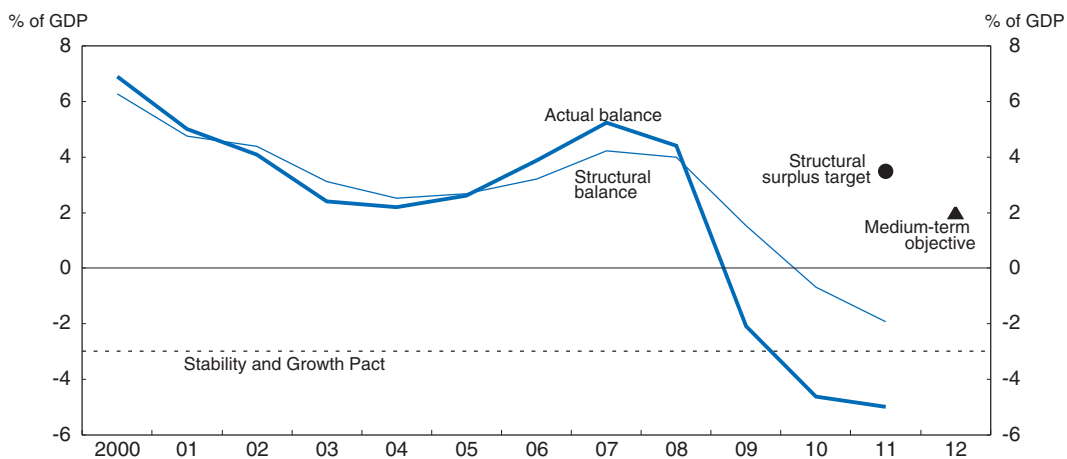
* The elasticity of unemployment with respect to the tax wedge is taken from Bassanini and Duval (2006). The semi-elasticity of the primary balance with respect to GDP is assumed to be 0.48 (Girouard and André, 2005).

Although the structural reforms in the labour market outlined in Box 2.3 are an attractive way to close the sustainability gap, the size of the gap means that substantial efforts would be needed. For example, consolidation achieved through increasing the retirement age would require raising it by five additional years on top of the two years already assumed in the baseline scenario. This would mean bringing the average effective retirement age from 60 in 2007 to 67 years by 2030, roughly a 20% increase in the average working life. Even with significant structural reforms to work incentives and the pension system (see Chapter 3), such an improvement in labour supply and employment would prove challenging. Thus the extent of the gap is likely to require further action in terms of expenditure cuts and tax increases. Such measures should be undertaken in a way that minimises any adverse effects on resource allocation and work incentives. In this regard the planned increase in the VAT rate from July 2010 is one small step in the right direction, although it fills less than 10% of the total sustainability gap.


Reaching sustainability will require new fiscal targets

The fiscal surplus targets in place prior to the recession will not be met, although the central government expenditure ceiling remains intact (Figure 2.6). Along with many EU countries, Finland is expected to experience deficits beyond the 3% of GDP deficit threshold stipulated by the Stability and Growth Pact (SGP). In Finland, the SGP target was complemented by an ambitious set of fiscal targets set by the government in its Government Programme of 2007 (see Box 2.4). Most of these, as well as the government's employment and unemployment targets, will not be met. Apart from the deep recession, this also reflects the partial coverage of the expenditure ceiling and the multiplicity of fiscal targets.

Figure 2.6. **Targets for the general government financial balance prior to the recession**



Source: OECD, OECD Economic Outlook 86 Database.

StatLink  <http://dx.doi.org/10.1787/827722700161>

Fiscal policy needs to target several different goals

Revised fiscal rules, if set up appropriately, can simplify and reinforce the required consolidation effort. Research suggests that rules tend to facilitate fiscal consolidation and enable larger and more sustained consolidations (Guichard *et al.*, 2007). On a general level, fiscal policy should contribute to stability, efficiency, sustainability and distributional goals. When setting fiscal targets and designing a fiscal regime, consistency with overall policy objectives is therefore paramount (Barker *et al.*, 2008). Fiscal policy rules can help policymakers take longer term considerations into account by increasing the costs of short-sightedness in decision making. Thus these rules can help to achieve more time-consistent fiscal policy making (Calmfors, 2005).

A revised fiscal framework needs to make more room for stabilisation

The 2011 surplus target and the deficit floor left little room for stabilisation policies in the recent recession, forcing the government to suspend them. Although the depth of crisis forced many OECD countries to take extraordinary action, the Finnish targets would most likely not have been sufficiently flexible to deal with even a more normal downturn in an efficient way. Already in the Stability Programme update for 2007, the government foresaw

Box 2.4. Fiscal and labour market targets

The Stability and Growth Pact (SGP) deficit floor was complemented by several national targets set by the government in 2007:

- A medium-term objective of a general government structural surplus of 2% of GDP in 2012. In the Stability Programme update 2009 (Ministry of Finance, 2010) the medium-term objective was set to 0.5% of GDP in 2013.
- A central government structural surplus target of 1% of GDP by 2011 (roughly equivalent to 3.5% surplus in general government finances according to the Stability Programme update for 2008). This target was suspended in February 2009.
- A central government deficit floor of 2.5% of GDP. According to the Stability Programme update 2009 (Ministry of Finance, 2010), central government deficits will exceed 2.5% of GDP for the period 2009-13.
- A commitment to the multi-annual spending limits adopted in May 2007 covering non-cyclical central government spending.

The fiscal targets have been accompanied by a set of labour market targets:

- A specific employment target for 2011 (72% employment rate) and a long-term employment target (75%).
- Unemployment should be reduced to below 5% on a permanent basis.

that the central government structural surplus would significantly undershoot the 2011 target. Trying to achieve the surplus targets set by the government for 2011 and 2012 would thus have implied significant pro-cyclicality in the face of a recession. While the utilisation of numerical targets typically improves budgetary outcomes, allowing sufficient flexibility so that they do not hamper fiscal stabilisation is important (Debrun *et al.*, 2008).

A future fiscal framework should allow sufficient flexibility to deal with normal cyclical downturns. While such flexibility has been provided on the expenditure side by excluding cyclical expenditures from the central government expenditure ceiling, more flexibility in terms of surplus targets is needed. The recession has highlighted the importance of discretionary fiscal policies in stabilisation and the need for flexibility in the fiscal framework. The extent of the needed flexibility depends on both the size and the type of shocks that affect an economy, but also on related adjustment mechanisms including monetary policy and real exchange rate flexibility. Real exchange rate adjustment is slow in Finland due to a fixed exchange rate, the low overall inflation target and wage rigidity. A small country with high output volatility and relatively large automatic stabilisers requires relatively high short-term flexibility in the fiscal targets. Furthermore, monetary policy for euro area members is set in accordance with the needs of the whole zone rather than Finland alone. As Finland has a small weight in the ECB's inflation target and differs significantly from the average member in terms of industrial structure, trade patterns and its monetary transmission mechanism, the role of fiscal policy in stabilisation could be expected to be larger than in the average euro area country (Chapter 1). Fiscal flexibility can be achieved by targeting the structural deficit rather than the actual deficit, so that the automatic stabilisers are allowed to work fully. The government should avoid reinstating the deficit floor or setting numerical targets for the actual deficit in specific years as they are too inflexible and vulnerable to developments

outside the government's control. Fiscal stabilisation should also be made more flexible by making more use of sunset clauses on stabilisation measures to avoid the permanent weakening of the fiscal outlook that recent packages have been responsible for.

The fiscal targets should be closely aligned to longer term goals

A new fiscal framework should be based on long-term sustainability analysis, and include targets for further pre-funding, structural reforms or less generous future benefits (Box 2.5). The government's fiscal documents stress the importance of achieving fiscal sustainability (Ministry of Finance, 2009), which is monitored by annual submissions under the Stability Programme. The government has also acknowledged that there is a funding gap, which needs to be addressed through increasing labour participation or more pre-funding. However, no operational links have been introduced between the fiscal framework, fiscal sustainability and policies to increase participation so far. Based on an assessment of the fiscal sustainability gap, concrete measures to close the gap should then be outlined and implemented in the budget process (Swedish Fiscal Policy Council, 2009). While compliance with fiscal targets should be gauged on a yearly basis, new long-term targets could be set with a lower frequency to let the target work as a more stable anchor in the fiscal process.

Box 2.5. An outline for a revised fiscal framework

- Estimate the fiscal sustainability gap based on current policies on a less frequent basis (e.g. when the government program is launched and when the mid-term review takes place).
- Set out a 4-year rolling fiscal plan in terms of the structural surplus that is consistent with closing the sustainability gap. The fiscal plan should include a combination of structural reforms, expenditure ceilings for central government non-cyclical expenditures and tax policies.
- Reassess and modify the fiscal plan on a yearly basis according to the economic situation, new priorities, etc.
- Let an independent agency prepare yearly evaluations of the government's fiscal plan (and the sustainability estimates when relevant) to be published well ahead of the upcoming next budget. Ensure that the government has to respond to the evaluation, e.g. in the *Budget Review*.

Enforcement and monitoring could be enhanced

Although Finland has a strong fiscal track record compared to most other OECD countries, the introduction of a Fiscal Council could contribute further to the quality of decision making and reaching fiscal targets. The central government, the Bank of Finland, research institutes, government bodies and social partners all contribute to public discussion on fiscal policy. While this is useful, a more institutionalised framework may improve the public discussion even further. While institutional arrangements vary, a good example is the Fiscal Policy Council set up in Sweden in 2007. It assesses fiscal policy objectives (including sustainability), the efficiency of policies to reach those targets and the quality of the government's forecasts and analysis. Although it is an agency under the

Swedish Ministry of Finance, the council's independence and credibility are assured by the reputational status of its mainly academic members. Ideally, a Fiscal Council in Finland should be an agency under parliament, with a legal status similar to the National Audit Office, and should evaluate the government's assessment of sustainability and assess to what extent fiscal policy is in line with fiscal targets. In setting up such a council, issues of intellectual independence, competence and expertise are also crucial. The fiscal framework and public finances are likely to gain from an open and informed discussion on future challenges to the Finnish welfare state by experts. This is especially true given the complexity of fiscal issues and economic consequences of policy actions.

Consolidation can be facilitated by a more efficient tax structure

The revenue structure can be more efficient

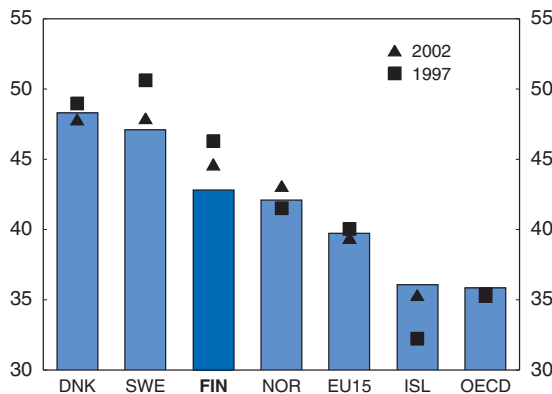
It is important that revenues are raised in the most efficient way, which often implies broadening tax bases, lowering tax expenditures and taxing less mobile factors (OECD, 2009a). The composition of tax revenues influences growth in GDP per capita (Johansson *et al.*, 2008). While corporate taxes tend to be the most harmful for growth and recurrent taxes on immovable property the least harmful, taxes on personal incomes and consumption lie in the middle. Evidence of the effects of social security contributions on growth is less clear, as the connection between contributions and benefits affects work disincentives created by these measures.

The relative success of Finland and the other Nordic countries in terms of combining high levels of GDP per capita and an extensive welfare state show that there is no one-to-one relationship between high taxes and GDP per capita. Still, in countries with high tax-to-GDP ratios, there is always a risk that incentives for work, education and investment may be blunted. The Government Programme of 2007 also stresses the importance of tax policies in fostering employment and growth. The need for fiscal consolidation only strengthens this conclusion.

In several respects, the Finnish tax system is relatively efficient and well adapted to the country's needs. While general government revenues in relation to GDP have decreased from the record levels of the 1990s, they still remain well above the OECD and EU averages. At the same time, they are lower than in Finland's Nordic neighbours (Figure 2.7). Taxation on corporate profits and capital is flat, broad-based and in line with the OECD average (Figure 2.8). However, taxes on labour are somewhat higher than the OECD average, though they have come down since the 1990s. High taxes on labour are likely to adversely affect incentives for working longer hours and investing further in education, even if hours worked per employee and returns on education in Finland are well above the other Nordic countries (OECD, 2008). As discussed in Chapter 4, the dual tax system could be improved upon.

Recent income tax changes have been substantial. The statutory top tax rate on labour income has been reduced by 5 percentage points over the past ten years, although at over 50% in 2009 it remains high in an international perspective.⁵ In addition, tax credits and deductions in the tax system have increased. While these increases have improved work incentives (OECD, 2008), these "carrots" have implied significant fiscal costs and need to be complemented by tightening access to and the amount of benefits in the welfare system to be effective in increasing labour supply (see Chapter 3).

Figure 2.7. **Aggregate tax-to-GDP ratio**
2008¹

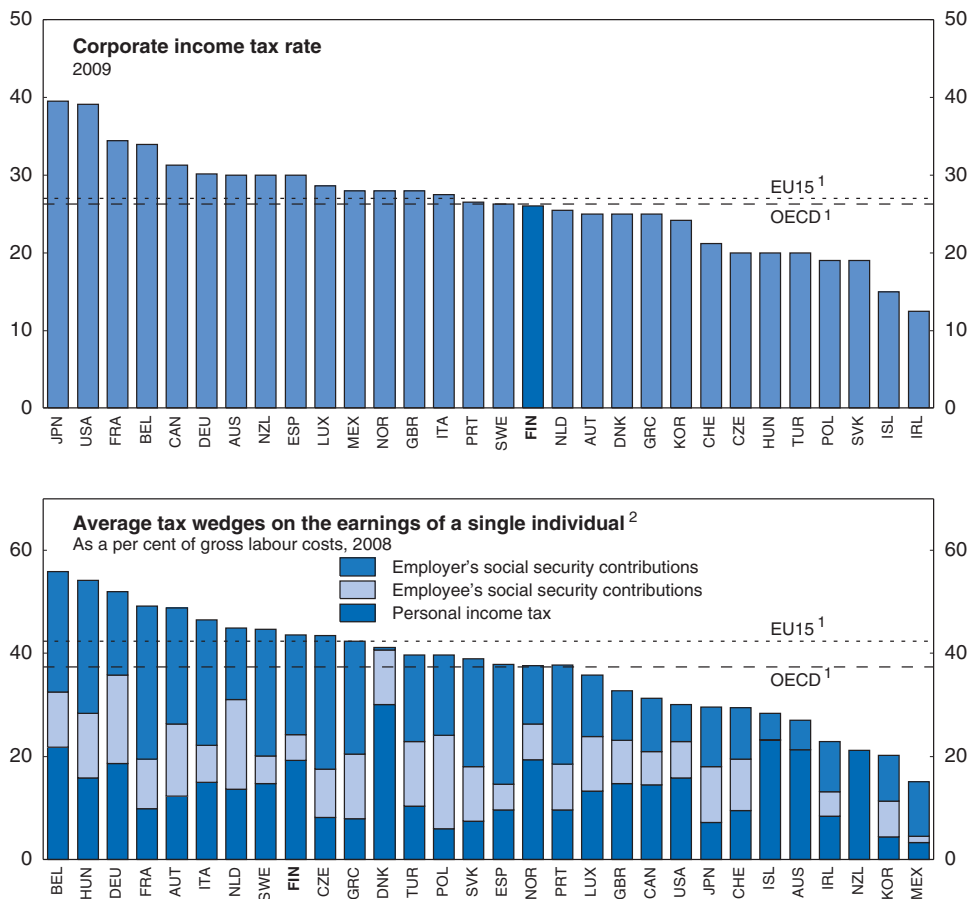


1. 2007 for EU15 and OECD.

Source: OECD (2009), Revenue Statistics Database, December.

StatLink <http://dx.doi.org/10.1787/827738517570>

Figure 2.8. **Corporate and personal income tax rates**



1. Unweighted average.

2. For a single individual without children. Tax wedges are calculated as the sum of personal income tax, employee plus employer social security contributions together with any payroll taxes as a percentage of labour costs (gross wage plus employers' contributions).

Source: OECD (2009), Taxing Wages 2007-2008 and OECD Tax Database.

StatLink <http://dx.doi.org/10.1787/827741105864>

In its 2007 programme the government set out to further lower income taxes to increase employment. The 2010 Budget also focuses on tax cuts by increasing the basic and earned income deductions, adjusting brackets and easing taxation on pensions. While these cuts will give a welcome short-term boost to demand, their longer term effects on labour supply are likely to be small. They do not improve work-incentives significantly because tax cuts apply to both labour and transfer incomes. Given that expenditure ceilings will need to be set tight in coming years (see below), extra vigilance should be pursued in order to hinder any use of tax expenditures to circumvent the expenditure ceiling which could hollow out the tax base. The government's recent decision to improve methods of measuring and reporting tax expenditures is thus welcome.

For a number of years municipal income taxes have increased, partly offsetting state income tax cuts. More than one-third of the municipalities plan to raise income taxes in 2010, in some cases by as much as 1.5 percentage points. This is likely to reduce the impact of the stimulus package (see Chapter 1) and raise tax wedges across the board. Reining in expenditure growth in municipalities in the longer run to stop further tax hikes should be a priority so as to minimise effects on work incentives and improve productivity in municipalities (see below).

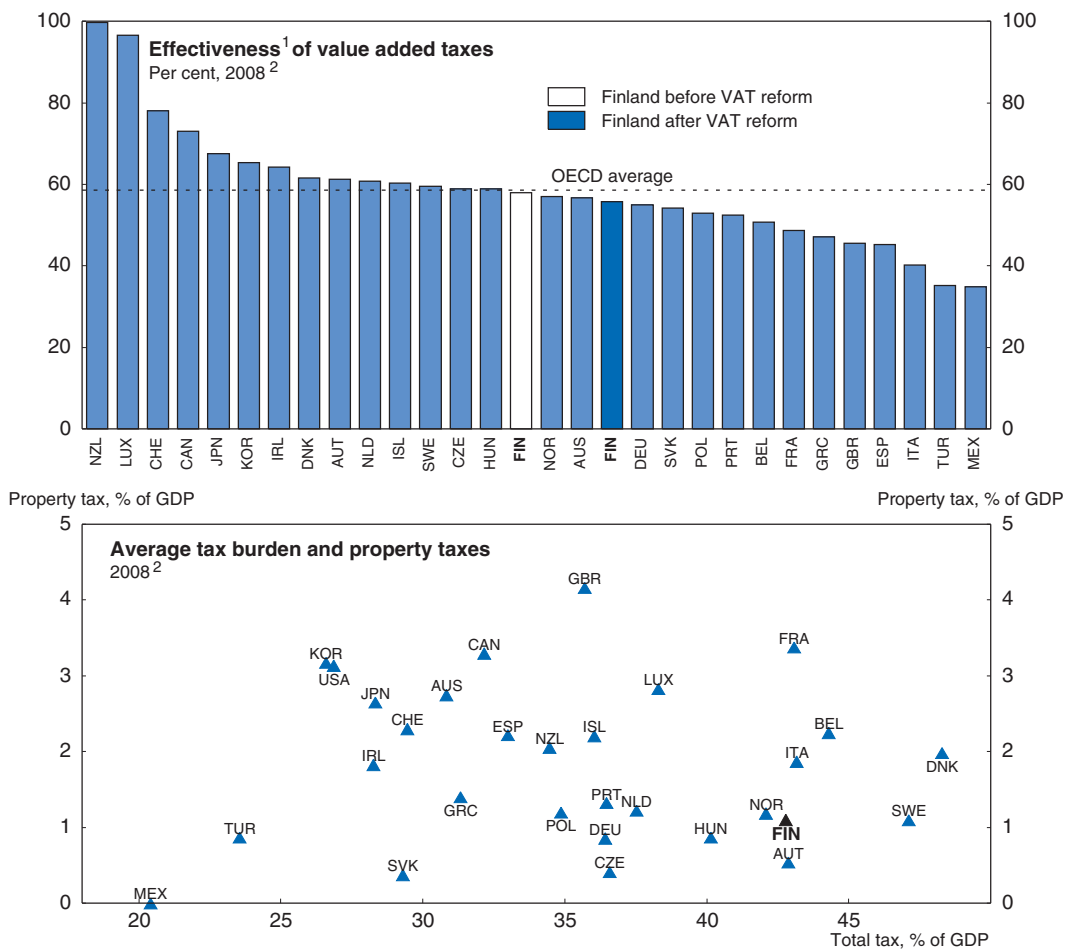
Preferential VAT rates should be increased

There is room to raise and broaden indirect taxes. The Finnish VAT system has three rates: the standard of 22%, a 12% reduced rate on food (reduced from 17% in October 2009) and a further reduced rate of 8% on a range of commodities such as accommodation services, books and passenger transport. In line with the OECD average, taxes on goods and services make up roughly 30% of total revenues. The 2010 Budget envisages a 1 percentage point increase in all VAT rates from July 2010, but the recent cuts on food, together with another announced cut on restaurant services from 22% to 13% weakens the tax base. Although there may be theoretical gains from differentiating VAT rates in terms of efficiency and equity, in practice this tends to create distortions and increase collection costs (Joumard and Suyker, 2002). The cut in VAT on food and restaurant services will decrease VAT efficiency in Finland, and the VAT revenue ratio is projected to decline from 61% to 58% due to the reform. This is well below best performing New Zealand, Luxembourg and Switzerland (Figure 2.9). Given that this tax cut is estimated to cost EUR 500 million per annum and that the distributional effects of reduced tax rates on food are relatively small, the authorities should at a minimum reverse the changes that have decreased uniformity in the VAT system. Distributional concerns could more efficiently be addressed by targeted transfers to the most affected groups, such as families with children, pensioners on basic pensions and students. A bolder step towards fiscal consolidation would be to move to a uniform 23% rate, which could increase revenues by 1-1.5% of GDP.

There is also room to further increase property taxes and environmental taxes


Recurrent taxation on immobile property is one of the most efficient sources of tax revenues as the tax base is immobile and evasion is difficult (Joumard and Kongsrud, 2003). Against this background, it is striking that Finland, along with the other Nordic countries with high overall tax burdens, tax property less than countries with lower tax burdens (Figure 2.9, bottom panel). Although property tax rates have increased during the last 10 years, the revenues generated have barely kept pace with GDP and have fallen

Figure 2.9. Tax efficiency could increase



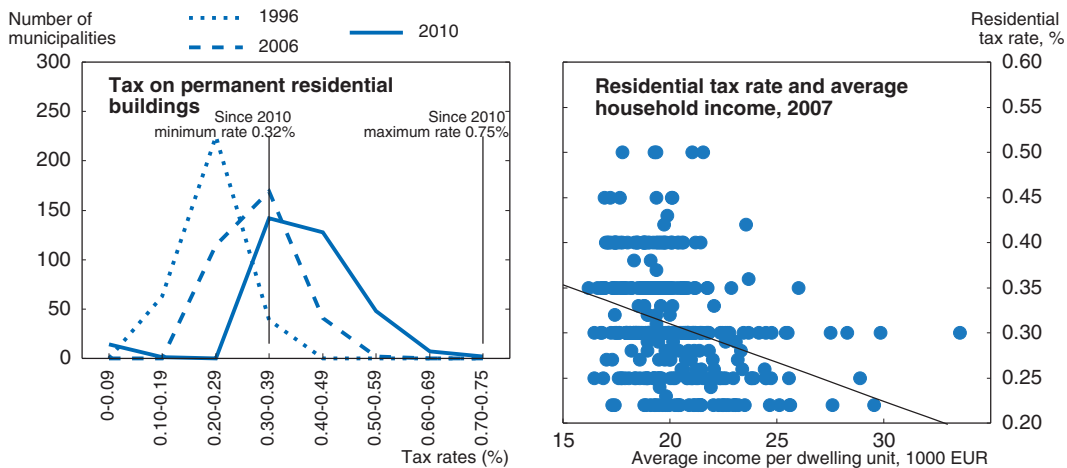
1. Defined as the effective VAT rate as a per cent of the standard statutory rate, where the effective rate is VAT revenues divided by the potential VAT base (i.e. consumption minus VAT).
2. Or latest available year.

Source: OECD, National Accounts, Revenue Statistics and Tax Databases, December 2009 and OECD calculations.


StatLink  <http://dx.doi.org/10.1787/827772006404>

significantly in relation to house prices. This is due to valuation assessments lagging behind market prices. This is now being addressed by tax authorities. Property taxes typically also have benign distributional effects. A number of studies point to high income households gaining disproportionately from under-taxation of housing. Higher property taxes may also improve intergenerational distribution of wealth (Barrell and Weale, 2009).

In Finland, property taxes are set by the municipalities within a range prescribed by the central government. While decentralised decision-making to the municipal level may enhance accountability, stronger centralisation could improve efficiency. Municipalities struggle to raise property tax rates, as local tax competition and lack of technical skills seem to keep rates close to averages (Figure 2.10) and well below the maximum, although they have increased recently. Currently, residential tax rates are regressive, as municipalities with high average incomes tend to set lower rates (Figure 2.10, right panel). Although efficiency and equity could be increased by nationalising the property tax, this is barred constitutionally.

Figure 2.10. **Municipal property tax rates**

Source: Ministry of Interior.

StatLink  <http://dx.doi.org/10.1787/827772323471>

In the previous Survey (OECD, 2008), the OECD recommended that the minimum property tax rate should be raised substantially. From 1st January 2010, the minimum tax rates applied to permanent dwellings and the general property tax have been raised slightly. To improve the efficiency of the tax composition and increase tax revenues without worsening income distribution, the government should consider:

- Ensuring that property valuations are close to market levels. The current process to harmonise the assessment of property values to market levels is therefore welcome.
- Further increasing the minimum property tax rates significantly and abolishing the maximum rates. This applies in particular to the tax on permanent residential dwellings, where rates are the lowest and the tax base is widest. The government should also consider taxation of agricultural and forest land.
- Constraining other sources of municipal revenues, such as income taxes (see below) and government transfers.
- While tax increases on property have to be phased in over an extended period to avoid disrupting the housing market, revenues from property taxation should at least move to the OECD average of 2% of GDP.

The government recently committed to the target of reducing CO₂ emissions by 80% by 2050. While not yet outlining the path to achieving this target, there are a number of existing schemes that effectively subsidise emissions and that the government should abolish, including the use of peat in energy production (Box 2.6). An environmental levy on peat should be considered.

Box 2.6. Climate change and environmental taxes

Climate change abatement targets are an important part of the government's policy agenda as articulated in the Government's Climate and Energy Strategy in 2008. It specifies how Finland would achieve the EU climate and environmental objective of cutting greenhouse gas emissions by 20% relative to 1990 levels by 2020. Other measures taken include amending taxation of motor vehicles by basing the tax rate on emissions. In 2009 the government also adopted a report on long-term climate and energy policy that extended its climate and energy strategy to 2050. This Foresight Report sets the ambitious target of cutting carbon dioxide (CO₂) emissions by at least 80% from the 1990 level by 2050. As part of the effort to achieve these targets, the government announced new environment taxes to be introduced in 2011. These are principally increases in fuels excises and, along with the changes made in 2008, go some of the way in lifting Finland's relatively low implicit tax rate on energy. This was around EUR 104 per tonne of oil equivalent in 2007, which was lower than the EU average of EUR 167 and close to half the rate of Sweden, Germany and Denmark.*

A number of areas remain where further progress could be made. Finland is one of the few countries in Europe that has not decreased its greenhouse gas emissions intensity of energy consumption since 2000 (EuroStat data). One reason for this is the use of peat in energy generation. In 2007 peat accounted for just 7% of all total energy production in Finland but comprised 15% of Finland's total CO₂ emissions. Finland has the ninth largest stock of peat (roughly on a par with Sweden) and the world's highest rate of peat emissions per capita (Wetlands International, 2009). While the Foresight Report sets a target of gradually phasing out the use of peat (and other fossil fuels) in energy production, the government has not yet formally committed to implementing all the recommendations of the report. Nor has it articulated plans to phase out the special treatment currently provided to the peat industry – due to regional policy objectives, peat is tax exempt in heat production and receives a subsidy in electricity production. The government should not extend the special treatment for peat when the current measures expire in 2010. There are other weaknesses in Finland's energy taxation policy related to the tax refund systems for certain energy-intensive industries and the agriculture sector, that should be also addressed.

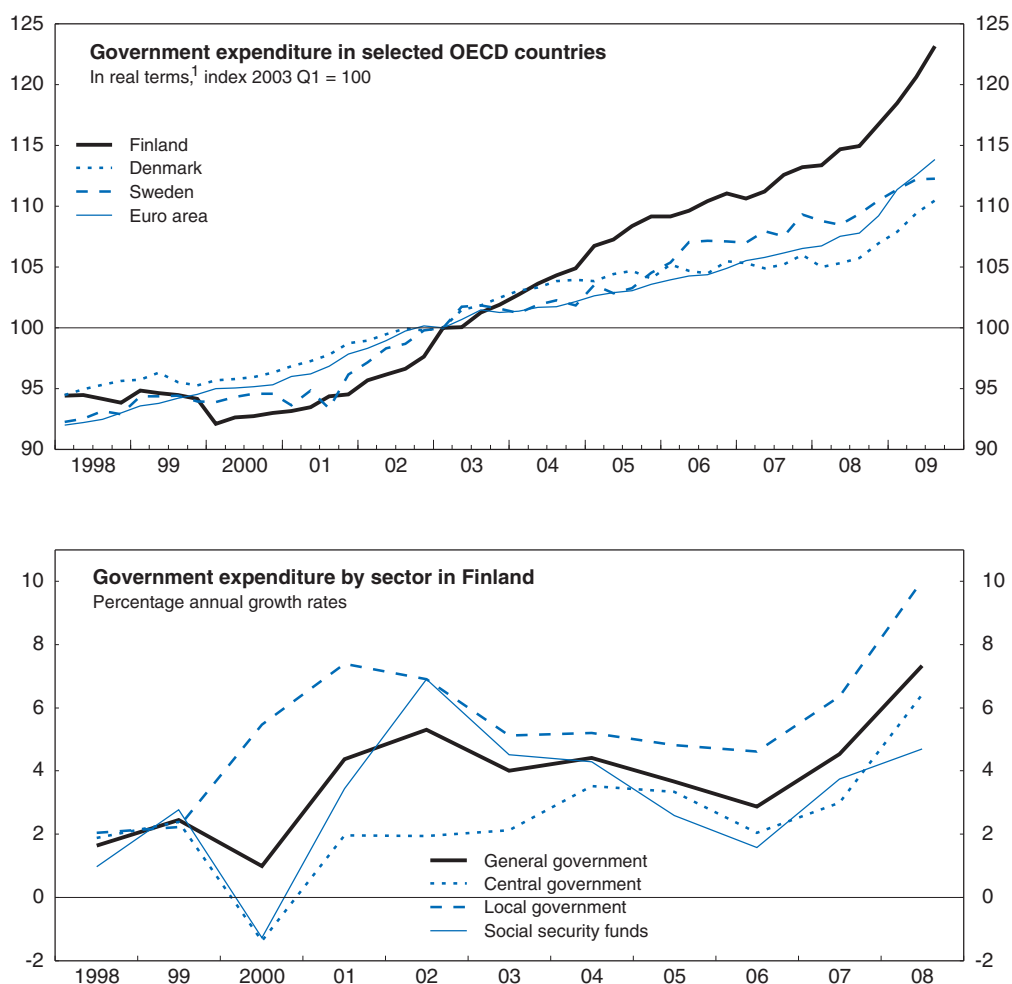
* Eurostat Database. Implicit tax rate on energy: euros per tone of oil equivalent.

Expenditure growth needs to be reined in and efficiency improved

The expenditure ceiling has not been able to contain overall government spending


The current central government expenditure ceiling was introduced in 2003 to curb spending growth and was further developed in 2007. It is set in real terms for a four-year electoral period, which is currently 2007-11, and covers non-cyclical, central government expenditures. The expenditure ceiling has been successful in containing central government expenditure during the years of buoyant revenues. The government estimates that the budget appropriations will stay within the spending limits between 2009 and 2011, but contingency margins are small at less than 1% of the expenditures under the ceiling (Ministry of Finance, 2009). While expenditure rules in general tend to promote fiscal consolidation and improve the functioning of fiscal frameworks, general government spending growth has remained relatively high in Finland. Although expenditures were reined in significantly in the late 1990s and early 2000s, more recently they have increased at a much higher rate than in *e.g.* Denmark, Sweden or the euro area (Figure 2.11). To ensure fiscal consolidation, real expenditure ceilings should be set on a declining trajectory from 2012 onwards until a sustainable fiscal position is reached.

Figure 2.11. Expenditures have been increasing rapidly



1. Deflated by the private consumption deflator.

Source: Statistics Finland and OECD, OECD Economic Outlook 86 Database.

StatLink  <http://dx.doi.org/10.1787/827860177615>

The excessive expenditure growth has mainly taken place in spending categories outside the ceiling and primarily in the municipal sector. As the ceiling applies to about a third of total government spending, growth in other categories has been pushing up outlays rapidly. In line with international evidence (Afonso and Hauptmeier, 2009), the high and increasing level of decentralisation in spending in Finland seems to have contributed to the fast growth in overall expenditures. The most rapid growth during the last ten years has been in municipalities (Figure 2.11, bottom panel). The central government may be contributing to this by implementing programmes that push expenditures to the local level. More importantly, municipalities have soft budget constraints, and are likely to have weaker fiscal discipline due to less exposure to negative spillovers from high labour taxes in terms of increasing unemployment, etc. Consequently, municipal expenditures soared while revenues were buoyant. As the previous Survey showed, the reliance on highly cyclical revenues, such as corporate taxes, has tended to ratchet up expenditures in good times. The subsequent decline in revenues has led to requests for further grants and municipal tax hikes.

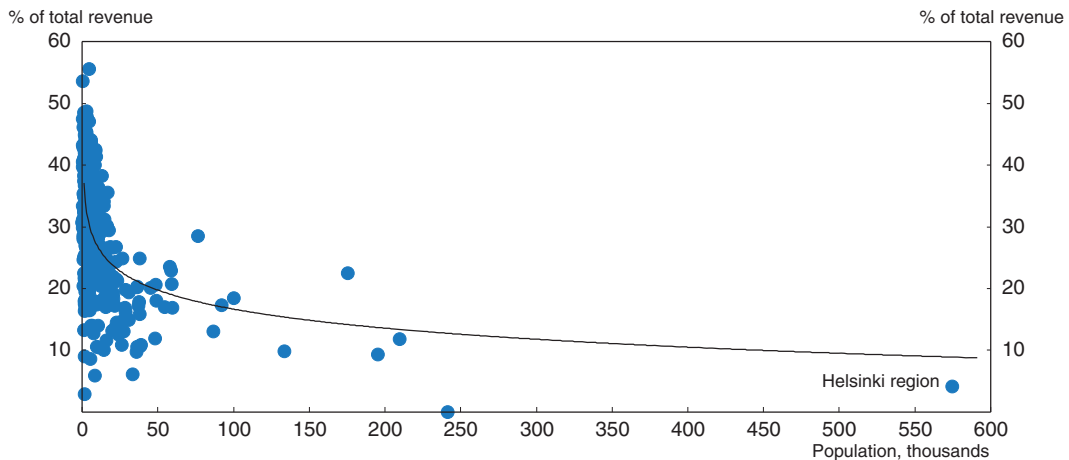
To rein in permanent expenditure increases enabled by temporary buoyant corporate tax revenues, the central government should consider taking over these revenues and amending the transfer system. Municipalities could be compensated with a transfer based on the cyclically-adjusted corporate tax base. From a theoretical perspective, caps on municipal spending could be considered in order to increase fiscal discipline, but this would prove impractical due to the large number of municipalities. The government therefore needs to pursue other means, like ceilings on the municipal income tax, or changing the transfer system so that municipal income tax increases automatically lead to significant partially offsetting grant cuts. While the introduction of the current block grant system seems to have improved budgeting procedures in municipalities (Moisio, 2001), the easy access to the tax instrument contributes to spending pressures. To constrain spending pressures, the government should also consider freezing transfers to municipalities or just adjusting them for increases in consumer prices to ensure that municipal spending as a share of GDP is lowered over the consolidation period.

The efficiency of municipal service provision could also be improved. Public services in Finland are generally of good quality and relatively cost-effective. World class basic educational attainment is achieved at relatively modest costs (OECD, 2009b) and health care outcomes are good in relation to spending (OECD, 2009c). However, the persistent decline in the productivity in the provision of many public services points to growing inefficiencies. Overall productivity in local government fell by more than 10% between 2000 and 2008. The fall has been widespread, but is particularly pronounced in the social work (-15%) and health (-12%) sectors. The buoyant resources channelled to the municipalities have contributed to the decrease in efficiency and seems to have created significant slack. Inefficiencies are especially large in municipalities where incomes are high and have been growing fast.⁶ Programmes implemented during the last few years to increase public sector productivity through administrative simplifications, better use of IT, establishment of minimum population-base requirements for school and health care districts and increased competition have yet to produce tangible results. One important factor behind the slump in productivity in municipalities seems to be that required plant level adjustment of inputs is not taking place.


Restructuring municipalities would support fiscal efficiency

Many municipalities are struggling to meet their service delivery obligations in the face of a rapid increase in old-age populations and dwindling tax bases due to demographics and migration towards economic centres (see Chapter 4). Finnish municipalities retain a remarkable degree of independence, so that even very small municipalities take decisions on complex issues such as tax policies and provision of education. It is likely that many of them lack sufficient expertise in those areas, given that the median population is lower than 5 000 inhabitants. Many small municipalities are also highly dependent on state grants and are therefore exposed to the fiscal situation within the central government (Figure 2.12).

The government's key strategy for municipal reform has been to encourage mergers and restructuring through financial incentives. The number of municipalities was reduced by over 80 between 2006 and 2009 to 348, but compared to other Nordic countries mergers have been timid (Box 2.7). As was discussed in the previous *Survey*, the mergers conducted so far do not seem to have produced measurable cost reductions. This is not surprising, given that merging municipalities typically agree to not lay off any workers for five years

Figure 2.12. **Grants to municipalities by population size**

Source: The Association of Finnish Local and Regional Authorities and Statistics Finland.

StatLink  <http://dx.doi.org/10.1787/827865151776>

Box 2.7. **Municipal mergers in the Nordic countries**

Successive governments have recognised potential advantages of rationalising Finland's fragmented municipal system. The scheme to restructure local government was overhauled in 2005 to promote larger, more viable units. This included revisions to the criteria for granting central government support for mergers to encourage them between several local authorities. These incentives led to some consolidation, with a significant number of mergers taking place between multiple municipalities. The total number of municipalities was reduced from 415 in 2008 to 348 in 2009. While the mergers aimed at increasing viability and efficiency of service provision, political compromises required to make some of them happen led to inefficiencies. In some instances long-term employment levels and conditions were grandfathered and highest costs or least efficient practices were maintained.

While the recent merger incentives in Finland have had some limited success, recent reforms in Denmark illustrate that dramatic restructuring can be achieved rapidly once there is political consensus. A committee established at the beginning of 2004 already had concrete proposals by the middle of the year, which were passed through parliament by mid-2005. This coincided with a window during which municipalities could merge voluntarily, including by signing cooperation agreements with larger neighbouring municipalities. Thereafter, mergers were enforced and by January 2007, 270 municipalities had been consolidated into 98 larger units, most of which now have at least 20 000 inhabitants. The aim was to give new municipalities greater financial and professional sustainability. One factor that drove reforms in Denmark was a concern that expertise was being spread too thinly, which had resulted in low capacity in smaller municipalities to effectively and efficiently manage themselves and the services they delivered.

In Sweden major reforms took place through the 1960s and 1970s, which reduced the number of municipalities from over 1000 to below 300. However, there has not been any further major consolidation subsequently. Unlike in Finland, the smallest Swedish municipality has over 2 500 residents, and around one quarter have populations below 10 000 compared to three-quarters in Finland. Only four municipalities in Denmark now have a population smaller than 10 000.

for reasons associated with the reform. It is also questionable whether reforms have been sufficiently radical to achieve municipalities of a sustainable size. Notwithstanding geographical and other factors, including the remoteness and low population densities of some Finnish municipalities, more profound measures may need to be considered, including wholesale mergers along the lines of the Danish example.

While there is a strong case for municipal mergers in terms of sustainability and efficiency in handling tax responsibilities and effective labour market policies, the case for scale economies in service provision is weaker. Municipalities with larger populations tend to have higher cost in service provision than smaller ones.⁷ There is some evidence, however, that increasing municipal size towards 24 000-37 000 people would lower average costs in comprehensive schooling (Aaltonen *et al.*, 2006). Mergers of municipalities alone are not likely to be a sufficient condition for containing costs and increasing efficiency in local government provision of services. A stronger focus on core services and restrictive replacement of retiring employees (especially in shrinking activities such as childcare) should contribute, which also has been stressed in the ongoing project (PARAS) to restructure local government and services. Furthermore, municipalities that rely more on private sector services enjoy higher levels of efficiency and there is clearly more scope for competition in larger municipalities. While achieving competition in core service provision in small municipalities may be difficult, creating incentives for reaping plant-level economies of scale through concentration and adjusting staffing to needs more readily should be a priority. The central government has few direct channels to influence productivity in municipalities, but restraining resources through tax caps and real cuts in transfers could contribute. Furthermore, the government should support research and benchmarking to lower the large disparities in efficiency of basic service provision across units and municipalities.

Public spending priorities need to be reconsidered

A number of overall spending cuts and changes in priorities should also be considered to improve the fiscal position. One area relates to how to pay for the costs of ageing, where non-pension age-related expenditures are expected to rise significantly, from 14% in 2005 to more than 18% of GDP in 2030. Raising the level of co-financing would contribute to lower costs and should be considered. In Chapter 1 and Chapter 3 a further number of spending cuts are considered including:

- The introduction of tuition fees (Chapter 1).
- Lowering accrual rates in the old-age pension system for the 53-65 year olds and raising the minimum retirement age; lowering the accrual rate for parental leave, unemployment and studies in the old-age pension system (Chapter 3).
- Abolishing the unemployment pipeline. Consider lowering unemployment benefits and replacement rates in the disability pension system (Chapter 3).

Box 2.8. Summary of fiscal recommendations

Fiscal sustainability and the fiscal framework

- Establish and communicate a fiscal consolidation plan as quickly as possible to achieve sustainable public finances. Start implementing consolidation measures when recovery firms.
- Revise the fiscal framework to enhance longer term sustainability and flexibility. The new targets should aim at closing the long-term sustainability gap with a four-year rolling fiscal planning horizon with annual sub-targets. The targets should be set in terms of the cyclically-adjusted balance and should consider the need for stabilisation. Given the size of the current sustainability gap, the government should aim for a 1.5% of GDP structural consolidation per year during 2012-15. This would leave a gap of 2.5% to be closed in the period after 2015.
- Strengthen the fiscal regime and support external assessment of policies through the establishment of a fiscal council.
- Consider more radical municipal mergers along the line of the Danish example.

Tax policies

- Raise revenues and the efficiency of the VAT regime by harmonising VAT to a single 23% rate.
- Further raise the lower bound on municipal property taxes and abolish the ceiling. Raise property valuations to market value.
- Consider ways to make municipalities less dependent on volatile corporate taxes either by transferring taxation to the central government or making those revenues less dependent on the business cycle.
- Consider a tax ceiling for municipalities' income taxes to restrain expenditure growth. Alternatively, the municipal transfer system should be amended to significantly weaken incentives for municipal income tax hikes.
- The government's commitment to address climate change is reinforced by its adoption of the 2050 report targets. Achieving this would be assisted by replacing the preferential treatment of peat with a levy and abolishing other distorting refund schemes for energy-intensive industries including the agriculture sector.

Expenditures

- Contain public expenditure growth by setting tight expenditure ceilings over the four-year cycle from 2012.
- Consider freezing transfers to municipalities or just adjusting them for inflation during the consolidation.
- Improve measures of and reporting on tax expenditures.
- Increase competition in service provision in larger municipalities to help reversing the decline in local government productivity.
- Use benchmarking, restructuring and mergers to increase efficiency and reap economies of scale in basic service provision in municipalities.
- Consider central government spending priorities, for instance by switching to more loan-financing and reduced grants in the tertiary education system and introducing tuition fees (see Chapter 1).

Notes

1. Unchanged policy is defined as keeping tax rates constant (implying an almost constant tax-to-GDP ratio) and maintaining expenditure shares of GDP, with the exception of old-age related spending which will develop according to pension rules and demographic developments.
2. The OECD estimate is based on an expected real annual return of 2.7% while the government's estimate relies on an expected 4% annual real return.
3. The government estimates that ageing-related costs will rise by 5.7 percentage points of GDP by 2030 (Ministry of Finance, 2010).
4. Between 1992 and 2000, underlying total receipts in relation to potential GDP increased by 0.3 percentage points, while underlying current disbursements excluding interest rates in relation to potential GDP fell by 8.1 percentage points.
5. The top rate varies across municipalities as it consists of a state tax rate (30.5%), a communal tax rate (average 18.6%) and a church tax rate (average 1.3%) yielding an overall average of 50.4%.
6. See Loikkanen and Susiluoto (2005) and Järviö et al. (2005).
7. These estimates have to be taken cautiously, however, as larger municipalities may provide more complex services than smaller ones.

Bibliography

- Aaltonen, J. et al. (2006), "Efficiency and Productivity in Finnish Comprehensive Schooling 1998-2004", VATT Research Reports, No. 127, Helsinki.
- Afonso, A. and S. Haptmeier (2009), "Fiscal Behaviour in the European Union: Rules, Fiscal Decentralisation and Government Indebtedness", ECB Working Paper, No. 1054, Frankfurt.
- Andersen, T. (2008), "Fiscal Sustainability and Demographics Should We Save More or Work More?", mimeo, University of Aarhus.
- Ardagna, S. (2004), "Fiscal Consolidations: When Do They Work and Why?", *European Economic Review*, Elsevier.
- Barker, F., Buckle, R. and R. St Clair (2008), "Roles of Fiscal Policy in New Zealand", *New Zealand Treasury Working Paper*, 02/2008, New Zealand Treasury.
- Barrel, R. and M. Weale (2009), "Fiscal Policy, Fairness between Generations and National Saving", mimeo, National Institute of Economic and Social Research.
- Bassanini, A. and R. Duval (2006), "Employment Patterns in OECD Countries: Reassessing the Role of Policies and Institutions", *OECD Economics Department Working Papers*, No. 486, OECD, Paris.
- Calmfors, L. (2005), "What Remains of the Stability Pact and What Next?", *Swedish Institute for European Policy Studies*, 8/2005, Stockholm.
- Debrun, X. et al. (2008), "Tied to the Mast? National Fiscal Rules in the European Union", *Economic Policy*, Vol. 23:54.
- European Commission (2009), "Sustainability Report 2009", *European Economy*, 9/2009, Brussels.
- Finnish Centre for Pensions (2009), "Investment Operations of the Earnings-related Pension Scheme", www.etk.fi/Binary.aspx?Section=57949&Item=59841, Helsinki.
- Girouard, N. and C. André (2005), "Measuring Cyclically-adjusted Budget Balances for OECD Countries", *OECD Economics Department Working Papers*, No. 553, OECD, Paris.
- Guichard, S. et al. (2007), "What Promotes Fiscal Consolidation: OECD Country Experiences", *OECD Economics Department Working Papers*, No. 553, OECD, Paris.
- Grönqvist, C. and H. Kinnunen (2009), "Impact of Recession on Labour Supply: Experiences from the 1990s in Finland", *BoF Online*, 10/2009, Helsinki.
- Henriksson, J. (2007), "Ten Lessons About Budget Consolidation", *Bruegel Essay and Lecture Series*, Brussels.
- Järviö, M. et al. (2005), "Productivity and its Drivers in Finnish Primary Care 1988-2003", VATT Research Report, 118, Helsinki.

- Johansson, Å. et al. (2008), "Tax and Economic Growth", *OECD Economics Department Working Papers*, No. 620, OECD, Paris.
- Journard, I. and P.M. Kongsrud (2003), "Fiscal Relations across Government Levels", *OECD Economics Department Working Papers*, No. 375, OECD, Paris.
- Journard, I. and W. Suyker (2002), "Options for Reforming the Finnish Tax System", *OECD Economics Department Working Papers*, No. 319, OECD, Paris.
- Kinnunen, H. (2009), "Impact of the Recession on Fiscal Sustainability", *BoF Online*, 11/2009, Helsinki.
- Loikkanen, H. and I. Susiluoto (2005), "Cost Efficiency of Finnish Municipalities in Basic Service Provision 1994-2002", *Urban Public Economics Review*, No. 4.
- Ministry of Finance (2008), "Stability Programme Update for Finland 2008", Helsinki.
- Ministry of Finance (2009), "Budget Review 2010", Helsinki.
- Ministry of Finance (2010), "Stability Programme Update for Finland 2009", Helsinki.
- Ministry of Interior (2004), "Proposals for Adjustment of Municipal Financing and State Grants", *Ministry of the Interior Publication*, 52/2004, Helsinki.
- Moisio, A. (2001), "On Local Government Taxation and Spending Behaviour", *VATT Discussion Paper*, No. 257, Helsinki.
- OECD (2006), *OECD Economic Surveys: Finland*, OECD, Paris.
- OECD (2008), *OECD Economic Surveys: Finland*, OECD, Paris.
- OECD (2009a), "Tax Expenditure and Base Broadening", *OECD Working Party No. 2 on Tax Policy Analysis and Tax Statistics*, mimeo, Paris.
- OECD (2009b), *Going for Growth*, OECD, Paris.
- OECD (2009c), *Health at a Glance*, OECD, Paris.
- OECD (2009d), *OECD Economic Outlook 86*, OECD, Paris.
- Swedish Fiscal Policy Council (2009), *Swedish Fiscal Policy 2009*, Stockholm.

ANNEX 2.A1

Fiscal scenarios

The macroeconomic scenario up to 2011 is based on the *OECD Economic Outlook 86* (OECD, 2009d). The output gap is assumed to close by 2015. Thereafter the assumptions on growth and inflation are close to the government's assessment in the *Stability Programme update 2008* (Ministry of Finance, 2008). The interest on government gross debt is assumed to be 4.7% and the interest rate on government gross financial assets is set to 3.1%, implying a differential in line with the historical average of 1.6%. Gross government financial assets in relation to GDP are assumed to remain at their 2011 level at 101% and property income, apart from interest income, is assumed to remain constant as a share of GDP from 2011 and onwards. Age-related expenditures are assumed to increase by 5.4 percentage points of GDP between 2011 and 2030 in line with Kinnunen (2009) and remain more or less unchanged thereafter.

Table 2.A1.1. **Summary of macroeconomic assumptions**

	2008	2011	2012-15	2016-30	2031-50
GDP growth (%)	0.8	2.4	3.3	1.5	1.3
Labour productivity growth (%)	-0.5	1.4	2.3	2.0	1.8
Employment growth (%)	1.6	0.2	0.4	-0.5	-0.5
Inflation (GDP deflator, %)	1.8	1.5	2.0	2.0	2.0
Interest rate on government debt (%)	3.7	3.2	4.5	4.7	4.7
Interest rate on government assets (%)	2.0	2.2	3.0	3.1	3.1

Source: OECD, *OECD Economic Outlook 86* and OECD computations.

In the “unchanged age-related spending” scenario, non-interest expenditures are assumed to stay constant as a share of GDP. The “consolidation” scenario assumes that primary net lending improves by 1.5% of GDP per annum during 2012-15 and by an average of 0.8% during 2016-18.

Table 2.A1.2. **Summary of fiscal projections**

As a percentage of GDP

	2008	2011	2012-15	2016-30	2031-50
Baseline scenario					
Primary net lending	3.7	-5.7	-4.2	-5.7	-7.4
Net lending	4.4	-5.2	-4.4	-8.6	-18.3
Net debt	-51	-39	-24	39	216
Gross debt	41	62	77	140	318
Unchanged age-related spending scenario					
Primary net lending	3.7	-5.7	-3.4	-2.3	-2.3
Net lending	4.4	-5.2	-3.6	-4.2	-7.7
Net debt	-51	-39	-25	12	90
Gross debt	41	62	76	113	191
Consolidation scenario					
Primary net lending	3.7	-5.7	-0.4	2.4	0.7
Net lending	4.4	-5.2	-0.4	2.8	1.3
Net debt	-51	-39	-32	-45	-48
Gross debt	41	62	70	56	53

Source: OECD, OECD Economic Outlook 86 and OECD computations.



From:
OECD Economic Surveys: Finland 2010

Access the complete publication at:
https://doi.org/10.1787/eco_surveys-fin-2010-en

Please cite this chapter as:

OECD (2010), "Paving the way for sustainable public finances", in *OECD Economic Surveys: Finland 2010*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/eco_surveys-fin-2010-5-en

This work is published under the responsibility of the Secretary-General of the OECD. The opinions expressed and arguments employed herein do not necessarily reflect the official views of OECD member countries.

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

You can copy, download or print OECD content for your own use, and you can include excerpts from OECD publications, databases and multimedia products in your own documents, presentations, blogs, websites and teaching materials, provided that suitable acknowledgment of OECD as source and copyright owner is given. All requests for public or commercial use and translation rights should be submitted to rights@oecd.org. Requests for permission to photocopy portions of this material for public or commercial use shall be addressed directly to the Copyright Clearance Center (CCC) at info@copyright.com or the Centre français d'exploitation du droit de copie (CFC) at contact@cfcopies.com.