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Ageing, Welfare Serviced and Municipalities in Finland

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ABSTRACT/RÉSUMÉ

Ageing, welfare services and municipalities in Finland

With population ageing setting in sooner and more forcefully than in other OECD countries, Finland needs to reorder its fiscal priorities so as to ensure fiscal sustainability. That will require considerable reform as public spending currently expands vigorously. While GDP growth has slowed from the exceptionally rapid pace of the late 1990s, public consumption has continued to grow fast, as new obligations by central government and popular demand led municipalities to expand service provision. After some consolidation in 2003, local government spending has accelerated again and the deficit has widened to ¾ per cent of GDP in 2004 for the municipalities considered as a whole – despite still larger transfers from central government. At the same time, the tax burden is high, especially on labour. Ensuring the sustainability of public finances over the long term, while maintaining the essential parts of the welfare society will only be possible by *i)* raising the effectiveness of public spending, *ii)* reforming the financing of municipalities to encourage better control of spending and limit future rises in municipal income taxation and *iii)* rebalancing the mix between public and private provision and funding of services. This working paper discusses ways in which progress could be made on such a policy agenda. It relates to the 2004 *OECD Economic Survey of Finland* (www.oecd.org/eco/surveys/finland) updating the Survey's analysis by incorporating data for 2004 and recent developments.

JEL classification: H2, H4, H5, H7, L3.

Keywords: Fiscal policy, fiscal federalism, local governments, property tax, income tax, public sector efficiency, welfare services, contracting out, vouchers, ageing, pensions, Finland.

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Vieillissement, services sociaux et collectivités locales en Finlande

Avec une population qui vieillit plus rapidement et plus fortement que dans les autres pays de l'OCDE, la Finlande se trouve dans l'obligation d'ajuster ses priorités budgétaires afin d'en assurer la viabilité à plus long terme. Il faudra pour cela des réformes considérables, car l'expansion des dépenses publiques est actuellement très forte. Bien que la croissance du PIB se soit ralentie par rapport à son rythme exceptionnellement rapide du début des années 90, la consommation publique a continué à progresser rapidement, les nouvelles obligations imposées par l'administration centrale et par la pression des usagers ayant amené les municipalités à accroître leur offre de services publics. Après une certaine stabilisation en 2003, les dépenses des collectivités locales se sont à nouveau accélérées et le déficit a été porté à ¾ pour cent du PIB en 2004 pour les municipalités considérées dans leur ensemble – malgré le versement de transferts encore plus importants par l'administration centrale. Quant à la charge fiscale, elle reste élevée, surtout celle qui pèse sur la main-d'œuvre. Il ne sera possible d'assurer la stabilisation à long terme des finances publiques tout en maintenant les éléments essentiels de la protection sociale qu'à condition *i)* d'améliorer l'efficacité des dépenses publiques, *ii)* de réformer le financement des communes pour les inciter à mieux contrôler leurs dépenses et limiter les augmentations futures de l'impôt municipal sur le revenu et *iii)* de rééquilibrer le partage entre le secteur public et le secteur privé dans l'offre et dans le financement des services publics. Ce document de travail examine les moyens de progresser dans la réalisation de ce programme. Il se réfère à *l'Etude économique de 2004 de l'OCDE sur la Finlande* (www.oecd.org/eco/etudes/finlande) et met à jour les analyses effectuées dans cette étude en y insérant des données pour 2004 et en prenant en compte l'évolution récente.

JEL classification : H2, H4, H5, H7, L3.

Mots clés : Politique budgétaire, fédéralisme budgétaire, collectivités locales, impôt immobilier, impôt sur le revenu, efficience du secteur public, services sociaux, externalisation, bons d'achat, vieillissement, retraites, Finlande.

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AGEING, WELFARE SERVICES AND MUNICIPALITIES IN FINLAND

by Jens Lundsgaard[1]

Introduction

Growth in public spending has been vigorous and pressure for raising spending is likely to continue to be strong, especially due to ageing. At the same time, the tax burden is high, especially on labour and this is widely seen as an obstacle to achieving the governments' employment target (OECD, 2004d, chapter 3). Achieving the government's medium-term objectives and ensuring the sustainability of public finances over the long term, while maintaining the essential parts of the welfare society will only be possible by *i)* raising the effectiveness of public spending, *ii)* reforming the financing of municipalities to encourage better control of spending and limit future rises in municipal income taxation and *iii)* rebalancing the mix between public and private provision and funding of services. The recent *OECD Economic Survey of Finland* released in October 2004 (OECD, 2004d) analysed ways in which progress could be made on such a policy agenda. Since then, municipalities have announced their income tax rates for 2005 implying an increase by 0.2 percentage point relative to 2004. Thereby, the average municipal income tax has gone up every single year since 1997, prompting the permanent secretary of state of the Ministry of Finance to warn that "if local authorities do not rapidly initiate the necessary reforms, there will be no limit to the rise in municipal taxes".[1] Moreover, a government working group has published a set of proposals for adjustments of municipal finances and state grants in December 2004. Against that background, this working paper updates the analysis of the *Economic Survey* and contrasts the proposals of the government working group with the OECD assessment and recommendations in the *Economic Survey* of October 2004. The paper begins with an assessment of the overall fiscal position and then addresses the three policy areas listed above.

The fiscal position in the context of rapid ageing

Recent fiscal performance

1. The general government financial surplus has shrunk from a peak of 7% of GDP in 2000 to 1.9% in 2004, with this surplus more than accounted for by the social security and pension funds (**Figure 1**). While some of this decline is a result of cyclical weakness, more than half of the decline reflects discretionary fiscal policy. Although the general government fiscal balance remains in surplus, the decline in the cyclically-adjusted balance has been among the most marked in the OECD over this period, exceeded only by the United Kingdom and the United States. And with announced tax cuts, Finland is expected to remain among the OECD countries with the most expansionary fiscal stances over the coming years.

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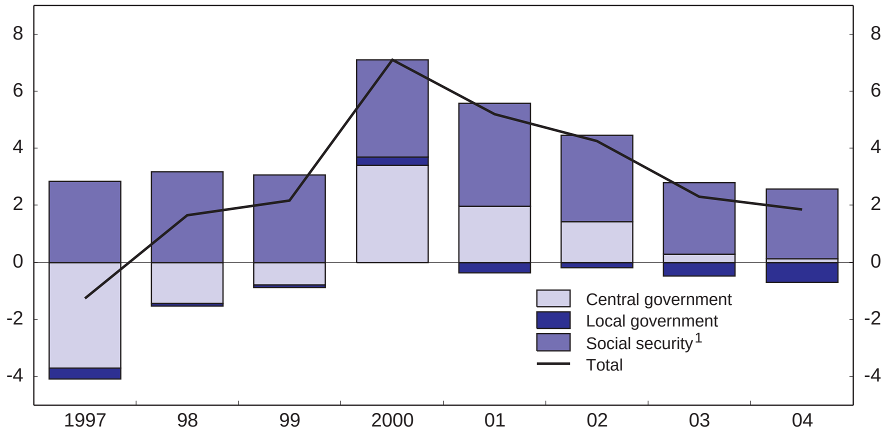
1. The author is staff at the OECD Economics Department. This paper draws on material originally produced for the *OECD Economic Survey of Finland* published in October 2004 under the responsibility of the Economic and Development Review Committee. The author is endebted to Isabelle Duong for her research assistance and to other colleagues in the Economics Department for their helpful comments, in particular David Turner, Peter Hoeller, Isabelle Joumard, Andrew Dean and Val Koromzay. Help from Ville Salonen at the Ministry of the Interior and Antti Moisio at the Government Institute for Economic Research (VATT) in accessing Finnish administrative and research material has been crucial. Any opinions expressed in this paper are the author's and should not be attributed to the Organisation or its member countries.

Figure 1. Recent fiscal developments
In per cent of GDP



1. Including employment pension funds.

Source: Statistics Finland.

2. The fiscal stance has been looser than implied by the fiscal objectives of the previous government, elected in 1999, which was to maintain a general government surplus of about 4½ per cent of GDP by keeping central government spending at its 1999 level in real terms until 2003.[2] Repeated expenditure slippage, however, meant that central government spending in 2003 was about 8% above the 1999 level (**Figure 2**, panel A). The current government's fiscal policy objectives are less ambitious and aim for a gradual increase in central government spending of 4% in real terms over the four-year period to 2007, which is equivalent to ¾ per cent of GDP (**Box 1**). The central government spending limit for 2005-08 decided in spring 2004 and the limits for 2006-09 did *not* revise upwards the limits set in 2003 for 2004-07, and the 2005 budget respects these limits (Ministry of Finance, 2004a, 2005a and 2005b). However, developments in the municipal sector, which accounts for three-quarters of public employment, risk undermining fiscal discipline. In particular, the acceleration in municipal consumption spending since 2001 is a matter for concern because it has driven up municipal income tax rates which are set by municipalities individually and are outside the control of central government (**Figure 2**, panel B). After a year of consolidation in 2003, the volume of municipal public consumption resumed rapid growth at a rate of 2.8% in 2004. Total public consumption volume has expanded by an annual average of 2% from 1995 to 2004 and public employment by close to 1¼ per cent. Whereas private sector employment is still 8% below the pre-crisis level in the early 1990s, public employment is now above its pre-crisis level. During the second half of the 1990s, strong private sector productivity growth, improvements in aggregate labour utilisation and modest public sector wage developments meant this expansion could be accommodated without a rise of the share of public consumption in GDP. However, with potential growth having slowed since 2000 and public sector inflation having increased, the share of public consumption in potential GDP has risen by 1 percentage point, demonstrating the need for public spending to adjust to a less optimistic outlook for potential growth.

3. Although recent budgets have cut income and indirect taxes substantially (**Box 2**), taxation of labour is still very heavy. Both the average and the marginal tax wedge on labour are among the highest in the OECD, even after the tax cuts implemented in recent years (**Figure 3**). Reducing the tax wedge on labour further is therefore of great importance for longer-term performance, given the increasing mobility of skilled labour and growing evidence that high tax wedges act as a disincentive to work effort. But with the ongoing global recovery, it is increasingly important to match tax cuts with spending restraint or with increases in other taxes, such as property taxes, that are less distortionary than labour taxes. The income tax cuts implemented in 2003 and 2004 have helped sustain growth during the global downturn, but with the output gap expected to close in 2005, demand stimulus is no longer needed. Tax cuts should now focus on bringing about structural improvements in employment and business activity on a permanent basis.

Box 1. The fiscal policy objectives

The government's fiscal policy objectives are set out in the June 2003 government programme and stipulate:

- The central government debt-to-GDP ratio must be reduced (excluding cyclical factors).
- The government aims to secure balanced central government finances under normal conditions of economic growth (*i.e.* in cyclically-adjusted terms) at the end of the electoral period in 2007, measured in terms of national accounting.
- Growth in real spending by central government is limited to EUR 1.12 billion over the four year electoral period. A similar amount is envisaged for tax cuts.

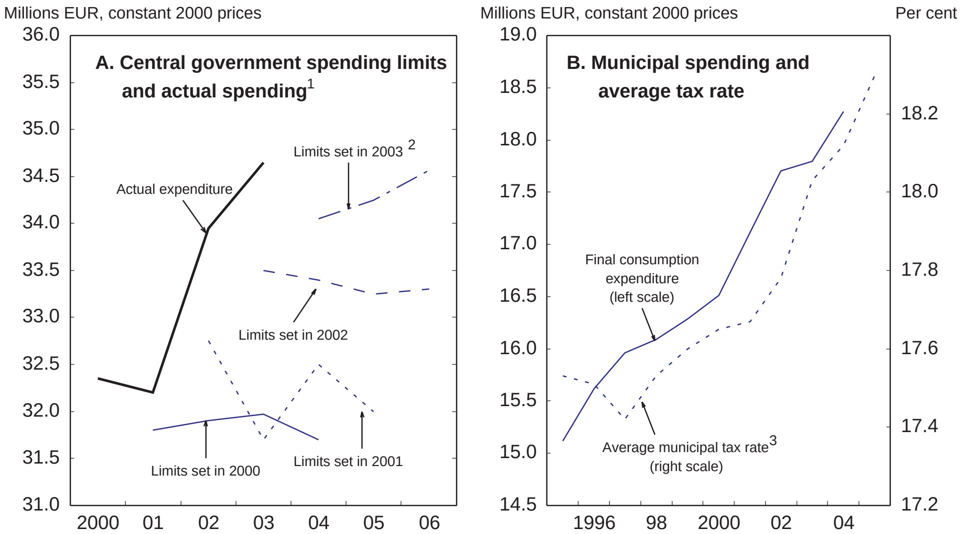
The institutional framework gives particular emphasis to the spending objective via the decision on central government spending limits made by government and communicated to parliament each year in March. Each year the spending limits are updated reflecting price and cost developments and structural changes in the budget, but the government has emphasised that apart from these technical adjustments, the limits are not supposed to be changed.

The spending limits cover all central government outlays (including transfers to municipalities) except variations in social security spending reflecting business cycle movements, interest payments on public debt and a few other spending items such as government spending covered by revenues received from the European Union. Consequently, the spending limits concern about 75% of the central government budget and accounts for about 20% of GDP. Municipalities, on the other hand, are *not* constrained by these spending limits and can determine spending and tax rates autonomously.

To avoid an excessive deficit, the fiscal framework includes an "emergency brake" stating that "the government's underlying premise is that the central government deficit, in national account terms, should not exceed 2¾ per cent of GDP *even* in conditions of weak economic development. If, *in the light of forecasts*, the deficit *threatens* to grow larger than this, the government will, *without delay*, propose the necessary measures for reducing expenditures as well as other measures to avoid an overrun."

Source: Prime Minister's Office (2003), Ministry of Finance (2003a, 2004a and 2005b).

Figure 2. Expenditure slippage and municipal tax hikes



1. Following the definitions of the central government budget, not the national accounts. Includes transfers to municipalities.
2. These are the limits set by the old government. The expenditure limits of the new government exclude cyclical components and interest payments and are therefore not directly comparable.
3. Weighted by taxable income.

Source: Ministry of Finance, Statistics Finland and the Association of Finnish Local and Regional Authorities.

Box 2. Recent budgets and tax cuts

The 2003 and 2004 budgets

Reducing the taxation of earned income has been a key element of the 2003 and 2004 budgets as well as of the supplementary budget for 2003 introduced after the change of government in May 2003.

- State income tax rates were cut by 1 percentage point at all income levels from January 2004, following a similar reduction by ½ percentage point from January 2003 and ½ percentage point from July 2003 (0.4% of GDP). Thresholds in the state income tax scale were increased by 1% each year (0.1% of GDP). Also the maximum deduction for work-related expenses was raised (0.2% of GDP) and the maximum earned income allowance in municipal taxation has gradually increased from EUR 2 140 in 2002 to EUR 3 550 in 2004 (0.3% of GDP) which should raise incentives to work at low income levels.

- Car taxation was reduced by 14% from January 2003 and alcohol taxation was cut by a third from March 2004 to counter cross-border trade following EU enlargement (0.3% of GDP). Conversely, energy taxation was raised by 5% in 2003 (0.1% of GDP).

Spending was raised in several areas with active labour market policies and health care standing out as the main examples (0.1% of GDP each). Transfers to municipalities have been raised to compensate for cost increases in health and social services and loss of tax revenue because of the increase in the earned income tax allowance (0.4% of GDP).

Income tax cuts announced following the collective wage agreement reached 29 November 2004

Personal income taxes will gradually be reduced by a further 1.1% of GDP until 2007. In 2005, state income tax rates are cut by ½ percentage point in most income brackets and the maximum earned income allowance in municipal taxation is increased to EUR 3 850 (0.2% of GDP). Also, thresholds in the state income tax scale are raised by 2% to reflect inflation (0.1% of GDP). The tax credit for domestic help is also expanded.

In 2006, state income tax rates will be cut a further 1 percentage point (1½ percentage point for the lowest income bracket) and a new earned income allowance will be introduced for state income taxes, supplementing that in municipal taxation (0.5% of GDP).

Finally in 2007, the rearrangement of income brackets and tax rates is completed and the earned income allowance in state taxation is increased (0.3% of GDP).

Corporate and capital tax reform in the 2005 budget

A reform of corporate and capital taxation came into force at the beginning of 2005. The immediate net fiscal effect will be a reduction of tax revenue by ¼ per cent of GDP.

- The corporate income tax rate is reduced by 3 percentage points to 26% and the tax rate on investment income paid by individuals is reduced by 1 percentage point to 28%. In order to neutralise the revenue effects for municipalities, the share of corporate tax revenue flowing to municipalities increases from 19¾ per cent to approximately 22% from 2005.

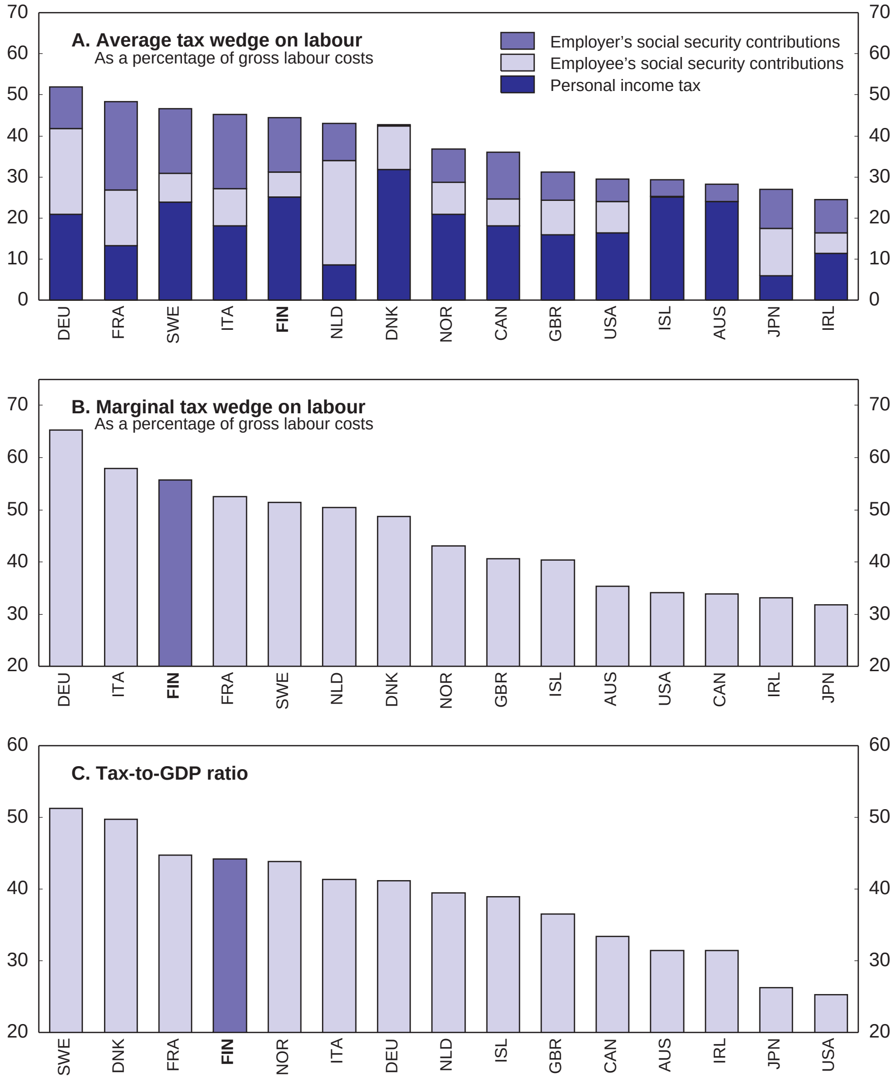
- Partial double taxation of dividends will be introduced. Revenue on voluntary pension insurance schemes will be taxed as capital income instead of as earned income. The transfer of enterprises to descendants is now taxed less. The net wealth tax rate is reduced in 2005 and will be completely abolished from 2006. Companies are no longer taxed on the gains from sales of assets but cannot deduct losses either.

Other elements in the 2005 budget

The budget contains a series of smaller initiatives, but respects the spending limits originally announced in May 2003 and noted in the government programme. For 2005 the spending limit is EUR 28.8 billion out of which 28.5 billion is allotted in the budget with the remaining 0.3 billion left to cover salary increases for government employees and any supplementary budget spending introduced during the fiscal year. State grants to municipalities are adjusted upwards by the equivalent of ¼ per cent of GDP in 2005 to reflect an increase in costs for statutory tasks incurred over recent years. The budget entails state net lending of -0.6% of GDP in 2005.

Source: Ministry of Finance (2003b, 2003c, 2003d, 2004b, 2004c, 2004f and 2005a).

Figure 3. Tax wedges on labour[1] and aggregate tax-to-GDP ratio
2003



1. For a single individual at the income level of the average production worker. 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, *Taxing Wages 2000-2003.*

The governments medium term fiscal projections

4. The November 2004 Stability Programme projections (Ministry of Finance, 2004d) suggest that the general government surplus will remain at about 2% of GDP until 2008, by which time the output gap is projected to have closed (**Table 1**). Given that the pension and other social security funds are projected to run surpluses above 2½ per cent of GDP, this implies that the central government would miss its target to be in balance by the end of the electoral period in 2007 and instead remain in deficit by around ½ per cent of GDP over the period from 2005. Taxes are projected to fall by almost 1% of GDP between 2003 and 2007, but this is partly offset by higher social security contributions (up ¾ per cent of GDP). Total expenditure is projected to decline slightly as a share of GDP, matching the decline in revenues. But there

is a change in the balance between public consumption and capital spending; gross fixed capital formation is projected to fall to just over 2½ per cent of GDP, which will be the lowest level in more than three decades, while public consumption (collective and individual) rises by ½ per cent of GDP to the highest level since the mid-1990s. In summary, it appears that, absent positive surprises, the government risks missing its fiscal objectives – the same conclusion emerges from the OECD's medium-term baseline projection. Nevertheless, the general government surplus as a share of GDP would remain among the highest in the OECD, raising the question as to whether this is an issue of major concern.

Table 1. The 2004 Stability Programme fiscal projections

Per cent of GDP

	2003	2004[1]	2005[1]	2006[2]	2007[2]	2008[2]	Change 2003-07
Financial balance							
General government	2.1	2.0	1.8	2.1	2.2	2.0	0.1
Central government	0.2	0.0	-0.5	-0.4	-0.3	-0.6	-0.5
Local government	-0.5	-0.4	-0.3	-0.2	-0.1	0.0	0.4
Social security funds	2.4	2.4	2.7	2.7	2.6	2.6	0.2
General government							
Total revenues	50.7	50.5	50.3	50.6	50.5	50.5	-0.2
Total expenditure	48.6	48.5	48.4	48.5	48.4	48.5	-0.2
Financial surplus	2.1	2.0	1.8	2.1	2.2	2.0	0.1
Net interest payments	0.2	-0.2	-0.3	-0.2	-0.2	-0.2	-0.4
Primary balance	2.3	1.8	1.6	1.9	1.9	1.7	-0.4
Components of revenue							
Taxes	32.3	31.8	31.5	31.4	31.4	31.3	-0.9
Social security contributions	12.2	12.3	12.6	12.9	12.9	12.9	0.7
Other revenues	6.2	6.4	6.2	6.2	6.2	6.2	0.0
Total revenues	50.7	50.5	50.3	50.6	50.5	50.5	-0.2
Spending components							
Collective consumption expenditure	7.9	7.9	8.0	8.0	8.0	8.1	0.1
Individual consumption expenditure	14.5	14.6	14.7	14.8	14.9	15.0	0.4
Social income transfers	17.2	17.3	17.2	17.2	17.1	17.1	-0.1
Interest payments	2.0	1.7	1.6	1.7	1.7	1.7	-0.3
Subsidies	1.4	1.3	1.3	1.3	1.2	1.2	-0.2
Gross fixed capital formation	2.9	2.8	2.7	2.7	2.6	2.6	-0.3
Other expenditure	2.9	2.9	3	2.9	2.8	2.8	-0.1
Total expenditure	48.6	48.5	48.4	48.5	48.4	48.5	-0.2
Gross debt level	**45.6**	**44.6**	**43.4**	**42.5**	**41.7**	**41.1**	**-3.9**
Cyclical developments							
GDP output gap	-0.8	-0.2	0.2	0.2	0.0	0.0	0.8
Cyclically-adjusted balance	2.6	2.1	1.7	2.0	2.1	1.9	-0.5
Cyclically-adjusted primary balance	4.6	3.8	3.3	3.6	3.8	3.7	-0.8

1. Estimate and macroeconomic forecast.
2. Medium-term projection.

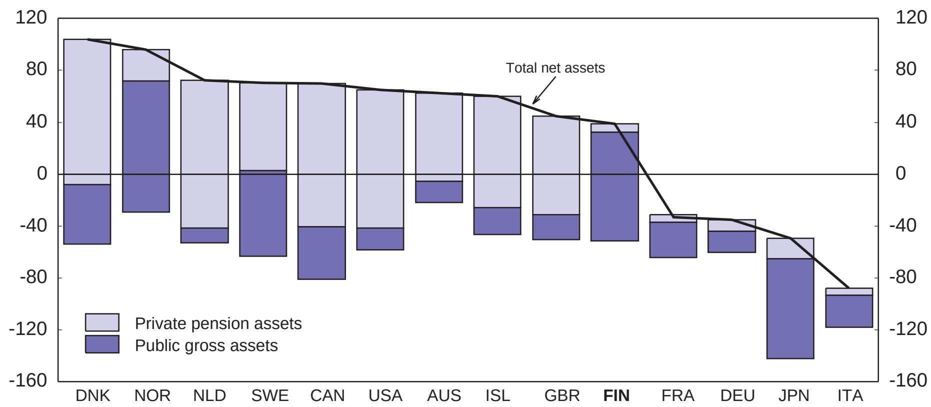
Source: Ministry of Finance, Stability Programme for Finland, November 2004 update.

The current fiscal position appears strong, but this is partly misleading

5. Comparisons of the general government's surplus (at 1.9% of GDP in 2004) and net asset position (34% of GDP) with other OECD countries can, however, be misleading because of the inclusion of the pension funds within general government. While, of course, the assets held by pension funds should be taken into account when assessing fiscal sustainability, other countries accumulate pension assets in schemes that are recorded outside general government. Some of these are mandatory and some are voluntary. Including such private sector pension assets changes Finland's comparative position considerably (**Figure 4**). In particular, a comparison with Denmark and the Netherlands is striking, because their occupational pension schemes are compulsory or quasi-compulsory, but they are recorded in the private sector. At respectively 104 and 73% of GDP the combined net asset position of general government and private pension schemes jointly is considerably stronger than that of Finland at 39% of GDP in 2001. Compared to the large continental European countries, however, Finland is relatively well prepared for ageing by having partly pre-funded the future pension liabilities for the earnings-related pension with substantial assets held by the pension funds.

Figure 4. Government and private pension assets[1]

2001, in per cent of GDP



1. Combined assets of general government and private tax-favoured retirement schemes. The lower starting point of the bars is public gross debt as a per cent of GDP.

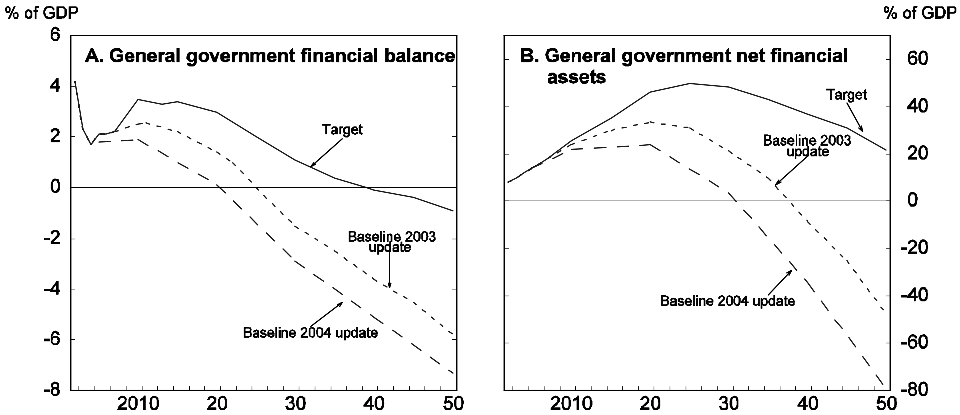
Source: OECD.

6. Long-run calculations of fiscal sustainability suggest that having accumulated net assets equal to one-third of GDP raises the sustainable expenditure level by 2% of GDP, as compared to a number of European countries with a net debt position of close to about half of GDP (**Annex A1**). However, working in the opposite direction, the fiscal room for manoeuvre is more constrained because of the timing and magnitude of the ageing shock. With ageing setting in early (about a decade earlier than in most other countries) the sustainable expenditure level is reduced by nearly 1% of GDP. Likewise, the stronger response of ageing-related public spending due to comprehensive welfare provision reduces the sustainable spending level by another 1% of GDP. Thus, starting with net assets rather than net debt does *not* imply that Finland can run smaller surpluses than other countries for the rest of this decade, because ageing sets in early and pay-roll taxes may need to rise by another 5 percentage points to cover future ageing-related spending, even after the recent pension reform.

Ensuring fiscal sustainability will require continued policy reform

7. With ageing happening earlier and more rapidly that in most OECD countries, the current fiscal policy is not sustainable in the sense that the current generosity of pension and transfer incomes and spending on public services cannot be maintained at current levels without raising taxes in the future. If current policies are maintained, OECD calculations indicate a need to consolidate government finances by 1 to 2% of GDP and run general government surpluses of 3 to 4% of GDP for the rest of the decade, even assuming some improvement in the employment rate (**Annex A1**). The government's own projections have arrived at a similar result; the "baseline scenario" of Finland's stability programme suggests that a continuation of current policies will imply general government surpluses of about 2% of GDP over the remainder of the decade which will eventually result in accelerating debt as the fiscal costs of ageing materialise, leaving a bill to be paid by future generations (**Figure 5**). The baseline scenario looks even worse in the latest (November 2004) update than in the November 2003 update, as more age-related public spending has been included in the calculations, such as sickness insurance expenditure. Conversely, an alternative "target scenario" included in the Stability Programme's November 2003 update assumes additional fiscal consolidation measures (an unspecified combination of tax increases and spending cuts) in the years 2008-10, after the current electoral term, which is sufficient to raise the surplus by about 1% of GDP and avoid a sharp deterioration in debt (or any need to raise taxes) in future decades.

Figure 5. Long-term fiscal scenarios[1]



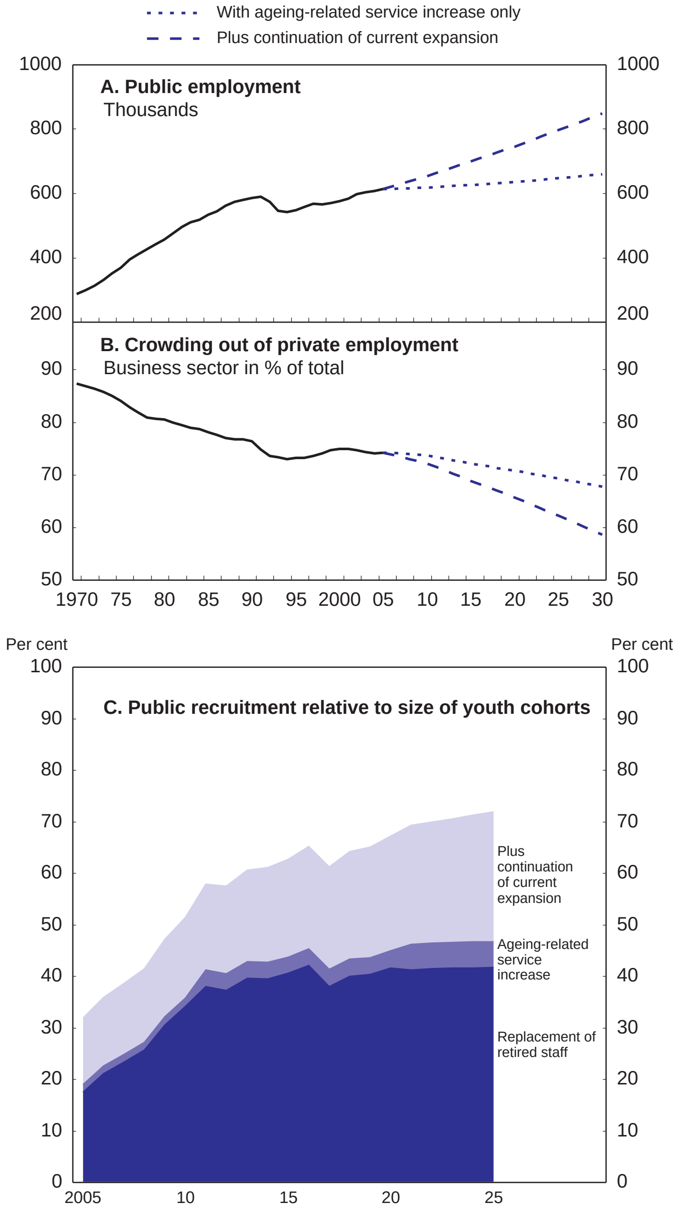
1. The baseline scenarios assumes a constant tax rate, whereas the target scenario assumes additional consolidation (expenditure cut and revenues increased) so that the financial balance is 1% higher than in the baseline by 2010.

Source: Ministry of Finance, "Stability Programme for Finland", November 2003 update for baseline 2003 and target scenario, and November 2004 update for baseline 2004 scenario.

8. The need for fiscal prudence is further underlined when viewed from the perspective of the labour market because a continuation of the current expansion in public sector employment would have dramatic consequences for private sector employment once ageing sets in strongly. Between now and 2025, merely meeting the demographically determined additional service demand would imply an increase in public sector employment by about 6%. However, with the population of working age expected to decline by about 11% over the same period, and in the absence of any improvement in the aggregate employment rate, the share of the business sector in total employment would fall from 74 to below 70%.[3] But public employment actually expanded by close to 1½ per cent annually from 2000 to 2003 – an increase that cannot be attributed to demographic changes – and if this continues on top of the ageing-related increase, then the share of business sector in total employment would fall to 60% two decades from now (**Figure 6**, panel A and B).[4] The problem is aggravated by the fact that public sector retirement will double less than a decade from now. Currently, replacing those who retire from the public

sector requires the equivalent of one in five of the young entering the labour market. But with more rapid retirement, it will require two in five already in the next decade, and if the current expansion of public employment were to continue in addition to ageing-related service spending, the equivalent of *three out of every five* persons entering the labour market would have to enter the public sector (**Figure 6**, panel C).[5] A substantial improvement in public sector productivity is therefore the only viable option for the longer term so that a growing service demand can be met without increases in public employment that would crowd out private sector demand.

Figure 6. Scenarios for public employment



Source: OECD.

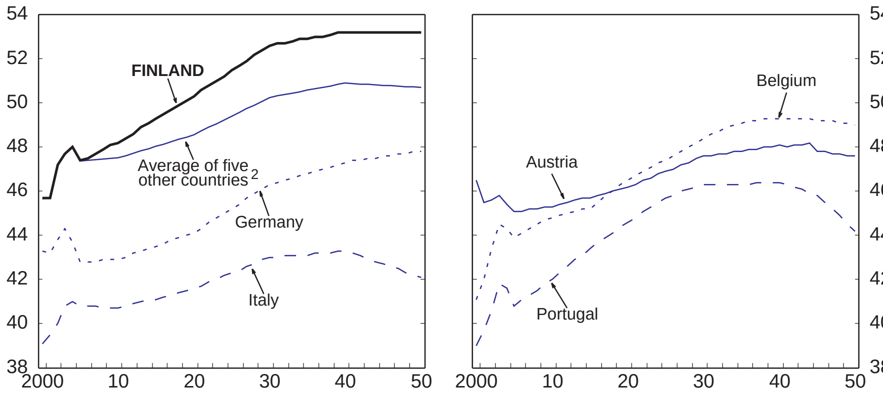
9. To ensure fiscal sustainability, and create room for further tax cuts, three broad policy directions should be pursued in addition to reforms to raise employment.

- *Raise efficiency in public services*. Even modest efficiency improvements in the provision of publicly funded services can contribute to substantial fiscal improvements if continued year after year. A recent exercise by the Bank of Finland (Kinnunen, 2002) suggested that modest public sector productivity growth in ageing related public services (especially health) would significantly improve long-term fiscal sustainability, and by more than the effect of the pension reform to be implemented in 2005. Nevertheless, it should not be underestimated how demanding it will be to achieve even modest productivity improvements as productivity has declined during recent years.
- *Reform the financing of municipalities.* Recent increases in municipal spending and deficits raise concerns that they will eventually lead to further increases in municipal income tax rates, which will thwart the objective of reducing the overall tax burden on labour. Reforms which lead to greater certainty in the revenues available to municipalities and provide them with greater incentives to expand their tax bases or pursue more efficient spending might reduce some of this pressure. In addition, changes to the menu of taxes available to municipalities should be considered.
- *Reconsider the priorities for public spending*. Public spending, including transfer payments, is a relatively large share of GDP and ageing will lead to further upward pressure (**Figure 7**). To cope with these pressures there is a need to consider what the core welfare services are and whether future increases in service demand can be met via private funding. There is also a need to reduce the cost of transfer payments, which account for a relatively large share of public spending. This share rose in parallel with that of the other Nordic countries (excluding Iceland) over the 1970s and 1980s, increased steeply during the deep recession of the early 1990s, but although it has declined since then, it has maintained a persistent differential *vis-à-vis* Denmark, Norway and Sweden of 4 percentage points (**Figure 8**). Thus, one way of safeguarding the core welfare services, while creating the room for tax cuts, is to reduce transfer payments. Reform of some of these schemes, particularly those relating to early retirement, could also improve labour market performance.

10. The means by which progress along these lines can be made is discussed in the remaining part of this working paper. Until such reforms are implemented, it appears prudent to balance, at the very least, the central government finances.

Figure 7. Ageing related change in public spending[1]

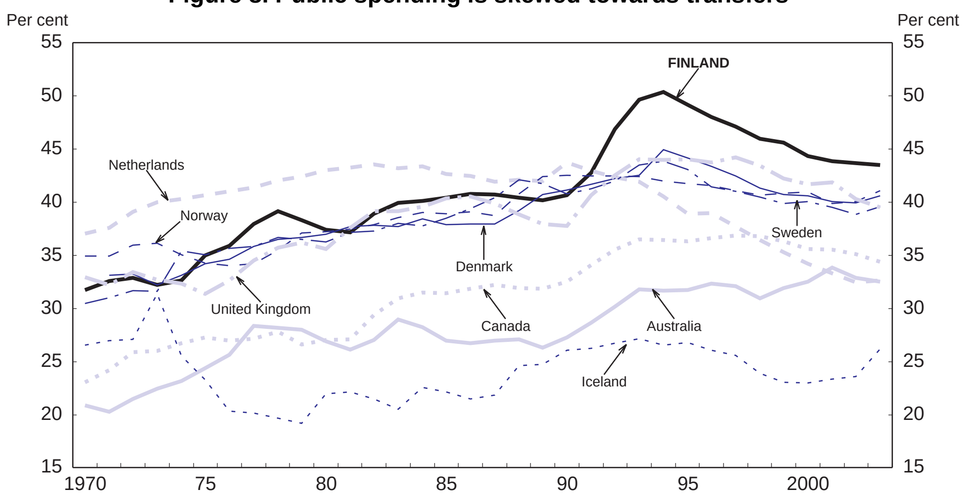
Primary current expenditure in per cent of GDP



1. The countries included here are those for which reasonably comparable information is available in the Stability Programmes 2003/04. The projections include demographically induced changes in spending on pensions and health care for all countries shown here. For Germany and Italy education and unemployment benefits are also included, for Portugal education and child care, and for Belgium early retirement, occupational diseases and industrial accidents, unemployment and family allowances.
2. Percentage point increase similar to that of the weighted average of Austria, Belgium, Germany, Italy and Portugal, but rebased to match primary current expenditure in Finland in 2005.

Source: National Stability Programmes, (ultimo) 2003 updates; OECD.

Figure 8. Public spending is skewed towards transfers[1]



1. Social security transfers as a percentage of the sum of public consumption and social security transfers.

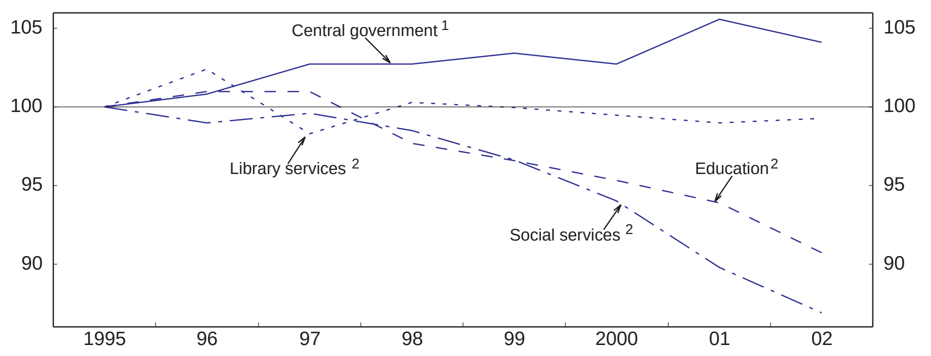
Source: OECD.

Improving services via more efficient provision

11. Due to the nature of public welfare services there are difficulties in measuring productivity. Nevertheless, even allowing for measurement problems, there has been a worrying decline in productivity in delivering public welfare services since the late 1990s, particularly in education and social services provided by municipalities, which comprise a large share of overall municipal spending (**Figure 9**).[6] This reflects an upward drift in spending that is not matched by increased service provision. Moreover, although there is a popular perception that the rise in service spending over recent years has only made up for cuts in the crisis years of the early 1990s, total public employment already reached its pre-crisis level in 2001.

Figure 9. Productivity in public administration and services

Index 1995 = 100



1. Includes also administrative functions and services such as the police which are localised across the country, but are part of the central government sector. Measured figures cover about 69.5% of the central government sector.
2. Provided by municipalities.

Source: Statistics Finland.

12. While cost containment brought efficiency gains during the 1990s, other mechanisms are needed now to ensure value for money in publicly-funded services. The deep cuts in public employment and service spending during the recession of the early 1990s were undoubtedly difficult to manage, but appear to have had the beneficial effect of reducing non-essential spending. In health care, for instance, productivity in both hospitals and local health centres had declined steadily during the 1980s, but the trend was reversed with substantial productivity improvements in the early 1990s. Thus, the reductions in inputs taking place in the early 1990s did not lead to a commensurate decline in measures of output such as number of patient visits or operations. The implied productivity gains were maintained during the mid-1990s, but between 1997 and 2001 productivity has fallen sharply in health centres (Järviö, 2004).

13. Increases in spending over recent years have been motivated by the desire to expand service provision, but in practice, the extra resources have not paid off in terms of more output or better outcomes. This may reflect a misperception of the extent to which extra input actually matters for service quality. For example, in the case of schools, the evidence shows that the number of students per teacher matters only slightly for learning outcomes unless class size becomes large (above 25 to 30 students). Finland is a good example of this, boasting the number-one position regarding the ability of 15-year olds to read, understand and analyse a text as measured in the PISA study, despite the fact that the number of students per teacher and spending per student are both close to the OECD average (Hanushek, 2002; OECD, 2001 and 2003a).[7] To bring about improvements in outcomes, any spending increases therefore have to be tightly targeted based on available evidence of where it can produce improved outcomes. Moreover, the variation in cost-efficiency across municipalities indicates that substantial improvements are possible if more were to adopt best practice. A recent study of municipal health care centres found some evidence of improvement of

those centres having low productivity in 1997, but still with large variation remaining (**Figure 10**; Järviö and Räty, 2003).

Figure 10. Variation in health centre productivity

Source: Government Institute for Economic Research, VATT.

14. With the aim of raising public sector productivity, the government has launched a broad programme aiming at administrative simplifications, better use of IT and increased exposure to competition (**Box 3**). This initiative is welcome as new mechanisms are needed to stop the decline in productivity in publicly-funded services and to ensure that the current standards can be maintained without increasing taxes over the medium term. A broadly based strategy should include five main elements:

- *Realise the productivity potential in administrative functions via increased IT usage which will free resources for other services.* The differential between the gradually improving productivity in central government, which has many administrative tasks, and the declining productivity in education and social services shown in **Figure 9** is striking.[8] This differential is likely to persist, as new technologies continuously widen the scope for automation of administrative procedures. To reap the full potential of IT investments, however, it is essential that the necessary organisational changes are implemented and this may include adjustments in the allocation of tasks between central government and municipalities (OECD, 2003b).

- *Ensure better control and prioritisation in the ongoing expansion of service spending*. While IT can bring administrative savings, such savings are not enough to match the magnitude of the current expansion of service spending or to offset the productivity declines in other services. A better management of resources in these other services is therefore of vital importance to prioritise and focus increases in public service spending on where they bring most value. In this respect a closer dialogue between central government and municipalities to clarify the limited fiscal room for increased service spending is important. In any case, simply spending more money will not work as the labour force is contracting in aggregate.

- *Increase the use of benchmarking.* Contrary to other Nordic countries, such as Norway, detailed published benchmarking of municipalities is underdeveloped in Finland. While many data are recorded, these results could be made more widely available, for example by publishing league tables of input and output indicators

- *Change the way funding is allocated among service providers to improve incentives to be more efficient.* Sharpening incentives via funding mechanisms is more effective than specific targets for client satisfaction. Experience from other OECD countries shows that attempts to drive through improved performance via centrally-stipulated, detailed quantitative targets for service outputs can also have adverse effects (OECD, 2004a). However, broader quantitative measures and targets can be important in guiding the overall priorities and reallocation of resources across services. Activity-based funding in health care could be better developed given the international evidence showing that waiting times for surgery are not simply determined by how much money is spent on health care, but just as much by the way in which funding is allocated among hospitals. Countries that involve some degree of activity-based funding typically have shorter waiting times than countries in which hospitals receive fixed budgets (**Figure 11)**.

- *Increase the use of contracting out.* The scope for contracting out is large not just for support functions, but also for social and welfare services. Non-profit institutions and private firms already play an important role in providing institutional placement for children and youth, adapted housing for the elderly and disabled, helping substance abusers and providing work rehabilitation (**Figure 12)**. But the role of non-profit institutions and private firms is surprisingly little developed in institutional care and home help for the elderly and disabled and in day care for children, which are the three largest areas of social services.[9] Moreover, in comparison with other countries, there seems ample scope for involving a wider mix of providers thereby increasing contestability in service provision. In Norway for example, private institutions receiving public funding cater for two in five children in institutional day care (**Figure 13)**. Replacing municipal institutions with other providers is not a goal in itself, but the very low share of non-public providers indicates that moving towards a wider mix of providers could raise efficiency by making service provision contestable and testing and spreading innovations in work organisation and service provision. In some social services, private providers are highly concentrated in the Uusimaa region surrounding the capital, but in all services, some private providers exist in virtually every region.[10]

Box 3. The government's programme to raise public sector productivity

The programme aims at substantial productivity gains over the medium term. The main channels for improving productivity are:

- Adjustment of administrative procedures relating to accounting, human resource management, etc. with a view to simplify procedures.

- Increased use of information technology to introduce more self-service opportunities via the internet for citizens and firms and to make administrative data processing automatic. In connection with this, work sharing among administrative offices across regional borders will be enhanced, including call centres, and by making better use of spare capacity where it exists.

- Reaping economies of scale and scope via outsourcing of non-core and support activities.

To support this, the use of statistical information and research on public sector productivity will be enhanced. While the basic data for productivity analysis exist, they are so far used only sparingly to monitor and analyse productivity developments, for example in health care and education. The ongoing efforts aim to provide these productivity data to municipalities and to supplement them with data monitoring client satisfaction and the work load experienced by staff. Also, a set of processes related to the annual budget cycle are being implemented:

- In its budget proposal, each ministry has to prepare a plan for enhancing productivity covering also activities funded by transfers to municipalities and non-government organisations. This procedure will begin with the budgets for 2006 to be prepared during 2005.

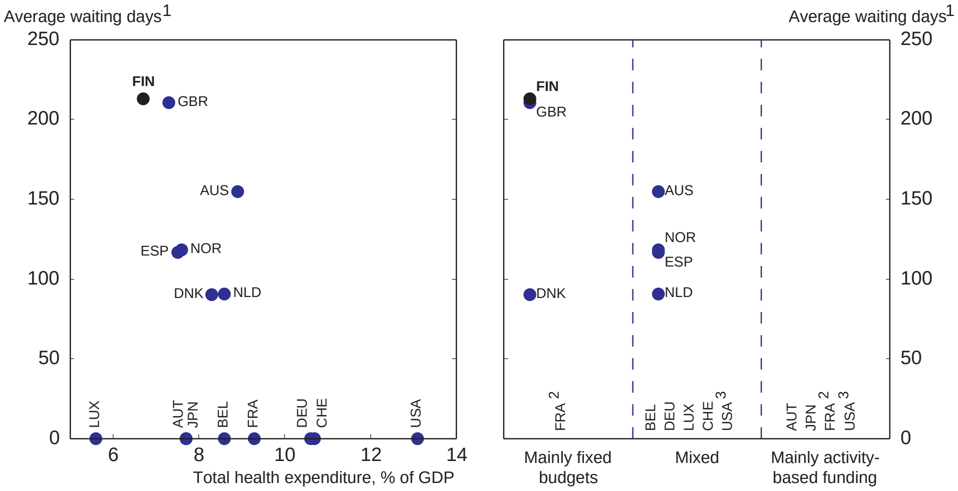
- Within the newly established Basic Services Programme a document evaluating the balance between municipal welfare services and public funding is now part of the annual decision on central government spending limits which include grants to municipalities. This document includes a chapter on efficiency and measures to raise it (Ministry of Interior, 2004a).

- While the budget system encourages efficiency gains as each ministry has a fixed budget envelope that allows ministries to reallocate funding to the activities and purposes they find most valuable, the incentives to invest in for example IT solutions that can bring future savings, may be more muted. To address this issue, the Ministry of Finance is considering an arrangement to allow ministries to "borrow" extra budget resources for such investments conditional on a clear plan for how productivity gains are to be achieved and future savings to be "paid back" via reductions of the ministry's future budget envelope.

At a later stage, it is intended to set quantitative targets for productivity growth based on the plans drawn up by ministries.

Figure 11. Waiting times, spending and incentives

2000



1. Mean waiting times for persons admitted for inpatient surgery. Simple average for hip replacement, knee replacement, cataract surgery, varicose veins, cholecystectomy, and inguinal and femoral hernia.
2. In France, public hospitals have fixed budgets, while private hospitals treating publicly funded patients receive activity-based funding.
3. In the United States, Health Maintenance Organisations use mixed funding mechanisms, while the public Medicare programme uses activity-based funding.

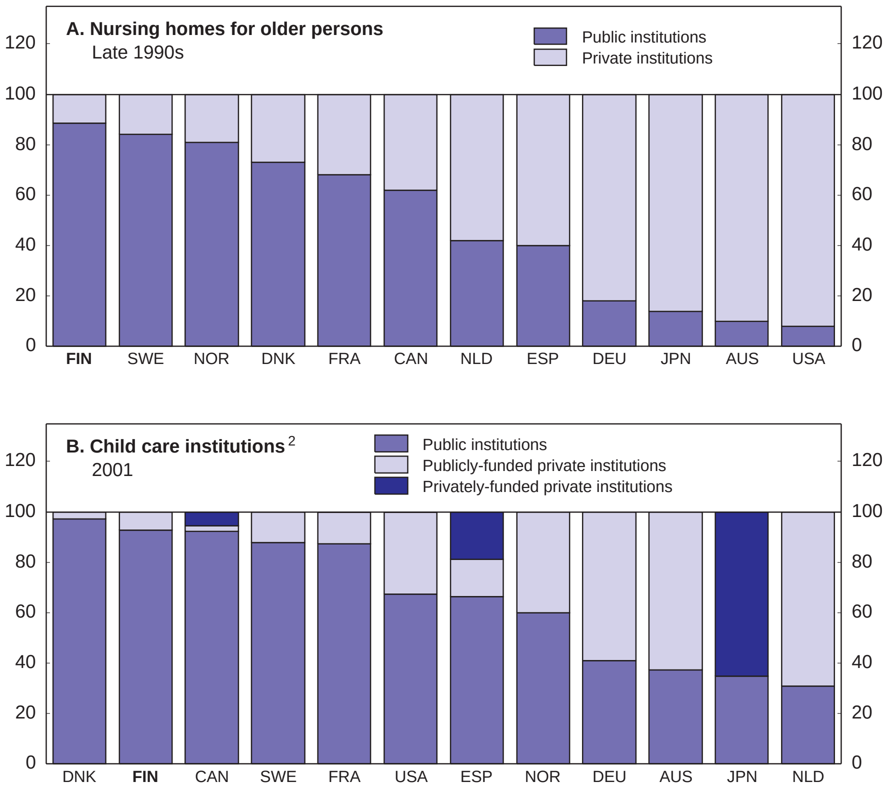
Source: OECD Health Data 2003; Siciliani and Hurst (2003), "Explaining Waiting Times Variation for Elective Surgery across OECD Countries", *OECD Health Working Papers*, No. 7.

Figure 12. Public and private providers by service area

Share of total output value, 2002

Source: Employers' Confederation of Service Industries.

Figure 13. Public and private service providers:[1] an international comparison



1. Based on the number of users in each type of institution. Private institutions include both non-profit institutions and private firms.
2. Includes pre-primary education and organised centre-based programmes designed to foster learning and emotional and social development in children from 3 years to compulsory school age. For Australia, Germany and Norway, some of the private institutions may be predominantly privately funded, but the available data cannot determine the exact share of private and public funding for private institutions.

Source: OECD.

15. Considering the large number of comparatively small municipalities, mergers should lead to economies of scale. With an average size of 11 400 inhabitants, Finnish municipalities are much smaller than in Sweden where the average size is 30 700 inhabitants. Moreover, in Denmark, where the average size is 19 600 inhabitants, a completely reformed municipal structure will take effect from the beginning of 2007. The guiding principle is that municipalities should have a minimum size of 30 000 inhabitants and those below 20 000 having refused to merge have been forced to enter into binding partnerships with other nearby municipalities to ensure professional sustainability in the tasks they perform (Danish Ministry of the Interior, 2004 and 2005). However, mergers do not automatically ensure gains in cost-effectiveness or lower taxes, as research has been unable to find clear evidence of reductions in total spending in those Finnish municipalities that have merged (Moisio and Uusitalo, 2003) over recent decades. While mergers have led to savings on administrative functions, total spending has typically increased more than in comparable municipalities as extra spending growth notably in education and health care has more than offset savings on administrative functions. Based on the available research, it is not clear whether this extra spending growth reflects higher service standards or inefficiencies. For a number of years, policy promotes mergers via central government grants to cover the preparatory costs, but this has only led to very few mergers in recent years. For municipal mergers to be instrumental in meeting the fiscal objectives, a more active approach to inducing consolidation and co-operation among the many municipalities focused clearly on improvement in cost efficiency is therefore needed so that the potential economies of scale lead to cost savings.

16. It is therefore encouraging that the government in April 2005 has issued a review of the structure of municipalities as well as the state administration preparing for a larger reform (Ministry of the Interior, 2005). The basic principles set out by government are that the size and population base of municipalities must be sufficiently large to ensure professional service provision, and in particular specialised health care should be provided by larger units. To improve cost effectiveness, it is also envisaged to involve a wider variety of providers including incorporation of current public entities and more purchase of service from private sector entities in order to benefit from economies of scale. These principles are to be followed up by an action plan before autumn 2005 leading to a genuine reform of the municipal structure with legislation to be presented before the end of 2008.

Reforming the fiscal framework guiding municipal spending and taxation

17. While there appears to be ample scope for raising productivity in public services, it is equally important to assure that municipalities have incentives to pursue these options. With a favourable macroeconomic environment, the risk is that spending simply drifts up leading to slack rather than genuine service improvements.

18. Municipal employment and spending growth has been remarkably rapid recently. In 2002 alone, municipal employment grew by over 2% or 10 000 persons, and on average from 1995 to 2003 employment grew 1½ per cent a year in the municipalities whereas it remained unchanged in central government. As municipalities account for three-quarters of total public employment, increases of this magnitude could undermine the government's fiscal strategy. This is illustrated by the adjustment of government transfers paid to municipalities in the 2005 budget. Legislation requires that state grants to municipalities are adjusted at four-year intervals if municipal spending on statutory tasks has increased faster than the state grant. As a consequence transfers to municipalities would have to rise ¼ per cent of GDP from 2005 onwards — which is more than the stipulated increase in the total central government spending limits from 2004 to 2005 which include grants to municipalities. Virtually all of this adjustment relates to health and social services and it came as a surprise when public finance statistics were released in late 2003 (Ministry of Finance, 2004a). To avoid deviating from its spending limits, the government has proposed to implement this adjustment only gradually over four years beginning in 2005 and to abolish this

feature of the legislation. Ending the automatic adjustment of grants should increase the fiscal responsibility of municipalities and is welcome.

19. But even without an automatic adjustment of state grants, the increased cost within municipalities can undermine fiscal policy by pushing up municipal income taxes and thereby reverse the recent central government tax cuts. The central government's grant to municipalities is part of the central government's spending limit, but otherwise municipal finances are not covered by the fiscal objectives set out in the government programme. While each municipality is obliged to balance its budget over three years, there are no limits on spending. The government does not have an explicitly stated fiscal policy objective for municipal spending developments apart from what is implicit in the medium and long-term scenarios for general government finances. While there is an ongoing dialogue to build consensus between central government and municipalities, it does not conclude with any binding agreements concerning municipal spending growth or tax rates. Each municipality has full discretion to raise its income tax rate if spending pressures accumulate. After a period of stability since the mid-1990s, average income tax rates began to increase in 2002 so that 2005 income tax rates are two third of a percentage point above the 2001 level. Further tax rises may be forthcoming as the deficit of the municipalities has risen to ¾ per cent of GDP in 2004. This corresponds to a further 2 percentage point rise in municipal income tax rates if municipalities choose to restore budget balance by tax rises rather than spending restraint. And if public consumption growth continues at current rates then tax increases could be even sharper. Indeed, rising deficits, while municipal employment is expanding by 1 to 2% annually suggests that there is too little focus on improving efficiency in municipal service provision.

20. The strength of current pressures for increased municipal spending risks causing substantial fiscal slippage over the coming years, which is also illustrated by past developments in the other Nordic countries. In Denmark, the average income tax rate of municipalities and regional authorities went up by 3 percentage points from the early 1990s to 2000 (**Box 4**). If a similar development were to occur in Finland, all of the central government reductions in labour taxation in 2003, 2004 and 2005 would be completely neutralised by the end of this decade. This underscores the urgency of reforming municipal finances and strengthening the domestic coordination of fiscal policy.

21. In December 2004, the government announced a reform of municipal finances to take effect from January 2006 (**Box 5**). The reform addresses some of the problems analysed in the Economic Survey of Finland (OECD, 2004d), but far from all. In light of the problems that adverse developments in municipal finances could bring, a number of other changes should therefore be considered, including changes to the menu of taxes available to municipalities and implementing a framework for avoiding spending hikes.

Box 4. Control problems in municipal finances in other Nordic countries

Municipal service spending caused substantial fiscal slippage in Denmark during the 1990s

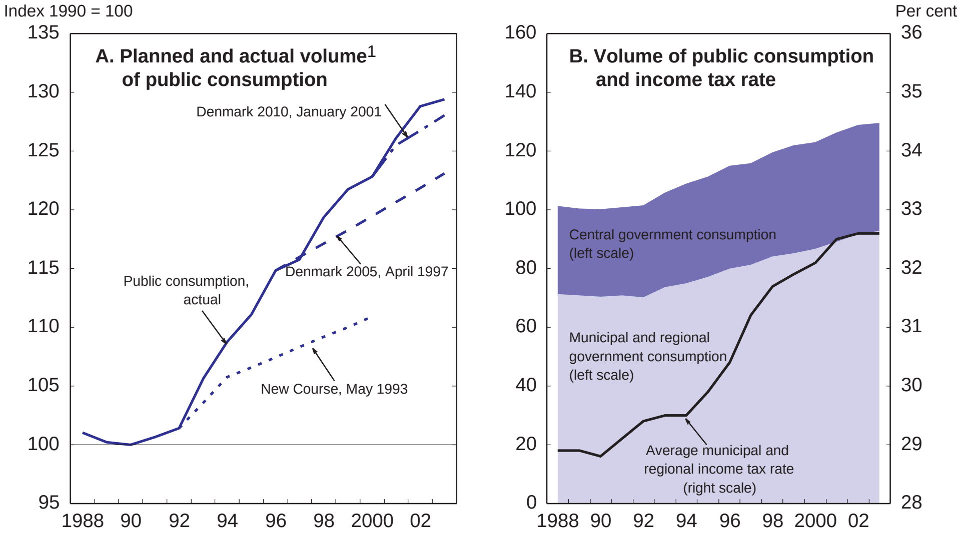
Throughout the 1990s, growth in public consumption in Denmark outpaced the government's medium-term objectives primarily because service spending in municipalities and regions grew strongly. After stability during the late 1980s, a new government came into power with the ambition to kick-start the economy and gradually raise the provision of services, as stipulated in the plan "New Course" of May 1993. The actual growth in public consumption, however, outpaced what was intended (**Figure 14**, panel A), a pattern that has been repeated for the later plans, "Denmark 2005" from April 1997 and "Denmark 2010" from January 2001.

Developments in municipal and regional service spending are key to understanding why these slippages occurred, as consumption growth has been more rapid at the local and regional level and because the larger part of public consumption is administered by municipalities and regional governments, as in Finland. Part of the increase reflects obligations imposed by parliament and central government which have been matched by increased transfers, but the reason why public consumption has increased so much is that service demand has grown more than anticipated, and virtually every year, actual municipal and regional service spending growth has outpaced what was stipulated in the annual agreement between central government and the municipalities and regional authorities. As a consequence, the average income tax rate of municipal and regional authorities has increased by 3 percentage points between the early 1990s and 2000 (**Figure 14**, panel B). In particular, growing health care spending has contributed to this development.

Instruments to achieve coordination between central government and municipalities

Looking at experience from the other Nordic countries, one option is to make agreements between government and the association of municipalities on maximum spending and tax increases. Such agreements exist in Denmark, but did not prevent the unintended upward spending drift. In Norway, there has been an upper limit on the income tax rate municipalities can set for two decades but the experience has been mixed. All municipalities now apply the maximum rate and even in cases where individual municipalities receive large extraordinary income they prefer to increase spending rather than being the only one to reduce tax rates. Cutting taxes is considered to signal to central government that there is scope to reduce grants. Moreover, with all municipalities applying the maximum tax rate, the onus is back on central government to finance spending increases via grants as local politicians are freed from the fiscal responsibility to justify higher tax rates (Rattsø, 2003). Other options are to "tax tax rises", with central government confiscating a proportion of the revenue from tax increases, as recently introduced in Denmark, or to issue tradable permits for tax increases as suggested in the 2003 *Survey* of Denmark (OECD, 2003c).

Figure 14. Public consumption and municipal tax rates in Denmark



1. Problems with the deflator calculations in the Danish national accounts during the 1990s may imply that too much of the value growth in public consumption is attributed to volume growth and too little to price increases (Davidsen and Hanus, 2001). Nevertheless, the qualitative conclusions drawn above remain valid. Public employment measured in full-time equivalents increased by over 9% from 1992 to 2000 – twice as much as originally intended, and the share of public consumption in trend GDP increased by about 1 percentage point, whereas the intention with the 'New Course' plan was for it to decline.

Source: Danish Ministry of Finance (1993, 1997, 2001 and 2003); Danish Ministry of Taxation; Davidsen, S. and N. T. Hanus (2001), *Analyse af det offentlige forbrug siden 1992* (Analysis of public consumption since 1992), Danish Ministry of Finance Working Paper, No. 1/2001; Statistics Denmark; OECD.

Box 5. Recommendations from the government working group on municipal finances

The main recommendations are outlined below. Most are to take effect from the beginning of 2006, but some will require more preparatory work.

- No changes to the income tax meaning that municipalities continue to set their tax rate as they choose.
- The lower limits for the tax rates on immovable property are raised from 0.22 to 0.30% for primary residences and from 0.50 to 0.75% for most other immovable property, while the upper limits are abolished. For secondary residences, power plants and vacant lots, for which special tax rate bands apply, upper limits will continue to exist.
- Municipalities with large changes in population size are to receive additional state grants.
- Conditions for discretionary grants for municipalities facing special circumstances are to be tightened with stronger requirements for each municipality concerned to draw up a fiscal consolidation plan.
- The formulas for calculating state grants relating to education, social welfare and health care based on population and local characteristics are to be adjusted and simplified.
- The up-rating of state grants with actual municipal cost developments will no longer happen automatically, but requires discretionary decision. The working group, however, does *not* propose that such cost compensation is ended altogether.

As a package, these proposals have limited budgetary effects for the state as well as for individual municipalities.

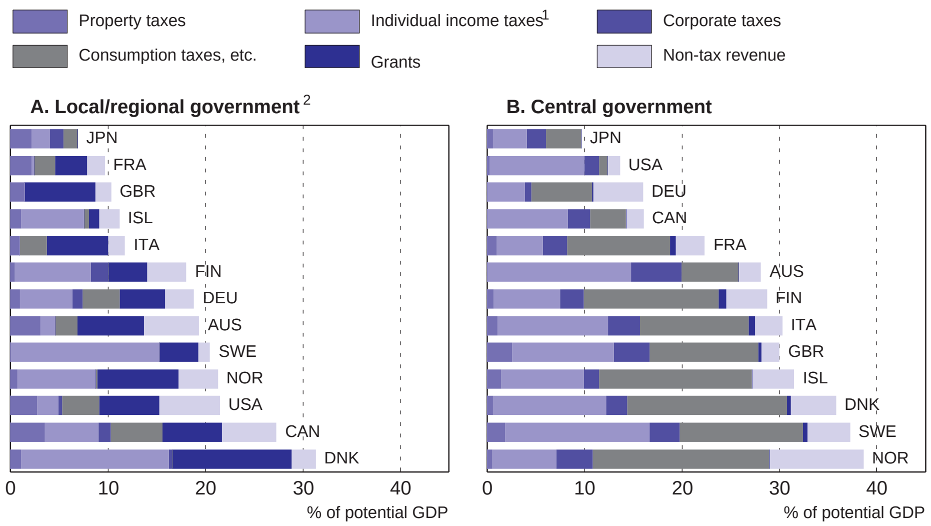
Source : Ministry of Interior (2004b).

Changing the menu of taxes available to municipalities

22. The increase in municipal spending has been financed by increased income tax revenue, higher state grants and borrowing. Revenue from corporate income tax is volatile and has declined from a peak of 22% of total municipal tax revenue in 2000 to 7% in 2003, partly due to the reduction in the municipal share of total corporate tax revenues from 36½ to 19¾ per cent. As with changes in the personal income tax base, this has been compensated by increasing central government grants since 2002. Property taxes have increased their share of total municipal revenues slightly, but still account for only 5%. Although the tax revenue accruing to municipal finances as a share of GDP is high by international standards, it is not higher than in other Nordic countries, and relative to non-tax revenue and central government grants it constitutes a smaller share of municipal finances than for example in Sweden (**Figure 15**). Higher tax revenues at the local level should not be ruled out, but this should not be allowed to undermine the central government's tax policy objectives by increasing taxation of labour.

Figure 15. Composition of revenue

2001 or latest year available



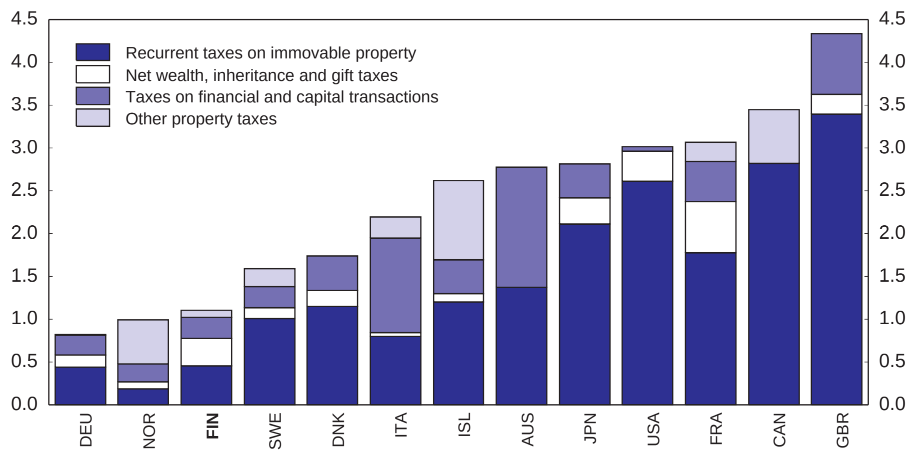
1. Also includes payroll taxes and social security contributions where these accrue to local, state/regional or central government.
2. For the federal countries, *i.e.* Australia, Canada, Germany, United States, panel A combines local and state levels.

Source: OECD, *Revenue Statistics, 1965-2002,* 2003 ed.

23. Property taxation, and in particular the taxation of immovable property (buildings and land), is low in international comparison (**Figure 16**). All revenues from taxation of immovable property accrue to municipalities, whereas the revenue from other property taxes such as the net wealth tax, the inheritance tax and the taxes on financial transactions accrue to central government. The total level of these different property taxes in Finland is among the lowest in Europe and much lower than in Australia, Canada and the United States.[11] This is striking since taxes on immovable property are generally considered among the taxes best suited for financing local government (Joumard and Kongsrud, 2003). The virtue of increasing taxation of immovable property are particularly clear as Finland subsidises housing via the tax deductibility of mortgage interest payments which is not matched by taxation of imputed rental income (Catte *et al*., 2004).

Figure 16. Property tax revenue

As a percentage of GDP, 2002[1]

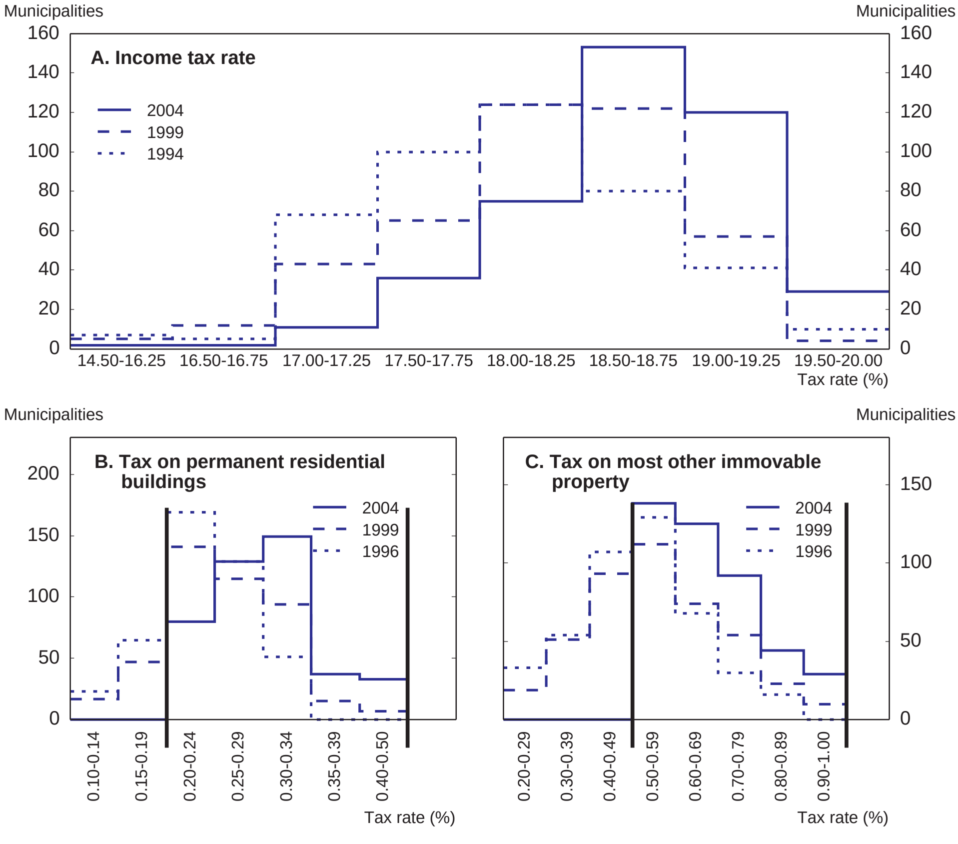


1. 2001 for Australia and the United States.

Source: OECD, *Revenue Statistics, 1965-2002*, 2003 ed.

24. While municipalities can freely choose their income tax rate, the tax rate for immovable property can only be set within a fairly narrow interval given by law. For primary residences, tax rates can vary between 0.22 and 0.50%, and for most other immovable property between 0.50 and 1.00%.[12] Indeed, it is difficult to see the economic rationale for having an upper limit on property tax rates while none exists on income tax rates. The lower limit for property tax rates should thus be raised and the upper limit abandoned. This is a point where the reform announced in December 2004 chimes with the recommendations of the 2004 Economic Survey (OECD, 2004d) as the lower limits will be raised by 2006 from 0.22 to 0.30% for primary residences and from 0.50 to 0.75% for most other immovable property, while the upper limits are abolished. It should, however, be noted that while the distribution of property tax rates has shifted upwards over the last decade, most municipalities still do not apply the top level, but choose property tax rates in the lower end or middle of the range, presumably because property taxes are politically unpopular (**Figure 17**). To achieve a change in the composition of taxation from labour to property, it is therefore important to raise the lower limit for property tax rates and/or constrain the recourse to income tax increases. Following the latter route, municipalities could be given the requirement that any increase in income tax rates must be paralleled by an increase in property tax rates – at least for municipalities that currently have a low rate of property taxes compared with income taxes. This would reduce the extent of income tax increases while maintaining the fiscal autonomy of municipalities.

Figure 17. Distribution of municipal tax rates

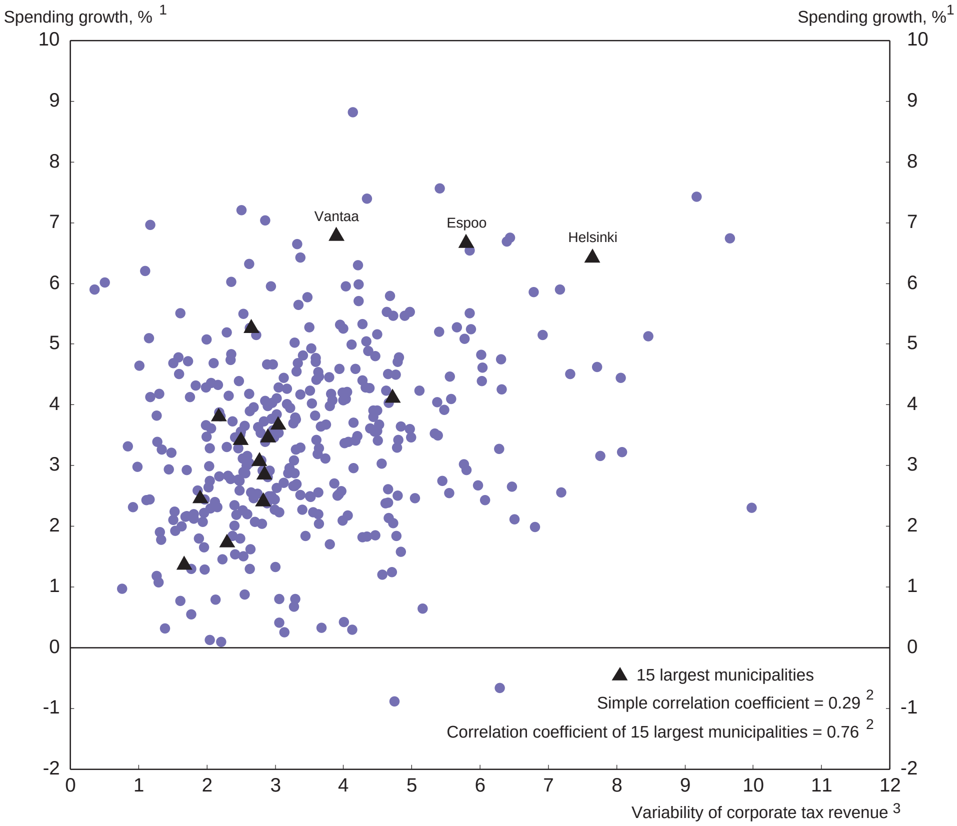


Source: Ministry of Interior.

25. Having a very unstable revenue component, such as corporate taxes, is likely to produce ratchet effects in spending, as municipalities tend to raise spending when revenues grow fast while finding it hard to cut back when revenues recede. In Norway, this process is considered to have been a key factor behind rapid spending growth, leading to strong political pressures for increased grants from central government in periods when corporate tax revenues have slumped (Rattsø, 2003; Lotz, 2004), and the municipal share in corporate tax revenues was therefore abolished in the late 1990s. A similar process is operating in Finland, where part of the revenue from corporate taxes accrue to municipalities and is distributed in proportion to how many people a particular firm employs in plants in each municipality. The municipal revenue share has been reduced gradually from 45% in 1997 to 19¾ per cent in 2004, but this process seems to have stalled, and while the corporate tax rate has been reduced from 29 to 26% from 2005, government has kept municipal revenue unchanged by raising their share from 19¾ to around 22%. Thereby, municipalities are still exposed not only to the fluctuations in corporate profitability but also to the specific fortune of firms located within their boundaries *via* this arrangement. In Helsinki and Espoo where much of Nokia's activities are located, corporate tax revenues reached peaks of respectively 26 and 28% of municipal operating expenditure in 2000, with a subsequent decline to 7 and 9% in 2003. For both municipalities this led to a boost in spending but in particular for Helsinki it seems not to have been matched by increased satisfaction with services, suggesting that the windfall led to inefficiencies. Helsinki has since then gone through a fiscal consolidation process, but that has been difficult and the personal income tax rate has gone up from 15% in 1992 to 17½% in 2004, illustrating the ratchet effect. Similarly, it is striking that Espoo did not in *any* year during the boom take measures to reduce its personal income tax rate which instead went up from 16½ in 1992 to 17½ per cent in 2004 – in exact parallel with the national average. Considering the development across all Finnish municipalities, it is seen that in municipalities where fluctuations in corporate tax revenue were of significant magnitude, the part of spending which is not financed by corporate tax revenue, has grown more than in other municipalities (**Figure 18**). In other words, municipalities have *not* succeeded in finding sufficient savings to match the recent decline in corporate tax revenues.[13] The broader macroeconomic implication of financing municipalities partly by corporate income tax revenue is likely to be that fiscal policy becomes pro-cyclical. Corporate tax revenue should thus be shifted completely to central government, as recommended also in previous Surveys (OECD, 2002a and 2003d). A simultaneous increase in property taxation could compensate for the revenue loss in a fashion that largely maintains the regional distribution of municipal income as immovable property will generally be valued higher in areas with a profitable and growing business environment.

Figure 18. Municipal corporate tax and spending growth

1997-2003



1. Average annual growth from 1997 to 2003 of operation expenditure less corporate tax revenue, *i.e.* current spending which has to be financed from other revenues. Volumes based on GDP deflator.
2. Municipalities below one-sixth of average size are not included.
3. Standard deviation of the ratio of corporate tax revenue to operation expenditure in the years 1997-2003.

Source: Ministry of Interior and OECD calculations.

Strengthening the framework for controlling spending in municipalities

26. The current approach to overall cost control in the municipal sector is based on consensus building. The Basic Services Programme introduced in 2003 aims at achieving a better balance between financial resources and the tasks and obligations of municipalities. It consists of an annual budget review and service assessments (Ministry of the Interior, 2004a). It is supported by a Committee for Municipal Finances and Administration consisting of an equal number of delegates from government ministries and the Association of Finnish Local and Regional Authorities. Underlying this cooperative framework is an intention expressed in the government's 2003 programme to compensate municipalities for spending associated with new service obligations and expansion of existing tasks and to compensate for revenue changes when the tax bases are altered by central government decisions. The programme may stem an otherwise important source of drift in service spending, namely the lack of co-ordination as central government ministers and members of parliament press for new obligations for municipalities to raise service provision in their particular area of interest, while not paying attention to the associated costs. The expansion of "citizen rights" to benefit from certain services has gained momentum and municipalities feel that this is a key source of the upward drift in spending. Under these circumstances, introducing a system of fiscal compensation (from central government to municipalities) for such obligations will help if it

disciplines central government ministers and parliament. To have that incentive effect, such compensations must come from the budget of the relevant government ministry rather than the overall state budget.

27. Together with its decision on central government spending limits made each spring, the government now publishes a projection for the block grants to municipalities based on an estimate of municipal spending and revenues for four years which matches the planning horizon for the central government budget. The size of the block grants is negotiated in the Committee for Municipal Finances and Administration, but these negotiations do not limit the ability of individual municipalities to subsequently raise income tax rates. In parallel, a plan for service assessments to be undertaken between 2004 and 2007 has been prepared (Ministry of the Interior, 2003). These assessments focus on specific aspects, such as morning and afternoon activities for school children, and address both the quality of service provision and the scope for improving cost efficiency including via structural changes and cooperation among municipalities. This co-operative approach is likely to improve services by advancing the implementation of new technology in conjunction with better organisation which can give cost savings as discussed earlier. However, the overall fiscal outcome may be higher public spending, as in many areas the service assessments are likely to raise national service standards with no limits on municipal taxes.

28. The acceleration in spending and the rapid decline in productivity reviewed earlier in this paper indicates that stronger mechanisms might be needed to damp the municipal spending dynamics. Various instruments have been used in other Nordic countries, limiting the possibility for municipalities to hike income tax rates (**Box 4**), but such instruments have to be adapted to the specific circumstances of each country. Freezing the current income tax rates would imply a different and arbitrary treatment of municipalities because their income tax rates currently vary by a couple of percentage points (Figure 17). Alternatively, fixing an upper limit on municipal income tax rates in the same way as for property tax rates, will only affect those municipalities currently close to the upper limit and, as the experience from Norway shows, such a single upper limit can create adverse incentives. A better way forward for Finland would therefore be to maintain the autonomy of municipalities to determine income tax rates, but commit each individual municipality more firmly to the macroeconomic necessity of meeting the apparent demand for more and better services *via* efficiency improvements rather than higher tax rates.

- *Raise transparency* by developing benchmarking of service efficiency (unit costs) in a way that can alert citizens and municipal councils when local service efficiency is below average. Such benchmarking is currently under-developed, in particular compared with Norway (**Box 6**).

- *Consider combining benchmarking with enhanced fiscal procedures.* A weakness of benchmarking of public services can be that citizens tend to be interested mostly in the quality of the services they use personally and less in cost efficiency of the wider range of municipal activities. Benchmarking and transparency therefore risk reinforcing an asymmetric interest-group pressure to drive up public spending and, in turn, taxes.[14] Thus, there may be a case for combining benchmarking with enhanced fiscal procedures to ensure that in the case of below-average efficiency, any expansion of service provision is funded by first exhausting the potential for productivity improvements and reductions in unit costs before increasing municipal tax rates. For example, if a municipality with above-average unit costs wished to provide child care services to more families, it would do so, first by approaching the national average for the number of children per employee in its child care institutions. Only once it reached the point where its unit costs are equal to or go below the national average, would it expand child care coverage through investing in new facilities and employing more child care teachers funded by increased taxes. If municipal tax rates continue to rise over the coming years, then there is a case for considering institutional changes that would oblige local democratic institutions to "think twice" before raising expenditure or taxes, while at the same time maintaining their autonomy from the state. For example, it could be a requirement to have a two-thirds majority in the municipal council, a public hearing or even a local referendum for a decision to increase tax rates in a municipality with above-average unit costs.[15] In Switzerland, 17 out of 26 cantons require that new municipal spending projects are approved by a public referendum, and research has found that this requirement has effectively limited public spending (OECD, 2002b).

29. The Norwegian KOSTRA information system shows that it is feasible to compile the necessary data to genuinely benchmark municipal service unit costs and possibly support an enhanced fiscal procedure (**Box 6**). Measuring productivity in services like education and health care can be very difficult because of hard-to-observe quality aspects of both inputs and outputs (National Statistics UK, 2004). By contrast, unit costs are easier to measure provided that total expenditure can be broken down in main service areas and the number of users can be counted in an auditable way. In schools, for example, it can be hard to establish quality-adjusted productivity indices, but it is straightforward to calculate the cost per pupil which is all that would be needed here. The detailed form in which such benchmarking is implemented and what enhanced fiscal procedures it might be linked with can be varied in a number of ways, but what remains is that a number of the recent municipal tax hikes (Figure 2 and 17) could probably have been avoided if the municipalities in question had addressed the possibilities for raising efficiency more vigorously, as it is clear that service efficiency has declined (Figure 9) with quite some variation in the level of efficiency across local units and only slow convergence (Figure 10).

Box 6. The Norwegian KOSTRA information system

This box illustrates how benchmarking of service unit costs could be implemented and used in Finland if municipal data were made publicly available to a similar extent as currently in Norway.

The Norwegian KOSTRA information system obliges municipalities to report about their service provision and resource use. Covering more than a thousand variables for each municipality it is so far unique in the world in terms of the detail it provides and its user friendliness for the public, researchers and decision makers. The first year for which data have been collected was 1999 and from 2001 the coverage of municipalities and their activities has been more or less complete with all information being publicly available via the internet on www.ssb.no/kostra. Data for 2003 were already published on March 15 as submitted by the municipalities and later, on June 15, in the final version audited by Statistics Norway. This impressive timeliness implies that municipalities can take their comparative performance on last years data into account already when they set the direction for next year's budget and decides about next year’s tax rates in the autumn.

For each area of activity, KOSTRA provides information on *priorities* (in terms of public spending per inhabitant or relative to some measure on need), *coverage* (the number of users such as the share of 3-5 year olds having a kindergarten place) and *productivity or unit costs*. In addition, it includes information on the municipality’s financial position, user charges, extent of contracting with private service providers as well as information on conditions determining service needs, such as the population structure, family structures, local mortality or life expectancy, share of immigrant population, employment and unemployment, and geographic conditions such as average travel distance to the municipal centre. Data on unit cost have gone through extensive adjustments to ensure comparability such as to reflect the average number of users during the fiscal year, and take account of depreciations and internal transactions.

The type of unit costs that is most appropriate for benchmarking depends on the service in question. Although this is currently not done in KOSTRA, the actual unit costs could be adjusted for inter-municipal differences in conditions such as population density, immigrant population and other factors that may warrant higher spending and possibly higher unit costs across municipalities so as to base benchmarking and any enhanced fiscal procedure on the residual variation in unit costs. They are three types of unit costs:

- Genuine unit costs are readily available for most education services, in the form of cost per student in high schools or vocational schools, while for example in child care it can be necessary to adjust for intensity of participation. KOSTRA has a measure of “operating expenditure for municipal child care institutions per adjusted child hour” and a similar variable for operating subsidies to private child care institutions.

- Unit costs that are conceptually correct, but could be prone to manipulation are available for most health care services. In particular payments via the DRG system for health care treatments relies on information about these "prices" or unit costs, and for long-term care institutions, KOSTRA compares municipalities based on operating expenditure per place.

- For other services, however, the number of users may be more difficult to specify (for example for roads) or the concept of unit costs can be misleading (for example in home care for older persons where low unit costs may not reflect efficiency, but rather that more persons with lesser needs receive publicly funded home care a few hours a week). In these cases it is safer to use information on total spending relative to some measure of potential need (for example limited population density for roads or share of older persons in the population for long-term care). Such measures are always available in a form that cannot be manipulated.

30. Another option would be to strengthen the reward for keeping tax rates low. The tax equalisation system is based on *potential tax revenue* per capita which is the total revenue from income, corporate and property tax that the municipality would have had if it had applied the national average tax rate for income and property tax. In cases where per capita potential tax revenue is below 90% of the national average, the municipality is fully compensated as the grant it receives from central government is augmented by an amount equal to the difference between that municipality's potential tax revenue and 90% of the national average potential tax revenue. Conversely, municipalities above 90% of the average potential tax revenue have their state grants reduced by 40% of the amount by which their potential tax revenue exceeds 90% of the national average.[16] A possible problem is that for municipalities significantly below the 90% threshold there is no fiscal incentive to make the tax base grow (by attracting high-earning citizens or firms). Tax competition thus exerts no control on spending increases in these municipalities. The tax equalization system could be changed so that municipalities with below-average potential tax revenue receive less than 100% of the difference between their tax revenue and the national average/potential, which is the case in the other Nordic countries (Lotz, 2004), so giving municipalities at all income levels increased incentives to boost their tax bases by limiting growth in tax rates.[17]

31. Finally, to strengthen the fiscal responsibility of municipalities, the access to discretionary grants should be reconsidered. Municipalities can apply for extra financial assistance grants if they are exposed to special circumstances, and these discretionary grants grew during the late 1990s to a peak in 2000 where 148 out of the 430 municipalities were granted assistance, amounting to a total of EUR 71 million. In later years the total amount and the number of municipalities receiving assistance has declined, and in December 2003, 95 municipalities received a total of EUR 47 million. At around 0.05% of GDP, this does not in itself constitute significant fiscal slippage, but it weakens the incentives for municipalities to take responsibility for their financial situation and deal with inefficiencies. The requirements for municipalities receiving such grants to commit to specific fiscal retrenchment measures *via* negotiations with the Ministry of the Interior have been tightened recently, but still it seems unwarranted that each year one out of five municipalities should need to be "bailed out" by discretionary grants from central government. The conditions for receiving *ad hoc* financial support should therefore be tightened further.

Creating room for future welfare service demand by rebalancing public and private funding

32. With the strong spending pressures stemming from ageing, it will be necessary to focus public spending on what is essential for safeguarding welfare. Improving efficiency in public service provision can free resources and, if pursued vigorously, it can go a long way to make it fiscally sustainable to maintain today's service standards. But over the longer term, service demand from the elderly — who on average will be wealthier than today — is likely to grow far beyond today's service standards. Allowing part of this future demand to be met by private spending is therefore important so that public spending can be focused on what is most essential. While public funding and equal access to services that are truly necessary is a central feature of the welfare society, future service demand is likely to evolve well beyond what can be considered as essential. The risk is that if core public welfare services are not distinguished, then expanding demand for less-vital services will drive up public spending, simply because such services are produced in the public sector today, with the risk of crowding-out spending that is more vital for

safeguarding welfare. To avoid such a situation, institutional arrangements allowing growing demands to be met via increased private spending should be put in place. At the same time, consideration should be given as to whether current public service spending is sufficiently focused on where it is most needed, or whether the underlying policy objectives could be achieved — or even better achieved — with less demand on public finances, thereby providing room to cope with the future ageing-related spending pressure. Key to the success of such a strategy will also be the further development of an alternative private service supply, which will also help to promote both entrepreneurship and service sector job creation.

33. In parallel with more focused funding of services, the justification for the most expensive elements of pensions and transfer incomes should be reconsidered. The pension reform agreed in 2003 which is now being implemented contains a number of aspects that underpin fiscal sustainability such as the automatic adjustment of pension benefits to changes in average life expectancy (OECD, 2003d). Nevertheless, the Central Pension Institute still projects that contribution rates will have to rise from 22% in 2005 to 27% in 2035. More than half of this increase is explained by two expensive elements introduced with the reform: a 1.9% accrual rate from the age of 52 and inclusion of non-wage periods such as study when calculating the level of pension benefits. Removing these two elements which do not give incentives to stay in the labour force would reduce pension outlays by 1¾ per cent of GDP in 2050. Reconsidering these aspects and closing the remaining pathways to early retirement should be a priority, while preparations for further pension reform should get underway.

Ageing-related spending – meeting some of the future service demand via private funding

34. The authorities have started a review of user charges for health care and social services so as to bring these into line with cost developments for these services. The share of municipal health and social service operating costs being financed by user charges has declined from 12.2% in 1995 to 10.7% in 2002. The decline has been clearest for basic and specialised health care and institutional care for older persons, together representing three quarters of municipal spending on health and social service, whereas the share of user charges has grown for dental care and home help for older persons. The government has adopted the principle of adjusting user charges to reflect cost developments for these services as a part of the Basic Services Programme (Ministry of Interior, 2004a). This principle should be welcomed, but is unlikely to be sufficient over the longer term.

35. Firstly, consideration should be given to whether public funding should be available for all forms of care services, or for example confined to treatments with proven effectiveness. As much as half of the total increase in health care costs over the past half-century is due to new technologies and therapies for previously untreatable conditions. Recent developments in imaging, biotechnology and pharmaceuticals suggest that this trend is likely to continue (Aaron, 2003), and the prospects of future molecular medicine and treatments based on results of research on the human genome are considerable. While some of these medical advances are likely to bring cures for serious conditions that are today hard to deal with, other advances will have a “well-being” character, for which access can hardly be considered a core element of a welfare society. While prioritisation already exists implicitly today, as for example in the coverage of drugs and the treatments offered in public health care that are selected on the basis of their medical effectiveness, the need for distinguishing core treatments from treatments with a “well-being” character will probably grow.

36. Secondly, the way users are charged for ageing-related services, particularly personal care and practical help at home could be re-shaped in a way that makes it easier for users to pay for extra services themselves. Today municipalities have fairly wide discretion over the level of user charges, but there are limits set by legislation. These limits are typically defined as a maximum charge per visit, for example a maximum EUR 7 per visit by a nurse in the home of an elderly person, combined with an annual ceiling of EUR 590 introduced in 2000. The way in which maximum charges are defined has a bearing on the

incentives users face to search for less costly solutions. Instead of setting a fixed charge per intervention, municipalities should rather set a subsidy determined *inter alia* by the intensity of need, but let each user carry the marginal cost. Apart from giving an incentive to search for less costly solutions, it would also allow users to contribute more resources themselves to pay for extra services. The introduction of vouchers for the elderly receiving personal care and practical help at home is a step in this direction, although it so far operates on a limited scale with incoherent legislation being seen by municipalities as the largest obstacle (Räty, 2004 and Räty *et al.,* 2004).

37. The ability of seniors to pay for services will in practice also depend on the financial market instruments available:

- *Reverse mortgages* allow home owners to gradually withdraw equity. For the elderly who have limited liquid savings but who have paid down their mortgage debt, this instrument would enable them to finance for example temporary or permanent need for practical help in the home. Reverse mortgages have been introduced by some financial institutions in Finland.

- *Private health insurance* is not without drawbacks in terms of administrative and other transaction costs, but could still be a source for financing some spending. In Australia and Ireland, for example, private voluntary health insurance plays a significant role alongside the public health care system (OECD, 2004b).

As in most other OECD countries, Finland seeks to advance private savings via tax-favoured voluntary pension schemes, and the government's recent proposal for adjusting the tax treatment should be welcomed. With assets of 7% of GDP these schemes are fairly small in Finland compared to the statutory occupational pensions (see also **Figure 4**).[18] Nevertheless, private savings via voluntary pension schemes can help seniors to finance service demand, although the fiscal costs of favourable tax treatment can be substantial and notably low-income groups may not respond much to tax incentives. A particular problem with tax-favoured voluntary pension schemes is that they can lead to tax planning and simply shift savings from other arrangements, not raising the overall level of household savings and thereby not mitigating the fiscal challenge of ageing. The reform of capital taxation taking effect from 2005 (**Box 2**) is partly addressing this issue by making the magnitude of tax subsidy provided for savings within voluntary pension schemes less dependent on individual circumstances. For an average person, the proposal does not change the magnitude of the tax subsidy, but the proposal may lower it for middle-to-high income groups while raising it for low-income groups (**Box 7**). The government's proposals should be welcomed, but will not ensure neutrality between different savings vehicles with respect to their more or less favoured tax treatment. Consideration might be given to reducing the special tax subsidy given to voluntary pension schemes by introducing, for instance, a partial taxation of the returns that accrue to the assets held in voluntary pension schemes, while lowering capital income taxation more generally. This line should also be pursued for the other financial instruments. The focus should be on developing instruments and market regulations without introducing costly tax incentives.

Box 7. Proposed changes to the tax treatment of voluntary pension schemes

As in many other countries, voluntary pension schemes in Finland are subject to the expenditure tax regime, which implies that contributions are deductible from taxable income, the return on accumulated savings is exempt from taxation when it accrues, but pensions are taxed. Other forms of savings are subject to the comprehensive income tax regime so that savings are not deductible from taxable income and returns on assets are taxed the year they accrue, but savings are not taxed when spent. Having the two arrangements side-by-side implies a distortion with the voluntary pension schemes being tax favoured relative to other savings vehicles. So far, all voluntary pension schemes have fallen under the earned income tax regime. The progressive tax rates have thereby applied both to the tax deduction of contributions and to the taxation of the pension.

The proposed legislation which is to come into force from 2005 will change this situation, as *individual* voluntary pension schemes will be treated under the capital income taxation regime implying that contributions will not be deductible under the earned income taxation regime but under the capital income taxation regime where a flat tax rate of 29% applies. This is about 20 percentage points lower than for earned income taxes. In parallel, pensions will be taxed as capital income rather than earned income. The tax exemption of returns as they accrue, however, will not be changed. Finally, individual voluntary pension schemes will only benefit from the favourable tax treatment if they are received at age 62 or later, compared to 60 years now.

A problem with tax deductibility under earned income taxation is that the outcome for the person saving depends on her/his relative income position while making contributions and while receiving pension payments. If a person has lower income when retired and therefore faces a lower marginal tax rate, then the person gets a net subsidy as the contributions entail a larger tax reduction than the tax paid on the pension. A particular problem is that the *pension income deduction* makes the combined marginal tax rates faced by pensioners at low income levels higher than the rates these persons have typically faced when saving. They will suffer a tax sanction which can turn out to be substantial. Covering the individual voluntary pension schemes under capital taxation will solve these problems. This change is in line with the suggestions of recent OECD work pointing to the benefits of making the value of the tax deductibility of contributions less dependent on income (Yoo and de Serres, 2004).

The government's proposal does not consider taxing investment returns, and the move to treating individual voluntary pension schemes under capital income taxation should not be confused with putting them on a tax-neutral position *vis-à-vis* other savings vehicles. The immediate effect on tax revenues will be positive with an estimated increase in tax revenues of EUR 130 million (0.1% of GDP) from 2006 onwards, although for 2005 tax revenues will temporarily decline by an estimated EUR 70 million (0.05% of GDP) as the changes are phased in. But there will be no long-term fiscal gain as the tax payments from pensioners will be less under capital taxation than hitherto, and the government estimates that on a net present value basis the fiscal effects of the reform are by and large neutral for an unchanged savings volume within these pension schemes and for unchanged retirement patterns. In other words, the proposed reform does not change the tax subsidy for the voluntary pension schemes on average.

Source: Ministry of Finance (2004e).

Reconsidering existing spending – focusing on what is most essential to safeguard welfare

38. In addition to finding ways of funding growing demand in ageing-related services, today's service spending should also be scrutinised for areas where public resources could be freed for other purposes. Higher education and child care are two examples where the policy objectives could be better achieved with less demands on public funding and better coordination between central government and municipalities could be warranted.

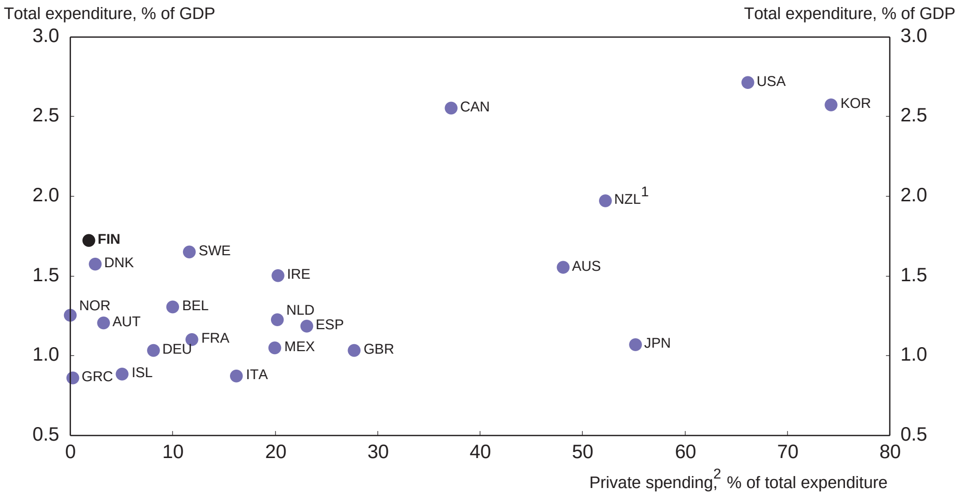
Higher education

39. While higher education is vital for economic growth, the role of comprehensive public funding is increasingly being questioned. Indeed, in a number of European countries, the reliance on public funding seems to have become a strait jacket for universities as the many competing demands on public budgets have led to declining resources per student as the number of students has gone up rapidly over the latter

decades without additional funding. By contrast, the OECD countries spending most on higher education institutions rely only partly on public funding (**Figure 19**). Experience from countries like Australia and New Zealand, indicates that with appropriate loan arrangements, equity of access can be maintained with less demand on public funding. These countries have introduced forms of graduate contributions whereby former students repay their tuition cost out of their income as graduates, an arrangement that the United Kingdom will be pioneering in Europe from 2006 (OECD, 2004a).

Figure 19. Expenditure on tertiary education institutions

2000



1. For New Zealand, OECD education data has information about public spending only. Other spending components are estimated based on the Statement of Financial Performance for tertiary education institutions from the cash flow from tuition fees, revenue from services provided, investment income and other sources. Using the same data source to estimate public spending produces results that are consistent with what the New Zealand authorities report to the OECD education data.
2. Contributions from students, donations and other non-government sources, net of tuition fees paid by government, as a share of total expenditure.

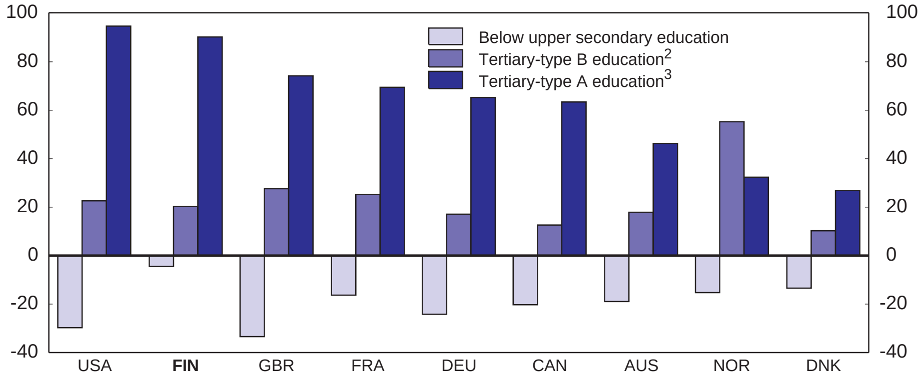
Source: Statement of Financial Performance for tertiary education institutions in New Zealand; OECD, *Education at a Glance - OECD Indicators*, 2003 *ed*.

40. With 1¾ per cent of GDP being spent on higher education institutions, lack of resources is less of a problem in Finland than in other European countries, but there are other reasons why it would benefit Finland to allow higher education institutions to attract private funding including contributions from students. First, to broaden its growth potential, Finland would benefit from development of knowledge intensive services as argued in Chapters 1 and 3 of the recent Economic Survey (OECD, 2004d). Maybe combined consultancy and training for professionals in those industries where Finland has world leading capabilities such as paper, forestry, engineering and electronics could develop to a large service industry based on cooperation between institutions of higher education and business firms in those industries. To explore the potential and give it the best conditions to grow, education institutions would need to be able to charge students for tuition. Similarly, higher education institutions would have clearer incentives to make their general programmes more international if it became standard practice to charge foreign students coming to Finland in pursuit of a partial or full degree, as argued by a recent OECD review of polytechnics (OECD, 2003e). While non-EU students can be charged under separate arrangements, students from other EU countries can only be charged if nationals are charged, making it necessary to develop general arrangements for student contributions.

41. Individuals with higher education benefit from a relatively high earnings premium, supporting the case for the introduction of graduate contributions for tuition costs. Whereas the overall earnings distribution is very narrow in Finland, the differential between persons with a different level of education is fairly large. Econometric studies of the relation between education and earnings which control for other characteristics find that returns to education on average are higher in Finland than in other Nordic countries (Asplund, 2001; PURE, 2001; Uusitalo, 1999; Wössmann, 2003). Moreover, behind this average is a "truncated" income distribution with little difference between those with little or no post-compulsory education, those with upper secondary and those with practically oriented tertiary education. But the earnings premium on tertiary education similar to an advanced university degree as compared with persons with upper secondary education only is very large compared with other European countries (**Figure 20**).

Figure 20. Relative earnings by level of education[1]

Percentage difference from upper secondary education, 2001



1. For those aged 25 to 64 years old.
2. Tertiary education with an orientation towards practical, technical or occupational skills.
3. Tertiary education with a theoretical orientation and advanced research program.

Source: OECD, *Education at a Glance - OECD Indicators*, 2003 ed., Table A14.1.

42. In conjunction with these earnings differences, the current funding arrangement is likely to be regressive because of the absence of any contribution by students to tuition costs as well as extensive financial support for students' living costs. A typical full time student aged over 20 and living apart from her/his parents would get a monthly grant of EUR 259 in 2004 which is taxed as income and a housing supplement covering 80% of the rent with a maximum benefit of EUR 172 which is exempt from taxation.[19] Net of taxes this gives EUR 400 a month corresponding to 56% of what a single working mother with two children has for herself if she is earning two-thirds of the average production workers' income. Coming on top of this, the state-guaranteed bank loan of up to EUR 220 a month, makes the total financial resources available for a full time student correspond to about 85% of what the single working mother has for herself.[20] However, about half of the university students study part time and are therefore not eligible for grants and often make their own living by working. About one-third of the university students take state-guaranteed loans. With this system Finland puts more emphasis on grants than other OECD countries as they absorb 18% of total public spending on higher education. In both Sweden and Norway most of the financial support for students' living costs is in the form of loans. Changing this funding system can also benefit study times with beneficial effects on the employment rate as illustrated by a recent study finding that students take longer time to complete their studies in those European countries where the public share of higher education funding is largest (Brunello and Winter-Ebmer, 2003). The current system was introduced in 1992 with the ambition of reducing study times by replacing a loan-based system with grants. The effects however have been very modest and changes in study completion time can mainly be explained by changes in the level of unemployment determining access to part-time jobs for students (Häkkinen and Uusitalo, 2003).

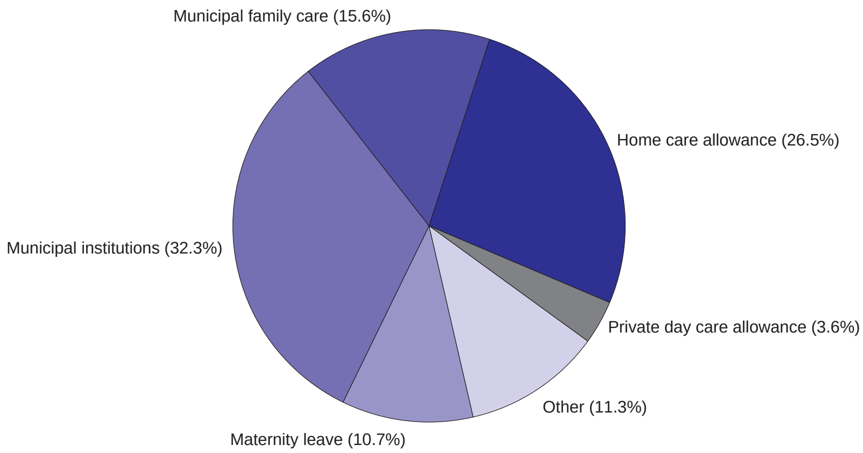
43. The recent Employment Working Group proposed a switch from grants to a loan-based support system for living costs, making more funding available in the early years of study while strengthening the incentives to complete studies on time (Employment Working Group, 2003). A legislative proposal is now being prepared which, however, does not replace existing support, but adds to it by raising the maximum monthly guaranteed loan amount from EUR 220 to EUR 300 and introducing a partial tax allowance for debt repayments on the condition that courses and exams have been completed within the stipulated time.[21] As a side effect this will create an incentive for graduates to remain in Finland rather than migrating. This proposal should be welcomed. But reforms should be more ambitious and the grants and housing allowance should be abolished while the maximum guaranteed loan amount should be raised in parallel. Going further by introducing graduate contributions for tuition costs while at the same time using the savings to lower top income tax rates should also be considered as it would make it more attractive for highly-skilled foreigners to come and work in Finland.

Childcare

44. Child care is an example where public spending could be better coordinated across levels of government to achieve direct fiscal savings and better support the employment and entrepreneurship policy objectives. Municipalities are responsible for organising child care for children under school age and about half of all children under school age are in municipal child care institutions or in family day care organised by the municipality (**Figure 21**). Parents pay a charge depending on income with a monthly maximum of EUR 200 in 2003 for one child and EUR 180 for each additional child. As an alternative to municipal child care, parents can use a private institution and receive a private child care allowance (operating essentially as a voucher), and for children under three, parents can also choose to care for the child themselves at home and receive a child home care allowance. This system appears to work well, but in some municipalities, large supplementary payments are now added on top of the statutory child home care allowance which creates disincentives to work (**Box 8**). Reducing these supplementary payments while getting a better market-based supply of child care can benefit not just public finances but also the government's employment target.

Figure 21. Day care arrangements for children under school age

Share of children aged 0-6 years at year-end 2002



Source: KELA, Statistical Yearbook of the Social Insurance Institution, 2002.

Box 8. Child care allowances

Parents who do not make use of municipal child care are entitled to a *private day care allowance* if the child is in a private facility. This has grown more common over recent years, but still only 4% are in private child care which can be provided by either non-profit institutions or self-employed child minders. The monthly allowance is EUR 118 per child plus an income-related supplement of up to EUR 135 per child. On average the monthly payment to families receiving the private day care allowance in 2002 was EUR 166 (EUR 128 per child). This payment is taxed as income for the person providing care. The allowance is paid directly to the provider of child care but its level is independent of the total price charged by the private provider (although the allowance cannot exceed the total price charged by the provider). This implies the desirable property that parents have a clear incentive to search for less costly solutions as they will obtain cost savings via smaller net charges.

Parents who care at home for children below the age of three are entitled to a *child home care allowance* and a quarter of all pre-school children are cared for in this way. The monthly payment is EUR 252 for one child and EUR 84 for each additional child under three years. If apart from a child under three years other children under school age are cared for at home another EUR 50 is paid. In addition, an income-related supplement of up to EUR 168 per month which does not depend on the number of children cared for is paid. On average the monthly payment to families receiving the child home care allowance in 2002 was EUR 346 (EUR 226 per child). This payment is taxed as income. On top of the payments from the social security institution (KELA) described above, however, some municipalities pay substantial additional amounts. Such *municipal* supplements are paid for one in five children under the private day care allowance and child home care allowance with an average monthly amount per family in 2002 of EUR 203 (EUR 185 per child).

The municipal supplement of the child home care allowance can hamper incentives to work. The problem does not arise for an unemployed parent, as the child home care allowance cannot be received along with unemployment benefits so it does not add to the replacement rate. However, for a second earner with limited earnings potential, the net income loss of leaving work to care at home for a couple of children may be limited as the combined effect of taxes and the child home care benefit implies that the person retains only little of the extra value produced if in work. The situation depends on the additional municipal supplements, as with only the statutory allowances disincentive problems do not arise (Kurjenoja, 2004). This calls for reducing the additional municipal supplements to the child home care allowance, in particular where there is only one child as in that case the net production loss compared to when the person is in work and the child in institutional care would be pronounced. In fact about 60% of the families receiving child home care allowance have only one child. A related problem is that students can receive study grants and child home care benefit at the same time, possibly muting the incentives to complete studies without delays, and this problem would also be mitigated by lowering the child home care benefit.

Overall assessment and concluding remarks

45. With rapid ageing ahead it will be challenging to keep the welfare society intact. It will require a strong commitment throughout publicly-funded services to constantly raise efficiency, while prioritisation will be needed to focus public spending on what is really essential to safeguard welfare. The ongoing upward drift in service spending and the deficit in municipalities provide a clear sign that efficiency and prioritisation have not been pursued vigorously enough. Moreover, continuation of the current growth in public employment will not be feasible over the coming decades as many public sector employees will retire, while the labour force starts to contract. This macroeconomic reality needs to be better reflected in the fiscal framework of municipalities: improvements or expansion of publicly-funded services should be pursued via new work practices, improved organisation and better use of information technology, and only if a municipality is above the national average in terms of service efficiency should it be allowed to increase tax rates. And any further revenue increases should preferably come from raising taxes on immovable property rather than income taxes, so as not to undermine the government’s objective of raising employment by lowering taxes on labour.

46. Over the longer term, even the best efforts to raise service efficiency are unlikely to be sufficient to match the demand for still more and better services adding to the spending pressures from demographic change and going well beyond what can be considered basic necessities. Allowing part of the future service demands to be funded by the elderly themselves as they grow increasingly wealthy will be necessary to avoid other service spending, that is more essential to safeguard welfare, being crowded out. Such arrangements should gradually be put in place now because they need time to evolve in order to function well. Meanwhile, the young could carry more of the cost of higher education themselves with the savings used to reduce high top income tax rates that otherwise may have increasingly harmful effects on work incentives and location decisions given increased globalisation.

ANNEX A1. WHAT FISCAL SURPLUS IS APPROPRIATE?

47. Given the high level of unemployment, the argument is sometimes made that Finland should cut taxes or raise public spending to stimulate the economy rather than continue with fiscal surpluses. Proponents of this view often point to the fact that the current surplus on general government net lending of 2% of GDP is higher than in any other European Union (EU) country, among which the larger ones have deficits of 3-4% of GDP. Also, the general government has net assets whereas all other EU countries have net debt is taken to imply that Finland could better afford fiscal deficits than other countries. This annex demonstrates why these arguments are misleading and why Finland needs to have larger surpluses now than other countries. Firstly, ageing sets in particularly early in Finland and is also stronger than in many other countries. Secondly, starting with assets implies that a higher level of spending or lower level of taxes and a lower primary fiscal balance can be sustained over the coming decades, but general government net lending – which is typically the focus of fiscal policy analysis – needs to be higher than if Finland had started off with debt. Reducing high labour taxes is important, but room for this should be created via labour market reforms and spending restraint, not via a deterioration of the fiscal balance.

48. The general government surplus is generated by the occupational pension funds, whereas central and local government are moving into deficit. The calculations made below are based on the official projections of how the future demographic changes will affect public spending on pensions, health care and long-term care for older persons reported in the November 2003 update of Finland's Stability Programme (**Table A1.1**). This incorporates the effects of the recent pension reform.[22] To quantify the need for fiscal consolidation, the following calculations consider what permanent shift in the tax-to-GDP ratio or the spending-to-GDP ratio would be required to avoid an unsustainable rise in the debt-to-GDP ratio, while assuming that the tax-to-GDP ratio should remain constant thereafter.[23] The methodology draws on earlier OECD work (Blanchard *et al.*, 1990) that outlined a summary "index of sustainability", also known as the "tax gap", and its recent application to the euro area (OECD, 2004c). As in the "target scenario" of the Stability Programme, general government net assets are required to reach 20% of GDP at the end of the calculation horizon in 2050. Aiming for a positive net asset position in 2050 avoids a situation whereby the fiscal balance will need a large correction from a deficit at the end of the calculation horizon, although this *ad hoc* method does not fully mirror an infinite horizon sustainability requirement.

Table A1.1. Key assumptions of Finland's stability programme

	2000	2010	2020	2030	2040	2050
Ageing-related public expenditure, per cent of GDP						
Pensions	10.7	11.8	13.3	14.7	14.6	14.5
Acute health care	4.6	4.9	5.2	5.6	5.7	5.8
Long-term care	1.6	1.9	2.2	2.7	3.3	3.3
Employment rate, per cent	66.9	68.7	71.2	72.5	72.8	73.2

Source: Ministry of Finance (2003), *Stability Programme for Finland, November 2003 Update*.

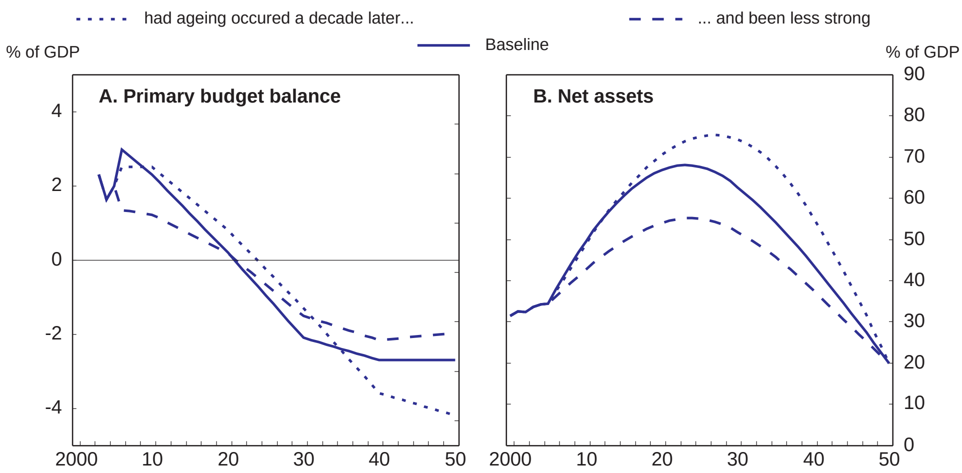
49. With these standard assumptions, an upwards adjustment of the fiscal balance of about 1% of GDP would be needed to ensure fiscal sustainability. This illustrates that the current fiscal policy is not sustainable in the sense the current pension benefits and standards in services like health care cannot be maintained without raising taxes in the future, thereby leaving a fiscal burden for future generations.

50. The magnitude of demographically-induced-spending increases differ across countries reflecting both differences in when and how strongly demographic changes set in and differences in institutions, including to what extent pensions and long-term care provision are publicly funded and how far countries have progressed with reforms to motivate later retirement. In Austria, for example, ageing is not projected to raise public spending as a share of GDP because the growing spending on health and long-term care is mirrored by declining public pension spending as private pensions increase their share. Compared with these other countries, ageing sets in earlier and more forcefully in Finland (see **Figure 7** in the main text).

51. The need for fiscal consolidation in Finland can be compared with what it would have been if ageing had *not* set in earlier and *not* been stronger than elsewhere by running variant simulations. Had ageing not occurred so early in Finland, but rather *a decade later*, then fiscal sustainability would have been attained by a slightly smaller adjustment of the primary budget balance. With more time to accumulate assets a larger deficit can be afforded when the ageing-related costs peak (**Figure A1.1**). A larger difference can be observed relative to the situation, *had ageing occurred not just a decade later in Finland, but also been less costly*. If the change in ageing-related spending in percentage points of GDP had been similar to that of the weighted average of the other five countries shown in **Figure 7**, then the primary budget balance could have even been loosened, as fewer assets would need to be accumulated to reach fiscal sustainability (**Figure A1.1**). But Finland is *not* in this position, and therefore should consolidate now.

Figure A1.1. Effect of early and strong ageing on fiscal sustainability requirements

General government

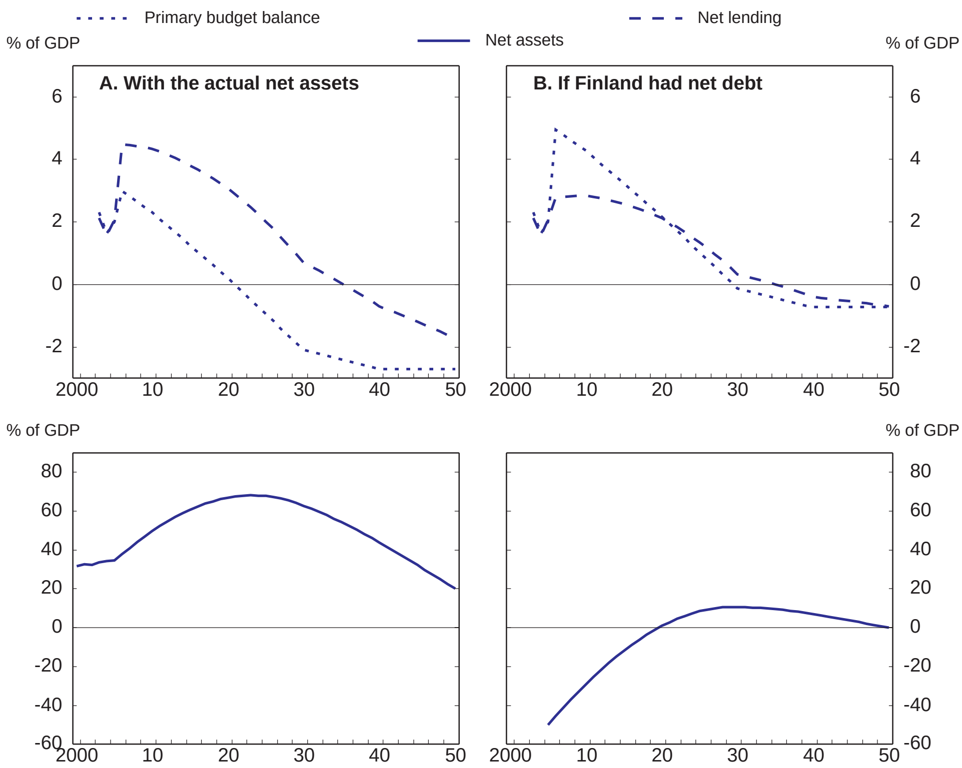


Source: OECD

52. The pre-funding of pension liabilities allows Finland to maintain much of its extensive welfare provision because there is no burden of interest payments on public spending. Having net assets equal to one-third of GDP makes the sustainable expenditure level almost 2% of GDP higher than if general government had net debt equal to half of GDP as a number of European countries do. But starting with net assets rather than net debt does *not* imply that Finland can run smaller surpluses than other countries for the rest of this decade. Having such assets does allow Finland to run small deficits on *average* over the future, whereas indebted countries have to run surpluses on average over the future. Countries starting with net debt need to run large *primary* balances now which can be run down as ageing-related spending rises, but looking at *net lending* this is disguised by the profile of interest payments being large now but small later as debt is repaid. For countries that start with net assets, the profile of interest payments/receipts will be different, meaning that the run-down of the *primary balance* as ageing-related spending rises will have to be reflected in the total budget balance showing high surpluses now and deficits later. Consequently, having net assets equal to one-third of GDP allows Finland to have a primary budget balance more than 2% of GDP lower than if general government had net debt equal to half of GDP but gives no "discount" on the requirement for the total balance of net lending (**Figure A1.2**). To avoid tax hikes when ageing-related spending pressures set in, the assets cannot be spent before then.

Figure A1.2. Effect of net assets on fiscal sustainability requirements

General government



Source: OECD.

NOTES

1. This statement by Mr. Sailas came in an interview reported by the Helsingin Sanomat on 20 December 2004, http://www.helsinginsanomat.fi/english/article/1101978048581.

2. When the previous government was elected in 1999 the initial fiscal objective was to maintain a central government structural surplus, although this was later re-specified as an actual surplus of 1½-2 per cent of GDP, together with a general government surplus of 4½ per cent of GDP.

3. The demographic and employment projections underlying these calculations are those used in the central scenario discussed at the end of this chapter.

4. These estimates are based on projections for ageing-related service spending included in the 2003 Stability Programme (Ministry of Finance, 2003e). The average annual public employment growth from 2000 to 2003 was 8 000 persons of which no more than a thousand can be attributed to service demand induced by demographic changes. The scenario with continued growth therefore assumes that about 7 000 public employees are added each year in addition to the ageing related increase.

5. This calculation is based on detailed information about the age structure of persons currently employed by the state, assuming that this is representative also for municipalities.

6. The productivity indices in **Figure 9** are calculated on the basis of inputs, measured as total costs deflated by input deflators for different segments of public sector inputs, and outputs measured in physical terms, for example number of home visits or students. Quality changes in the form of changes in the composition of output are reflected in the indices, but more subtle quality improvements or deteriorations such as the frequency of medical errors are not reflected (Statistics Finland, 2004 and 1999). Currently, these productivity trends are not integrated into the national accounts, which so far have followed the traditional convention of setting output volume equal to input volume for non-market services, implicitly assuming zero productivity change. As in other EU countries, this is to change in 2006, although Statistics Finland has made the reservation that it will only change practice after a probationary period.

7. While the *level* of productivity in education compares well with other countries, it should also be recognised that it seems to have declined recently (**Figure 9**).

8. Earlier studies show that this differential is not a new phenomenon as for example productivity improved by an annual average of 0.7 per cent and 2.4 per cent in the tax and customs administration respectively over the period 1980-93, compared to an annual decline of 1.4 per cent in hospitals over the same period (Järviö, 2004).

9. The total output of institutional care and home care for elderly and disabled and day care for children amounted to EUR 2.7 billion in 2002 compared with EUR 0.5 billion for the three other services shown in **Figure 12**.

10. Half of the private providers of day care for children and institutional care for elderly and disabled are located in the capital region. A similar concentration, however, is not seen for other social services such as home help for elderly and disabled or institutional placement for children and youth (STAKES, 2003).

11. Moreover, the composition is skewed towards the net wealth tax which previous *Surveys* have recommended to abolish (OECD, 2002a).

12. These limits have remained unchanged for a number of years. Forests and agricultural land are exempt, however, and buildings used by non-profit organisations are in many municipalities only taxed lightly. On the other hand, for vacant lots municipalities can choose to set a special tax rate between 1 and 3 per cent, and also power plants and in particular nuclear power plants can be made subject to above-standard tax rates. Property taxation at the municipal level was introduced in 1981 but only reached its current level with the reform in 1993.

13. In principle, the pattern in **Figure 18** could reflect that municipalities try to smooth consumption despite the fluctuating corporate tax revenue. However, there is also a positive correlation of 0.51 between the fluctuations in corporate tax revenue and the *total* level of operating expenditure in the 15 largest municipalities indicating that not only have the municipalities been unsuccessful finding savings to match the decline in corporate tax revenue, fluctuations have even led municipalities with large and fluctuating corporate tax revenues to *raise* spending more than other municipalities, where in fact they ought to have held back in response to both the recent decline in corporate profitability and the gradual reduction in the share of corporate tax revenues accruing to municipalities.

14. The typical finding from studies of who in practice read benchmarking results is that service providers and professionals are the most interested as they are concerned about their public image and compare their own position with that of colleagues (Reilly *et al.*, 2002). Many citizens even appear to be unaware of the municipal tax rates they are paying. A recent survey in Denmark found that while four out of five knew who their mayor was and what functions and services the municipality was responsible for, only *one out of three* knew what municipal income tax rate they were paying within a margin of 5 percentage points – even though comparisons of municipal tax rates feature prominently in newspapers every year (Pedersen, 2003). This clearly illustrates that even in a Nordic context with municipalities playing a large role, local democracy may exert only a limited control on the upward drift in income tax rates that seem to be underway in Finland, and that there is a need for better information on each municipality's efficiency and the link to taxes.

15. If a proposal to raise taxes is turned down in a referendum, the municipality would then still be obliged to balance its budget over three years, and it would therefore have to reduce the speed of service expansion (or ultimately reduce the level of spending in real terms).

16. Basing these rules on *potential* tax revenue implies that the tax equalisation transfer to/from any particular municipality does not depend on its tax rates. Indirectly, though, the income tax rate set by each municipality affects the level of tax equalisation transfers via its effect on the average municipal tax rate. That is, if one municipality increases its income tax rate, it will increase the transfer from *all* of the municipalities with per capita tax base larger than 90 per cent of the average and to *all* of the municipalities with per capita tax base below 90 per cent of the average, but as this effect is spread out over all municipalities, it does not enter with any particular weight in the decision for each municipality considering whether to raise its tax rate.

17. For such a change to be budget neutral it must balance the increases and reductions in equalisation payments by different municipalities. To do so, the threshold would need to be raised from the current 90 per cent of potential tax revenue or the contributions made by wealthy municipalities be reduced from the current 40 per cent. Fine tuning of these parameters will also re-distribute among municipalities and would need careful attention.

18. In 2003, 320 000 persons (12 per cent of the population aged 25-60) had established one or more voluntary individual pension schemes and 100 000 persons (4 per cent of the population aged 25-60) had similar individual schemes established by their employer.

19. For students living with their parents the monthly grant is only EUR 106 unless the parents (jointly) earn less than an average production worker's income, and the housing supplement is not available. If the student is below 20 years, this monthly grant is only EUR 39. Grants are also available for students in secondary education, but are lower than the rates for tertiary education.

20. A single person with two children working full time and earning 67 per cent of APW has an annual gross income of EUR 18 546, but a disposable income of EUR 21 507 because housing and family benefits exceed the income taxes and social security contributions. If each child consumes 2/3 of an adult, the disposable income left for the adult is EUR 717 a month (OECD, 2004c). An alternative comparison would be with a single person at the APW income of EUR 27 682 who has a monthly disposable income of EUR 1 580, the student's grant, housing supplement and loan being equal to about 40 per cent of this.

21. The government has announced its intention to present legislation on this matter to parliament in autumn 2004, with changes taking effect from August 2005.

22. Additional assumptions made here are that other elements of current spending will remain a constant share of GDP, and that public net investment will have to be raised from its current level of ½ per cent of GDP to 1¼ per cent of GDP. Moreover, a constant differential between the real interest rate and the GDP growth rate of 1 per cent is assumed.

23. Notice that as the contribution rates for the pension funds are expected to rise in the future, the assumption of a constant tax-to-GDP ratio implies that other tax rates are lowered when the pension contribution rates are raised.

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