

PUBLIC FINANCES IN THE TWENTY-FIRST CENTURY: LIMITATIONS, CHALLENGES AND DIRECTION OF REFORMS IN FINLAND

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1 Introduction¹

The most serious challenge for the financing of the public welfare systems in Finland will come from the accelerating pension, health care and social service expenditures due to rapidly ageing population from the latter half of the 2010s². The financing pressures related to the future demographic trends are not unique to Finland, but shared by virtually all European countries.³ However, the expenditures related to the population ageing start to grow in Finland almost a decade earlier than elsewhere as the baby-boom generation reaches the retirement age. The increasing tendency to take early-retirement reinforces the on-going process by adding to the expenses and reducing the financing base via declining labour force participation. The

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² Pension system in Finland is a mixture of unfunded (pay-as-you-go system) and funded systems. Earnings-related pensions are mandatory and benefits are financed by employers' and employees' contributions and returns on the pension funds' assets. Earnings-related pensions are supplemented by incomes-tested national pension system.

³ See e.g. OECD (1996), European Commission (1997).

combination of these three trends - ageing population, increasing number of those taking early retirement and declining labour force participation - will place the social security system under financial stress despite the partially funded pension system.

Preparing for the ageing of population must start in good time to be able to finance the current welfare systems also in the future. Moreover, the burden for adjustment for governments and individuals increases the longer the actions are delayed. With this in view the Economic Council set up a working group in 1998 whose task was

to evaluate the operating framework of the public sector in Finland, the long term challenges and pressures for change, and to present different policy options to ensure that the public sector will be able to carry out and develop its main welfare functions in a sustainable manner.

The Working Group Report was published by the Prime Minister's Office in the beginning of 1999⁴. The analysis of the long-term fiscal trends and policy conclusions presented in this paper are essentially based on the Working Group Report. Consequently, the purpose of this paper is firstly, to discuss the evolution and challenges faced by the Finnish welfare systems, and secondly, to present long-term projections based on generational accounting to illustrate the extent of the financing pressures in a rapidly ageing society with declining population and labour supply. Thirdly, policy options to address the financing pressures are discussed. The focus here is on the medium- and long-term sustainability of the public finances while the Working Group Report covers also issues related to the extent and role of the public sector, incentive effects of the welfare systems and distribution of income between the generations.

⁴ Public Finances in the Twenty-First Century: Limitations, challenges and direction of reforms, Prime Minister's Office Publication Series. The author of this paper was a member of the Economic Council's Working Group.

2 Development of the public sector in Finland in 1960-98

2.1 Expansion of the welfare state

The shaping of the public sector in Finland during the last three decades has been greatly influenced by the expansion of the welfare state similar to that in other Nordic countries. In the provision of educational, social and health care services as well as basic social security universals are stressed – services and benefits are available to the entire population by the same criteria and often free of charge or at a very low price. The universal system is supplemented by a collective social insurance and means-tested benefits.

Parallel to the construction of the welfare state the size of the government, as conventionally measured, increased significantly. Government expenditures as a share of GDP rose from less than 30 per cent to almost 50 per cent between 1960 and 1990. Expenditures on welfare services (education, health care and social services) doubled within this time period and those on current transfers (unemployment, pension and social security benefits) quadrupled. In the 1960s welfare functions formed around 40% of total public expenditure in Finland, whereas their share at the present is some 70%.

Taxes had to be increased substantially to finance the growing expenditures. From 1960 to 1990, tax revenue as a per cent of GDP rose by 16 percentage points. Unlike in many other European countries, the public sector finances in Finland remained roughly in balance throughout the whole period because the accumulation of the earnings-related pension funds kept the social security funds in surplus. The government debt ratio, on average 10% of GDP, was very low by international comparison until the early 1990s.

The situation changed dramatically in the early 1990s, when the economy was hit by an unprecedented deep recession and banking crises. Government expenditures soared and peaked at 62% of GDP in 1993. Despite substantial increase in taxation, the general government budget plunged into a deficit of 8% of GDP, whilst the government debt ratio quadrupled within three years. After vigorous consolidation measures and several years of rapid growth, the general government budget balance finally turned into a surplus in 1998.

2.2 Challenges posed to the traditional all-embracing-welfare state

The recession in the early 1990s revealed in a painful way the vulnerability of the public finances. It became evident that the sustainability of the public finances in general and the Finnish welfare state in particular were built on the assumptions of a permanently high employment rate and robust economic growth. Without these two prerequisites a balanced budgetary position can be achieved only by very high level of taxation. From a longer-term perspective, the combination of declining employment rate, high tax burden and high expenditure ratio is not sustainable even in favourable growth conditions⁵.

Raising the already high tax burden even further to finance the rising pension and health care expenditures will be difficult and increasingly constrained for several reasons. Firstly, economic integration and the creation of the European single market have increased tax competition and pressures to lower taxes. Due to the single market regulations certain commodity taxes and excise duties have to be lowered in Finland by 2004, which will result in a loss of tax revenue. Secondly, the sustainability of the welfare systems require a high level of employment. Past increases in the tax burden have aggravated distortionary costs and incentive problems especially in labour markets⁶. High tax-wedge on labour and high marginal tax rates at the lower end of the wage scale have contributed significantly to the rise in the structural unemployment and fall in the employment rate in the 1990s. Objectives to reduce unemployment traps and distortions in the labour markets and to raise employment rate and efficiency in the economy would require a substantial reduction in the overall tax ratio and reforms in the benefit systems⁷.

Leaving aside financing pressures, criticism towards the current welfare system has been raised because of its rigidity, complexity and detrimental effects on incentives in general. The system adjusts weakly to

⁵ See Leppänen (1998).

⁶ See Tyrväinen (1995).

⁷ See Virén (1998).

changes in working life and is expensive as the most part of the current transfers is allocated to the working age population. Because a significant part of the incomes is circulated via the public sector, the difference between the gross and net tax ratios is large. Moreover, the systems favour early retirement which has been detected as one of the reasons why the cost pressures from population ageing start to accelerate in Finland on average ten years earlier than in many other EU countries⁸.

Attempts have been made to solve the incentive problems in labour markets by better co-ordination of taxation, employment policy and social security systems. Changes have also been made in recent years to pension systems. Reforms in the computing of pension wages and indexing⁹ pensions will entail marked savings in pension expenditure in the long term. However, despite the recent reforms to reduce the attractiveness of early retirement and measures to increase the effective retirement age, several channels for early retirement are still a fundamental problem¹⁰.

3 Long-term fiscal developments: demographic evolution, labour force participation and productivity matter

In the absence of welfare reforms, long-term fiscal developments are basically driven by demographic trends and existing social benefit and pension schemes. In addition, two other trends play a key role for the sustainability of public finances: the evolution of labour force participation rate and productivity growth, i.e. the earnings growth, which determine the contribution base and the growth of pension contributions. Even though all long-term projections are bound to be highly uncertain and public finances will hardly follow the projected paths, they are nevertheless necessary when seeking to assess the

⁸ See Viitamäki (1998).

⁹ The pension index for the early retirement is a weighted average of consumer price index and wage index, the weights being 0.2 and 0.8, respectively.

¹⁰ See Hytti (1998).

seriousness of the financing problems and the extent of adjustment required to keep public finances on a sound footing¹¹.

The following long-term projections for Finland are generated within the framework of generational accounting. The projections extend to 2050, so that the effect of the changing demographic structure on public finances could be captured as fully as possible. To gauge the degree of uncertainty related to these long-term projections, various scenarios on productivity growth, labour force participation rate and the earnings-related pension funds were performed. The assumptions on which the alternative scenarios are based are explained in the Box next page.

3.1 Demographic trends, labour supply and long run productivity growth

Chart 1 depicts the development of the population until 2050 as estimated by the Statistics Finland (1998). The problems of an ageing society are aggravated by the fact that the population starts to shrink rapidly after 2025. Another factor contributing to the financing pressures of the current welfare systems is the fact that the population in Finland will age at a record rate by 2030 compared to other EU countries. The proportion of those over 64 years of age in the population is about 15% at the present and lower than the EU average. By 2030 it will rise to 26%, which, after Italy, is the second highest in the EU. Unlike several other EU countries, the proportion of pensioners in the population will no longer rise after this, and it will be lower than the EU average in 2040.

The financial pressure caused by demographic developments is reinforced by the growing tendency to take early retirement. Indeed, the number of pensioners during the next ten years will go up mostly due to the rapidly increasing number of those taking early retirement (aged 55 to 64), while after 2010 the growth is led by those taking normal retirement. Due to demographic trends the number of working age population starts

¹¹ See e.g. BIS (1998).

Assumptions on the long term projections

Long-term projections of the effects of demographic factors on public finances are based on several assumptions on economic developments, of which most are highly uncertain¹². Specifically, if advances in medical technology come at ever-increasing cost and if the incidence of health expenditure on the elderly continues to rise, the fiscal burden could become substantially higher than assumed in the projections.

Short term developments in 1998-2002 are based on the Ministry of Finance 1998 medium-term projections and the Ministry of Labour's scenario 'Labour Force 2017'. Real GDP growth is projected to be on average 3.2%, productivity growth 2% and employment rate about 65%.

Demographic developments. The latest population prognosis of the Statistics Finland (1998) is used. The key assumptions concern *the average fertility* that is assumed to remain at the current level, *the life-span* that is expected to be about 5 years longer in 2030 for men and 3.5 years for women than at present and *the annual net immigration* of 4000 people, i.e. the same amount as on average during the past few decades. These assumptions imply that the population starts to fall in the early 2020s.

Supply of labour from 2002 onwards. Two alternative scenarios were assumed for the supply of labour. *Scenario A*, which is treated as the baseline, assumes that the participation rates of different age groups would remain roughly at their current levels. *Scenario B* assumes that the labour force participation will increase especially in the age groups over 45. The average participation rate in 2030-50 will be nearly 4 percentage points higher in scenario B. Under scenario A, the supply of labour starts to fall around 2005 and under B, around 2015.

Productivity. Until 2010 the average productivity growth is assumed to be 2% per year. From 2010 onwards two different scenarios were assumed: *high productivity growth* of 2% per year (baseline assumption) and *low productivity growth* of 1% per year.

¹² Detailed description of the assumptions used can be found in 'Public Finances in the Twenty-First Century: Limitations, challenges and direction of reforms, Working Group Report, Prime Minister's Office Publication Series 1/1999.

Unchanged relative earnings between public and private sector. The level of real earnings in private and public sector is assumed to grow according to the average productivity of the economy.

Unemployment rate is assumed to fall from the level of 10% to 5% by 2010.

Employment rate. The employment rate will rise to 71% by the mid-2020s under scenario A (lower participation rate) and to 74% by 2030 under scenario B (higher participation rate). Employment rate of 74% in scenario B corresponds to the rate that prevailed in the end of the 1980s.

Long-term real GDP growth. Real GDP is assumed to grow at a rate of 2.7% during 2003-2010. After 2010 the growth rate will depend on the productivity and labour supply assumptions. In scenario A, the growth rate of the economy in 2011-2050 is 1.6% in case of high productivity and 0.6% in case of low productivity. In scenario B, the growth rate is 0.1 percentage point higher than in A under both productivity assumptions.

Government expenditure. Development of the government expenditure is based on the current legislation, demographic factors and assumptions on earnings (productivity) and employment. Specifically, social benefits are assumed to be determined by the present legislation over the entire projection period. The level of benefits is assumed to grow in line with the employees' pension index for early retired (the weights being 80% for consumer price index and 20% for wage index). The expenditure categories covered by the projections include expenses on education, health services, social services, pensions, unemployment, other current transfers, other public expenditures and interest on government debt. The development of welfare services in scenarios A and B do not differ (high/low labour supply and employment rate). Overall, the projections are cautious – several expenditure items may go up more than expected (especially education expenditure and expenditure on social and health services). Moreover, the development of pension expenditure is highly sensitive to the assumptions on employment rate and productivity.

Government income. The overall tax ratio is set to remain at the estimated 1999 level (almost 46% of GDP). The tax structure will however change. Firstly, the single market regulations entail a lowering of certain commodity taxes and excise duties by 2004. Hence, it is assumed that the revenue from indirect taxes falls by one percentage point to GDP in 2002. Secondly, due to rising employment and falling unemployment the revenue from the earnings related pensions contributions will go up and the revenue from unemployment insurance contributions go down. To keep the total tax ratio unchanged over the projection period requires that other social insurance contributions and tax rate on earned income is lowered.

Chart 1. Development of the population
(in thousands)

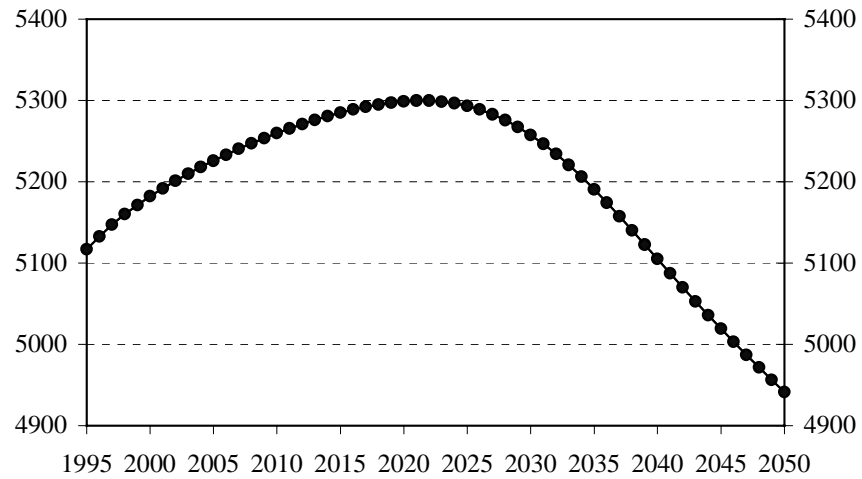


Chart 2. Supply of labour
(in thousands)

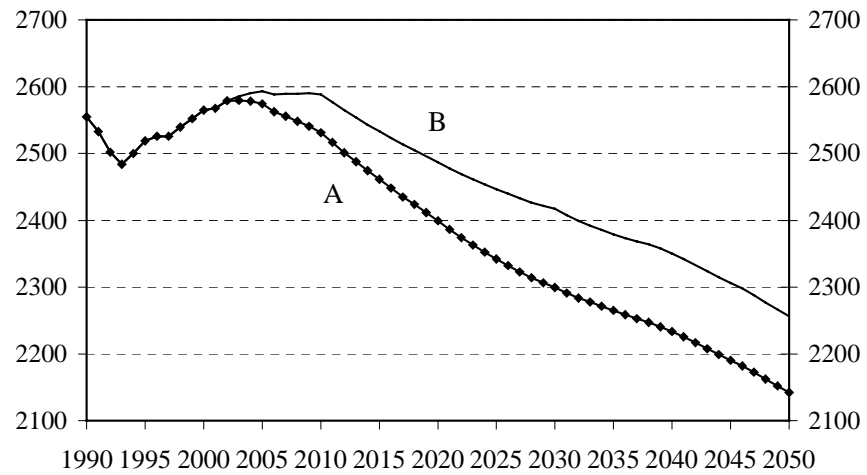
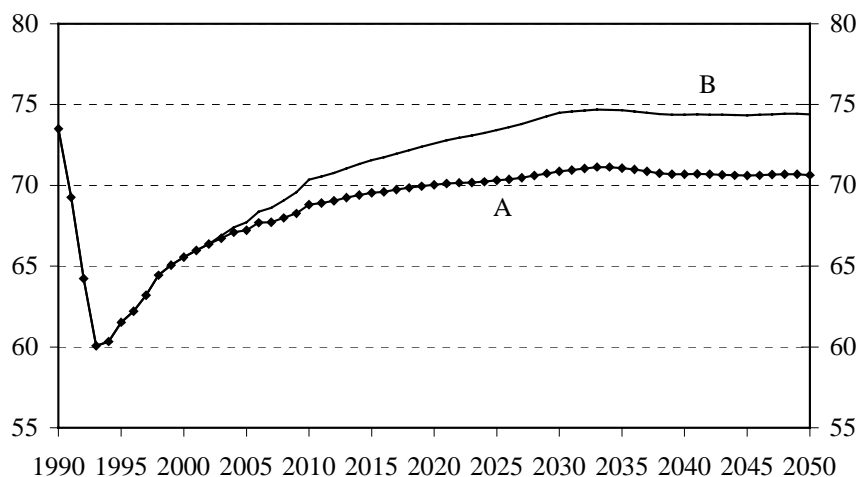


Chart 3. Employment rate
(in percentage)



to fall right after the turn of the millennium. If the labour force participation rate remains at the 1998 level (around 73%), the supply of labour starts to shrink already in 2005 (scenario A in Chart 2). By gradually increasing the participation rates (by 4 percentage points by 2030, which would then correspond to the level of the 1980s), the contraction of labour supply could be postponed by ten years (scenario B in Chart 2). A precondition for the higher participation rate is a substantial decrease in the early retirement.

Views on the long run productivity trends are highly mixed. Although the recent growth rate in productivity has been in excess of 2% per year, its future growth will depend on technological progress and capital accumulation, which could be adversely affected by a decline in saving prompted by the retirement of the baby boom generation. It has also been claimed that the ageing of the population will inevitably lead to lower average productivity as resources are increasingly shifted from industrial production to services. On the other hand, new technologies are expected to raise the productivity not only in the industrial production but in services as well.

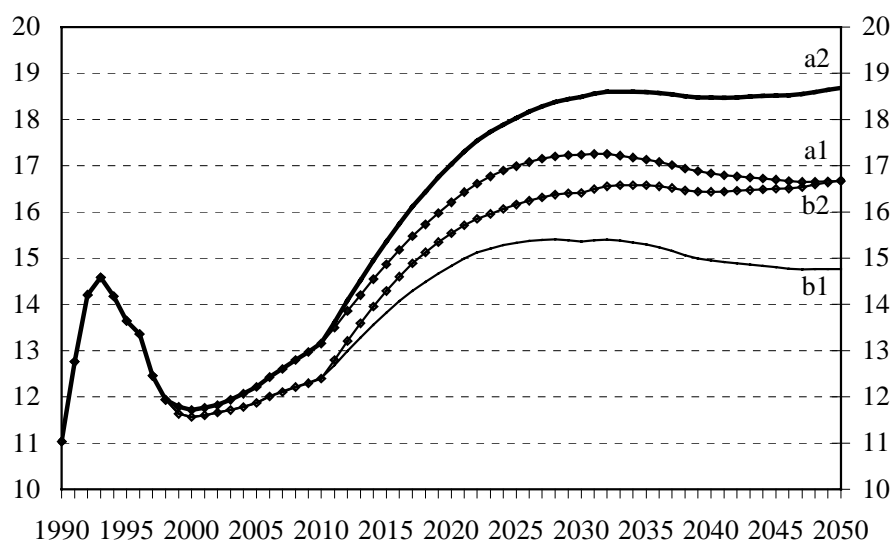
As the future productivity trends are uncertain and as they have a substantial effect on economic growth and thus, on the shape of the public finances, two alternative scenarios were calculated to illustrate the impact of productivity on the future pressures on public finances. The baseline scenario is based on the assumption that the annual productivity growth will remain at the current level of 2%, while the alternative scenario assumes a lower productivity growth of 1%.

3.2 Pension and health care expenditure will grow, but to what level?

Pension expenditure has been estimated on the basis of the latest estimates on the lengthening of the life-span and assumptions on labour force participation and the level of earnings (productivity). The proportion of the population taking early retirement has been adjusted on the basis of assumed labour force participation. Moreover, it has been assumed that the average pension in relation to average earnings will fall in the long-term. A main reason for this is that old-age pensions will rise much more slowly than the increase in real earnings because of the adjusted index and the proportion of old-age pensions in relation to all pensions will increase.

The importance of productivity growth and labour force participation rate on the evolution of the pension expenditure as a share of GDP can be seen clearly from Chart 4. In the baseline scenario with low labour participation rate and 2% productivity growth (scenario a1) the pension expenditure as a share of GDP will start to grow quite steeply from 2010 onwards and peak at the beginning of the 2030s at slightly above 17% of GDP, which is around 5 percentage points higher than at present. However, if the productivity growth were 1 percentage point lower than in the baseline (scenario a2), the ratio of pension expenditure to GDP would increase to close to 19% of GDP. The pressure on public finances would be highest when the productivity growth and labour force participation rates remain low, and conversely, the lowest pressures are generated by a scenario with high labour participation rate and high productivity growth (scenario b1). In the latter case the ratio of pension expenditure to GDP will peak at 15.5% by 2020. Hence, depending on the scenario the ratio of pension expenditures to GDP will rise by 3-7 percentage points by the 2030s from their current level.

Chart 4. Evolution of pension expenditure
(in percentage of GDP)

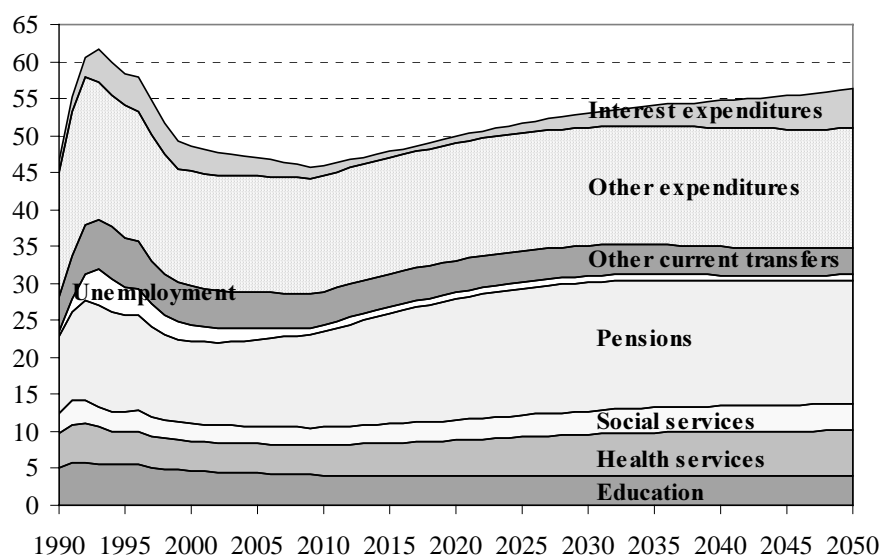


Note: *a1 = low labour-participation, growth in productivity 2% annually*
a2 = low labour-participation, growth in productivity 1% annually
b1 = labour-participation rises, growth in productivity 2% annually
b2 = labour-participation rises, growth in productivity 1% annually

In the baseline projection with lower labour force participation rate and 2% productivity growth expenditure on social and health care services will increase only slowly in the medium-term, but the growth will accelerate around 2010. A marked increase in the social and health care expenditures is expected to take place in the 2020s and 2030s when the number of the elderly will peak. The number of pensioners will increase by 50% by 2030. Health care expenditure to GDP will go up by one third from its current level, if the different age groups use health care services in the future as they did at the end of the 1990s. By 2040 the ratio of social and health care services to GDP will increase by 3 percentage points.

The real growth in total government expenditure will be slightly less than GDP growth until 2010 and thereafter the expenditures are projected to grow annually at a slightly faster pace than the real GDP. Although the ratio of government expenditure to GDP starts to rise as of

Chart 5. Government expenditure as a share of GDP
(in percentage)



2010, it will remain clearly below the peak level of the early 1990s over the whole projection period. However, due to rapidly increasing government debt to GDP ratio the interest burden will start to accelerate in the late 2020s.

3.3 *Earnings-related pension contributions on a rising path*

Pensions in Finland are financed by earnings-related pension contributions and returns on the pension funds' assets¹³. The level of the social security funds was well over 40% of GDP in 1998 and it is expected to reach around 50% by 2010. If the funding is continued according to present legislation the funds will accumulate to 65% of GDP

¹³ In long-term projections the real return on the assets is assumed to be 3% per year.

by 2030, the level which will be equivalent of about two years' private sector total wage sum.

The need to raise the pension contributions can however be contained by gradually reducing the accumulation of the funds when the baby-boom generation starts to retire¹⁴. Nevertheless, a complete depletion of the pension funds is not reasonable, because funding can be used to prevent annual fluctuations in the earnings-related pension contributions stemming from fluctuations in employment and demographic structure. Moreover, some degree of funding is necessary to prevent a need to raise earnings related pension contributions substantially at the point when all the pension funds' capital has been depleted. The upper panel in Chart 6 depicts the evolution of pension funds when the funding continues according to the present legislation and alternatively, if the accumulation of funds is let to go down gradually to 20% of GDP¹⁵.

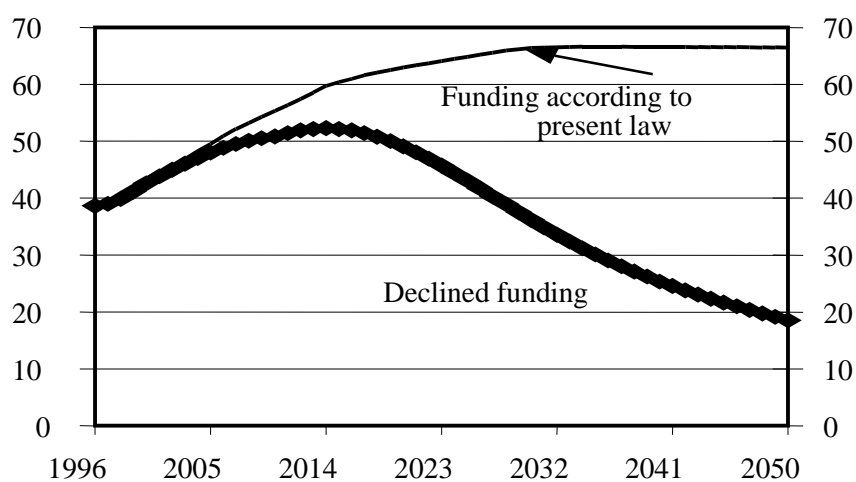
A policy allowing a gradual adjustment of the earnings-related pension funds to the level of 20% of GDP until the beginning of the 2040s will contain the pressure to raise contribution rates substantially during the next two decades (Chart 6, the lower panel). With low labour force participation rate and annual productivity growth of 2% (Chart 7, the baseline scenario a1) the earnings-related pension contributions have to be raised steadily until the mid-2030s, when they would amount to around 30% of the wage sum. Hence, even in the case of reduced funding the contribution rate has to be increased around 10 percentage points of the payroll from the current level. From the mid-2030s to 2050 the contribution rate would have to rise further by 2 percentage points to 32% of the wage sum.

¹⁴ The assumption on the rate of return on the earnings-related pension institutions' investment is crucial when comparing the advantages of the gradual diminishing of the funding rate to continued funding. If the funding is continued as it is now, and the funds stabilise at the level equivalent of the 2 years' payroll in the 2030s, one percentage point lower real rate of return on the funds' assets would require 2 percentage points higher pension contributions as a share of the wage sum.

¹⁵ It has been assumed that the earnings-related pension contribution will increase evenly to the level where it would correspond together with the return on the pension funds' assets to pension expenditure after the retirement of the baby-boom generation.

Chart 6. Pension funds (in percentage of GDP) and the earnings-related pension contributions (in percentage of the wage sum)

Earnings-related pension funds



Earnings-related pension contributions

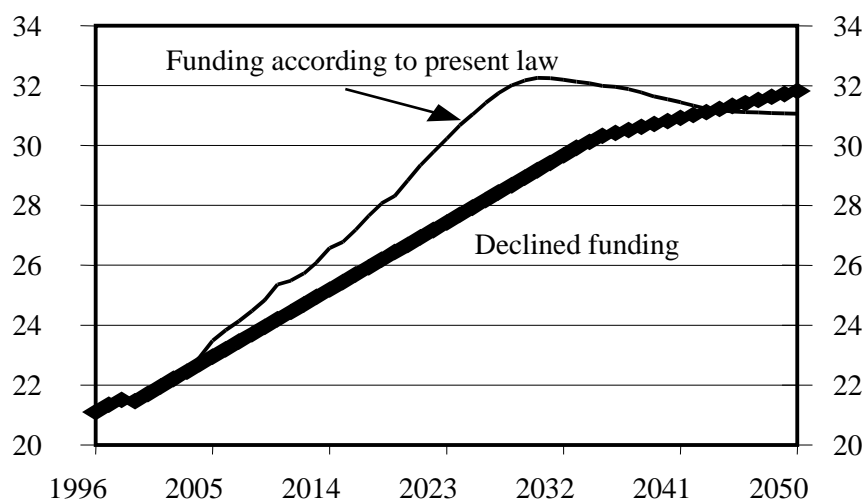
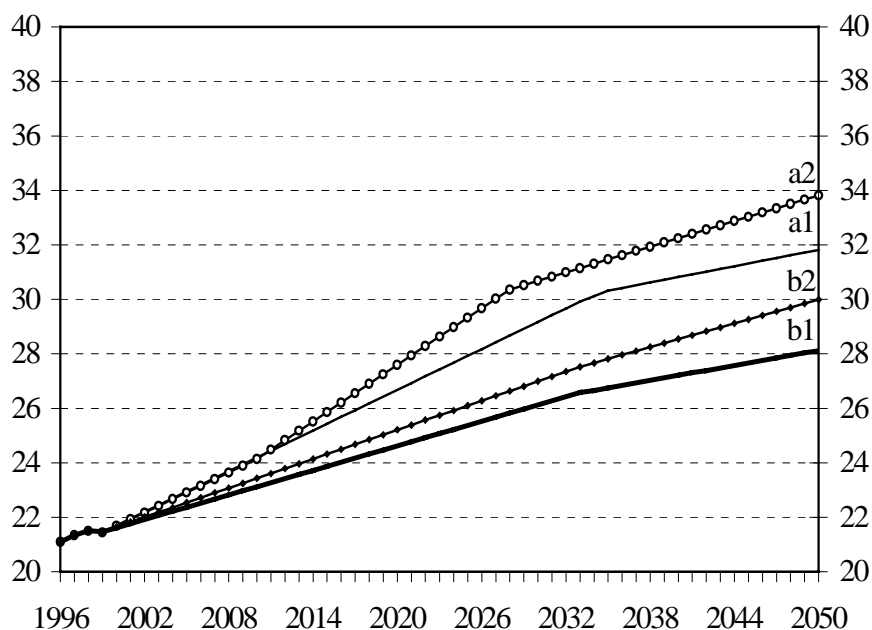


Chart 7. Earnings-related pension contributions
(percentage of the wage sum)



Note: a1 = low labour-participation, growth in productivity 2% annually
a2 = low labour-participation, growth in productivity 1% annually
b1 = labour-participation rises, growth in productivity 2% annually
b2 = labour-participation rises, growth in productivity 1% annually

With lower productivity growth, the pension contribution will have to be raised even more sharply to about 34% of the wage sum at the end of the 2040s (scenario a2). In this scenario the ratio of pension funds to GDP will be higher (around 30%), because the rate of return on the funds' assets in relation to the growth in the real payroll and the domestic product would be greater (due to lower productivity).

If the labour participation rate goes up, the need to increase the earnings related pension contributions will be much smaller even in conditions of slow productivity (scenario b2). The pressures to increase the pension contributions would be lowest, if in addition to the higher participation rate the average growth in productivity were high

throughout the projection period (scenario b1). In this scenario the earnings-related pension contributions will amount to about 28% of the wage sum in 2050.

These calculations show that, all else equal, a gradual increase in the labour participation rate by 4 percentage points would reduce the need to raise pension contributions as a share of the wage sum by 4 percentage points by 2050. Moreover, one percentage point higher productivity growth would result in 2 percentage points lower pension contributions in the end of the projection period.

3.5 Evolution of the budget balance and government debt

Under the baseline projection (a1) of lower labour force participation rate and higher productivity growth the budget balance will remain strong over the medium-term. The overall budget surplus (net lending) will peak at around 5% of GDP in 2010 (see Chart 8). If the overall tax ratio does not rise as is assumed in the projections, the budget surplus will start to contract and turn into deficit in the mid-2020s in line with the diminishing surplus of the pension funds. However, the deficit will approach the 3% of GDP limit of the Stability and Growth Pact only in the late 2040s. The primary balance¹⁶, which does not include the revenue on the pension funds' assets, will turn into deficit considerably earlier.

Government debt to GDP will go down steadily until the end of the 2010s in all scenarios (Chart 9). The debt to GDP will be around 10%, which corresponds to the pre-recession level. Thereafter, the evolution of the government debt ratio will differ dramatically in various scenarios. A combination of low productivity growth and low labour participation will lead to an exploding debt ratio (scenario a2), which will be close to 250% by 2050. A scenario with high productivity growth and low labour participation (baseline scenario a1) will result on a debt ratio of 100%, while under the scenario with high productivity and high labour force participation (scenario b1) debt accumulation will proceed at

¹⁶ Defined as the overall balance net of interest revenue and expenditure.

Chart 8. Fiscal position of the general government Net lending
(in percentage of GDP)

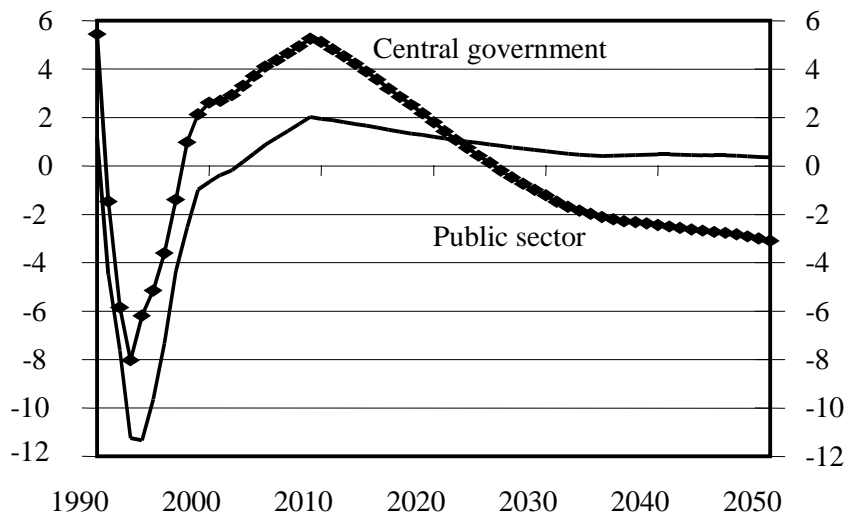
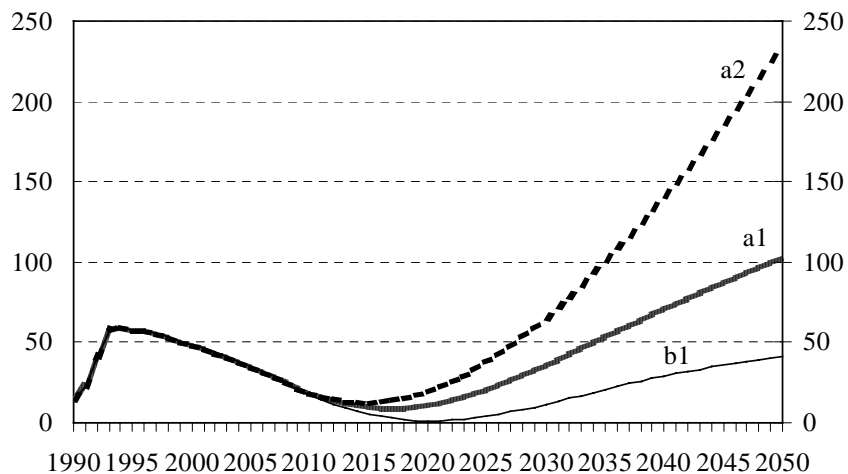


Chart 9. Government debt
(in percentage of GDP)



Note: a1 = low labour-participation, growth in productivity 2% annually
a2 = low labour-participation, growth in productivity 1% annually
b1 = labour-participation rises, growth in productivity 2% annually

considerably lower pace. In this alternative the debt ratio will be less than 50% in 2050. Hence, high productivity and high labour force participation rate are crucial for the long-term sustainability of the government debt.

4 Making the objectives compatible

The message conveyed by the long term calculations is clear: even in favourable circumstances the financing pressures arising from the population ageing are substantial. Under the most optimistic scenario, which assumes increasing labour force participation rate and continued high productivity growth, pension and health care expenditures will rise by roughly 6 percentage points of GDP by the 2030s from their present level. This is the highest amongst EU countries. If the labour force participation rate remains more or less at the current level and productivity growth slows down, the level of expenditures may go up by as much as 10 percentage points of GDP.

Keeping the government finances on a sound footing and at the same time maintaining the pension and health care systems in their present form leaves policy makers with a few choices. Besides being politically difficult, policy reforms must be implemented in a way that takes into account not only the long-term challenges but also the short- and medium-term constraints. In the new fiscal policy framework of EMU policy makers must adhere to the medium-term objectives of the Stability and Growth Pact and to avoid breaching the deficit limit of 3 per cent of GDP during normal economic conditions. To guarantee enough room for manoeuvre in fiscal policy to cope with economic fluctuations without risking the deficit limit requires that general government finances are kept structurally in surplus in Finland.

Due to the sizeable surplus of the social security funds, over 3% of GDP, the general government overall balance will remain well in surplus over the next decade. Thereafter the surpluses start to fall rapidly and turn into deficits in the wake of the gradual dissolving of the pension funds and the growing pension expenditure. To avoid a marked weakening in the general government fiscal position and accelerating government debt ratios increasing structural surpluses in the central and local government finances are indispensable. The vital question for policy

makers is then, how to accomplish this without raising tax burdens or reducing dramatically the level of basic welfare services and pension benefits. Radical reforms of the pension or health care systems are difficult without compromising their universality and increasing individual responsibility at the same time.

Obviously, policy measures to raise labour force participation rate and productivity are crucial if the current welfare systems are to be preserved and the long-term sustainability of public finances is to be achieved without increasing the overall tax ratio. This is clearly demonstrated by the long-term projections: the pressure on public finances will intensify when the labour-tax base is growing only slowly or is shrinking. Increasing tax rates on labour to compensate for the weakening of the tax base would only lead to a vicious circle by aggravating labour market distortions, increasing unemployment and reducing labour force participation.

Higher participation and employment rates are feasible only if the number of unemployed and those taking early retirement can be sharply reduced. In addition to removing the incentives for early retirement and disincentives to work longer, this would require a marked lowering of the tax burden targeted on labour. As tax reductions are costly in terms of the budget balance and government debt ratio, keeping the budget in surplus and the debt on a sustainable basis will not be possible without savings in government expenditure and structural reforms to current transfer and service systems¹⁷. Failing to implement the necessary changes in the welfare system, the longer-term prospect is for rapidly increasing tax burden on declining number of those in the labour force.

The social security reforms should focus on solutions that activate people and reduce disincentives in the labour market. The simplification of social security and the reconciliation of the different

¹⁷ Getting the right balance between pursuing the fiscal consolidation and cutting taxes is discussed extensively in the European Commission (2000) report on Public Finances in EMU – 2000.

systems is important¹⁸. Some progress in this area has been made in recent years, but there is clearly a need to go beyond the measures already implemented. The insurance premium nature of earnings-related pension contributions as well as other social security contributions should be made more direct, even though they are part of the tax wedge. In the context of pension contributions this could be enhanced by extending the calculation of the pension wage to the entire working career and making the connection between contributions and pensions stronger. One option in the field of social security and social services could be the development of *personal social accounts and service insurance* that connect payments and benefits at the individual level¹⁹. In the long-term they could replace some of the existing forms of providing social security and social services.

Improved cost efficiency is also necessary in the production of welfare services. This can be achieved by abolishing overlapping organisations especially in medical care and by increasing co-operation among local governments, encouraging private production of welfare services and increasing competition between public and private producers.

¹⁸ These reforms were also stressed in the country specific recommendations for Finland in the 1999 Broad Economic Policy Guidelines by the European Commission (1999).

¹⁹ The basic idea behind personal social security accounts is to replace part of the taxes with compulsory savings. In the case of e.g. unemployment security a new employee has to save a given amount in his own unemployment account. If the person becomes unemployed, the unemployment security is paid from his personal account. Only after the account becomes emptied, the person would be entitled to receive public unemployment security. If compulsory deposits in the wage earner's own account are not of a tax nature even though their usage is regulated, the marginal tax rates could be lowered substantially. With care insurance the policy holders transfer the risk caused by acquiring care services to an insurance company and pay a premium in return. On personal social accounts, see e.g. Fölster (1997), Lassila and Valkonen (1998) and Orszag et al (1997).

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