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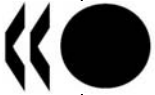
Product Market Competition  
and Economic Performance  
in Finland

**Jens Høj,  
Michael Wise**

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**By**  
**Jens Høj and Michael Wise**

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## ABSTRACT/RÉSUMÉ

**Product market competition and economic performance in Finland**

Following the deep recession in the early 1990s growth has been strong, but the scope for economic catch-up remains considerable and cross-country empirical evidence suggests that enhancing competition is an important means of achieving this. Structural reforms to strengthen competition in the early 1990s did boost growth and were also ahead of similar developments in the EU. However, indicators suggest that relatively weak competition remains in a number of sectors. Moreover, potential competition is reduced by a sparse population and relative long distances to large markets, which together with the prevalence of local monopolies and public ownership in many network industries, point to the need for greater vigilance to sustain and promote competition. Further reforms to promote product market competition should focus on fundamental changes in the regulatory approach as well as more incremental measures to intensify competition. The competition authority should concentrate resources on problems of horizontal collusion and the effectiveness of the new leniency programme should be improved. In addition, the role of the sector regulators should be enhanced to strengthen *ex ante* regulation of network industries, particularly to counter the market power of local monopolies and secure effective non-discriminatory third party access. This should be combined with a more rigorous and transparent evaluation and competition neutral financing of universal service obligations. Further measures, aimed at levelling the playing field between public and private business, should include a broad-based privatisation programme as well as the introduction of clear and transparent rules for public participation in market activities in addition to the establishment of an administrative public procurement authority to improve the functioning of this market.

This Working Paper relates to the 2004 OECD Economic Survey of Finland ([www.oecd.org/eco/surveys/finland](http://www.oecd.org/eco/surveys/finland)).

*JEL codes:* K21, L11, L16, L33, L43, L81, L87, L9, O57

*Key words:* Finland, productivity and growth, product market competition, competition law, regulatory reform, retail sector, network industries, public procurement, public ownership.

\* \* \* \* \*

**Concurrence sur le marché des biens et performance économique en Finlande**

Après la sévère récession des années 1990, la croissance économique a été forte mais la convergence en termes de la productivité est encore loin d'être complète et les comparaisons empiriques internationales suggèrent qu'un renforcement de la concurrence pourrait résorber une part significative de ce retard. Certes, les réformes structurelles mises en œuvre au début des années 1990 pour renforcer la concurrence ont soutenu la croissance et ont même souvent été plus précoces qu'au sein de l'Union Européenne. Néanmoins, divers indicateurs suggèrent que le degré de concurrence reste insuffisant dans de nombreux secteurs. En outre, le degré potentiel de concurrence reste contenu en raison de l'éparpillement de la population et l'éloignement par rapport des longues distances d'accès aux grands marchés, qui, combinés à l'importance des monopoles locaux et de l'actionnariat de l'état dans de nombreuses industries de réseaux, suggèrent la nécessité d'une vigilance renforcée pour promouvoir la concurrence sur le marché. En ce sens, de nouvelles réformes devraient combiner changements de fond quant à la compréhension de l'activité du régulateur d'une part, et mise en œuvre plus incrémentale de certains dispositifs d'autres parts. L'autorité en charge de la concurrence devrait ainsi concentrer ses ressources sur les problèmes de collusion horizontale. L'efficacité du nouveau programme de clémence devrait être améliorée. En outre, le rôle des régulateurs sectoriels devrait être accru afin de renforcer *ex ante* la régulation des industries de réseaux, en particulier pour contrebalancer le pouvoir de marché des monopoles locaux et assurer l'accès non discriminatoire des tierces parties. Une évaluation plus rigoureuse et transparente et un financement des obligations de service universel plus neutre pour la concurrence semblent aussi requis. Pour homogénéiser les conditions de concurrence entre le secteur public et le secteur privé, la mise en œuvre d'un programme de privatisation à grande échelle, la définition d'une législation claire et transparente concernant la participation du secteur public à des activités concurrentielles, et l'installation d'une autorité publique charge de l'achat public pour d'améliorer le fonctionnement de cette marché seraient aussi pertinentes.

Ce Document de travail se rapporte à l'Étude économique de l'OCDE de la Finlande, 2004 ([www.oecd.org/eco/etudes/finlande](http://www.oecd.org/eco/etudes/finlande)).

*Classification JEL :* K21, L11, L16, L33, L43, L81, L87, L9, O57

*Mots clés :* Finlande, productivité et croissance, concurrence sur le marché des biens, droit de la concurrence, réforme structurelle, vente au détail, industries de réseaux, achat public, secteur public.

## TABLE OF CONTENTS

ABSTRACT/RÉSUMÉ.....	2
PRODUCT MARKET COMPETITION AND ECONOMIC PERFORMANCE .....	4
Introduction .....	4
Macroeconomic performance and indicators of competition .....	4
Foreign competition is limited.....	10
Competition law and its enforcement.....	14
Extensive public ownership can create competition problems .....	16
Regulatory policies at the sectoral level .....	19
Retail distribution .....	20
Professional services.....	23
Network industries.....	24
The public sector may stimulate competitive markets .....	35
Macroeconomic effects of regulatory reform .....	36
Overall assessment and scope for further action .....	37
BIBLIOGRAPHY .....	41
<b>Boxes</b>	
1. Meat prices in Europe .....	10
2. The Finnish legal and enforcement framework .....	15
3. Public ownership in Finland .....	17
4. The relative performance of state-owned companies .....	19
5. The Finnish market for alcohol.....	22
6. Agricultural support and restructuring.....	23
7. The electricity market and price formation.....	25
8. Interconnection regulation and termination costs in telecommunications .....	31
9. Different forms of variable airport charges .....	34
10. VAT handling charges for purchases abroad.....	35
11. Competition problems when public units participate in market activities .....	36
12. Economy-wide effects of sectoral reforms .....	37
<b>Tables</b>	
1. Output, employment and productivity	
2. Central government ownership	
3. Key structural features of the retail sector	
4. Pre-tax electricity prices in Europe	
5. Pre-tax natural gas prices for industry	
6. Assumptions and effects of pro-competitive regulatory reform in selected industries	
7. Summary of recommendations	
<b>Figures</b>	
1. Indicators of product market regulation	
2. R&D spending and industry structure	
3. Hirschmann-Herfindahl indices of industry concentration	
4. Price difference between Finland and the European Union	
5. Import penetration	
6. Import penetration by type of manufacturing industry	
7. Openness indicators	
8. FDI positions in OECD countries	
9. Relative size of the public enterprise sector	
10. The food prices index in Finland relative to the European Union	
11. Distribution charges to household customers	
12. Telecommunication charges	
13. Broadband penetration and user charges	

## PRODUCT MARKET COMPETITION AND ECONOMIC PERFORMANCE

Jens Høj and Michael Wise<sup>1</sup>

### Introduction

1. Since the deep recession of the early 1990s growth has been strong and productivity gains were among the highest in the OECD. However, the scope for economic catch-up remains considerable. A substantial productivity gap *vis-à-vis* the best performing OECD countries persists and unemployment remains uncomfortably high and most of it is structural. Lowering it calls for labour market reforms, but more intense product market competition should also have a positive impact (Alho, 2002; Nicoletti and Scarpetta, 2003). The OECD Growth Study and other empirical work have shown that competition plays a key role in raising economic growth. In Finland, the promotion of competition through broad-based regulatory reforms started in earnest in 1988, and accelerated after the economic crisis of the early 1990s and prior to European Union (EU) membership. They boosted growth and were in a number of cases ahead of the European liberalisation process. Nevertheless, some features of the economy, such as the prevalence of local monopolies and public ownership in many network industries give rise to competition issues. Moreover, greater vigilance to sustain and promote competition is required as the potential for competition is reduced by Finland being sparsely populated and relatively isolated from large markets. The difference between the outstanding productivity performance of Finnish world market leaders, such as Nokia, and the development in protected domestic sectors also points to a lack of competition. The policy challenge now is to raise the performance of the latter sectors.

2. The paper first reviews Finland's growth performance over the past decade, before analysing product market competition indicators to gauge the strength of competitive pressures and the implications of barriers to trade and foreign direct investment. This is followed by an assessment of the general competition policy framework and its role in promoting competition. Subsequently, the competition issues associated with widespread public ownership are discussed. Next, an examination is carried of a number of sectors where better regulation can be expected to have particularly large impacts, including a number of network industries, and the role of public procurement is highlighted. The paper concludes with estimates of the possible macroeconomic effects of regulatory reforms and a set of policy recommendations.

### Macroeconomic performance and indicators of competition

3. Over the past decade, growth performance was better than in most other OECD countries, reflecting both the recovery from the economic crisis at the beginning of the 1990s and the strength of the information and communication technology (ICT) sector, which is dominated by the telecommunication equipment producer Nokia. Productivity gains were rapid after the recession but have been much slower more recently. As a counterpart, employment growth was subdued for several years after the recession, but was considerably stronger over the second half of the 1990s. The global downturn in the ICT sector is a reason why growth decelerated more sharply in 2000 than in most other European countries, and also highlights the potential vulnerability of the economy to the performance of a single company. Labour shedding during the recent slowdown was limited, but employment has not recovered to the pre-recession peak of the late 1980s, leaving unemployment still uncomfortably high (**Table 1**). Moreover, Finland has a relatively low level of average hourly productivity. While it is high in manufacturing, there is still considerable scope for catch-up in the sheltered and public service sectors, despite the good performance in the 1990s. This point to the need for reforms to foster the catch-up process.

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1. This paper was originally prepared for the OECD Economic Survey of Finland published in November 2004 under the authority of the OECD's Economic and Development Review Committee. Jens Høj is an economist in the Economics Department and Michael Wise is a lawyer in the Competition Division in the Directorate for Financial and Enterprise Affairs. They are indebted to Jørgen Elmeskov, Mike Feiner, Val Koromzay, Andrew Dean, Maria Maher, Giuseppe Nicoletti, Peter Hoeller, David Turner and Jens Lundsgaard, and other colleagues in the Economics Department for useful comments. Special thanks to Isabelle Duong for her excellent technical assistance.

Table 1. Output, employment and productivity

	Finland		Norway mainland	Sweden	France	Germany	Italy	United Kingdom	United States
<b>A. Growth decomposition, 1992-2002</b>	92-02	97-02							
Average GDP growth	3.3	3.4	3.2	2.5	2.0	1.3	1.6	2.9	3.2
<i>of which:</i>									
Productivity	2.5	1.5	1.9	2.5	1.1	1.1	1.3	2.0	1.8
Employment	0.7	1.8	1.3	0.1	0.9	0.2	0.3	0.9	1.4
<i>of which:</i>									
Unemployment <sup>1</sup>	0.3	0.8	0.2	0.1	0.1	-0.2	-0.0	0.6	0.2
Labour force	0.4	1.0	1.1	-0.1	0.8	0.4	0.3	0.3	1.2
<b>B. Labour productivity growth, 1992-2002<sup>2</sup></b>									
Agriculture <sup>3</sup>	6.5	4.4	4.3	3.5	3.0	4.8	4.0	1.7	1.5
Total manufacturing	5.4	4.2	0.8	7.0	3.6	2.1	1.6	2.6	3.9
Food products, beverages <sup>4,5</sup>	3.9	2.6	1.8	2.6	-0.9	1.3	0.8	0.9	-1.7
Printing and publishing <sup>5</sup>	3.8	0.8	-1.1	3.3	1.1	1.4	0.4		-1.8
Machinery and equipment <sup>5</sup>	9.7	10.3	1.4	13.2	7.3	2.1	1.7	4.4	11.2
Electricity, gas and water	6.4	4.8	4.1	1.8	2.1	5.4	5.5	7.6	1.2
Construction	-0.1	-1.5	-0.6	0.6	-1.1	-0.2	-0.1	1.9	-0.2
Total services	1.7	0.9	2.0	1.7	0.2	1.0	0.9	2.1	1.6
Wholesale and retail trade <sup>5</sup>	2.6	2.1	5.2	3.4	0.6	-0.8	0.9	2.5	3.8
Communication <sup>5</sup>	4.8	4.5	4.3	3.9	2.7	7.6	3.4	5.1	2.3
Financial services <sup>6</sup>	7.0	1.2	4.2	4.9	-1.0	3.3	2.8	1.3	4.1
Other services	0.5	-0.1	0.3	-2.4	-0.2	0.2	0.2		0.0
<i>Memorandum items:</i>									
GDP per capita <sup>7</sup>	75.0		79.4	78.3	76.7	71.9	72.9	75.3	100.0
GDP per hour worked <sup>7</sup>	77.0		94.9	82.8	107.0	91.7	96.6	74.6	100.0
VA per hour in manufacturing <sup>7</sup>	96.2		91.1	88.9	105.4				100.0

1. A positive sign indicates that unemployment has declined and contributed to boost output growth.
2. Or latest available year.
3. Including hunting and fishing.
4. Including tobacco.
5. 1993-2002 for Sweden.
6. Including non-financial services for the United Kingdom.
7. 2002 levels, with 2000 PPPs. United States = 100.

Source: OECD, STAN database.

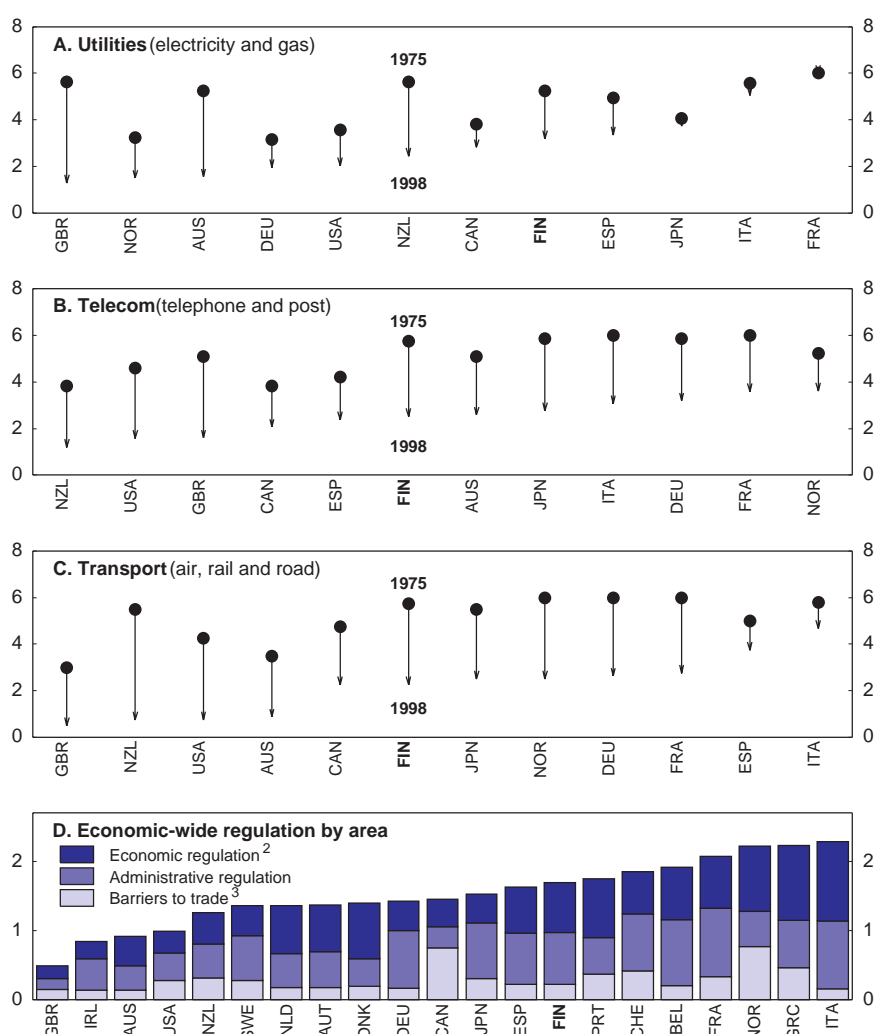
4. Productivity growth has been broadly based across sectors, but over recent years, it has proved difficult to sustain a rapid pace. In manufacturing, productivity growth slowed, although the pace remains strong in international comparison. This can largely be ascribed to continued high productivity growth in the communication equipment sector, the so called “Nokia effect”.<sup>2</sup> On the other hand, the service sector has seen productivity growth falling back to levels experienced in some of the slower growing OECD economies with a consequent stagnation in the catch-up process.

5. The strong productivity increases in the aftermath of the economic crisis in the early 1990s reflected partly a substantial labour shake-out and partly regulatory reforms that were implemented – often ahead of reforms in other EU countries – in the wake of the economic crisis and in preparation of EU membership in 1995. These factors led to an initial boost to productivity growth in the agriculture and food processing sectors, but the process has slowed, reflecting lack of competition and state aid in agriculture, that is sizeable even by EU standards (OECD, 2003a). In a number of service sectors, such as distribution,

2. The communication equipment sector has enjoyed annual productivity increases of nearly 20 per cent over the decade as well as a tripling of the sector’s share in total employment.

construction, and financial and business services, productivity growth has slowed to rates which are well below the best performers, prolonging the catch-up process. On the other hand, the liberalisation of the telecommunication and electricity sectors boosted productivity performance. Nevertheless, there is still scope for further regulatory reforms, even in the better-performing service sectors, as the stringency of regulations is about average in the OECD (**Figure 1**). A main element pushing up the ranking in the OECD's indicator on the stringency of business regulations is the widespread public ownership in the service sectors, such as telecommunications, postal service and the railways, as well as in a number of manufacturing industries. Administrative barriers, impeding entrepreneurship and small and medium-sized enterprise (SME) formation, have been reduced with the introduction of one-stop shops and simplified procedural matters for issuing licenses and permits. Nevertheless, overall administrative barriers are at the same level as the OECD average.

**Figure 1. Indicators of product market regulation<sup>1</sup>**



1. The regulatory stance is measured by a synthetic indicator ranging between 0 (least restrictive) and 6 (most restrictive) for each year and sector. It covers public ownership, barriers to entry, market structure, vertical integration and price controls. See Nicoletti and Scarpetta (2003) for details.
2. Includes barriers to competition and state control.
3. Includes trade and FDI restrictions.

Source: Nicoletti G. and S. Scarpetta (2003), "Regulation, Productivity and Growth: OECD Evidence", *Economic Policy*, April; OECD Regulatory database.

6. The strong productivity performance is related to high spending on research and development (R&D) which, at nearly 3½ per cent of GDP, is among the highest in the OECD. R&D and competition are often reinforcing each other as the latter forces companies to search for new products and processes to maintain or expand markets – in the process moving production up the value added chain. The Finnish manufacturing sector is characterised by a relatively high technology intensity and accounts for the bulk of overall R&D spending. However, nearly two-third of R&D spending by the manufacturing sector takes place in the export-oriented (and Nokia dominated) communication equipment segment (**Figure 2**, panel A and B). OECD research indicates that, in general across all OECD countries, domestic product market regulation has a negative effect on R&D spending (panel C) as well as on the diffusion of information technologies through ICT investments (panel D). For the latter, there is relatively large scope for catch-up in the case of Finland (Daveri and Silva, 2004). An additional issue is that public programmes providing business services support to innovative SMEs are possibly crowding out otherwise profitable private business (Väänänen, 2003).<sup>3</sup> Thus, R&D spending can be maintained at high levels by relying less on public support programmes and more on intense rivalry in domestic markets, which would also increase information technology diffusion.

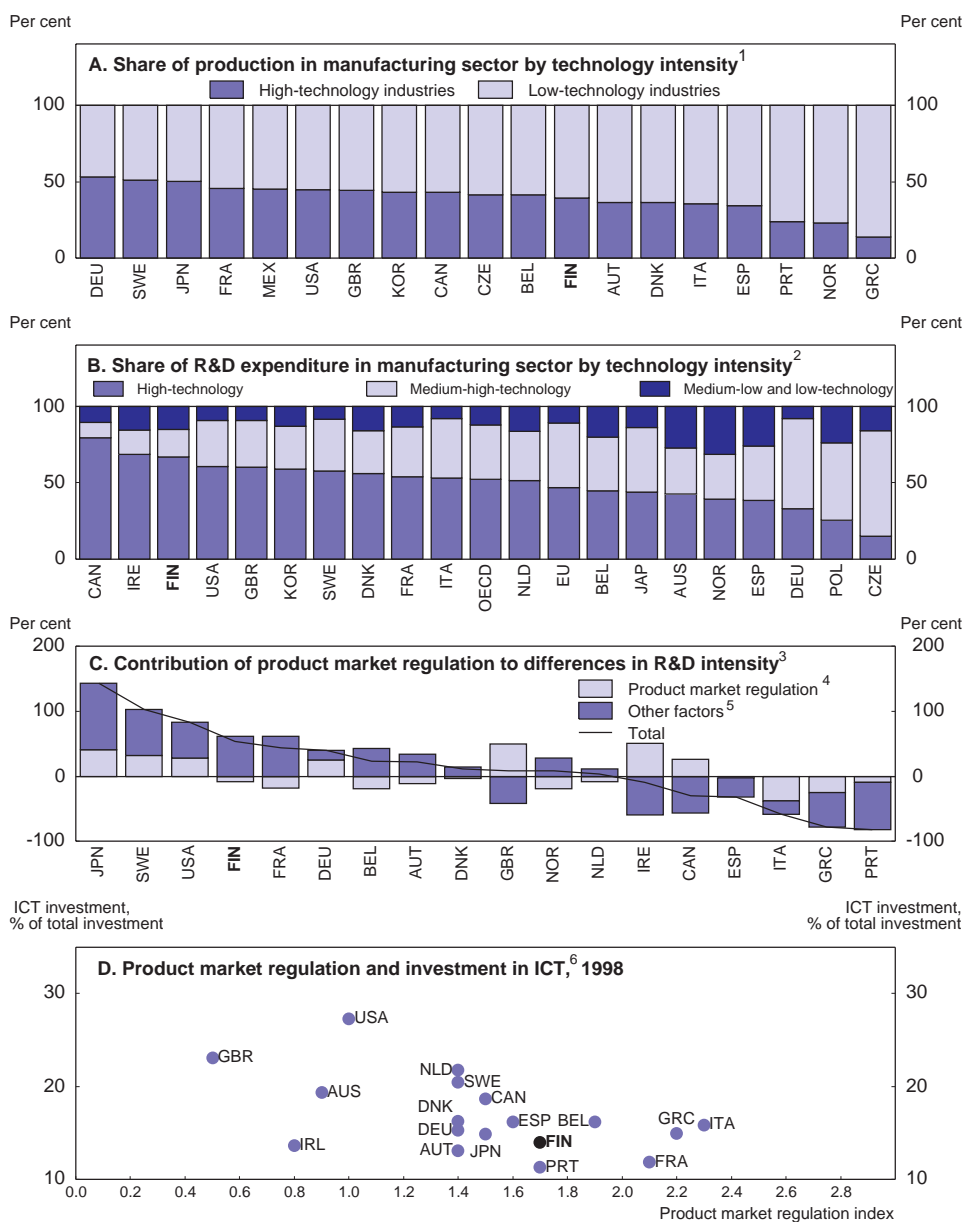
7. *Concentration* tends to be high in most industries, also when compared with other smaller economies, and is pronounced in segmented industries (**Figure 3**). In itself, high concentration within the national boundary is not necessarily a sign of market power if the highly concentrated sectors are exposed to foreign competition, but the Finnish economy has a surprisingly low import penetration. Moreover, even when firms are in fierce international competition, such as in the wood product industry, the lack of domestic competition may reduce consumer welfare if such firms are able to pursue a pricing-to-market strategy at home. The prevalence of co-operatives in the primary production of food results in high concentration in this sector. The distribution sector is dominated by an unusually small number of vertically-integrated chains, linked through co-operatives and franchising. Such integration may lead to efficiency gains, but this will only benefit consumers if competition is sufficiently intense. In the transport sector, the government-owned incumbents' near monopoly status dominate both in the railway and air transport segments. The combination of high concentration and government ownership is also found in alcohol retailing, the communication sector and in the utilities. On the other hand, mark-ups are more or less in line with international levels with the exception of an internationally high mark-up in the Nokia dominated communication equipment sector, which probably reflects innovation rents and continuous efficiency improvements in the context of a highly competitive international market.

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3. SME support programmes have been found to underpin private spending on R&D, perhaps offsetting capital market imperfections (Hyytinen and Toivanen, 2003). However, public programmes providing business services support do not appear to alleviate any obvious market failures, raising the concern that such programmes might be crowding out otherwise profitable private business.

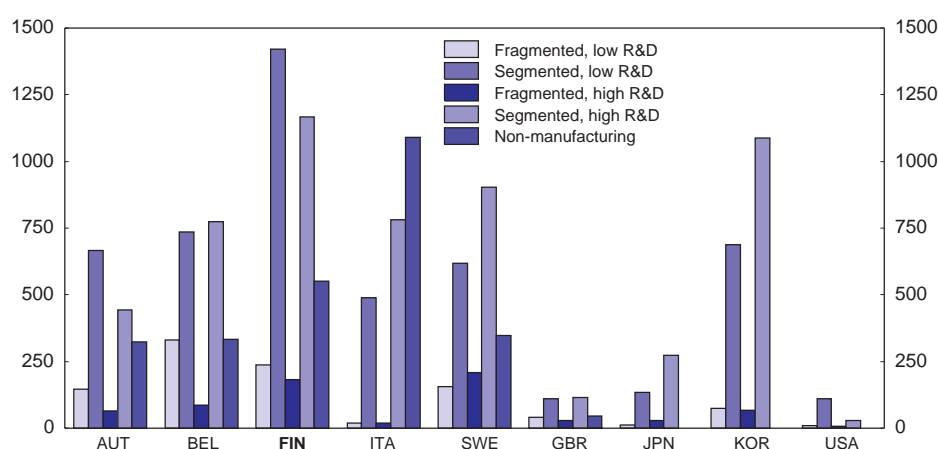


**Figure 2. R&D spending and industry structure**



1. Latest available year : 2001 for Denmark and United States; 2000 for Belgium, Czech Republic, France, Mexico and United Kingdom; 1999 for Canada, Finland, Germany, Greece, Italy, Norway, Portugal, Spain and Sweden; 1998 for Japan and Korea.
2. 1998 for Norway and the OECD; 1999 for Denmark, France, Ireland, Netherlands, Sweden and the European Union; 2000 for all other countries.
3. Percentage deviation from OECD average, adjusted for industry composition.
4. Includes administrative and economic regulations.
5. Includes employment protection legislation, other controls, country-specific effects.
6. ICT: Information and communication technology.

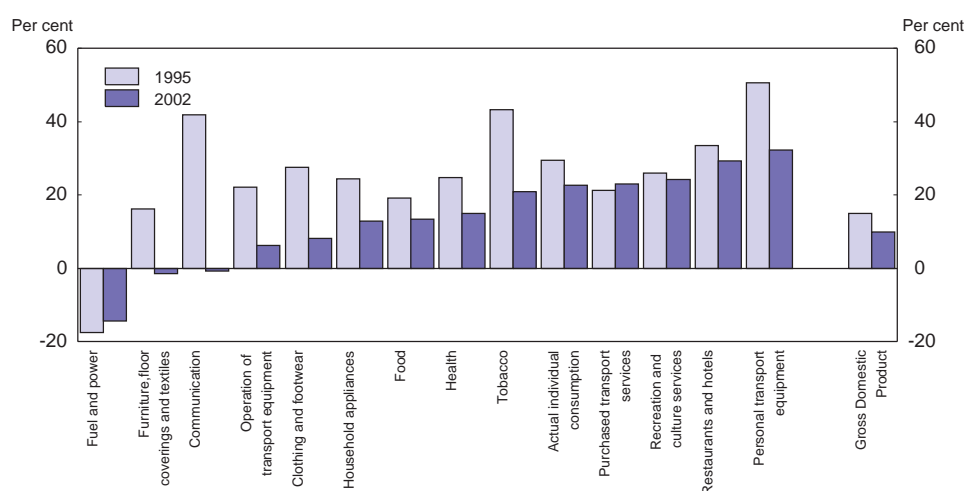
Source: OECD, STAN and ANBERD database.

**Figure 3. Hirschmann-Herfindahl indices of industry concentration<sup>1</sup>**

1. Based on establishment data for Japan, Korea and the United States and on enterprises data for the others.

Source: OECD, Statistics on enterprises by size class (SEC database).

8. *Prices* tend to be higher than in most other EU countries, although EU membership has led to a narrowing of the price differentials (**Figure 4**). Nevertheless, in areas where rapid price convergence could have been expected, such as for food, price differentials remain considerable. This may point to competition problems in the highly concentrated and vertically integrated food producing and retailing sectors. For example, some meat prices are still considerably above the EU average (**Box 1**). A closer inspection of the products where high taxes push up prices shows that also pre-tax prices are higher than in other countries. For example, Finnish pre-tax prices for tobacco and alcohol are about 20 per cent and 80 per cent higher than in Germany and France, respectively. By contrast, liberalisation efforts in the electricity and telecommunications sectors have resulted in electricity prices below the EU average and communication prices that are in line with the EU average.

**Figure 4. Price difference between Finland and the European Union<sup>1</sup>**

1. Percentage difference between the price levels in Finland and the average price levels of EU15 countries.

Source: Eurostat.

### Box 1. Meat prices in Europe

European meat prices were strongly affected by the bovine spongiform encephalopathy (BSE) and foot-and-mouth scares in 2001. Such price developments can be used to trace differences in market power across countries. Across Europe, the diseases lowered prices for beef and increased prices for pork and chicken, before reverting the following year towards their initial level. In Finland, price trends diverged from the European pattern, possibly indicating the presence of market power.

In 2001, European producer prices for beef (across all types of animals) fell by nearly 20 per cent before rebounding strongly the following year. The Finnish producer prices increased initially for bulls and heifers and declined moderately for cows. The following year prices came down, but that still left Finnish prices for bulls and heifers close to their 2000 level and nearly 20 per cent above the average price in the north of Europe, although the decline in prices for cows was stronger and left prices below the average price in the north of Europe. The 2001 producer price increase for pork was similar in Finland and Europe, but the Finnish decline the following year was less pronounced, leaving Finnish pork prices about 10 per cent above the average level in the north of Europe. Somewhat surprisingly, Finnish chicken prices are about one-third higher than in the north of Europe and follow a time path that appears unrelated to developments there. These price developments indicate that Finnish meat producers may have relatively more market power than in other countries, at least temporarily.

The pass-through to consumer prices tends to be relatively slow with the fluctuations in consumer prices for meat being of a smaller magnitude than for wholesale prices. However, considered over the period 2001-02, Finnish consumer prices for beef increased faster than producer prices and to a larger extent than in other European countries. For pork, a greater share of the initial increase in producer prices was passed on to consumer prices in Finland than in other countries. Moreover, the following year when producer prices for pork fell, it was only in Finland that consumer prices continued to increase. These price trends might point to less competition in the retail sector for these goods than in other countries.

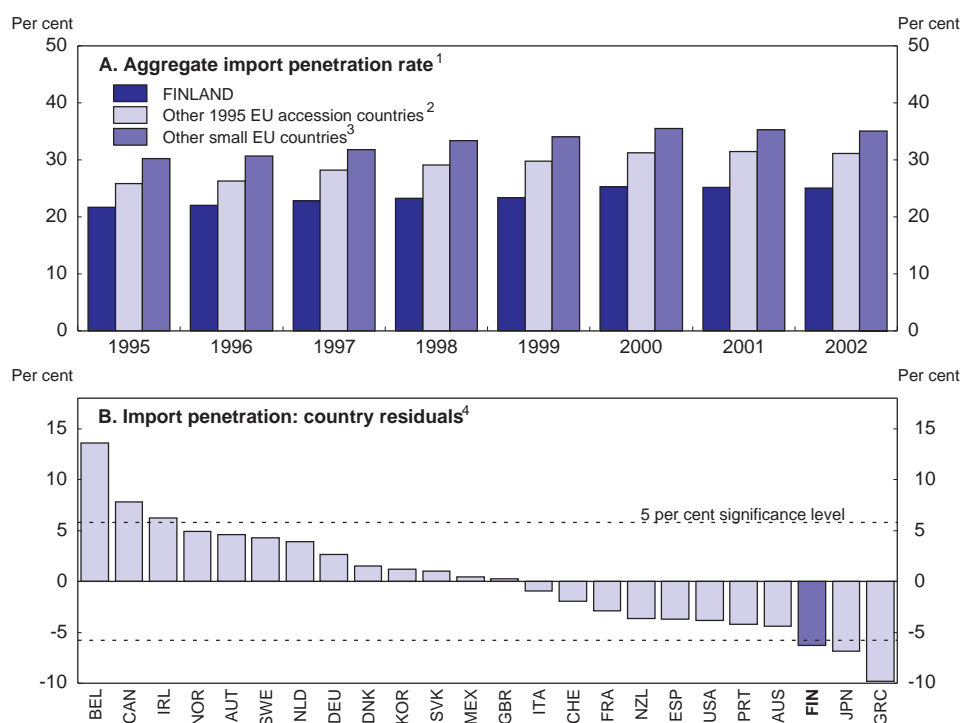
### Foreign competition is limited

9. Foreign competition is important, particularly for smaller countries, to increase competitive pressures on domestic markets. However, the Finnish economy shows surprisingly low import penetration, even when controlling for transportation costs and per capita income (**Figure 5**).<sup>4</sup> Moreover, following EU accession, imports rose less rapidly than in the other accession countries. Both the import penetration for agriculture and manufacturing industry is well below that of other smaller (northern) European countries, where the former may be explained by continued high subsidies (see below). A further breakdown by industry type reveals a similar picture across all industries (**Figure 6**). In particular, import penetration in low R&D spending industries is low, irrespective of whether the industry is segmented, such as food manufacturing, or fragmented, such as printing and publishing. Even in segmented industries with high R&D, such as communication equipment, import penetration is low, even though these are normally associated with a high degree of international rivalry. Trade policies are an EU competency (**Figure 7**). However, a number of EU agreements are still in place, such as in agriculture, and specific national standards, especially in construction and building materials sectors, continue to be an issue (the Finnish Standards Association applies more than 15 000 national standards), as they can be a hindrance to trade (OECD, 2003a). In addition, the Finnish recycling system for beverage containers raises barriers for foreign entry for natural mineral water, as EU regulations require that such products to be bottled at source, thus increasing transportation costs associated with the recycling system.<sup>5</sup>

4. Investigating home bias via a gravity equation, Chen (2004) also found that Finland is more closed than the large EU countries. She argues that the late accession of Finland to the Union may be a possible reason for the apparent lower degree of market integration.

5. There are two additional issues concerning beverage containers. There is a differential tax treatment of refillable (tax exempted) and of reusable (standard tax rate of 16 cents per litre) containers – and if the latter does not belong to a recycling system the tax rate is 67 cents per litre. There are three different

Figure 5. Import penetration

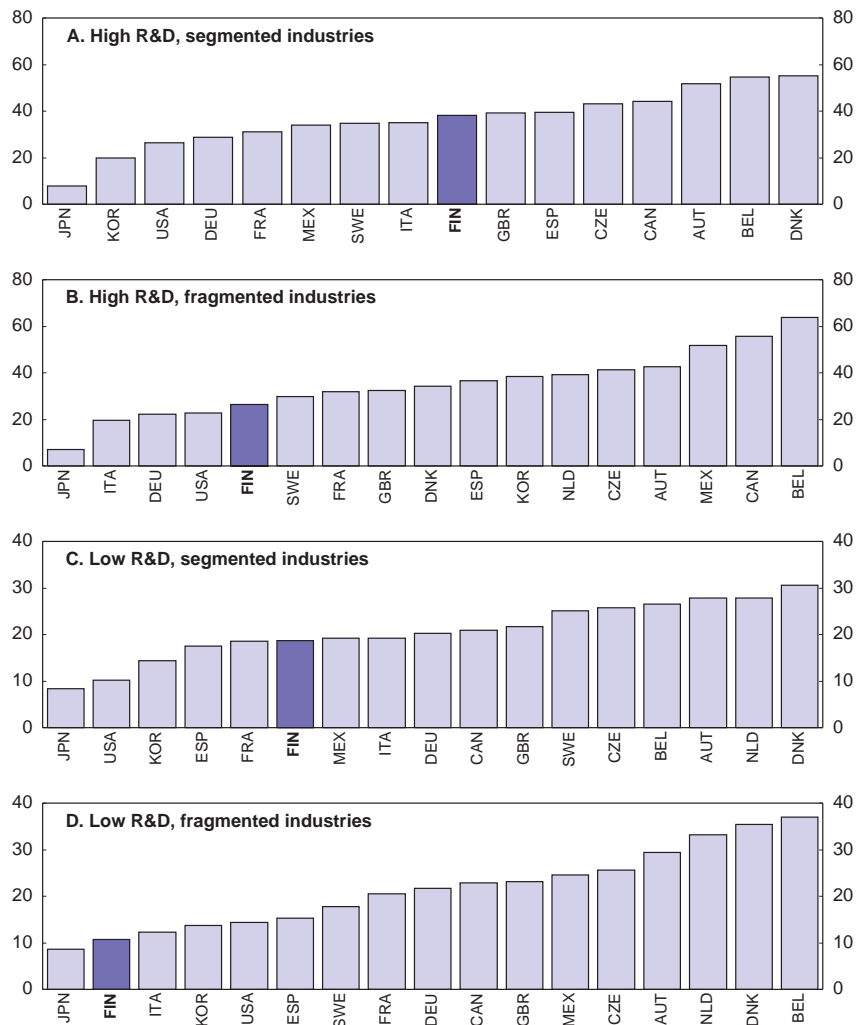


1. Defined as the ratio of imports of goods and services relative to GDP plus imports of goods and services.
2. Unweighted average of Austria and Sweden.
3. Unweighted average of Belgium, Denmark, Greece, Ireland, Netherlands and Portugal.
4. Residuals after control for effects of country size, GDP per capita and transportation costs.

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recycling systems, which have raised competition concerns with respect to dominance by large incumbents and entry for small companies and importers.

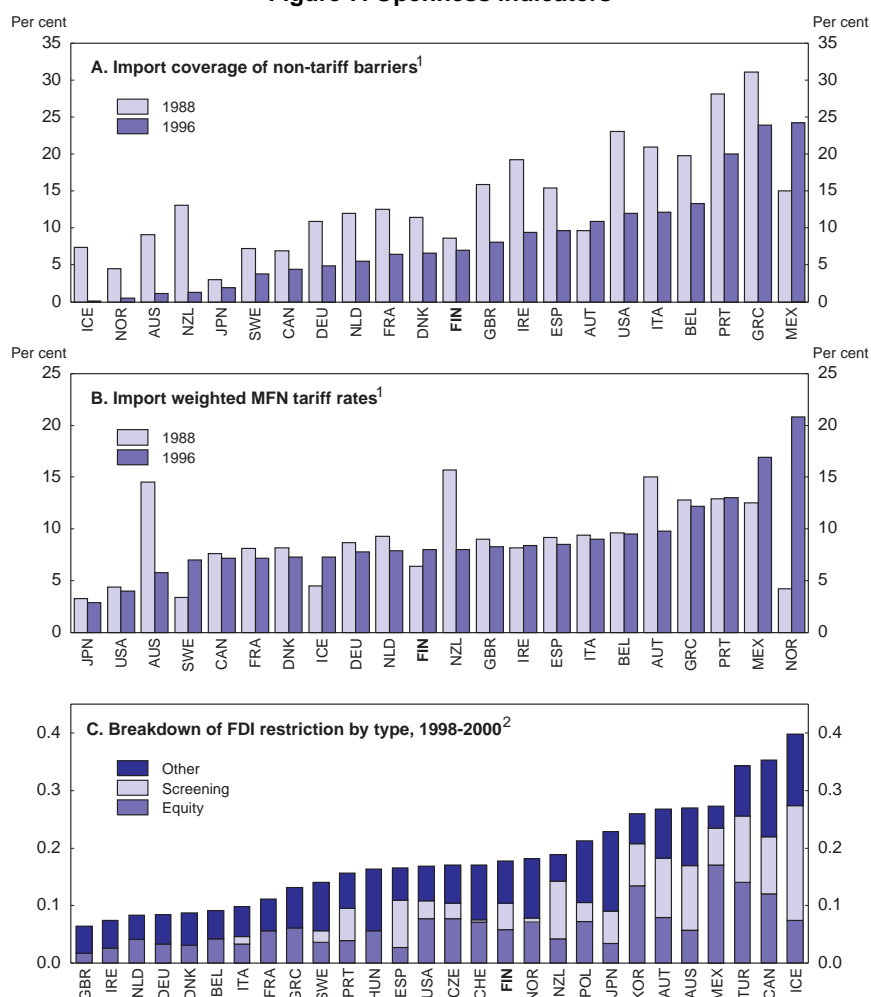
**Figure 6. Import penetration by type of manufacturing industry<sup>1</sup>**



1. Segmented market structures are characterised by large firms and significant barriers associated with high costs, while fragmented market structures are characterised by small firms and low sunk costs and entry barriers.

Source: Oliveira Martins, J., T. Price and N. Mulder (2003), "A taxonomy of market structure cluster", *OECD Economics Department*, mimeo.

Figure 7. Openness indicators



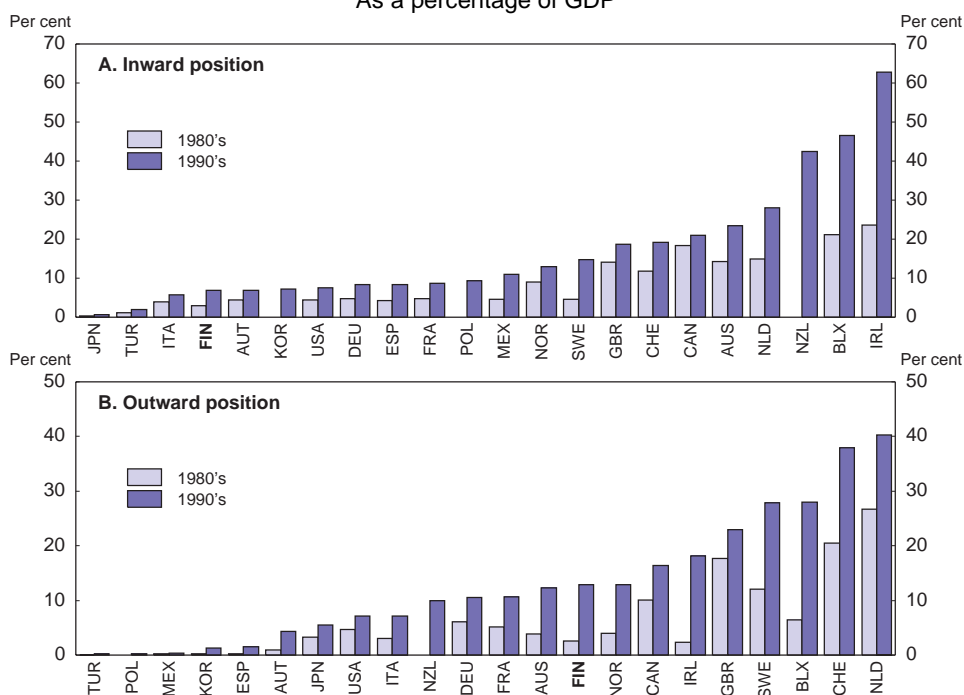
1. OECD calculations based on UNCTAD data. Aggregation from 2-digit level tariffs to national level using sectoral value-added weights.
  2. The indicator ranges from 0 (least restrictive) to 1 (most restrictive). The most recent year for which data are available varies across countries between 1998 and 2000.
- Source: UNCTAD.

10. The economy also appears relatively closed when looking at the inward foreign direct investment (FDI) position, which is among the lowest in the OECD area (**Figure 8**). While there are no formal barriers to inward FDI, the low position may be related to market and institutional conditions that discourage inward FDI – particularly in the service sectors – arising mostly from public ownership, small markets, high labour costs, and relatively high effective marginal taxation (**Figure 7**, panel C) (Yoo, 2003).<sup>6</sup> The overall degree of restriction is now similar to the OECD average. Finland has removed many restrictions during the 1990s, when it had one of the most restrictive inward FDI policies in the OECD. Nevertheless, OECD estimates suggest that removing the remaining restrictions as well as easing product market regulation could boost the inward FDI position by up to a third (Nicoletti *et al.*, 2003). Also other policies,

6. Other barriers to inward FDI include special establishment permissions in a range of business activities for entities from outside the European Economic Area and that only companies established in Finland can avail themselves of pension insurance. In addition, other factors, like the small size of the Finnish market and its peripheral location in relation to the EU market, may also reduce the attractiveness for foreign investors (OECD, 2003a).

especially labour market policy, play an important role in explaining the relatively limited FDI inflow, pointing to important interdependence effects between policies. In some sectors FDI has been playing a role in promoting competition, such as in retailing, where both Swedish and German investments have resulted in more competitive markets (see below), although similar effects are not visible in the telecommunications market, where the partly government-owned incumbent merged with the government-owned Swedish incumbent (Telia).

**Figure 8. FDI positions in OECD countries<sup>1</sup>**  
As a percentage of GDP



1. Average values over the two periods. For countries where the FDI position data are not available, values of bilateral stocks reported by their OECD partners were summed to obtain an approximate measure of multilateral FDI stocks.

Source: OECD, *International Direct Investment Statistics Yearbook: 1980/2000*, 2001 ed.

### Competition law and its enforcement

11. The legal and enforcement framework for competition conforms to European Community practice (**Box 2**). It has been updated repeatedly and has been generally successful in supporting significant changes in the Finnish economy since the late 1980s, but it needs further strengthening. Most importantly, sanctions imposed by the courts have been too low to deter serious violations. The competition law provides – in line with European practice – for fines of up to 10 per cent of annual group worldwide turnover. The Finnish Competition Authority (FCA) has wide-ranging responsibilities and acts independently. Its *de facto* independence should be recognised formally. It is relatively small and the time required to decide cases has been increasing. The FCA has only been able to bring about a half dozen proposals for enforcement action each year to the Market Court, which is responsible for imposing fines in competition cases. The latter's case load is dominated by public procurement disputes. A number of measures should be implemented to enhance enforcement capacity. The FCA has long had substantial activity in liberalised network industries, partly reflecting the absence of sector regulators until recently. Strengthening the sector-specific regulatory oversight of liberalised network industries could free up FCA resources to address cartels and other restraints. The Market Court should use the new scope for imposing sanctions that are significant enough to secure deterrence. This would also increase the effectiveness of the leniency programme, which could be further enhanced by introducing individual liability to give

executives stronger participation incentives. To allow the Market Court to concentrate on major competition cases, an administrative public procurement authority should be established in combination with a minimum jurisdictional threshold.

### **Box 2. The Finnish legal and enforcement framework**

A stronger enforcement body, the Finnish Competition Authority (FCA), was created in 1988. It was followed by substantive updates of legislation, while merger control was adopted in 1998. Finland brought its law into full conformity with the prohibition-based system of EC competition law in May 2004. The practical impact of the change is modest, though, because Finland's competition law, which was originally based on applying general principles case by case to correct abuses, had already been interpreted and applied to be generally consistent with EC law. The modernised enforcement system eliminates the reviewing of applications for exemption, while Finland's new law expands the FCA's role by empowering it to issue orders to cease violations.

Although cases inevitably respond to complaints, the FCA tries to focus enforcement attention on sectors that are economically significant and whose characteristics suggest competition problems. These include forest products and wholesale distribution of consumer products, where the FCA is concerned that industry structure and practices may lead to gate-keeper control over competition. Other areas of particular attention are public services, including health and financial and network industries. The FCA is paying increasing attention to horizontal collusion. One substantial case, against bid rigging in asphalt, has become public, and others are under investigation.

The leniency programme under the 2004 law is designed to deal with the fact that only the Market Court, and not the FCA, has the power to impose fines. However, the FCA can now promise leniency to the first applicant. Although some of the pending matters were prompted by leniency programmes in other Nordic countries, Finland's own leniency programme has not yet produced any completed enforcement action. If sanctions are not significant, the promise of leniency in exchange for insiders' direct evidence does not work. For years, the FCA's proposals to impose substantial fines against horizontal misconduct have been eviscerated in court. The new law should lead to higher fines. Before, the law set a maximum of EUR 670 000, which is well below the likely gain to a significant, long-standing cartel and in practice no court decision ever reached this statutory benchmark. The new law repealed the maximum and provides now for fines of up to 10 per cent of annual group world-wide turnover. This is consistent with the European Community approach, but the new law has not yet been tested in Finnish courts. The asphalt case that was submitted to the Market Court in March 2004 will be a serious test: the FCA alleges that the seven companies in the cartel were rigging bids nationwide for eight years, and has asked the Market Court to impose fines of EUR 97 million.

The FCA operates within the Ministry of Trade and Industry, but its enforcement independence seems secure despite the absence of formal protections. The FCA's manpower has grown by about 20 per cent over the last decade, but it remains a comparatively small organisation with a staff of about 65, which is about half the size of competition agencies in similarly-sized OECD countries and in the Nordic area. A major case, such as the recent asphalt investigation, can tie up much of the staff for an extended period. With several horizontal investigations now pending, the FCA's cartel unit seems overstretched, with the case-processing times nearly doubling between 2000 and 2002, although the situation may improve as available resources increase with the elimination of applications for exemption.

The Market Court, established in its present form in 2002, is still settling into its status. This new body combines jurisdiction over marketing practices and unfair competition with the powers of the old Competition Council to impose orders and fines to enforce the Competition Act. Assigning these functions to a judicial body removed a concern about the appearance that both prosecution and decision powers were under the influence or authority of the Ministry of Trade and Industry. The new Market Court has not indicated a policy direction in competition matters, in part because it is swamped by yet another responsibility, to decide disputes about public procurement. It handles over 200 procurement cases per year, compared to about 25 under the Competition Act and an equal number about unfair competition and marketing practices. Most of the competition matters are complaints against the FCA for not taking action in small controversies. The most important cases are the proposals from the FCA for orders or other remedies, but there are only about a half dozen of these per year. The Market Court has not used its power to dismiss cases of minor importance.

A significant proportion of the FCA's workload is about abuse of dominance, because application of the general competition law has been a principal tool to prevent abuses by network monopolies. The FCA maintains informal ties with the sector regulators in the energy and telecommunications sectors. Sectoral regulation does not displace the Competition Act, and the FCA has stepped in about issues such as broadband access and pricing where the coverage of the telecoms law was not clearly established. The conceptual framework under the sectoral laws for evaluating the prices and terms of network access is still evolving, as Finland's legislation has led to case-by-case determinations in the regulatory process. The relevant regulatory standards are related to those of competition law (and in telecoms, the FCA and the regulatory body co-ordinate about analytic issues such as market definition and determination of market power), but the standards may not be identical. In electric power, for example, the courts ruled that rates that are reasonable under electric power legislation could not be challenged as abuses under the competition law.

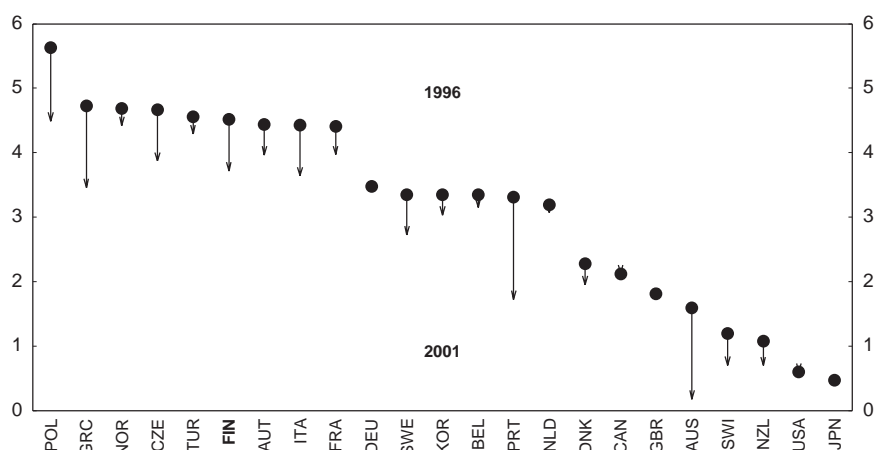


### Extensive public ownership can create competition problems

12. A defining feature of the Finnish economy is the high degree of public ownership (**Figure 9**) (Willner, 2003). The prevalence of government ownership is in many cases related to Finland's history (**Box 3**). As in many other OECD countries, publicly-owned firms are active in network industries, which are increasingly being opened up for competition (**Table 2**). Publicly-owned firms compete with private companies in a number of sectors, such as alcohol retailing, air transportation, financial services, energy, manufacturing, forestry and mining. In addition, local governments have widespread holdings in such areas as utilities and the liberalised telecommunications. The playing field can be uneven if government-owned firms benefit from at least implicit financial guarantees or have a dominant position in the market.

13. Most of the government-owned companies in the manufacturing sector face foreign competition, thus reducing potential competition problems. On the other hand, many of the government-owned companies within the service sectors are active in more protected domestic markets and often have a dominant position, which creates a risk of strategic behaviour undermining competition by, for example, hampering non-discriminatory access in telecommunications or cementing a dominant position by co-operating with other market participants as in the airline industry. If such activities are against the competition law the deterrent effect of sanctions is limited by fines ultimately being paid by the public purse. In addition, the expected effect of sanctions is reduced further by the possibility that legislative action will undo the enforcement decision. Some commentators even consider government-owned companies to be more prone to pursue exclusionary strategies than profit-maximising private firms, because incentives for managers of the former are more geared towards maximising revenues, which for example could explain the participation of the government-owned telecommunications incumbent in the German auction for UMTS licenses (Sappington and Sidak, 2003). Privately-owned firms may refrain from competing fiercely when facing competition from a government-owned company because of the political risk associated with such a company going bankrupt, and instead exploit their higher efficiency by allowing the government-owned competitor to be the price leader in the market. Indeed, the somewhat lower efficiency of government-owned companies probably arises from their corporate governance not always being focussed on profit maximisation and efficient operation (**Box 4**).<sup>7</sup>

**Figure 9. Relative size of the public enterprise sector<sup>1</sup>**



1. Index 0-6 scale from lowest to highest share of public enterprises, index based on the extent of state ownership and (gross) proceeds from privatisations.

7. Another concern is information asymmetries between state enterprises and private companies. A recent Supreme Administrative Court ruling argued that state enterprises are public authorities, which must obey the Act on Openness of Government Activities, implying that information provisions applied to state enterprises are different from those applicable to private companies (Finnish Competition Authority, 2003).

### Box 3. Public ownership in Finland

The historical background for the widespread public ownership in Finland is different from that in most other countries. Following the establishment of the Finnish Republic in the aftermath of the First World War, private capital availability was seen as insufficient to support industrial development – a role that was filled by the government. Another factor was the need to pay war reparations after the Second World War. However, neither of these factors play any role today.

Finland has no explicit privatisation programme. The government distinguishes between three types of publicly-owned companies. “Special assignment” companies – including businesses in sectors like alcohol retailing, broadcasting, and gambling – are associated with wider public policy objectives and will remain – despite some privatisation – under public control. In companies with strategic importance – like energy and air transport – the public ownership share may be reduced to below 50 per cent, but the government will remain a shareholder. The third group includes companies e.g. paper, metal engineering and banking, which may be divested.<sup>0</sup> Moreover, traditional network industries, such as telecommunication, railways and the postal services, used to be part of the public administration, but have been reorganised into limited companies. Public ownership in these sectors tends to decrease as liberalisation leads to entry and as the government reduces its shareholding. An example of the latter is in telecommunications, where the incumbent (formerly Sonera) is co-owned by private investors and the Swedish government (as the result of the merger with the Swedish Telia). The merger with Telia took place after Sonera incurred substantial losses arising from its German UMTS license, raising the issue whether better corporate governance could have prevented that investment in the first place.

Ownership control of government-owned companies is normally delegated to ministries (involving in all nine different ministries). Some also have the regulatory responsibility, creating a potential conflict between the state's role as owner and regulator. The conflict is partly addressed through the co-ordinating role of the Ministry of Trade and Industry. A recent report commissioned by the Ministry of Trade and Industry proposes a centralisation of the government ownership responsibilities as part of the process of separating such concerns from regulatory issues (Ministry of Trade and Industry, 2004).

Some measures have been taken to secure a level playing field, when government-owned firms are participating in market activities. One such measure is accounting separation, which is typically required to prevent government-owned firms from cross-subsidising between competitive and monopolistic activities, which can be a problem in deregulated network industries. However, this measure suffers from problems of asymmetric information between the regulated and the regulator and the subjective nature of accounting rules, pointing to the need for formal – legal or ownership – separation to secure a level playing field.

1. Legislation defines a state-owned company as the government holding at least 50 per cent and companies with a holding below that threshold as associated.

**Table 2. Central government ownership**

## A. Banking and manufacturing

Company	Share in September 2004	Minimum ownership
Alko Inc (retail)	100.0	100.0
Altia Group (wholesale)	100.0	50.1
Fortum Corporation (energy production and oil refining)	60.4	50.1
Kemijoki Oy (energy production)	67.0	50.1
Kemira Oy (chemicals)	55.3	15.0
Metso Corporation (metal engineering)	11.5	0.0
Outokumpu Oyj (metals and technology) <sup>1</sup>	37.8	10.0
Patria Industries (defence)	73.2	50.1
Rautaruukki (steel)	40.1	20.0
Sampo (banking and insurance)	21.3	0.0
Stora Enso Oyj (forestry)	11.6	0.0
Vapo Oy (peat)	66.7	50.1

## B. Network and traditional public sector industries

Company	Share in September 2004	Minimum ownership
Finland Post Corporation (post services)	100.0	..
Finnair Oyj (air transport)	58.4	50.1
TeliaSonera Corp. (telecommunications)	19.1	..
Oy Veikkaus Ab (gambling)	99.6	..
VR-group (rail transport)	100.0	..
Oy Yleisradio AB (broadcasting)	100.0	..

1. The Finnish Social Insurance Institution owns 12.3 per cent of the shares, implying that the majority of shares is within public ownership.

Source: OECD (2003), *Review of Regulatory Reform – Finland, A New Consensus for Change*, OECD, Paris.

#### **Box 4. The relative performance of state-owned companies**

The performance of government-owned firms may be hampered by less efficient corporate governance than in profit maximising private companies. Non-listed state-owned companies (such as Alko, Patria and Finland Post) have no market value to provide constant and direct monitoring and performance evaluation. The market valuation of partly privatised firms, like Finnair, is influenced by the constraints that governments are facing in the management of their shareholding. Lenders are serving an important monitoring function of management, but to the extent that loans are either explicitly or implicitly guaranteed by the government, this function is reduced. Additional financial support may arise from lower demands on rates of return on invested capital. Traditionally, performance incentives have been reduced by the lack of performance related remuneration of management in state-owned firms, but the Finnish government has introduced such measures over the past years, making this issue less of a concern. On the other hand, some government-owned listed companies have members of their Supervisory Boards appointed by parties represented in Parliament, which may mean that the participants in the oversight of state-owned companies may not necessarily have uniform and consistent goals, potentially leading to demands that the firms pursue non-profit objectives, such as regional or employment aims.

Measuring the relative performance of government-owned companies is not straightforward. In terms of return on equity for companies quoted on the Helsinki stock exchange, government-owned companies yielded on average a percentage point less than all companies quoted on the stock exchange (excluding the special case of Nokia) over the period 1997-2002. Comparing the average price/earnings (P/E) ratios in 2003 for government-owned companies with their relevant international peers shows that the best performing of the government-owned companies are in intense international competition. These include Metso (engineering) and Outokumpu (metals and technology group), although a number of other internationally competing government-owned companies, such as Kemira (chemicals) and Rautaruukki (mining) while having respectable P/E ratios are not performing as well as their international peers. Government-owned companies with dominating positions on their domestic markets, such as Finnair (air transport), Fortum (oil), and TeliaSonera (telecommunications) all have P/E ratios well below their international peers.

14. Short of privatising public assets in the business sector, the organisation of government-owned businesses as limited companies is a partial measure to level the playing field *vis-à-vis* private companies. An additional step would be to change the current system of conferring the government's ownership responsibilities to the regulating ministries, creating a conflict between the government's roles as owner and regulator, by transferring all ownership control of government-owned companies to one ministry with no regulatory functions. This should include the government-owned companies in sectors that are still only partially liberalised, such as railways and postal services. A further step would be to introduce measures to improve corporate governance of government-owned companies, for example by concentrating them in a profit-maximising holding company. However, only an extensive privatisation programme in the context of comprehensive regulatory reforms would solve the competition problems associated with publicly-owned companies in the sheltered sector. The government has agreed on a rule that a share of privatisation proceeds can be used for infrastructure investments, possibly speeding up privatisations.

#### **Regulatory policies at the sectoral level**

15. Regulatory policies for private service sectors vary in scope. Some sectors, such as retail distribution and professional services, are inherently competitive, but competition may be hampered by entry controls and self-regulation, pointing to the necessity of a forceful implementation of the general competition law and the elimination of exemptions from it. On the other hand, network industries are characterised by "natural monopoly" segments where competition is difficult to introduce. In these industries, regulatory efforts are directed towards securing non-discriminatory third-party access to the networks and the opening of potentially competitive segments to competition. A particular concern in these industries is the possibility for cross-subsidisation between monopoly areas and competitive activities, requiring a clear separation between various activities. Moreover, the market power of incumbents in these industries often implies that the playing field is anything but level. Internationally – but not in Finland – this has often led to the introduction of *ex ante* regulation of newly liberalised network industries, where the regulatory authority prescribes and enforces rules of conduct or access charges to support the

introduction of competition and prevent companies from exploiting their local monopoly power. As competition becomes viable in these sectors, the regulatory approach can be replaced by the application of general competition principles. The latter is characterised by *ex post* regulation, where the regulatory authority determines whether conduct or rates in a particular case conformed to norms or principles. International experience shows that the potential gains from opening up network industries to competition can be very large. In cases where concerns with respect to supply reliability and insufficient network capacity have been raised, these problems have been related to the design of reforms and not to liberalisation *per se*.

### ***Retail distribution***

16. The Finnish retail distribution sector is highly concentrated and characterised by a relatively low density of fairly small shops (**Table 3**). Food retailing is dominated by a few vertically-integrated chains, which tend to be organised as co-operatives or franchises. Moreover, food wholesaling is dominated by two central trade organisations with powers to influence the selection of goods and their pricing and destination. The vertically-integrated nature of the distribution sector explains why, despite the relatively small size of shops, productivity is higher than in most other European countries, although the lack of very large-scale operations means that potential efficiency gains are not realised.<sup>8</sup> On the other hand, the prevalence of high prices raises doubts as to how much of these efficiency gains are actually passed on to consumers. Indeed, the rapid structural changes in the food retailing sector during the 1990s only led to a limited increase in competitive pressures as margins for most food products were reduced only marginally (Peltomäki, 2001).<sup>9</sup> Another sign of limited competitive pressures is the relatively large price dispersion for identical grocery products, which indicates that the food retailers have some market power to pursue a pricing-to-market strategy at the local level (Aalto-Setälä, 2001).<sup>10</sup>

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8. For a more detailed discussion of the Finnish retail sector, see Marjanen (2000). The author also finds the survival of local retailing is independent of the existence of large format retailers, but most rely – less surprisingly – on attracting a larger customer base.

9. The sector's restructuring halved the number of shops and increased the supermarkets' market share from 3 per cent to a bit less than a quarter. In addition, from the mid-1980s to the beginning of the 2000s the number of rural shops fell from more than 2 600 to less than 900 (Home, 2002).

10. In addition, the finding that large grocery retailers have larger mark-ups could indicate that such firms prefer to use (at least partly) their more efficient operations to increase profits (Aalto-Setälä, 2002).

**Table 3. Key structural features of the retail sector<sup>1</sup>**

	Outlet density <sup>2</sup>	Employees per enterprise	VA per employed person <sup>3</sup>	VA per unit of labour costs <sup>3</sup>	Concentration in food retailing <sup>4</sup>
<b>Finland</b>	<b>44.7</b>	<b>5.2</b>	<b>125.2</b>	<b>108.7</b>	<b>69.0</b>
Austria	45.6	7.6	102.2	97.1	45.0
Belgium	73.8	3.8	108.3	92.9	48.0
Denmark	45.5	8.4	82.7	97.2	52.0
France	64.3	4.3	133.7	102.0	31.0
Germany	32.4	9.6	100.3	105.7	30.0
Ireland	45.0	8.2	95.4	99.2	52.0
Italy	128.8	2.3	97.4	78.9	9.0
Netherlands	53.6	8.5	87.6	116.1	41.0
Norway	67.7	6.0	92.0	104.5	86.0
Portugal	136.6	2.6	66.0	87.8	46.0
Spain	130.0	2.9	91.8	98.5	23.0
Sweden	63.9	4.3	104.0	85.1	60.0
Switzerland	53.3	8.6	117.7		81.0
United Kingdom	35.9	14.9	85.8	121.6	41.0
European Union <sup>5</sup>	69.0	6.4	100.0	100.0	10.0
EU excluding Italy, Portugal, Greece and Spain <sup>6</sup>	51.9	7.4	104.1	103.2	

1. 2001 or latest available data.

2. Number of enterprises per 10 000 inhabitants.

3. VA expressed in USD PPP terms. European Union = 100.

4. Market shares of the first three firms based on sales, 1996 data.

5. Unweighted average of EU 15 excluding Greece for the first four columns and including Greece but excluding Luxembourg for the fifth column.

6. Unweighted average.

Source: O. Boylaud and G. Nicoletti (2001), "Regulatory Reform in Retail Distribution", *OECD Economic Studies*, No.32, 2001/1; Eurostat.

17. There is evidence, however, that foreign entry is increasing competition in the retail market, notably the Swedish Axfood (whose SPAR retail franchisees have a market share of a bit less than 10 per cent) and more recently the German Lidl company, which has established 76 outlets despite facing problems in obtaining building permits and resistance from unions. One element in the latter's success in breaking into the Finnish market appears to have been the use of foreign beer as a marketing tool. The retail sale of beverages with a higher alcohol content than 4.7 per cent is a state monopoly (**Box 5**).<sup>11</sup> According to Gallup Food Information, the entry of Lidl has led to a price reduction of nearly 5 per cent for meat. Moreover, Maliranta (2004) has linked the increase in foreign ownership in retailing to a recent pick-up in the sector's labour productivity growth. More generally, Finnish food prices since the beginning of this decade (with the exception of the foot and mouth scare and BSE in 2001) have risen at a slower pace than in the EU (**Figure 10**).<sup>12</sup> This can be attributed to both increased competition in the retail sector and restructuring in the agricultural sector (**Box 6**).

11. The sale of beer is not completely liberalised as the National Product Control Agency has issued an instruction that beer cannot be sold at prices below cost of production.

12. The sharp fall in relative prices for processed food in early 2004 is related to the lowering of indirect taxes on alcohol.

18. Consumer welfare has benefited from more intense competition in the retail sector, although consumer choice is restricted by the lack of very large outlets, the low outlet density and the declining number of smaller specialised shops.<sup>13</sup> Thus, policies should be directed towards further expanding consumer welfare and choice by easing entry and improving the adaptability of existing shops to changing market conditions. Such measures should include the further relaxation of shop opening hours, which would for example enable the opening of 24-hour convenience stores.<sup>14</sup> Moreover, land use planning and control are governed by local government (with out of town large shops requiring special permission), which does not take into account wider considerations concerning competition and complaints have surfaced about problems in obtaining permits, pointing to the need for some liberalisation of zoning regulations. In addition, the abolition of the government's alcohol monopoly would increase the possibility for retailers to expand product range and increase the number of items for promotional purposes, thereby broadening entry strategies. So far little evidence of overt anti-competitive behaviour has been found in the retail sector. If such problems exist, perhaps the recently introduced leniency programme could help to uncover them. In addition, Post Finland's high administrative charges for handling value added tax (VAT) for goods purchased over the Internet should be reviewed (see below).

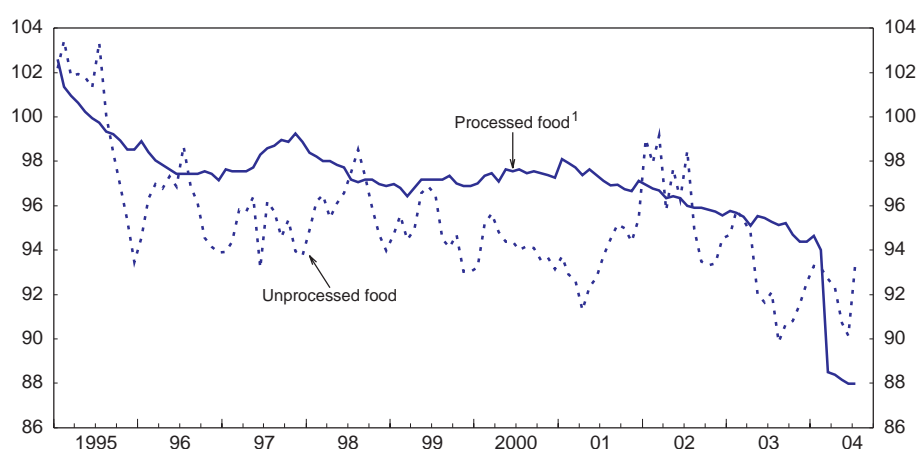
#### **Box 5. The Finnish market for alcohol**

The government operates a retail monopoly (Alko) for sales of alcoholic beverages stronger than 4.7 per cent for public health reasons. Import and wholesaling were liberalised following entry into the Union, leading to the entry of some 250 importers and wholesalers. However, competition in the wholesale market remains limited. Alko has monopsony power as other importers and wholesalers can sell only to it or the less important restaurant and hotel segment. Wholesalers can either deliver to each individual Alko shop or against a charge (to cover storage costs) to Alko's central warehouse. The retailer's price policy – consisting of a mark-up that is fixed up to a limit and thereafter declining to a lower bound – and a legal ban on promotional offers and discounts on alcoholic beverages prevent the use of strategies for promoting new products or clearing unwanted stocks. The selection process of products – process time from the registration of the offer to the listing date of the product is on average six months – has a negative effect on new entry. Non-selected products can still be sold through a so called sale-to-order list, where customers can ask any Alko shop to order the product from the supplier's warehouse. However, the list is not an attractive marketing device as the associated distribution costs can be high as products are sold in relatively small quantities and on an infrequent basis. Alternatively, the wholesaler can offer the product as a contract product, but must bear all associated costs if the minimum sale requirement is not attained.

EU regulation forced the government to remove limits on private imports of alcohol in January 2004 which, together with visa-free travel between Finland and EU accession countries Estonia, Latvia and Lithuania, has put pressure on the viability of maintaining a monopoly on retail alcohol in view of public health reasons. Already Hella and Mankinen (1999) pointed out that increasing cross-border trade in alcoholic beverages was leading to a normalisation of consumption towards the levels observed in other EU countries – a process that was expected to accelerate as EU integration is completed. Limiting the number of outlets in such circumstances amounts to imposing an implicit selective tax on consumers without easy access to an outlet. Indeed, in other OECD countries other instruments for controlling the availability of alcohol, such as taxation, location, opening hours, age limits and right of refusal to serve, are compatible with retail competition.

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13. There is some evidence that the establishment of large-scale retailers has led to the closure of small grocery and speciality shops, reducing consumer choice (Järvinen and Saarinen, 2003).
14. Current shop opening hour regulations restrict opening hours from 07:00 to 21:00 during weekdays and from 07:00 to 18:00 on Saturdays. Furthermore, only shops smaller than 400 square meters can be open on Sunday afternoons throughout the year.

**Figure 10. The food price index in Finland relative to the European Union**  
Index 1995 = 100



1. The decline in early 2004 is related to a lowering of alcohol taxation.

Source: Eurostat.

#### **Box 6. Agricultural support and restructuring**

Finland stands out as having still high food prices, a high level of subsidisation and a low level of import penetration. Reforms could thus lead to high welfare gains. Agriculture is even more heavily subsidised than in other EU countries, as Finland was allowed to maintain a large amount of national aid since it became a member of the European Union (see the previous *Survey* for a more detailed discussion). The amount of support has remained about constant over the past years at some 2¼ per cent of GDP with an unchanged split between EU and national programmes (OECD, 2003b). National aid in Finland is the highest in the EU and amounts to about twice the EU average. Indirect support from consumers in the form of higher than the EU average prices adds up to ¾ per cent of GDP. While the five-year transitional period for national payments, which was granted to compensate for the effects of the unfavourable climate on productivity, ended as foreseen in 1999, the Commission authorised Finland to continue to pay national support due to the serious difficulties caused by the accession. The current authorisation runs until 2007.

Despite rapid restructuring since EU membership – the number of farms declining from 103 000 to 73 000, the sector continues to account for a share of overall employment that is about twice the share in northern Europe. Despite rapid productivity gains, agricultural productivity still trails by more than 10 per cent and with a differential to the best performers of some 25 per cent. Import penetration in the sector is just above half of the average in northern Europe, pointing to limited pressures from abroad to accelerate the sector's restructuring process. With the extension of the transitional period it is doubtful that the productivity gap will be closed. Given that Finland does not hold a comparative advantage in agriculture, a further restructuring of the sector would reduce food prices and improve the budgetary situation.

#### **Professional services**

19. There is less self-regulation that restrains competition among professional services than in most other EU countries (Paterson *et al.*, 2003). This partly relates to an active approach by the FCA to remove such self-regulation as for example with the abolition of price recommendations by the Medical Association, Dental Association, Bar Association and the Association of Architects and Interior Architects, and the Association of Consultants. An OECD study found that this approach indeed increased price competition in professional services (OECD, 2000). In some areas, such as in architectural services, the competition-limiting rules continue to come under scrutiny. In the specific case, the rules of the Associations of Architects effectively restrict entry into architectural competitions.<sup>15</sup> Arguably,

15. The rules stipulate that architectural competitions (mostly organised by large public entities) must conform to the association's competition rules, which give members of the association both the right to participate



professional associations' self-regulation alleviates information asymmetries *vis-à-vis* their customers. However, such regulation often restrains competition, and the recent case shows the importance of remaining vigilant in this area.

### *Network industries*

20. Finland was one of the first countries in Europe to liberalise its electricity and telecommunications markets. In both cases, the regulatory approach has relied on *ex post* regulation with sector regulators mainly being responsible for securing third party access and the FCA mainly for pursuing infringements of the competition law. This approach has proved very time consuming. Elements of *ex ante* regulation will be incorporated to conform to the requirements of the new EU directive for energy. However, it is doubtful whether this will suffice to counter the market power of local monopolies. An additional problem is that the latter tend (particularly in the electricity sector) to be owned by local governments. In other network industries, deregulation has followed EU directives. A special case is the natural gas sector, which has been exempted from such directives.

### *Competition in the electricity sector*

21. The opening of the electricity market was completed in 1998 with the introduction of load profiling – which lowers switching costs – for small consumers, expanding the free supplier choice to all customers (**Box 7**).<sup>16</sup> In addition, the integration into the Nordic electricity market (Nord Pool) countered the ability of large incumbents to dominate the market, although the limited international interconnector capacity still leads to market power during peak load demand periods. Liberalisation has secured relatively low prices for households, but they remain higher for industrial users when comparing with countries that also liberalised early – the other members of Nord Pool and the United Kingdom (**Table 4**). Nevertheless, Finnish prices are below the EU average. In addition, local market power appears to be a problem. Prices vary considerably within Finland. The highest prices for smaller consumers are almost double the lowest prices, with a 15 per cent difference between the highest and lowest quartile.<sup>17</sup> Consumers do not appear to be sensitive to price differentials. Increased competition has changed the price structure, so that electricity is priced very competitively, but network access fees have increased by about 10 per cent since 1997, as the vertically integrated utilities (about half of the 90 local utilities) may be benefiting from their natural monopolies. Moreover, distribution charges exhibit a large dispersion (**Figure 11**), partly reflecting a sparse population, and partly reflecting differences in efficiency. Only about one-fifth of all distributors can be considered efficient according to their controllable operating costs.<sup>18</sup> On the other hand, the transmission charges on the national grid are among the lowest in Europe (IEA, 2004) and account for about 4 per cent of the household electricity price as compared with nearly one-third for local distribution charges.

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in such competitions and to sit on the judging panel. This organisation of competitions effectively constitutes a barrier to entry as only members of the association can participate in competitions that are organised in collaboration with the association. The FCA has ruled against these rules, but the association has appealed with the case still pending.

16. Generation is very diversified, relying on nuclear power plants (27 per cent of generation), coal-fired plants (21 per cent), hydropower (16 per cent), natural gas (13 per cent), a relatively high share of renewable energy sources, such as peat (10 per cent) with the rest provided by decentralised combined heating and power (CHP) systems.
17. For a typical household (medium-scale industrial customer), the components of the electricity price consists of 35 per cent (22 per cent) that can be attributed to network charges, 39 per cent (53 per cent) to the price of electricity and the remaining 26 per cent (25 per cent) to taxes and VAT.
18. To enhance efficiency, the EMA has allowed incentive bonuses, but so far only two high efficiency distributors have been allowed to benefit and no low efficiency distributor has been affected.

### Box 7. The electricity market and price formation

The market is characterised by relatively widespread public ownership and quite extensive cross-ownership. The central government has the majority shareholding in the largest utility (Fortum) and municipal utilities own substantial shares of the second largest (PVO). In addition, Fortum and other publicly-owned utilities together with partially government-owned manufacturing firms own a bit less than half of the shares in a PVO subsidiary (TVO). This subsidiary operates two of the four nuclear power plants and will construct and operate a recently licensed nuclear power plant. Both Fortum and PVO are vertically-integrated companies as are about half of the around 90 local utilities, which are mostly owned by the municipalities. To limit abuse of dominant positions, accounting separation has been introduced for vertically-integrated companies engaged in generation, transmission, distribution, and retail/trading. Only the national grid has been formally separated out in an independent transmission operator (Fingrid), which was created through a merger of publicly and privately-owned grid assets. The dimensioning of the national grid relies partly on market-based incentives, as Fingrid is responsible for maintaining Finland as one (wholesale) price area despite the tendency for prices to diverge between the (mainly electricity producing and low price) north and the (mainly electricity consuming and high price) south. The cost to Fingrid of purchasing and selling electricity provides information and incentives to invest in transmission capacity. On the other hand, there is no market-based incentive framework in place for investment in international interconnectors, which is subject to approval by the Ministry of Trade and Industry.

Competition has been effective in continuously lowering prices for electricity until the dry and cold winter of 2002-03 which depleted hydro resources and increased prices considerably. Prices have since come down, but are still 15-36 per cent above their previous level. Part of this can be explained by some nervousness in the market as it took most of 2003 before the depleted water reservoirs were back to normal levels (Montel, 2003). Another factor is the presence of relatively detailed retail price disclosure requirements which aims at protecting consumers against excessive price swings, but which tends to make prices sticky.

Electricity companies are obliged to inform their customers in writing at least one month ahead prior to price increases with the result that the companies normally only change prices with a month interval and probably even more rarely. This leads to more stable prices in Finland than in the other NordPool countries as prices respond less to market developments, thus reducing the efficiency of the market. Retailers with a dominant market position are obliged – as part of their supplier of last resort obligations – to provide official retail (“list”) prices, providing the basis for price comparisons with other retailers. The retailer may offer a different price to consumers outside its service area. These list prices exhibit a considerable variation as many of the distribution companies have their own generating capacity and prefer to sell electricity at cost-based prices to their local consumers rather than at market prices, explaining the low customer-switching rate of 4 per cent. Additional factors contribute to explain this low rate: some small suppliers do not even accept new customers from outside their supply area; in some cases, customers that applied to return to their local retailer were offered the higher market price; and switching charges are high (EMA, 2002).<sup>1</sup> These examples of strategic behaviour are part of a wider restructuring of the price structure, where the increased competition has led to competitively priced electricity and high network access charges as the vertically integrated utilities may be benefiting from their local natural monopoly power. Such a restructuring of prices often forms part of a strategy to foreclose entry of new operators, pointing to the need for isolating and regulating the natural monopoly element of the network.

A number of other factors are distorting the playing field. The incumbent utilities have been slow in providing information and metering services, which has hampered the switching of customers to other retail companies. Excessive charging continues to be an issue with one case – involving a utility owned by the Helsinki municipality – pending at the Market Court. Moreover, this and another 12 utilities enjoy an exemption from corporate taxation, because they are part of their municipality and have not been separated out as independent units. Whether the utilities are exploiting this apparent competitive advantage is unclear as at least some of the municipalities reportedly exact a charge on the utilities’ earnings that is equivalent to the tax savings, although this may be offset by a lower required rate of return.<sup>2</sup>

1. The switching charges were abolished in September 2003, at the same time as distribution companies were only allowed a meter reading charge if the previous supplier switch occurred more than a year earlier.
2. Currently, there are 13 utilities that are exempted from corporate income tax. Among them are quite big actors like Helsingin Energia, Tampereen Sähkölaitos, Kuopion Energia and Pori Energia.

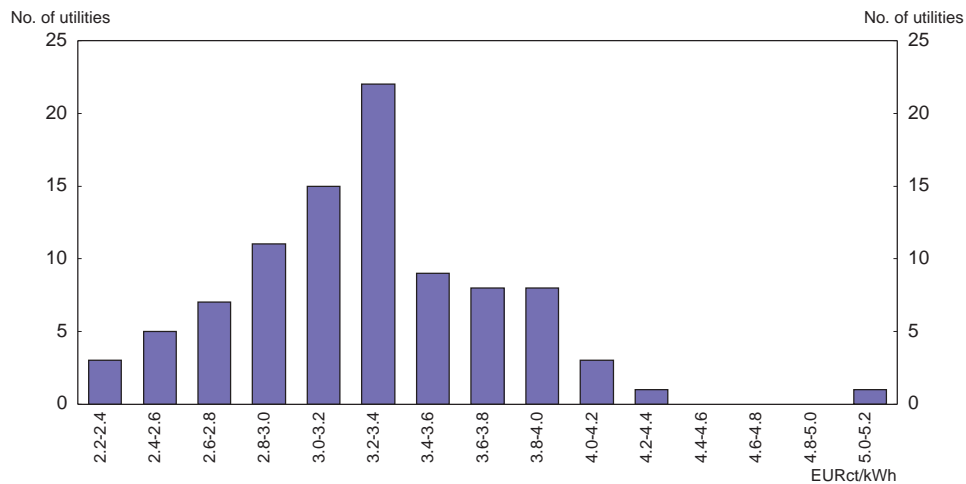
**Table 4. Pre-tax electricity prices in Europe**

1 July 2003, in euro cents per kWh

	Industry			Households		
	Small consumer	Medium consumer	Large consumer	Small consumer	Medium consumer	Large consumer
<b>Finland</b>	<b>6.8</b>	<b>5.3</b>	<b>4.2</b>	<b>15.2</b>	<b>8.0</b>	<b>4.9</b>
Belgium	12.2	7.3	5.0	14.8	11.2	7.1
Germany	13.7	7.4	6.4	20.4	12.5	6.6
Spain	9.5	5.3	4.7	11.2	8.7	5.7
France	8.3	5.3	..	12.6	8.9	7.1
Ireland	12.8	7.6	6.1	19.1	10.1	6.4
Italy	10.4	8.4	7.3	7.8	14.7	..
Austria	8.9	5.0	3.8	12.4	9.2	7.1
Luxembourg	12.7	6.8	4.3	21.7	11.9	7.2
Portugal	10.6	7.4	5.2	12.9	12.6	8.1
Greece	9.0	6.1	4.8	7.6	6.1	5.2
Denmark	6.5	6.9	..	17.0	8.7	7.2
Sweden	4.6	4.1	3.7	21.8	8.6	6.9
Norway	6.9	5.1	3.4	33.2	9.6	5.6
United Kingdom	7.3	4.7	3.9	16.0	9.2	5.5
Average Europe	9.5	6.2	4.9	16.3	10.1	6.6
Average liberalised markets <sup>1</sup>	6.3	5.2	3.7	22.0	9.0	6.3

1. Average of the other Nordic countries and the United Kingdom.  
Source: Eurostat.

**Figure 11. Distribution charges to household customers**  
Detached house, 5 MWh per year



Source: Energy Market Authority.

22. Regulation has not sufficed to counter local market power. The network companies set their own access charges, while the sector regulator (the Energy Market Authority (EMA)) ensures – in a lengthy *ex post* process – that they reflect cost developments and provide a reasonable rate of return on the basis of the annual report of unbundled accounts (IEA, 2004). This approach is opposite to the *ex ante* regulation in place in most other EU countries (EC, 2004). However, the new EU directive on the supervision of the electricity market will introduce more elements of *ex ante* regulation, requiring (by early 2005) the introduction of prior approval of the methodology for tariff calculations and a two-month time limit for dealing with complaints. In addition, EMA decisions become immediately enforceable.<sup>19</sup> The directive also requires formal unbundling of distribution and retailing activities, although this will not affect many of the local utilities as the directive is only applicable to firms with more than 100 000 customers<sup>20</sup>. Abuses of the competition law are dealt with by the FCA, but the high required legal standard means that action is mostly taking place when charges are manifestly unfair. Appeals (to the Supreme Administrative Court) suspend disputed decisions, enabling such actions to become part of a time-delaying tactic.<sup>21</sup>

23. The revisions of the regulatory framework will address some of the competition issues in the electricity market. Nevertheless, problems remain. The new directives will not affect many of the smaller utilities, and possibilities for exploiting local monopolies will remain. Measures to address such problems include effective *ex ante* regulation of access charges as well as the removal of overly detailed retail price disclosure requirements. Public ownership continues to be an issue in the sector, creating problems of an uneven playing field. A particular problem identified in the electricity sector stems from the tax advantages of some non-incorporated public utility enterprises. This calls for the mandatory incorporation of utilities. However, such a measure should be the precursor for privatisation and formal separation of activities.

#### *Natural gas*

24. Finland has a derogation from implementing the EU Gas Directive because there is only one source of natural gas (Russia).<sup>22</sup> The derogation will remain in place until Finland has more than one source of supply or is connected to the European grid. The natural gas market is dominated by the partly government-owned vertically-integrated Gasum Oy.<sup>23</sup> The 2001 Natural Gas Act requires unbundling of supply from the grid and the implementation of a new pricing system, although so far a degree of competition is only emerging in a very small secondary market (IEA, 2004). The regulatory approach is similar to the *ex post* regulation in the electricity market with EMA monitoring and establishing guidelines for Gasum's tariffs. However, this falls well short of an established transparent evaluation methodology

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19. Currently, EMA must refer its findings to the Supreme Administrative Court with the possibility of time-delaying appeals.

20. The threshold of 200 GWh transmitted electricity (covering at least 108 000 customers) means that more than 85 per cent of all distributed electricity will flow through legally unbundled lines.

21. The range of corrective measures in the Act on Competition Restrictions is meant to safeguard conditions for competition and not to solve disputes between market participants (FCA, 2003). Another sign that access charges are not always cost-based is the rule that in case of a merger, the merged companies can apply the highest of their access charges.

22. Russian gas comes on a 20 year take-or-pay contract (signed in 1994) with Gazprom prices tied to those of other energy resources. Most of the demand comes from combined heat and power plants, accounting for nearly ¾ of all natural gas.

23. Gasum Oy is responsible for all imports, transmission and wholesaling and has ownership stakes in local distribution companies. The company has a diverse ownership structure, with the government holding 24 per cent, the partly government-owned Fortum 25 per cent, the Russian Gazprom 25 per cent, the German Ruhrgas 20 per cent and Finnish forestry companies holding the remaining shares.

and the rare investigations of tariffs have been instigated by complaints rather than by the regulator.<sup>24</sup> Average natural gas prices are low by international standards, but a more detailed investigation of the pre-tax structure shows that only very large industrial consumers enjoy prices below those in other EU countries, while other industrial consumers face higher than average prices (**Table 5**).

**Table 5. Pre-tax natural gas prices for industry**

Mid-2003, EUR per Giga Joule (GJ)

	Small consumers	Medium consumers	Large consumers	Very large consumers
<b>Finland</b>	<b>8.1</b>	<b>6.4</b>	<b>4.6</b>	<b>3.4</b>
Belgium	6.2	5.3	4.5	..
Germany	7.6	7.1	6.0	3.7
Spain	4.9	4.7	4.4	4.2
France	7.8	6.6	5.0	3.5
Ireland	6.2	5.6	4.6	..
Italy	8.1	5.5	4.9	..
Austria	5.9	5.6	..	..
Portugal	7.8	5.8	3.8	..
Denmark	7.2	4.8	4.5	..
Sweden	6.4	6.1	4.7	..
United Kingdom	4.4	3.8	2.8	..
EU average	6.6	5.5	4.5	3.8

Note:

Small consumers < 4 186 GJ per year, 200 days.

Medium consumers < 41 860 GJ per year, 200 days 1600 hours.

Large consumers < 418 600 GJ per year, 250 days 4000 hours.

Very large consumers < 4 186 000 GJ per year, 330 days 8000 hours.

Source: Eurostat.

25. The new EU directives for natural gas will require a similar pricing methodology as in the electricity sector, but does not address the problem of a dominant vertically-integrated incumbent.<sup>25</sup> The successful introduction of full competition in the natural gas market will require more than one supplier, which, however, is unlikely to be forthcoming with the present market structure. Formal unbundling of the dominant incumbent's activities will level the playing field (by eliminating the possibilities for cross-subsidisation) and is a measure to introduce competition promoting market structures by enabling effective non-discriminatory third party access to infrastructure. The latter provides incentives for private investors to invest in alternative supply facilities, like for example liquefied natural gas. The benefits of formal unbundling over the weaker accounting unbundling can be seen in the correlation between the strictness of unbundling and prices in the EU, with for example the lowest prices in the UK (which relies on ownership unbundling) and some of the highest prices in Germany, which relies on management unbundling (EC, 2004). Formal unbundling, however, is not a stand-alone measure and should be combined with effective *ex ante* regulation to secure effective non-discriminatory third party access.

24. Gasum cooperates with EMA in a sort of *ex-ante* consultation before undertaking major spending to assure that the regulator approves the company's plans.

25. Some observers see no obvious reasons why gas production, gas transport, gas storage, local gas distribution and retailing should be provided by one company (Newbery, 2004).

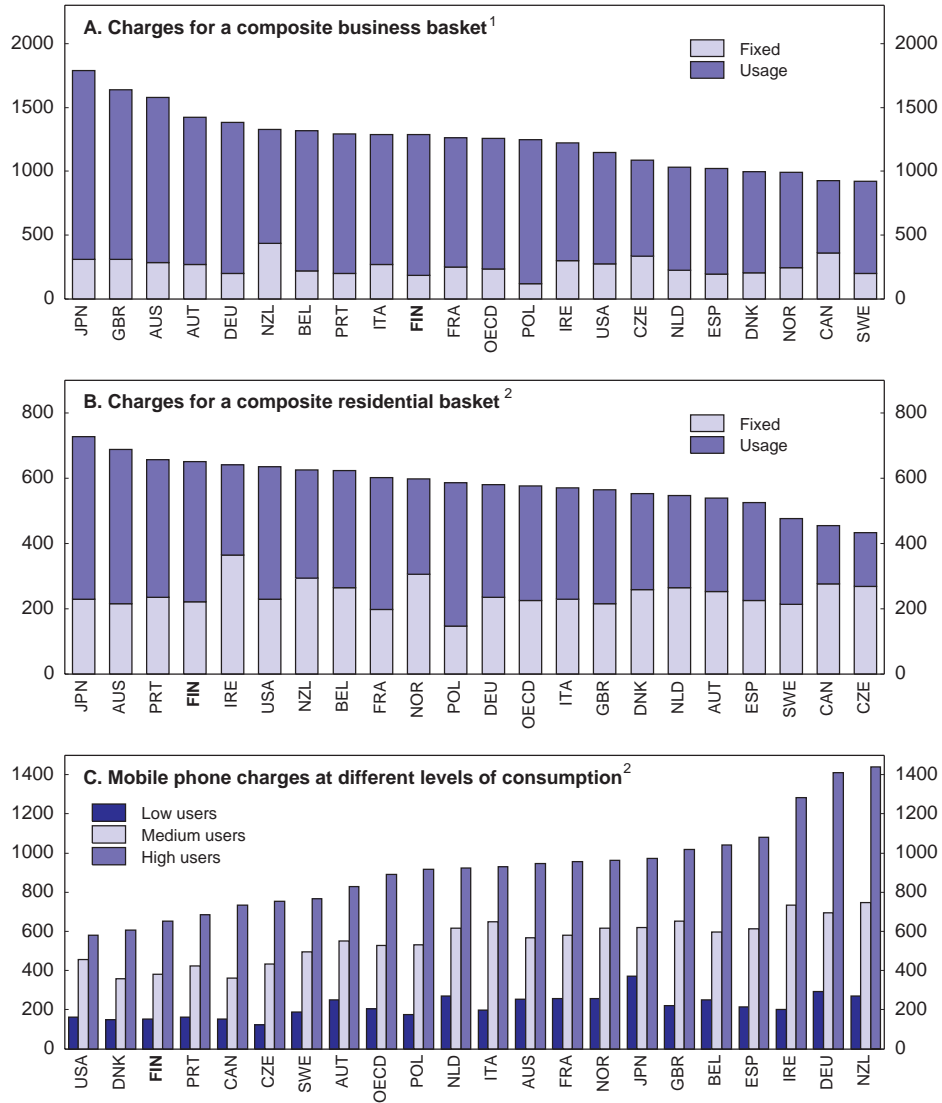
*Telecommunications sector*

26. Deregulation of telecommunications started earlier in Finland (1994) than in many other European countries, leading to a rapid and widespread expansion of mobile phones combined with relatively cheap service provision, although access charges for most services remain high. The regulatory framework in the sector was modernised with the incorporation of the EU Electronic Communication Directives into the Communications Market Act in 2003, making the telecommunications regulator (FICORA) the independent regulatory authority of telecommunications with a mandate of promoting competitive markets. The latter implies that FICORA can declare operators to have significant market power (FICORA is in the process of assigning significant market power to some 40 operators) and imposes obligations to eliminate impediments to competition. The FCA continues to be in charge of pursuing breaches of the competition law. Nevertheless, the regulatory approach has maintained many aspects of *ex post* regulation as competition is relied on to drive down wholesale prices for network access that in other countries are regulated.

27. The market structure for voice telephony is rather unusual. There are only four national operators (less than in other countries), but the second highest (43) number of local operators in the European Union (EC, 2003b). In reality, however, the market is more concentrated as 37 of the local operators are members of the Finnet Group and two local and two national operators belong to the Elisa Group. These two groups together with the incumbent national operator (TeliaSonera) command a market share of more than 90 per cent in almost all segments of the voice telephony market. The regulatory framework combined with the somewhat special market structure has created a competitive retail mobile market and a fairly competitive long-distance market. At the same time competition problems persist in the areas of local calls and high-speed internet connections, reflecting to a large extent the continued presence of local market power.

28. An international comparison shows that business user prices are at par with the OECD average, but higher than in Sweden, Denmark and the Netherlands, countries that also liberalised early. Mobile phone charges are also lower than in most other European countries. On the other hand, residential charges are among the highest in Europe (**Figure 12**). The latter is largely the result of the high cost for short-distance calls, arising from one of the highest interconnection charges for call termination on the incumbents' fixed networks. Also the cost of termination on mobile networks is high compared with other EU countries. The cost of termination seems to be the result of operators exploiting market power, as there is little regulation of termination charges (**Box 8**). As a measure to strengthen competition in the telecommunications market, full number portability was introduced in mid-2003. However, associated costs are prohibitively high. For example, the charges reported to the European Commission demanded by the two largest operators vary from EUR 16.80 to EUR 120. However, more recently there has been a general lowering of charges, which in the spring of 2004 were on average EUR 41, with individual charges ranging from EUR 0 to 125, even though such charges should be cost-based (EC, 2002). Moreover, international experience shows that portability only becomes significant when such switching charges are below EUR 10 and once they are above EUR 17 only very few numbers are ported (EC, 2003a). In sum, the observed high prices seem to originate in high access charges for most services, which competition has failed to lower, pointing to the need for more effective *ex ante* regulation.

**Figure 12. Telecommunication charges**  
In USD, May 2004



1. Excluding VAT.

2. Including VAT.

Source: OECD, Communications Outlook database.

### Box 8. Interconnection regulation and termination costs in telecommunications

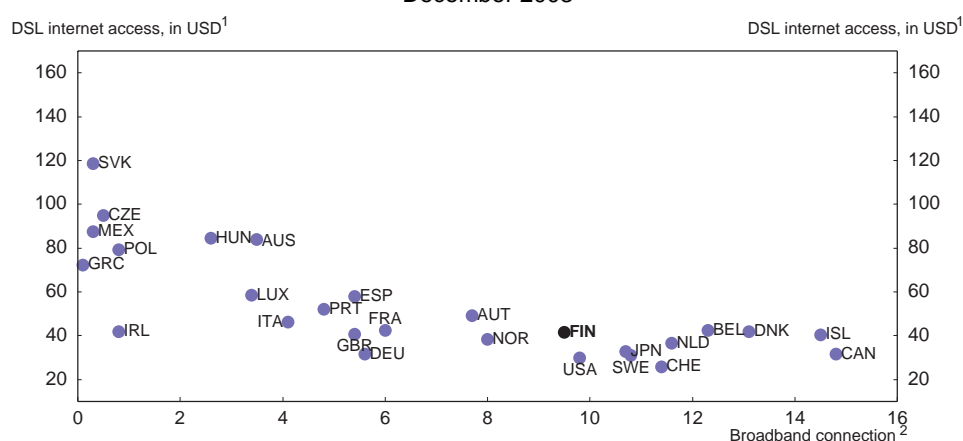
Contrary to other European countries there are no regulated termination rates for domestic calls in Finland. Mobile operators set their own retail “end-user” charges for calls to their networks and the fixed network operators set their own fixed network retail charges, so the total charge for a fixed-to-mobile call is the sum of the two. This system is thought to foster price competition between operators and thus achieve lower prices for interconnection. For competition to have its expected effect, the receiving party must take into consideration – when choosing an operator – the cost of the originating party and not just the cost of outgoing calls. However, judging from the level of “end-user” charges this seems unlikely to be the case. For example, the combined charges for fixed-to-mobile calls are similar to the highest termination charges in the EU (EC, 2003b). Moreover, the combined charges are about twice as high as the (cost-based) interconnection charge for an international call from a fixed network to a Finnish mobile network. An additional indication of the non-competitive end-user charges is the (mostly) higher charge for calling between two mobile phone operators as compared with calling within the same mobile phone operator, as the cost of the latter is presumably closer to the associated costs.<sup>0</sup> The interconnection charges for call termination on the fixed networks (determined by each individual operator) are also among the highest in the EU.

1. The cost of calls to other networks depends on the type of subscription and tends to vary from zero additional cost to twice the cost of within network calls.

29. The ability of operators to charge high prices for access to their networks is repeated in the broadband segment. Charges for broadband are relatively high and correspondingly penetration is less developed than in many other countries (**Figure 13**). As the network owners have been able to charge much higher prices for both full unbundled and shared access to the local loop as well as for unbundled broadband access than in other countries, the retail charges for broadband are unlikely to come down. Moreover, network owners have been engaged in strategic behaviour to prevent entry, such as charging wholesale prices to their competitors that were higher than their retail prices for broadband access or by refusing to lease broadband connections to competitors (FCA, 2003).<sup>26</sup> Broadband services could be delivered over the cable TV networks, which cover 40 per cent of all households, but such competition is unlikely to be forthcoming, as the local incumbents own most of these competing networks, pointing to the need for ownership <sup>TUR</sup>separation of non-telecommunication infrastructures.

**Figure 13. Broadband penetration and user charges**

December 2003



1. Monthly charges, including VAT. Modem rentals are excluded as in most countries they can be purchased by users.
2. Per 100 inhabitants.

Source: OECD, Communications Outlook database.

26. Such a price squeeze has also been found in other telecommunications segments. Sonera, for example, has been charging higher prices for wholesale transmission of content (logos and ringing tones) than retail charges for the same services to its own customers.



*Selected issues in transportation*

30. The *railway sector's* market share of land passenger transport has been declining gently over the past decade and is one of the lowest among the northern European countries (Seabright, 2003). The intense inter-modal competition from long distance bus transportation accentuates the need for liberalising the railway sector. However, the railways are only slowly being opened up to elements of competition, following closely the EU directives in this area. The results in terms of productivity have been disappointing: unlike in other European countries, the Finnish reforms have left trend productivity unchanged (Friebel *et al.*, 2004). The operation of tracks and services was separated into different companies (with the same parent company) in 2003 and the market for international freight services within the EU is beginning to be opened up. The latter, however, is unlikely to have much of an impact, as the Finnish railway gauge is not compatible with most EU members.<sup>27</sup> Furthermore, there are no plans to open the more important international railway freight service to Russia. More generally, as only non-EU members employ rolling stock compatible with the Finnish railway gauge, only the fully publicly-owned incumbent has rolling stock of sufficiently high quality and safety standards to be used in Finland. Thus, a key issue in promoting competition in the sector is to secure new service providers' access to the rolling stock. This requires the establishment of non-discriminatory rental rules and an independent rolling stock company, which should be in place prior to the opening up of national freight services to competition in 2008.<sup>28</sup> The reform process should be accelerated and extended to the formal separation of track and service provision combined with the opening up of competition in the area of passenger transport.

31. The *taxi market* is characterised by low entry costs, potentially fostering competition, but a number of non-cost factors tend to make for a non-competitive outcome in practice. There is a network effect in this transport segment: customers are given a single contact number to a central dispatcher that transmits the order (a so called "call" system). In most Finnish cities, the taxis are members of one association, which operates the "call" system (only few cities have more than one) with a uniform tariff regime for its members. The tariffs are regulated under a maximum tariff system. However, the lack of competition often leads the actual tariffs to be equal to the maximum permissible. In addition, entry is controlled through a licensing system operated by the region. The issuance of new licenses is based on an assessment of demand, customer needs, financial requirements and other market data with the regions often relying on the taxi associations for such information. This reliance on "insiders" gives new entrants powerful incentives to become members of the associations, diminishing competitive pressures. In addition, these associations have also been at the origin of price cartels as witnessed in a string of recent cases, where taxi operators have co-ordinated their bid for municipal public procurement contracts for transport services.<sup>29</sup>

32. The Finnish *domestic air transportation sector* is smaller than in other Nordic countries, which may be explained by the concentration of the large cities in the south of the country. The sector is dominated by the (partly) government-owned carrier Finnair. Entry is not promoted by the common ownership and organisation of airports. The dominance of Finnair is further strengthened through co-operation agreements (including code sharing and frequent flyer programmes) with the second largest domestic carrier, which has a market share of 5.7 per cent. This dominant position also has an effect

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27. If the currently debated privatisation of the Russian railway operator is decided and implemented, then the perspectives for international competition change substantially.

28. A new development in this respect is the creation of a company – jointly owned by the incumbent (35 per cent) and municipalities in the Helsinki area – which is to purchase and lease rolling stock for commuter traffic in the metropolitan area.

29. Another source of revenue for taxi owners is the secondary car market, where they can exploit the tax exemptions granted to taxis.

downstream in the market, as travel agencies tend to be dependent on the dominant carrier, raising the possibility of foreclosure of entry of both new carriers and travel agencies. The latter might explain the fact that the five biggest travel agencies (of which two are subsidiaries of Finnair) sell the vast majority of all tickets. In addition, Finnair also dominates the computerised reservation system (CRS) through its 95 per cent holding in Amadeus Finland – the dominant system in Finland.<sup>30</sup>

33. Almost all the airports are operated by the Finnish Civil Aviation Administration (FCAA), which is a state enterprise under the Ministry of Transport and Communications.<sup>31</sup> A uniform aviation charge – across all carriers and airports – is applied to all airports independent of the actual cost of operating individual airports.<sup>32,33</sup> Thus, there is a cross-subsidy from the few profitable international airports to the non-profitable regional airports.<sup>34</sup> Such cross-subsidisation leads to inefficient allocation of resources and is not conducive to competition as, for example, “no-frill low-cost” carriers are not able to exploit fully their cost advantages (**Box 9**). The cross-subsidisation lowers the cost of using regional airports in sparsely populated areas, helping to maintain air transport services to such areas. However, insofar as the latter is considered politically desirable, a more cost-efficient and pro-competitive measure would be to impose a public service obligation on such routes and purchase such services through competitive tenders.<sup>35, 36</sup> Such a measure should be combined with setting airport charges to reflect the true cost of each individual airport, allowing the tenders to reveal the full cost of servicing public service obligation routes and airports to differentiate in terms of cost and quality. The latter would be facilitated by privatisation of the airports. An additional measure would be to introduce a market-based system for slot allocation to replace the current “grandfathering” system.

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30. Bohrenstein (1992) observed that airlines used the CRSs to announce future price changes to elicit market responses without the airlines actually changing any prices. The only fares not listed on CRS systems are corporate rates negotiated directly with each individual customer. In Finland, the FCA recognises that these problems also extend to the fares of tour operators (revealed in the Finnmatkat case in April 2000). Switching costs for CRS systems are considerable (often requiring new support systems), creating lock-in effects and hampering entry of other CRS systems. Other competition concerns relate to the possibility for partial search (such as specifying airlines or alliances).
31. In addition, an independent unit of the FCAA – fully financed through cost-based fees – is responsible for air traffic safety. In addition to the FCAA airports, there are two municipal airports.
32. Airport charges typically include passenger, take off, en route navigation, and terminal navigation charges. Apart from the En Route Air Navigation Facility Charge, they are usually not directly cost-based. The charges are set to include a profitability target for returns on initial capital of 4 per cent.
33. A previous charge system with a differentiation between domestic and intra-EU flights and with a frequency-based discount system was deemed to be infringing EU law in 1999. Particularly, it was noted that the former differentiation did not reflect differences in costs and thus constitute discriminatory landing charges (EC, 1999).
34. Of the FCAA administered airports, 19 out of a total of 25 have runways sufficiently long to take international flights.
35. Currently, none of the 21 major domestic routes is run as a public service obligation route (The Nordic Competition Authorities, 2002).
36. The following principles are important to observe if public procurement in this area is to promote competition. Public purchases should be tendered in small portions to allow new small entrants to bid. Preference clauses should be included stipulating that the government is always allowed to use cheaper or better quality services offered by someone else. Fixed fares over a certain time lapse are preferable to percentage discounts as the latter may tend to bid up the fare for all other clients.

**Box 9. Different forms of variable airport charges**

A system of differentiated airport charges may be conducive to a more efficient use of available airport capacity and to intensify competition. Such systems can take different forms, with each having different effects.

- a) If charges depend on traffic intensity (*i.e.* varying over the day) resource allocation would be improved as such a charge system would directly address and alleviate congestion problems.
- b) If charges depend on cost, they vary between high and low cost airports, which would make smaller regional airports more commercially attractive to new entrants, such as low-cost carriers, thus increasing competitive pressure in air transport. The increased traffic flow to smaller airports would also remove, at least partially, the present need to subsidise small airports.
- c) Service dependent charges would facilitate entry of “no-frills” carriers as they tend to demand simpler and cheaper airport services as they are independent of catering services, interlining of baggage handling, aircraft docking, etc.
- d) Fare dependent charges establish a connection between the carriers’ costs and revenues and again would facilitate entry of low-cost carriers. However, such a charge system will have little effect on resource allocation and make the airport authorities’ revenue stream more unpredictable as it will come to depend on carriers’ pricing policy.

*Postal services*

34. Liberalisation of postal services is following the EU postal directive, which implies a *de jure* opening of the market, but *de facto* competition remains limited as new entry is prevented by high mandatory public service requirements. These are stipulated in the Postal Services Act and include five-day per week service and next day delivery for 95 per cent of all letters. Moreover a Universal Service Obligation (USO) fee is collected from companies with restricted licenses, which may be as high as 20 per cent – although currently Post Finland receives no compensation for its universal service obligations. However, imposing a USO fee on competitors may create a cost disadvantage for them as the associated benefits are larger than the assessed cost (Gönenç *et al.*, 2001). This points to the need for determining the compensation for the USO through an analysis of the associated costs and benefits – the latter arising from such factors as having a nation-wide brand and network. Sweden and New Zealand have carried out a cost-benefit analysis, which in both cases have led to the assessment that the cost of USO is balanced by the associated benefits, thus the incumbents are not receiving any compensation. Furthermore, in a funded system, the competitive disadvantage of imposing such an obligation on one operator is eliminated by the subsidy, removing the need to impose USO on all operators. Moreover, if the net cost of USO is found to be positive then such obligations should be financed through a fiscal transfer, since universal services benefit the entire economy, which would have the additional benefit of making the cost of USO explicit to taxpayers.

35. The incumbent Post Finland also enjoys a range of other advantages over its competitors. The government-owned company (ownership oversight is with the Ministry of Transport and Communication and FICORA is the regulator) is dominating the postal market. The company has ample possibilities for cross-subsidising its competitive activities with its revenues from the non-contested standard letter market (accounting for about 40 per cent of overall revenue) and the handling charges for VAT payments (**Box 10**).<sup>37</sup> Cross-subsidisation is prevented – in principle – by a requirement on Post Finland to separate its activities within its internal accounts, although the lack of capital accounting makes this unlikely to suffice. In addition, a time-consuming license application process hampers entry and the granted licenses are often restricted to three years despite the maximum legal limit of 20 years, which is considered to be too short to recuperate the sunk cost of establishing a postal network that can fulfil the required service standards (OECD, 2003b). Entry is further hampered by Post Finland’s ownership of the address register and by the incumbent not being obliged to provide access to its infrastructure, which is subject to commercial negotiations.

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37. Only one other company has obtained a post license, although it has not yet commenced operations.

**Box 10. VAT handling charges for purchases abroad**

Post Finland (Posti) is providing a custom clearance service in connection with VAT payments for goods purchased abroad through post-order catalogues and the Internet. The company is allowed to charge EUR 32 for smaller packages, which is supposedly a cost-based charge. However, similar charges in other Nordic countries are half or less of the Finnish charge. Other countries, such as France and Germany, have no charge, but ensure VAT compliance through spot checks by the tax authorities on the premises of the postal providers. In a thinly populated country like Finland, the evaluation of the correct size of the charge should not only include cost considerations, but also the effects on promoting competition in the retail sector. The potential for doing so is huge considering that Internet usage is relatively high in Finland and already in 1999 as many as 7 per cent of the population had made purchases over the Internet (Peltonen and Innamaa, 1999).

**The public sector may stimulate competitive markets**

36. Public procurement is both a vehicle to improve public sector efficiency and a means to increase product market competition. The public procurement market is, at some 15 per cent of GDP, comparable with the EU average, but still smaller than in other Nordic countries. Private producers are supplying about 20 per cent of the market, particularly in social and health services at the local government level, but there are large differences in the degree of outsourcing between municipalities (Ministry of Finance, 2003). Indeed, developing a private sector supply of welfare services is an important step to mitigate the fiscal implications of ageing as highlighted in Chapter 4. Moreover, a large part of public procurement is below the EU threshold, pointing to the importance of national measures to secure competitive tendering. An electronic information exchange (JULMA) for public tendering was established in 2002 and to further broaden the scope and knowledge of public procurement, an advisory board was founded by the central government and the association of local municipalities in early 2004. This body will provide free advice with respect to procurement legislation and to strategic consideration in terms of production, information and education (Ministry of Finance, 2003). These measures may alleviate some problems arising from the decentralised public sector organization with small local government units and large geographic distances, which may increase transaction costs and make it difficult to obtain economies of scale (Joumard *et al.*, 2004). The dispute settlement body is the Market Court, which provides a legal review and, as noted above, spends a considerable amount of time on relatively minor matters. A more efficient use of resources would be to establish an administrative public procurement authority (endowed with sanction powers) to address minor disputes, the non-issuance of tenders (particularly in the absence of complaints), and broader issues, such as proposing measures to secure a level playing field whenever private and public units are competing (**Box 11**). The Market Court should decide more substantial disputes and hear appeals against this authority's decisions.

### Box 11. Competition problems when public units participate in market activities

A central entity (Trading House Hansel) is handling larger procurements for all levels of government to exploit economies of scope and scale. However, smaller businesses have complained that this system has prevented direct sale to local government. Another concern has been the creation of monopolistic structures, such as when municipalities combine to offer educational services to tenders issued by the Labour Administration. The competition problems in the latter case are amplified when the public providers are not separated out into a company (FCA, 2002). Even when the latter is the case, the playing field is uneven if the company is engaged in several activities, as is the case in waste management (FCA, 2003). Additional problems of entry arise when incumbent providers receive long-term tender contracts.

The competition law applies in full to government activities, unless these are regulated by separate laws. There are jurisdiction complications, though, in enforcing the competition law against public production that is not taking place in a legally separate identity. When the latter is the case, the Competition Authority has no authority to order corrections, a point that was made clear in a case involving private and public owners of tennis facilities. Other sources of distortion, which the competition law cannot easily reach, are subsidies that are provided for carrying out social task, such as when private and public laundry services are competing, but where the latter received subsidies for employing handicapped people.

In-house providers of services offered for tendering often enjoy an advantage if they do not have to take into account the true cost of capital when submitting bids. They may benefit from an exemption from corporate taxation, an issue that has arisen in the electricity sector. In principle there is VAT neutrality between private and public producers, with public producers receiving a VAT refund of about 5 per cent (the estimated average amount of VAT spent on inputs). However, public producers also receive this refund in the case of VAT-free services, which puts the private producer at a disadvantage, implying for example that it can be cheaper for municipalities to arrange meal services in-house (Joumard *et al.*, 2004).

### Macroeconomic effects of regulatory reform

37. The macroeconomic benefits of reforms to increase competitive pressures can be substantial. The propagation and channels through which product market reforms affect the economy depend on a number of factors (**Box 12**). Assessing the impact of such reforms is a complex undertaking, but at least two simple approaches are useful to provide some rough indications. First, including synthetic indicators of regulatory stance in regressions of aggregate performance variables is a relatively straightforward method that does not require assumptions about the character of reforms. Following this method, Nicoletti *et al.* (2001) estimated that product market reforms in Finland in the 1980s and 1990s have increased the employment rate by about 2 percentage points and if Finland moved towards best practice for product market liberalisation in the OECD, then the employment rate could increase by another  $\frac{1}{4}$ - $\frac{1}{2}$  percentage point.

38. The second approach makes explicit assumptions about the potential for product market reforms to reduce price-cost margins and to enhance productive efficiency and performance. Following this approach, **Table 6** presents estimates of the possible economic effects on sectoral and aggregate economic performance of reforms in network industries, distribution and professional and community services. The estimates suggest that regulatory reform in these sectors may increase aggregate labour productivity by 3 to 3½ per cent and could lead to a decline in producer prices by 3 to 4 per cent. The estimates rely on judgemental assumptions about the scope for reducing price-cost margins and increasing labour and capital productivity within each sector based on a realignment with international practices. The economy-wide effects are obtained by using the 1995 input-output tables. No aggregate employment gains were factored in, even though dynamic effects of regulatory reform are likely to lower structural unemployment and increase labour supply. The estimates do not include effects of increased dynamic efficiency and improved resource allocation, which means that they are on the conservative side.

### Box 12. Economy-wide effects of sectoral reforms

In general, sectoral reforms change relative prices, which improve overall resource allocation and consumer welfare – effects that are further enhanced by dynamic effects. Reforms within a sector improve the sector's economic performance through a number of channels.

- Reforms reduce output prices via a lowering of price-cost margins, which in turn diminishes the scope for rent sharing, putting downward pressure on wage *premia* in the sector. Aggregate real wages, however, will be increased as output prices decline.
- Reform forces firms to reduce slack in the use of input factors (boosting X-efficiency), enhancing labour and/or capital productivity.
- In addition to these static gains, a more competitive environment stimulates efforts to innovate and adopt new technologies, which raises productivity growth.

Quantifying the effect of reforms on sectoral performance and their timing is bound to be subject to considerable uncertainty, and uncertainties rise further, when assessing the economy-wide effects. An example is that a sectoral reduction in wage *premia* may have beneficial effects on wage formation more generally. Furthermore, propagation of sectoral effects onto the wider economy depends on labour market institutions, as the initial effects of a sectoral reform may be a reduction in employment, which has to be employed elsewhere in the economy – highlighting the importance of a flexible labour market in maximising the economy-wide effects of reforms.

### Overall assessment and scope for further action

39. Finland has made considerable progress in introducing and promoting competition. However, the initial benefits from liberalising and opening up markets to more competition are waning. Available indicators point to relatively weak competitive pressures across a number of sectors. Thus, further reforms are required to promote competition, which should contribute to boosting growth as well as increasing the economy's resilience to shocks. The next phase of reforms requires both fundamental changes in the regulatory approach and more incremental measures to expand the scope for competition by exposing larger segments of the economy to increased competition.

40. The basic framework for general *ex post* regulation has a good foundation with the Finnish Competition Authority as a modern independent competition authority with an appropriate focus on promoting competition. The resources and tasks of the authority should be re-balanced, with greater attention to problems of horizontal collusion. The effectiveness of the new leniency programme should be enhanced by issuing fines sufficiently large to ensure deterrence and by introducing personal liability to create incentives for individuals' participation. The FCA should direct more of its resources on cartels and other restraints. The role of sector regulators should be enhanced. Although more elements of *ex ante* regulation are being implemented, such regulatory oversight of liberalised network industries should be strengthened further to support the introduction of competition and to prevent companies from exploiting their local monopoly power. Non-discriminatory third party access charges need to be applied more effectively and formal separation of vertically-integrated companies pursued. Regulatory capture, and over regulation should be prevented and as competition becomes viable in these sectors, the regulatory approach can be replaced by the application of general competition principles. Efforts to promote competition in network industries would also be helped by a more rigorous and transparent evaluation and competition-neutral financing of universal service obligations.

41. Another important measure to increase competitive pressures is to expose the large sheltered sector to increased foreign competition by removing remaining barriers to trade, particularly in agriculture, as well as addressing indirect barriers to inward FDI such as high effective marginal taxation and public ownership. A further step in this direction is to level the playing field between public and private businesses through a broad-based privatisation programme as well as introducing clear and transparent rules for public participation in market activities. Furthermore, an administrative public procurement authority should be established to improve the functioning of this market and to relieve the Market Court from being involved in minor cases. For the latter, an additional measure would be the introduction of a minimum jurisdictional threshold. Besides these general recommendations, a summary of the more detailed recommendations is presented in **Table 7**.

Table 6. Assumptions and effects of pro-competitive regulatory reform in selected industries

	Energy	Post and telecommunications	Road transport and railways	Retail distribution	Professional services <sup>1</sup>	Community social and personal services <sup>2</sup>	Total economy
<b>Assumptions (per cent change)</b>							
Costs of intermediate inputs	0	0	-5	-5	0	-5	
Labour costs							
Labour productivity	-7.5	-15	-10	-7.5	-10	-10	
Wages	-12.5	-7.5	-5	0	-10	-5	
Capital costs	-5	-10	-15	-10	0	-10	
Profits	-5	-15	-10	-5	-10	0	
Price elasticity of demand	-0.5	-0.5	-0.2	-0.5	-0.5	-0.2	
<b>Sectoral effects (per cent)</b>							
Direct price effect	-4.1	-11.9	-10.7	-6.9	-8.9	-11.3	
Price-induced output effect	2.0	6.0	2.1	3.5	4.5	2.3	
Employment, price-induced effect <sup>3</sup>	-5.5	-9.0	-7.9	-4.0	-5.5	-7.7	
<b>Economy-wide effect on (per cent)</b>							
Producer prices, direct effect	-0.1	-0.2	-0.6	-0.6	-0.4	-1.4	-3.2
Producer prices, total effect <sup>4</sup>	-0.2	-0.3	-0.9	-0.8	-0.7	-1.4	-4.2
Labour productivity (weighted by share in aggregate output)	0.2	0.2	0.5	0.6	0.4	1.2	3.3
<i>Memorandum items</i>							
Share in aggregate employment	0.9	2.1	5.3	11.5	4.2	17.6	
Share in aggregate value added	2.5	2.0	6.6	8.9	3.0	10.9	
Share in aggregate output	2.9	1.5	5.3	8.0	4.4	12.3	

1. ISIC74, Other business services.
2. Effects from improving public procurement policies and greater use of competitive tendering.
3. Resulting from the direct effect via productivity and the induced offsetting effect via higher output.
4. Combines the direct effect of the fall in prices of the sector being deregulated with that resulting from the fall in prices in other sectors due to lower input costs.



**Table 7. Summary of recommendations**

<b>The competition framework needs strengthening</b>
<ul style="list-style-type: none"> <li>The FCA should direct more of its resources towards addressing cartels and other restraints. The Market Court should be freed from minor public procurement disputes by establishing an administrative public procurement authority and introducing a minimum jurisdictional threshold. The <i>de facto</i> independence of the FCA should be recognised formally.</li> </ul>
<ul style="list-style-type: none"> <li>Sanctions need to be substantial and credible to secure deterrence. Moreover, individual liability should be considered. Both measures will contribute to increase the effectiveness of the new leniency programme.</li> </ul>
<ul style="list-style-type: none"> <li>As a part of a comprehensive programme to expand the role of competition, remaining import barriers, particularly in agriculture, should be removed and implicit restrictions on inward FDI in the form of high effective marginal taxation and public ownership should be addressed to increase foreign rivalry.</li> </ul>
<ul style="list-style-type: none"> <li>In publicly-owned companies formal separation between competitive and non-competitive activities should be introduced. The playing field <i>vis-à-vis</i> private companies should be levelled by removing public unit's tax advantages. To remove the conflict between the state's regulatory role and its ownership interests, the ownership function of publicly-owned companies should be concentrated in a ministry without regulatory oversight. However, the preferred solution should be an extensive privatisation programme.</li> </ul>
<b>Regulation in retail distribution should be relaxed</b>
<ul style="list-style-type: none"> <li>Shop opening and zoning laws should be reviewed to facilitate new entry.</li> <li>National agricultural subsidies should be removed and be replaced by income support, if deemed necessary, to increase competitive pressures from abroad.</li> <li>Remaining state monopolies should be removed to increase economies of scope.</li> </ul>
<b>Sector regulation needs comprehensive reforms</b>
<ul style="list-style-type: none"> <li>The role of sector regulators should be enhanced to support the introduction of competition and to prevent companies from exploiting their local monopoly power. Non-discriminatory third party access charges need to be applied more effectively and formal separation of vertically-integrated companies pursued. Regulatory capture and over regulation should be prevented and as competition becomes viable the regulatory approach can be replaced by the application of general competition principles.</li> </ul>
<ul style="list-style-type: none"> <li>A common approach to universal service obligations needs to be introduced, entailing cost-benefit analysis to determine the net cost of such obligations, which should be financed through a fiscal transfer.</li> </ul>
<ul style="list-style-type: none"> <li>The successful initial liberalisation of the <i>electricity sector</i> should be secured by expanding interconnection capacity to the other members of Nord Pool. Relatively detailed retail price disclosure requirements should be reduced to a minimum.</li> <li>Measures to restructure the <i>natural gas sector</i> are required to facilitate new entry. This measure should be combined with a general opening up of the market and the introduction of <i>ex ante</i> regulation.</li> </ul>
<ul style="list-style-type: none"> <li>In the <i>telecommunication sector</i> a more effective <i>ex ante</i> regulation is required, particularly to counter the market power of local telecommunication companies. To stimulate the creation of network competition, ownership separation of non-telecommunication activities should be implemented. Interconnection and termination charges should become subject to <i>ex ante</i> regulation.</li> </ul>
<ul style="list-style-type: none"> <li>In the <i>postal sector</i>, new entry should be stimulated by relaxing service requirements, speeding up license application processes and extending license periods to enable new entrants to recuperate initial sunk cost investments. Moreover, non-discriminatory access to the incumbent's infrastructure should be secured. Furthermore, competitive tendering for the USO should be introduced and charges should be cost-based.</li> </ul>
<ul style="list-style-type: none"> <li>In the domestic <i>air transport sector</i>, cost-based user charges for airport services should be introduced. Cross-subsidies of regional airports should be terminated. They should be privatised and unprofitable airports financed through a fiscal transfer. A market-based system for slot allocation should be introduced to improve resource allocation.</li> </ul>
<ul style="list-style-type: none"> <li>The liberalisation process in the <i>railway sector</i> should be accelerated, including formal separation of track and service provision and securing non-discriminatory third party access to rolling stock.</li> <li>Public regulation of the <i>taxi market</i> should be reviewed to increase competition in the sector.</li> </ul>
<b>Public procurement can be used to promote competition</b>
<ul style="list-style-type: none"> <li>An independent dispute settlement authority for public procurement with sanction powers should be introduced. The activities of such an authority should also include securing a level playing field whenever public units participate in market activities. To further this objective, public units that participate in market activities should be separated from public administrations.</li> </ul>

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