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Options for Reforming the Finnish Tax System

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ABSTRACT/RESUMÉ

Options for reforming the Finnish tax system

This paper reviews the Finnish tax system and the scope for further tax reform. Finland is among the most egalitarian countries in the OECD and a high tax burden is required to finance the associated public spending. Nevertheless, capital and corporate income taxation was substantially and effectively reformed in the early 1990s, through significant rate cuts cum base broadening measures. But, despite income tax cuts since the mid-1990s, high taxes, especially on labour income, still hamper growth potential and distort economic behaviour. In this respect, the poor performance of the Finnish labour market is revealing. Tax reforms have a major role to play in improving the long-term performance of the Finnish economy. Though the scope is limited, the tax burden should be shifted as much as possible from labour to property and consumption, while the earned-income tax allowance should play a smaller role, enabling cuts in statutory rates. Redesigning social security contributions to make them more employment-friendly, in particular for the low-paid and older workers, is also desirable. Meanwhile, taxation of capital should be kept competitive.

JEL codes: H2, H3, H7

Keywords: Finland; taxation; tax policy; tax reform; earned-income tax allowance

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Options pour la réforme du système fiscal finlandais

Cette étude examine le système fiscal finlandais et propose une série de nouvelles réformes dans ce domaine. L'équité est une des préoccupations majeures en Finlande. Cela se traduit par des dépenses publiques élevées, et des prélèvements fiscaux en conséquence. Néanmoins, l'imposition du capital et des bénéfices des sociétés a fait l'objet d'une réforme ambitieuse au début des années 90, avec des résultats satisfaisants. Les taux d'imposition ont nettement été réduits, alors que les régimes favorables ont été pour la plupart éliminés. Sur le marché du travail en revanche, la fiscalité continue d'engendrer des distorsions et de peser sensiblement sur le potentiel de croissance de l'économie, malgré les réductions de l'impôt sur le revenu survenues depuis la seconde moitié des années 90. A cet égard, les résultats médiocres obtenus sur le marché finlandais du travail sont révélateurs. Les réformes fiscales ont un rôle majeur à jouer dans l'amélioration des performances à long terme de l'économie finlandaise. Même si la marge de manœuvre est limitée, il convient, dans la mesure du possible, de rééquilibrer la charge fiscale, des revenus du travail vers la propriété immobilière et la consommation. L'abattement fiscal au titre des revenus du travail devrait aussi être reconsidéré, ce qui permettrait de baisser les taux marginaux statutaires d'imposition. Il serait enfin souhaitable de repenser le système de contributions sociales afin de le rendre plus favorable à la création d'emploi pour les moins qualifiés et les seniors. Par ailleurs, il convient de préserver la compétitivité du régime d'imposition du capital.

Classification JEL : H2, H3, H7

Mots-clés : Finlande; fiscalité; politique fiscale; réforme fiscale; abattement fiscal sur les revenus du travail

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Introduction

1. Finland is among of the most egalitarian countries in the OECD. Generous welfare services and large transfers aim at a high degree of income redistribution, but a high tax burden is required to finance the associated public spending. The tax system has also been designed to compress the already rather flat primary income distribution further. However, like the other Nordic countries, to stem tax base erosion, Finland radically reformed the taxation of the most mobile tax bases in the early 1990s. Capital and corporate income taxation has been streamlined, through significant rate cuts *cum* base broadening measures. However, high taxes, especially on labour income, still hamper growth potential, give rise to tax arbitrage and distort economic behaviour. In this respect, the poor performance of the Finnish labour market is revealing. The tax system, and its interaction with social transfers, has undermined work incentives and contributed to the emergence of serious labour shortages for highly qualified workers. At the same time, high non-wage labour costs have hindered employment creation. Pockets of very high unemployment still exist, even though activity has been very strong for several years, while some companies have moved part of their business to countries where costs are lower partly because of taxes. Addressing concerns about the increasing cross-border mobility of tax bases while keeping high quality public services and a fair amount of income redistribution will thus be key issues in reforming the Finnish tax system.

2. Against this background, the first section of this paper reviews the economic and social context in which tax policy has been designed, and will need to evolve in the future. The second section discusses the impact of the tax system on labour and capital markets, income distribution, collection and compliance costs as well as on the sustainability of the municipalities' fiscal position. The third section outlines the main options for further tax reform.

Forces shaping tax policy

The scope of the welfare state has expanded rapidly

3. Government outlays are currently close to the European Union (EU) average, while they were far above average during the deep recession of the early 1990s and clearly below average during the 1970s and 1980s (Figure 1). The rising scope of the welfare system during the 1980s and the steep downturn of the early 1990s undermined public finances, with net borrowing of the general government reaching a peak of more than 7 per cent of gross domestic product (GDP) in 1993. Public spending, as a share of GDP, peaked at 60 per cent of GDP in 1993 and stood at 55 per cent in 1995, 20 percentage points higher than in 1980 — the sharpest increase within the OECD area over this period after Greece and Portugal. The surge in spending over the 1980s was particularly strong for pensions, education and health, which are largely financed through wage-based taxes and contributions (Table 1). The wider coverage and increased generosity of welfare programmes also

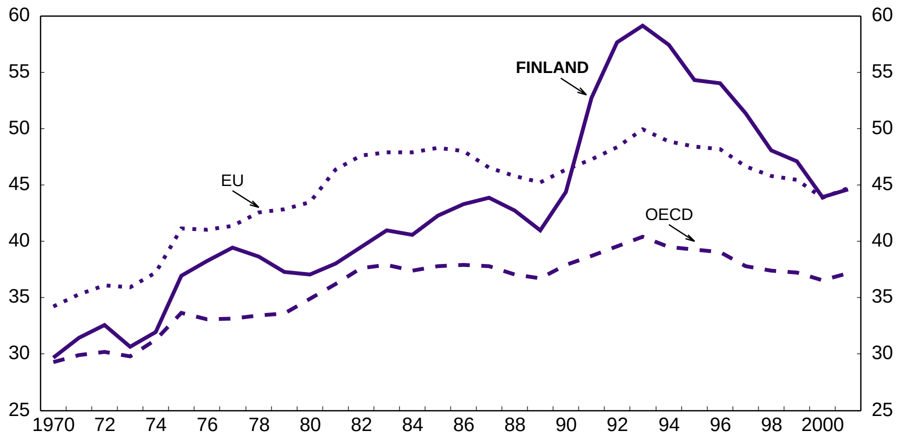
raised the sensitivity of public finances to the economic cycle. Reflecting the deep recession of the early 1990s, unemployment benefits as a share of GDP jumped by 3½ percentage points between 1990 and 1995, while old-age and disability pensions continued to rise rapidly since they were partly used as a substitute for unemployment insurance. In the early 1990s, the reform of the welfare system, which made most social benefits taxable while adjusting gross benefits upward, pushed taxes and public spending up further. Finally, with a ballooning public debt, interest payments also soared. Since the mid-1990s, the strong cyclical recovery and tight budgeting in the run-up to joining monetary union have brought government spending down to an estimated 45 per cent of GDP in 2001, close to the EU average. With revenues little changed since the mid-1990s, the budget balance turned from a large deficit into a sizeable surplus, which stood at 6.9 per cent of GDP in 2000, falling back to an estimated 3.7 per cent of GDP in 2001.

The tax system was redesigned to cope better with increased openness

4. The degree of openness of the Finnish economy has increased steadily over the past two decades. The desire to attract foreign investors and to keep domestic companies in Finland was one of the reasons for an ambitious reform of the taxation of capital and corporate income. Statutory tax rates, which have an important signalling function for investors (Hines, 2001), were more than halved between the mid-1980s and 1993, while significant base-broadening measures have mitigated the impact on effective taxation. The decision to join the European Union in 1995 sped up the replacement of the turnover tax, which applied mainly to goods, by a broader valued added tax (VAT).

Figure 1. **Government outlays**[1]

As a per cent of GDP



1. General government total outlays. Estimate for 2001.
Source: OECD (2001), *Economic Outlook*, No. 70.

Table 1. **Structure and changes in government outlays**

Per cent of GDP[1]

	Finland[2]			Other Nordic[2]			3 other EU countries[3]			United States and Japan		
	1980	1995	Change	1980	1995[4]	Change	1980	1995	Change	1980	1995	Change
Total expenditure	35.4	54.3	18.9	54.9	59.9	5.1	45.5	48.6	3.0	32.6	34.9	2.3
Public goods	3.3	3.3	0.0	6.5	5.8	–0.7	7.4	6.7	–0.8	8.8	7.8	–0.9
Defence	1.4	1.6	0.2	2.9	2.2	–0.7	3.2	2.4	–0.9	5.3	4.0	–1.3
General public services	1.8	1.6	–0.2	3.1	3.4	0.4	3.6	4.1	0.5	2.7	3.1	0.4
Other functions	0.1	0.1	0.0	0.5	0.2	–0.4	0.7	0.3	–0.4	0.7	0.7	0.0
Merit goods	11.5	15.2	3.7	17.7	17.3	–0.4	11.0	11.0	–0.1	9.8	11.4	1.6
Education	4.8	6.6	1.9	7.2	6.6	–0.6	4.9	4.6	–0.3	5.2	4.7	–0.5
Health	5.0	5.6	0.5	7.0	5.7	–1.2	5.4	5.6	0.3	4.2	6.3	2.1
Other social services	1.7	3.0	1.3	3.5	5.0	1.4	0.7	0.8	0.0	0.5	0.4	0.0
Income transfers	11.7	22.5	10.8	15.2	19.7	4.6	13.6	17.1	3.5	9.4	10.3	1.0
Pensions	5.5	8.9	3.3	6.3	7.7	1.3	8.0	10.1	2.1	5.6	6.5	0.8
Disability	2.9	3.9	1.0	2.0	2.5	0.5	1.7	2.5	0.8	0.8	0.9	0.1
Sickness	0.2	0.5	0.3	2.0	1.0	–1.0	0.7	0.4	–0.3	0.2	0.2	0.0
Family cash benefits	1.1	2.7	1.7	1.4	2.0	0.6	1.5	1.1	–0.4	0.4	0.3	–0.1
Unemployment	1.6	5.5	3.8	2.4	4.5	2.1	1.3	2.0	0.7	0.6	0.6	–0.1
Housing and other benefits	0.4	1.1	0.7	1.0	1.9	1.0	0.5	1.0	0.6	1.1	1.3	0.2
Economic services	0.9	1.1	0.2	7.4	5.1	–2.4	5.3	4.3	–1.1	4.3	3.6	–0.8
Public debt interest	1.0	4.0	3.5	3.7	5.7	2.0	4.8	7.5	2.7	3.2	4.5	1.4
Net lending	4.5	–3.7	–8.2	–1.3	–3.3	–2.0	–5.7	–6.4	–0.7	–3.1	–3.2	–0.1

1. Expenditure by function may not add up to total expenditure as these are derived from different sources. Weighted averages for all series except Finland.
2. In Finland and the other Nordic countries (Denmark, Norway and Sweden), public spending and taxes were pushed up by a welfare system reform in the early 1990s that made most social benefits taxable.
3. Italy, Netherlands and United Kingdom. Data on public outlays by function are not available for other EU countries.
4. 1993 for Norway.

Source: Atkinson and van den Noord (2001) and OECD, Social expenditure database (2000).

5. Despite these reforms, the erosion of tax bases is still a serious concern. Finland's specialisation in high-tech and fast-growing sectors — such as information and communication technologies — has intensified its reliance on foreign capital and highly qualified workers. Both tend to be more mobile internationally. In this context, the imputation system for distributed profits, which discriminates against foreign shareholders, is increasingly questioned. To attract foreign highly-skilled workers, Finland has recently lowered the tax burden on "foreign key persons", like a number of other EU countries (*e.g.* the Netherlands and Sweden).[2] However, the increasing mobility of highly-qualified Finns has also raised concerns as labour shortages in key sectors were intensifying during the late 1990s while some companies have moved or are considering moving to countries where costs are lower partly because of taxes.[3] To reduce such pressures, the government has cut taxes on labour since the mid-1990s. These tax cuts were also part of an incomes policy designed to forge wage agreements that do not threaten external competitiveness in a tightening labour market.

6. Consumption tax bases are also under increasing pressure. The commitment to abolish current restrictions on imports of alcohol and tobacco by 2004 will require a reduction of excise taxes on these products towards a lower level that prevails in other EU countries to avoid a significant increase in cross-border shopping and smuggling. The associated loss of tax revenues is estimated by the government to amount to almost EUR 0.55 billion by 2006 (*i.e.* about 1.7 per cent of total tax revenues in 2000).[4] Lowering the taxation of imported second-hand cars — which is currently being examined by the European Court of Justice since it potentially violates the principle of free movement of goods within the European Union — would induce a further loss estimated at EUR 0.2 billion. In addition, the development of e-commerce transactions, in particular for services delivered online, is expected to erode Finnish VAT revenues (by EUR 0.1 million according to the authorities).[5]

Upward pressures on public spending will re-emerge

7. While Finland has succeeded in bringing down total public spending from almost 60 per cent of GDP in 1993 to an estimated 45 per cent in 2001, upward pressures are expected to re-emerge in the medium term. After several years of thorough consolidation efforts, further expenditure restraint is difficult to achieve because there is pent-up demand for some public goods and services, while the most obvious and least painful cuts have already been implemented. In a longer-term perspective, the ageing of populations and related spending could put heavy pressure on public finances. Total old-age public pension spending as a share of GDP is projected to rise by 5 percentage points between 2000 and 2050 (Annex I). In addition, while public spending associated with health care and long-term care, at 8 per cent of GDP, is already high by OECD standards, it is projected to rise further, by 4 percentage points.

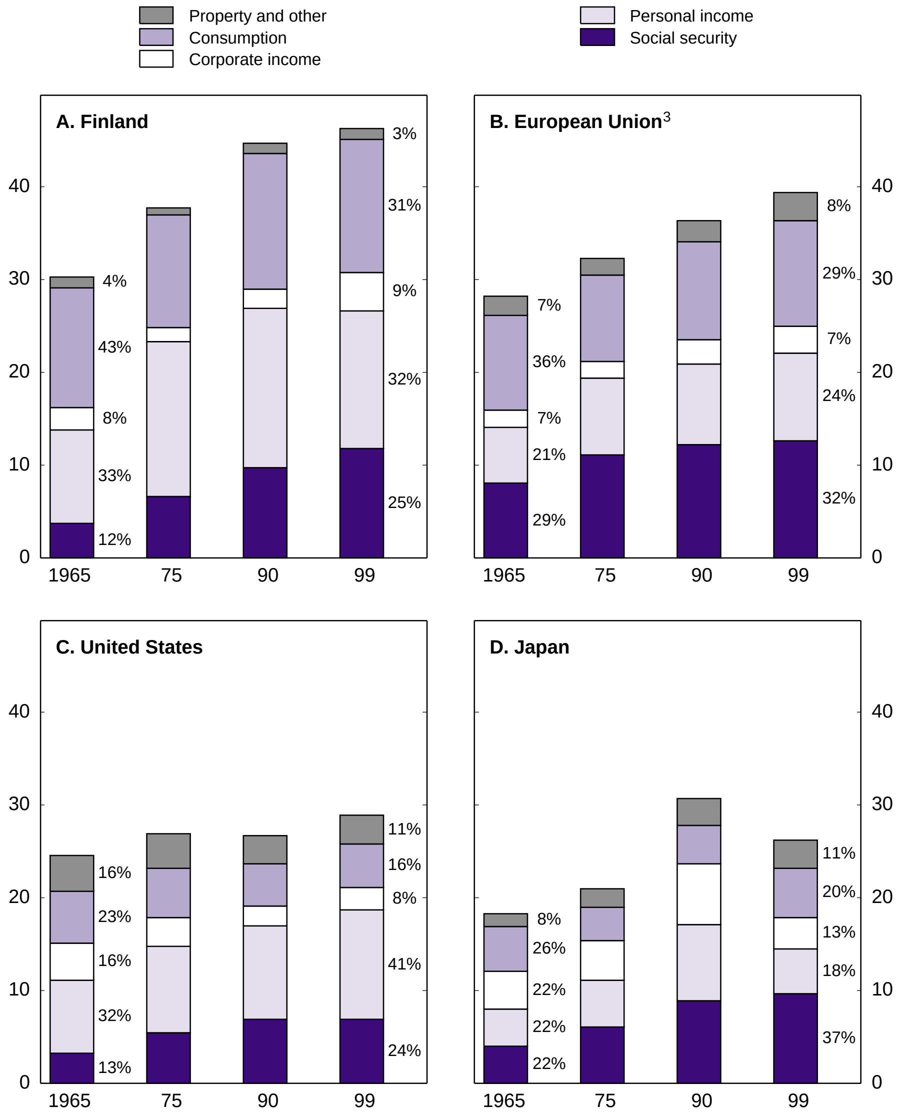
Main features of the tax system

Overview

8. The tax burden rose steadily up to the mid-1990s and is very high by international comparison. Measured by the tax-to-GDP ratio, it rose from 36 per cent in 1980 to around 45 per cent in the early 1990s.[6] The increase in social security contributions, required to fund the upsurge in unemployment benefits and other expanding welfare programmes, was a key driving force. Since the mid-1990s, the tax-to-GDP ratio has remained broadly stable, the boom in corporate income tax revenues being largely offset by cuts in personal income taxes (Figure 2). However, while some caution is needed in measuring the incidence of the tax burden, there is little doubt that average effective tax rates on labour are still among the highest in the OECD.[7] Since 1997, the government has implemented a series of cuts in taxes on labour ("earned-income") which are estimated to amount to 1¾ per cent of GDP for the period 2000-02 alone. However, this has not boosted labour supply

sufficiently to avoid labour shortages for highly qualified workers, while other population groups still suffer from a very high unemployment rate despite several years of steady growth. Highly progressive labour taxes lessen work incentives for highly-skilled workers while cuts in labour taxes at the lower end of the earnings scale have not led to equal cuts in labour costs because of the wage bargaining objective of reducing wage differentials. Revenues from the consumption, corporate and capital income taxes, as a share of GDP, are also high by international standards. However, with flat rates and a broad base, these taxes introduce fewer distortions. Strikingly for such an egalitarian country (Annex II), property taxation is low by international comparison, while it could contribute to narrowing the wealth distribution and to a sound funding of sub-national governments without jeopardising the tax base.

Figure 2. **The evolution of the tax mix**[1]
Per cent of GDP (per cent of total revenue)[2]



1. The breakdown of income tax into personal and corporate tax is not comparable across countries.
2. The bars show data as a per cent of GDP, the percentage figures show the share in total revenues.
3. Weighted average.

Source: OECD (2001), *Revenue Statistics*.

Taxes on labour are high

Several measures have focused on raising labour force participation, in particular of low-paid workers…

9. Since the mid-1990s, several tax cuts on labour income have been implemented, with the main objective of improving incentives to enter the labour market. The standard allowances for work-related expenses and for commuting costs have been raised (Box 1). Taxes on labour income have been further lowered through cuts in statutory rates, by 2 percentage points between 1997 and 2001 (Table 2).[8] Most other initiatives have been targeted on the low-paid. The lowest tax bracket was abolished in 2001, effectively raising the threshold below which labour income is not taxable. As a result, over 42 per cent of income earners is estimated to be exempted from state income taxes in 2001, up from 35 per cent in 1999. The successive increases in the coverage and generosity of the earned-income tax allowance (EITA) in municipal income taxation have, however, been the most significant move (Figure 3, Panel A). To improve work incentives for the low-paid further, the EITA no longer applies to unemployment benefits since 1997, thus contributing to lower the reservation wage for the unemployed. These measures, combined with strong activity, have lifted the participation rate. It has not yet climbed back to its pre-recession level of the early 1990s, but is high by international comparison.

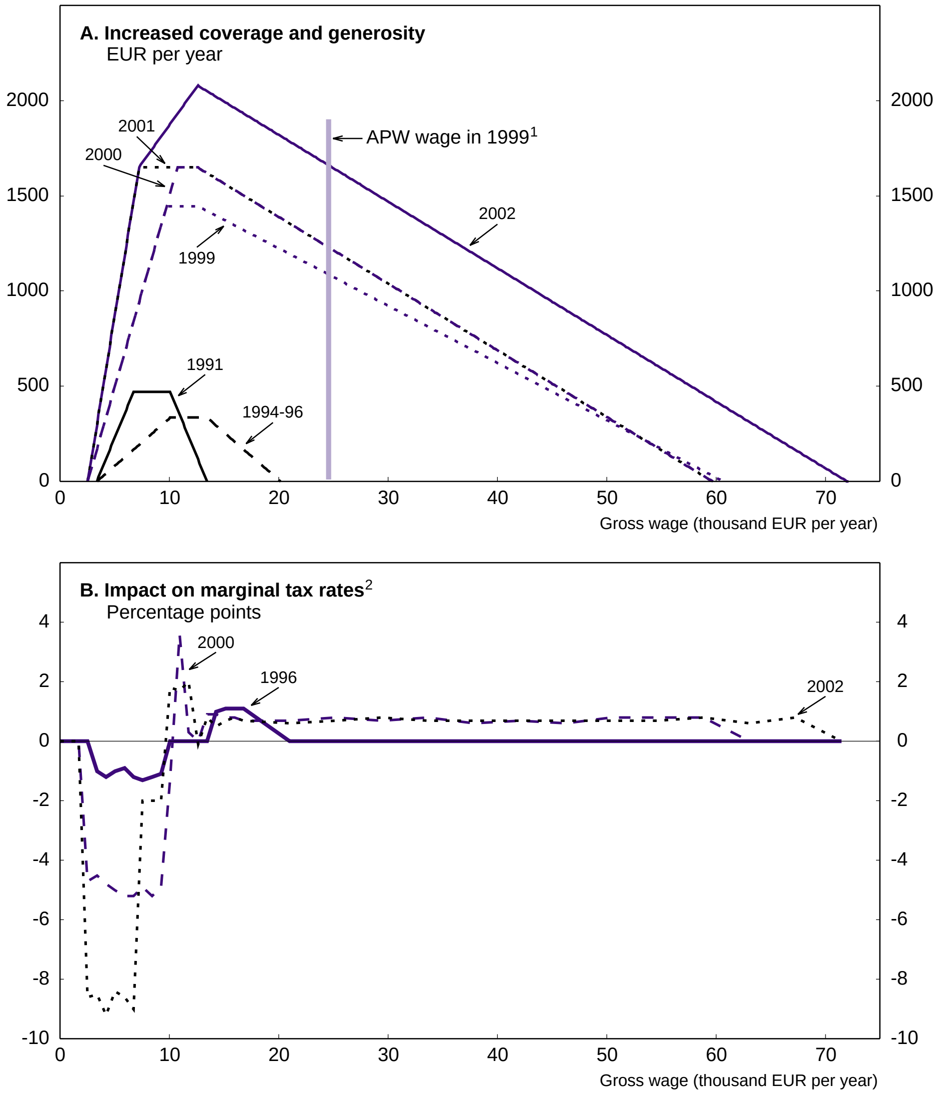
Table 2. **Rates and brackets of the state tax on labour income**[1]
Per cent

Tax brackets (in EUR)[2]	Marginal tax rates	Number of income earners in each bracket[3]	Number of persons paying tax to the state[3]	Distribution of taxpayers
2001				
0 —11 100	0.0	..	..	..
11 100 —14 296	14.0	..	..	..
14 296 —19 678	18.0	..	..	..
19 678 —30 947	24.0	..	..	..
30 947 —54 661	30.0	..	..	..
54 661 — …	37.0	..	..	..
1999				
0 — 7 905	0.0	31.5	0.0	0.0
7 905 —10 596	5.5	10.8	7.8	12.0
10 596 —13 455	15.5	10.0	9.6	14.8
13 455 —18 837	19.5	19.1	19.0	29.3
18 837 —29 601	25.5	19.9	19.8	30.6
29 601 —52 475	31.5	7.4	7.3	11.3
52 475 — …	38.0	1.3	1.3	2.0
1991				
0 — 6 728	0.0	42.0	0.0	0.0
6 728 9 419	7.0		10.4	15.3
9 419 —11 773	17.0	10.2	10.2	14.9
11 773 —16 482	21.0	21.5	21.3	31.3
16 482 —25 901	27.0	19.0	19.0	27.9
25 901 —46 252	33.0	6.2	6.2	9.0
46 252 — …	39.0	1.1	1.1	1.7

1. Rates and brackets apply to the individuals' labour income less the personal allowances they are entitled to as described in Box 1.
2. Annual taxable income.
3. As a per cent of total income earners.

Source: Ministry of Finance.

Figure 3. The earned income tax allowance



1. The wage of an Average Production Worker (APW) was EUR 24 623 in 1999.
2. The impact of the earned income tax allowance on marginal rates reflects the joint effects of the earned income allowance and the basic tax allowance.

Source: Ministry of Finance.

Box 1. **Taxes on labour income at the state and municipal level***

The so-called "earned-income" (or labour income) consists of wages, fringe benefits, the estimated labour share of non-incorporated business income and social security benefits, and is taxed at both the state and municipal level. Municipalities tax labour income at a flat rate (of their choice) while a progressive schedule is applied at the state level. Another feature of the Finnish tax system is the separate treatment of the spouse's labour income (work incentives of a potential secondary earner are thus less affected by the spouse's labour market situation).

Main tax allowances

- A standard deduction for work-related expenses equal to 3 per cent of the wage, with a maximum amount of EUR 400 in 2000 (up from EUR 250 in 1996).
- Travel expenses from the place of residence to the place of employment in excess of EUR 500 up to a maximum of EUR 4 700 in 2000 (up from EUR 2 700 in 1996).
- Premiums paid by any taxpayer for a private pension insurance (own and spouse's), other than lump-sum payments, up to EUR 8 400.
- Membership fees paid to trade unions or employees' organisations.
- An allowance is granted for pensions below a threshold. The maximum allowance amounted to EUR 5 900 at the municipal level and to EUR 3 900 at the state level in 2000.
- The earned-income tax allowance (EITA) in municipal taxation. It amounted to 20 per cent of the income exceeding EUR 2 500 in 2000, up to a maximum of EUR 1 600. The allowance is gradually phased out, with a 3.5 per cent reduction on income exceeding EUR 12 600 in 2000. It vanished at a taxable income of EUR 59 700.
- A basic allowance in municipal taxation, granted on the basis of taxable income after deducting all other allowances. The maximum allowance, EUR 1 500 in 2000, is reduced by 20 per cent of the taxable income exceeding this amount.

Rate schedule and rate cuts

- Municipal tax on labour income is levied at a flat rate, set by the municipalities without any limitation. In 2001, municipal rates varied between 15 and 19.75 per cent, with a 17.7 per cent average rate.
- At the central government level, a progressive schedule applies with the top rate set at 37 per cent in 2001. Table 2 provides further information on statutory rates and the distribution of taxpayers.

* In addition to state and municipal taxes, members of the Finnish state churches (about 85 per cent of Finnish taxpayers) are liable to a church tax on their labour income. It is levied at flat rates varying between 1 and 2.25 per cent, depending on the local ecclesiastical council. Moreover, churches receive 2 per cent of corporate tax revenues.

... but high marginal tax rates worsen work incentives,…

10. The impact of the earned-income tax allowance on marginal effective tax rates (METRs) varies significantly along the income ladder. In the phase-in range, it contributes to a remarkable reduction in METRs (up to 5 percentage points in 2000) but in the phase-out range — which started at an income level of about one half of the APW (average production worker) wage in 2000 — it induces an increase in METRs (Figure 3, Panel B). To avoid a significant negative impact on work incentives for a specific income group, the earnings span over which the earned-income tax allowance is phased out has been gradually extended. Virtually every worker (both wage earners and self-employed) benefits from such an allowance since 1999, while it concerned only 28 per cent in 1991.[9] As a result, while the vast majority of workers are in the phase-out range, the induced increase in marginal tax rates is relatively small in most cases (less than 1 percentage point) though for some income groups it approaches 4 percentage points. As a consequence, the EITA entails large deadweight losses,[10] and the cost of financing, in terms of foregone revenues, is expected to amount to EUR 0.8 billion in 2002, *i.e.* about ½ per cent of GDP.

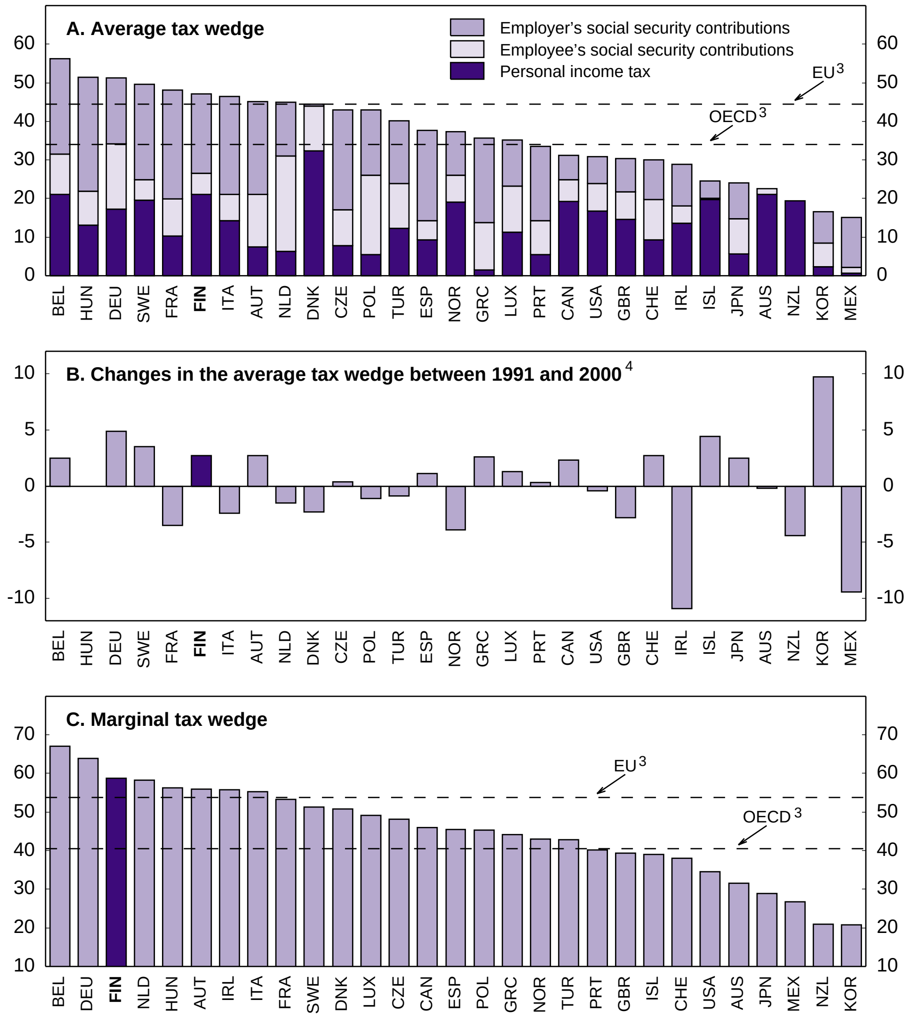
11. The marginal tax wedge on labour, which affects work incentives, has only slightly receded overall since the early 1990s and remains high by EU standards. In fact, while statutory rates on labour income have been cut somewhat, partial indexation of tax brackets for inflation in the early 1990s has pushed people into higher brackets.[11] At the wage level of an average production worker, the steepness of Finland's marginal tax wedge ranked third within the OECD area in 2000 (Figure 4, Panel C). The highly progressive rate schedule implies a heavy tax burden at higher wage levels (Figure 5, Panel B), while the Finnish industry specialisation requires a highly-qualified workforce which is quite mobile internationally.[12] Combined with the strong compression of wages, the steep progressiveness of labour income taxes also reduces the return for an individual investing in education and may thus discourage human capital formation (Asplund, 2000 and OECD, 2001). It may also create incentives to reduce work effort, in particular through shorter working time as evidenced in other Nordic countries (for Denmark, see OECD 2000*b*). The large and rising share of part-time jobs in total employment provides an illustration that incentives to take on a job have improved while those to reduce work effort are likely to have increased.

... with some adverse interaction with the social security system

12. The Finnish tax system applies separate taxation of married couples on their labour income, as well as on the investment income. This has the commendable effect of keeping METRs at a reasonable level for a family with a secondary earner working on a full or part-time basis. However, despite recent reforms, the tax system and its interaction with social transfers still create poverty and unemployment traps. The existence of means-tested social benefits based on the family income — such as the housing allowance and the childcare supplementary allowance — drives marginal effective tax rates to prohibitive levels for some groups (Table 3).[13] At low income levels, the combination of taxation and reduction in benefits results in extra effort being only little rewarded in terms of increased disposable income (a "poverty trap" arises). This may also discourage a potential secondary earner to take up a job (the "unemployment trap"). It was recently underlined that there is virtually no financial incentive for a spouse to accept a job with a monthly salary below EUR 2 500 (Bank of Finland, 2001), *i.e.* more than 20 per cent higher than the wage of an APW.[14] The decision to increase unemployment benefits in 2002 will further increase replacement rates (OECD, 2002). For older workers also, work incentives are poor. Despite recent measures tightening eligibility conditions for early retirement (OECD, 2000*c*; OECD, 2002), at age 60 the unemployment pension guarantees an income level which is often higher than the unemployment compensation, which is very close to the wage of low-skilled workers. Furthermore, pensioners do not pay pension and unemployment contributions, and below a relatively high level (around EUR 1 200 per month in 2001), pension income is granted a favourable tax treatment compared to wages.[15] Overall, the tax system creates incentives for people to retire early.

Figure 4. **Tax wedges on labour**[1]

As a per cent of gross labour costs, 2000[2]

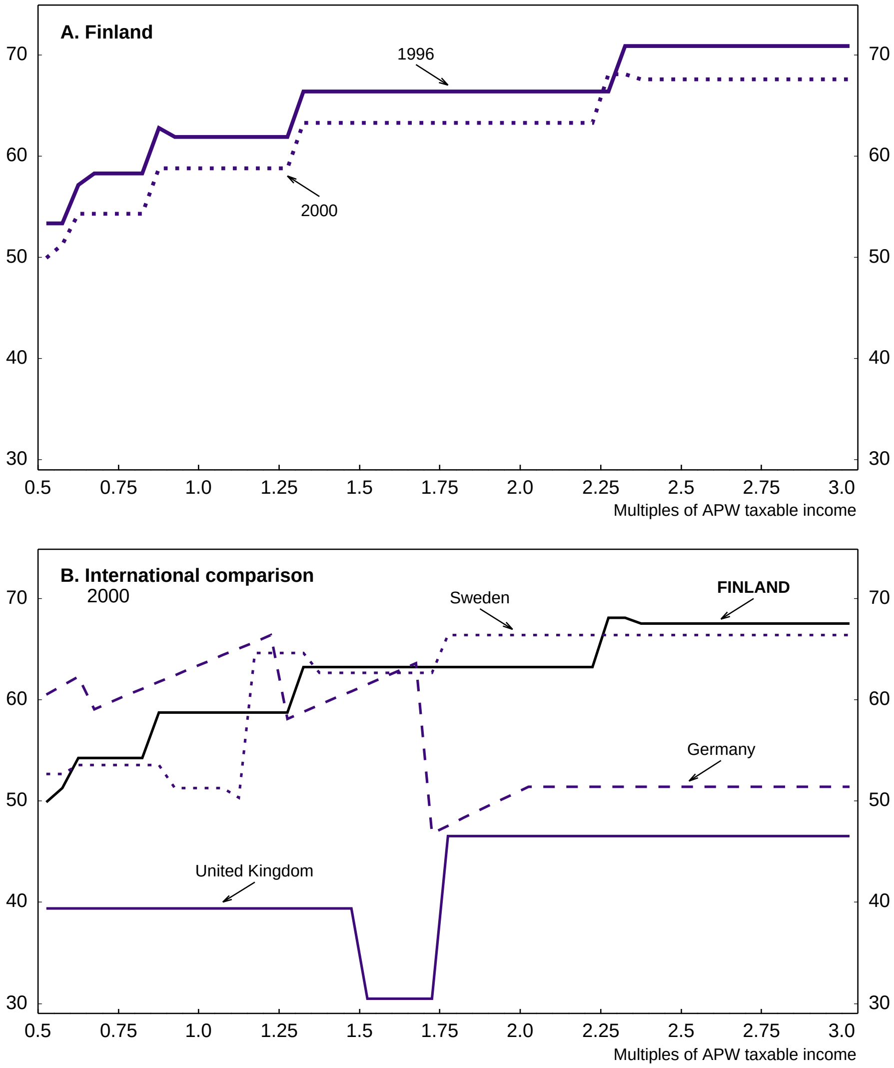


1. For a single individual at the income level of the average production worker. Tax wedges are calculated as the sum of personal income tax, employee plus employer social security contributions together with any payroll taxes as a percentage of labour costs (gross wage plus employers' contributions).
2. Data for 2000 are based on estimated wage levels of the average production worker.
3. Weighted average using 1995 GDP and purchasing power parities.
4. The first year refers to 1991 or the earliest year available. To be consistent with the 1991 data, the 2000 data for Austria excludes payroll taxes.

Source: OECD (2000), *Taxing wages*.

Figure 5. **Marginal tax wedge on labour:**[1] **recent changes and international comparison**

For a single person with no children, per cent



1. Tax wedges — between labour costs to the employer and the corresponding net take-home pay of the employee — are calculated by expressing the sum of personal income tax, employee plus employer social security contributions together with any payroll tax, as a percentage of labour costs.

Source: OECD (2000), *Taxing Wages*.

Table 3. **Marginal effective tax rates on additional income for different family types**[1]
1997

Principal earner	Full-time employed			Unemployed		Part-time employed
Secondary earner	Full-time employed	Part-time employed	Non-employed	Full-time employed	Part-time employed without benefit entitlements	Non-employed
Austria	30	21	76	32	43	135
Belgium	57	61	68	43	25	109
Canada	37	33	75	34	29	105
Denmark	50	48	84	55	61	84
Finland	**36**	**23**	**88**	**48**	**23**	**117**
France	28	38	76	29	30	69
Germany	51	50	80	31	19	115
Ireland	32	25	68	20	38	83
Italy	33	25	63	37	19	84
Japan	12	10	60	10	7	133
Netherlands	39	37	89	45	52	90
Spain	23	19	78	23	19	77
Sweden	37	42	88	43	42	79
United Kingdom	28	20	72	60	55	93
United States	19	11	68	20	0	102
Memorandum items						
OECD average	32	27	74	34	32	107
EU average	35	31	77	38	38	107

1. This table provides estimates of the incentives to increase working hours or to move from non-employment for the secondary earner of a family with two children, taking into account the labour market position of the principal earner. The marginal effective tax rate (METR) expresses the amount of earnings which are "taxed away", either via income taxes or means-testing procedures and lower benefits. METR = 1 – (net income in work – net income out of work) / change in gross income. Part-time employment corresponds to 16 hours or two days each week, and total earnings are 40 per cent of the average production worker level of earnings. Earnings from full-time employment correspond to an average production worker's earnings.

Source: OECD (1999*c*), *Benefit system and work incentives*.

Some tax measures have contributed to raising the demand for labour…

13. Several tax initiatives since the mid-1990s have aimed at lowering the cost of labour, and thus to stimulate job creation. Employers' contribution rates for the national pension scheme and the unemployment insurance scheme have been differentiated since the mid-1990s to favour job creation by giving some preferential treatment to labour-intensive activities and small enterprises (Box 2). Further reducing the relative cost of labour, social security contributions have been gradually lowered, as the general government fiscal position improved and buffer funds approached their maximum.[16] By favouring wage moderation, recent tax cuts on labour income may also have been partly reflected in a higher demand for labour. In fact, announced tax cuts have been a key factor influencing recent collective agreements. However, wage bargaining in Finland is characterised by a high unionisation rate, a relatively high degree of centralisation, and aims to achieve a more egalitarian wage structure. For instance, recent wage settlements have granted low-income earners higher wage increases. A growing proportion of wage increases has also taken the form of negotiated, and highly centralised, pay adjustments as opposed to a market-driven wage drift, thus disconnecting pay adjustments from productivity gains at the firm and individual levels. As a result, tax cuts targeted on low-income earners have hardly been reflected in lower costs for those groups most affected by unemployment and for which the elasticity of labour demand tends to be high.

Box 2. **The structure of social security contributions**

The financing of the Finnish social security system displays a rather unique feature: social security contribution rates vary according to the size and capital intensity of the company, as well as its employees' age structure.

In 2001, for the national pension scheme, the employers' contribution rate was 2 per cent when the depreciation on investment was less than EUR 50 000 or less than 10 per cent of the payroll; 4 per cent if depreciation exceeded EUR 50 000 and represented between 10 and 30 per cent of the payroll; 4.9 per cent when depreciation exceeded EUR 50 000 and 30 per cent of the payroll (Ministry of Finance, 2001).

For the earnings-related pension scheme, firms with 50 or fewer employees pay an overall rate of 22 per cent of gross wages. For firms with more than 50 employees, the rate can vary from 14.5 to 30.7 per cent depending on the age and gender of the insured employees. This reflects a substantial increase in the component covering disability and unemployment for workers aged 55 and over, because the associated risks increase.

Since 1995, employers' unemployment insurance contribution rates have also been differentiated: they were set at 2 per cent for small and medium-sized firms, *i.e.* with a payroll below EUR 0.8 million; and to 6.1 per cent for the remainder. Thereafter, these rates were gradually brought down to 0.8 and 3.1 per cent in 2001, respectively.

… but they are poorly targeted on those at the margins of the labour market

14. Overall, initiatives to enhance employment opportunities for those groups at the margins of the labour market have been sparse. The employment rates of the youth, older workers, and the low-qualified are very low, while labour costs are an important constraint on job creation. In fact, some labour-intensive companies have recently moved to low-wage countries and in some sectors a large proportion of workers are paid at the minimum wage level as set in collective agreements. However, in sharp contrast with many EU countries also plagued by a high level of unemployment, Finland has not introduced targeted cuts of social security contributions which have proved to be quite effective elsewhere in creating jobs for the low-qualified (*e.g.* in Belgium, France, the Netherlands and Spain).[17] Likewise, Finland has not opted for applying a reduced VAT rate on some labour intensive services as allowed by a 1999 European Commission (EC) Directive. Reduced rates are likely to stimulate the demand for these services, and hence employment, and bring part of the informal economy back to the surface. In Finland, the decision to make household employment deductible for individuals in 1997 may have similar effects. However, like the reduced VAT rates, it increases the complexity of the system.[18] Nevertheless, the tax system still introduces discrimination against less favoured groups. In particular, the way pensions are financed discourages firms from hiring older workers since employers' contribution rates for earnings-related pension schemes increase with the age of the insured employee (OECD, 2000*c* and Box 2).

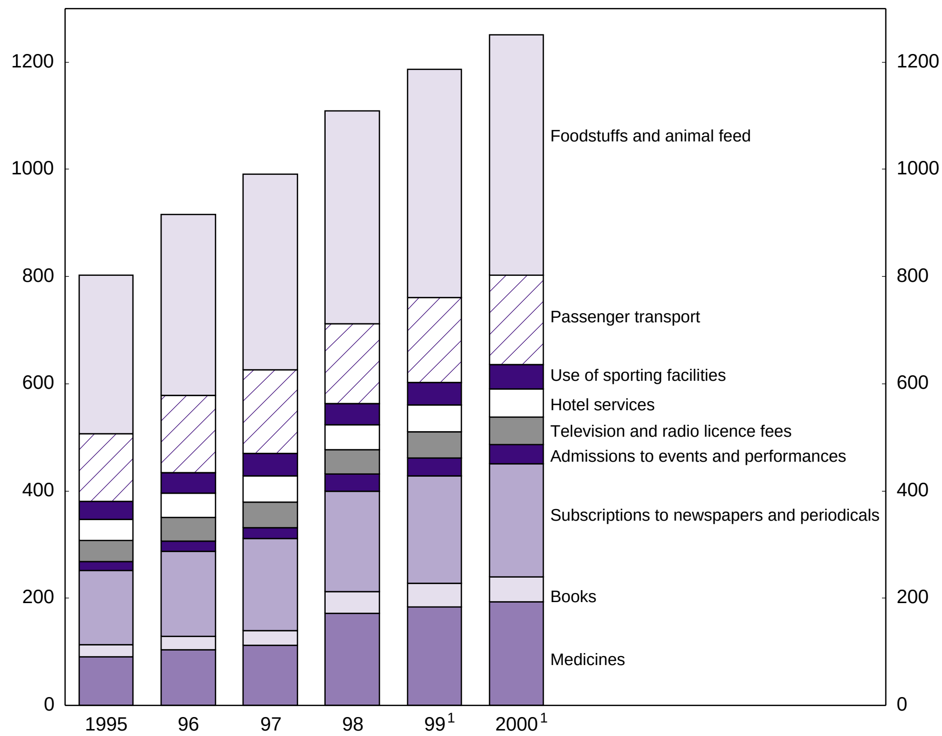
An important role for consumption taxes

15. Consumption taxes account for almost one third of total tax revenues, broadly in line with the EU average. Such a strong reliance on indirect taxation has several advantages. Consumption taxes are relatively neutral towards saving and investment decisions and they do not discriminate between imports and locally-produced goods.[19] They also provide a symmetric treatment of labour and transfer income, thus creating fewer disincentives to work. In addition, the value added tax has commendable self-policing properties since in most cases companies have an interest to register in order to be reimbursed for their own VAT payments. This makes VAT relatively easy to administer as reflected by the low administration costs for indirect taxes — 0.6 per cent of associated tax revenues in Finland, compared with 0.7 per cent for the income and wealth taxes and more than 2 per cent for real estate, inheritance and gift taxes.

16. The large indirect tax take reflects both a standard VAT rate which, at 22 per cent, is among the highest in the EU, and high excise taxes such as that on purchases of cars and on goods which carry a potential health risk (*e.g.* alcohol). While some countries justify the use of reduced VAT rates by advocating their role in achieving social redistributive goals — a role which is subject to controversy (Van den Noord and Heady, 2001) — in Finland, the contribution of reduced VAT rates in achieving these goals is considered to be rather small. However, the use of reduced VAT rates and the existence of special tax regimes for some sectors and regions reduce the yield from indirect taxes, create tax-related distortions on product markets, and increase collection costs. In fact, a relatively large share of goods and services are taxed at reduced VAT rates, partly reflecting the replacement in 1994 of the turnover tax that applied only to goods.[20] Associated tax expenditures amount to 10-11 per cent of VAT revenues, and almost one per cent of GDP (Figure 6). In addition, the Åland islands' special regime for VAT and the excise duty legislation induce sizeable revenue losses and extra work for the tax administration (Box 3).

Figure 6. **Tax expenditure resulting from reduced VAT rates**

Million EUR



1. Estimates.
Source: Government Institute for Economic Research (VATT).

Box 3. **Special taxation rights of the Province of Åland**

Under the Finnish constitution, the Province of Åland enjoys greater autonomy than other Finnish Provinces. In particular, it has exclusive rights to enact provincial legislation on matters concerning business taxes payable to the Province and its municipalities and has been granted some derogations in the application of consumption taxes.

Excise duty legislation

The Province of Åland is the only territory of the European Union, which was granted a derogation to the abolition, in 1999, of tax-free sales for people travelling within the EU area. Thus goods purchased on board of a ship passing by the islands are tax free, subject however to quantity limits. A custom duty system had thus to be set up. In 1997, the value of tax-free sales in the Åland islands was estimated at EUR 0.2 billion.

Value added tax

Finnish VAT law applies within the Province. However, for the transactions between the Province and EU countries, including mainland Finland, the Province is considered as a third country. This entails that goods travel tax free from the Province to other parts of the EU area. This increases opportunities for tax avoidance and has required the monitoring of cross-border trade flows, thus increasing the administrative burden.

Corporate income tax

The Province has a special tax regime for captive insurance companies which has been considered harmful by the EU Code of conduct group on business taxation and potentially harmful by the OECD since it offers a reduced municipal corporate income tax rate for these companies. To qualify for this special regime, a company has to meet two requirements: all shares of the captive company are owned by one single shareholder and only its shareholder or the shareholder's subsidiaries are entitled to take out an insurance with the company. This regime is however not yet active.

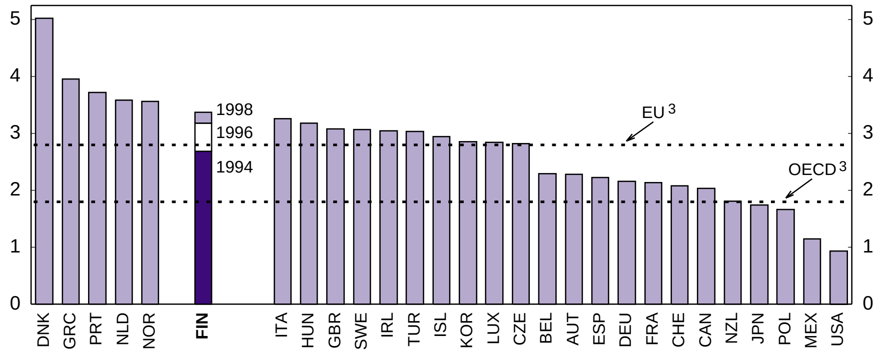
17. To mitigate the potential bias against the contracting out by municipalities resulting from the special VAT treatment for public bodies in place in most EU countries, Finland has introduced a special VAT refund scheme which applies to VAT paid on the inputs of municipalities (Aujean *et al*., 1999). This increases neutrality concerning contracting out of taxable services to the private sector. However, for tax-exempt services including medical and social services, the refund scheme stimulates own production by municipalities as they are compensated for the VAT paid on inputs while private companies are not. In the draft 2002 budget, the government has proposed to mitigate this bias by widening the refund scheme of the municipalities by a new compensation that would cover purchase of tax-exempt medical and social services. As this compensation is based on a rough estimate of the non-deductible VAT paid by private service companies, this will, however, only approximately level the playing field.

A heavy use of environmentally related taxes

18. Since the early 1990s, Finland has relied increasingly on environmentally related taxes. It introduced the world's first carbon tax in 1990 and implemented a green tax reform in 1997, raising taxes on carbon dioxide (CO_2) and introducing a tax on waste, while recycling part of the revenues through a cut in labour taxation (OECD, 1999; Vourc'h and Jimenez, 2000). It has also implemented taxes to reduce packaging and packaging waste.[21] In addition, Finland, like Denmark, Norway and Sweden, applies differentiated taxes on unleaded gasoline and on low-sulphur diesel, according to environmental criteria. This type of tax rate differentiation has contributed to the gradual reduction in the use of some of the most polluting automotive fuels.[22] At the municipal level, environmental services are largely covered by user fees, in accordance with the "polluter pays" principle (*e.g.* the tax on waste delivered to public landfills and the tax on dogs). Overall, revenues from environmentally related taxes have increased significantly over the 1990s and, at slightly less than 3.5 per cent of GDP in 1998, are high in international comparison (Figure 7).

Figure 7. **Revenues from environmentally related taxes**[1]

1998,[2] per cent of GDP



1. These data do not reflect environment related provisions in other taxes, including personal and corporate income taxes, such as accelerated provisions or tax credits for energy-saving and pollution-reducing equipment.
2. 1997 for Greece and Italy, 1995 for Iceland and Mexico.
3. Weighted average.

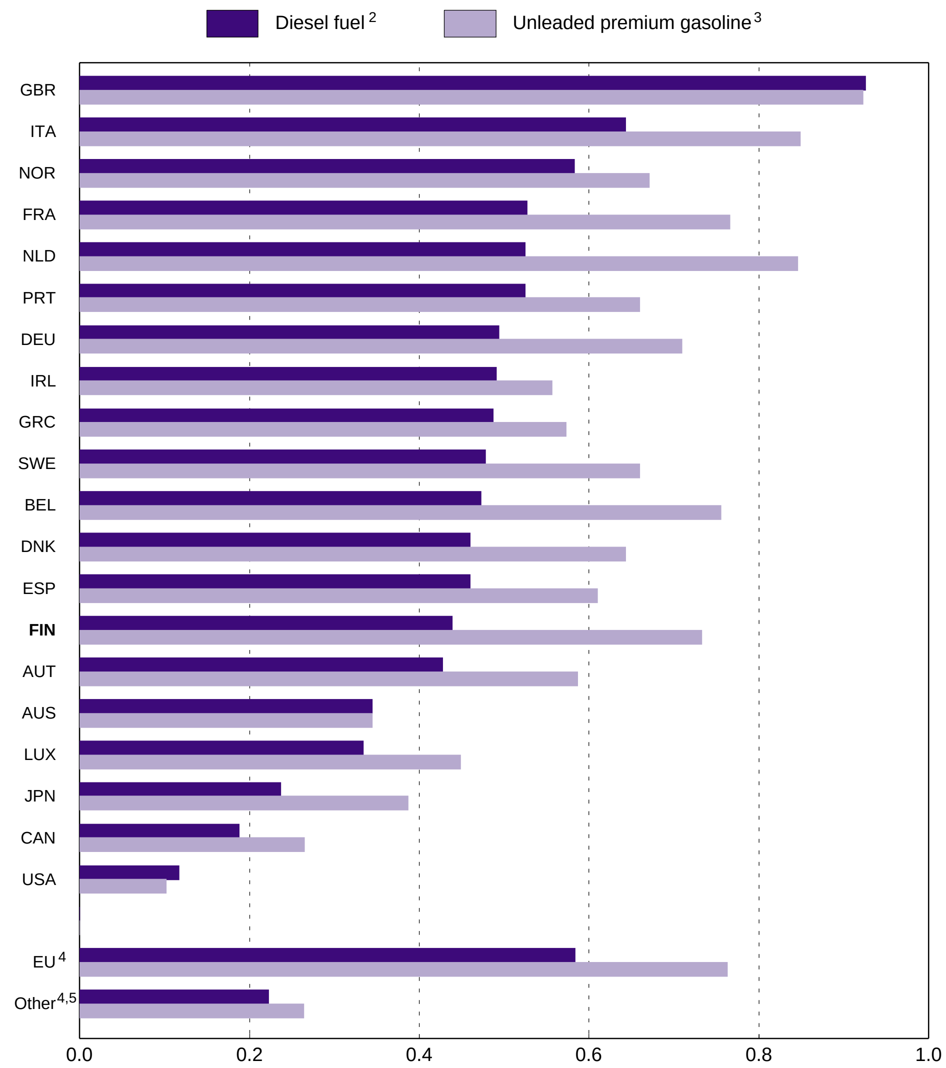
Source: OECD, Environmentally-related tax database, September 2001.

Environmentally related taxes are not all well-geared towards minimising abatement costs

19. Finland applies a large number of exemptions, rebates and refund mechanisms for heavy polluters, in particular for carbon/energy taxes, to mitigate any negative impact on the competitive position of the domestic industry, especially the forest-related industries and the basic metal industry. Fuels used in industrial production as raw material or auxiliary material or consumed as immediate inputs in the manufacturing of goods are exempt from carbon/energy taxes. In addition, industrial enterprises are eligible for a 85 per cent refund on the amount of tax on energy that exceeds 3.7 per cent of its value added.[23] The electricity tax is also differentiated by use, with a lower rate for industries and professional greenhouse cultivators — manufacturing initially paid only 54 per cent of the electricity tax paid by other users, such as households, rising to 61 per cent in 1998. The low taxation of diesel compared with gasoline (Figure 8) — with diesel releasing more CO_2 per litre and having higher associated other environmental costs — is another illustration of the failure of taxes to reflect in an appropriate manner the pollution content of, products or activities. An annual tax is levied on diesel vehicles but does not reflect appropriately the use of, and thus the emission of, pollutants generated by diesel vehicles.[24] These tax reliefs mean that a significant proportion of emissions is untaxed and excessive costs will be incurred in meeting environmental targets. Too much abatement is carried out, and too much output therefore lost, in sectors with relatively high marginal abatement costs, whereas too little advantage is taken of opportunities for abatement in sectors with low marginal abatement costs.[25] In addition, existing rebates for the carbon/energy taxes usually benefit the most capital-intensive firms (*e.g.* heavy metal and paper industries).

Figure 8. **Petrol taxes in international comparison: unleaded gasoline versus diesel**

Total taxes levied in 2000, USD per litre[1]



1. Using purchasing power parities (PPP).
2. Diesel fuel for commercial use for Canada; non-commercial use for all other countries.
3. 95 RON (research octane number) for all countries except: 91 RON for Australia and Japan, 97 RON for Canada and 98 RON for Denmark.
4. Weighted average using weights based on 1995 GDP and PPP.
5. Other non-EU OECD countries (excluding Iceland and Korea).

Source: IEA, *Energy Prices and Taxes* and OECD, *Main Economic Indicators*.

The taxation of income from savings has become much more neutral

The dual income tax has removed many distortions in the taxation of income from saving,…

20. The dual income tax system introduced in 1993 significantly improved the neutrality of the tax system towards different savings vehicles by imposing, at the personal level, a flat and unique tax rate on dividends, interest income as well as capital gains (Box 4).[26] The cut in marginal rates on income from savings (from the old top marginal rate of 64 per cent to the flat 25 per cent rate) was accompanied by a broadening of the tax base, through the abolition of the generous capital income allowances. Initially set at 25 per cent, the capital income tax rate has gradually been increased. The last hike took place in 2000, when the tax rate on capital and corporate income was raised from 28 to 29 per cent, and political pressures to raise it further are strong.

… but retirement savings and home-ownership still benefit from an overly generous tax treatment…

21. Though the adoption of the dual income tax system has certainly made the tax system more neutral towards saving vehicles in Finland than in many other OECD countries, the tax system still creates strong incentives to invest in retirement saving and housing.[27] As in many other OECD countries, several tax incentives to promote private pension savings (the third pillar) are provided. *First*, the effective tax rate is reduced by the deduction of premiums while pensions are taxed much later.[28] *Second*, returns on pension fund assets are tax exempt. *Third*, an annuity based on a private insurance policy is taxable in proportions varying between 60 and 10 per cent depending on the age of the policyholder (60 per cent below 44, 10 per cent at 92 or more). This has contributed to the steady increase in voluntary retirement savings since the early 1990s, though probably at the expense of other saving vehicles. As a share of total households' financial assets, saving in voluntary retirement schemes almost doubled between 1995 and 2000 to reach about 12 per cent in 2000.

22. Housing investment is also granted significant tax advantages. *First*, while imputed rents of owner-occupied housing are tax free, mortgage interest costs are deductible from the capital income tax base. This privileges housing investment over business investment. To be symmetric, tax deductibility of home ownership costs should only apply if housing were consistently treated as an investment good, with associated services (*i.e.* imputed rents) being taxed. However, the move to a dual income taxation system in 1993 has reduced the generosity of the tax treatment of debt-funded owner-occupied housing.[29] This reflects the fact that interest paid is deductible from the capital income component of individuals, which is taxed at a relatively low flat tax rate compared to the individual's marginal rate on labour. However, successive hikes in the capital income tax rates have also increased the tax value of the deductibility of mortgage interest payments. *Second*, capital gains from selling a dwelling are tax exempt if the dwelling has been used as a permanent residence by the taxpayer for at least two years. The tax expenditure resulting from the exemption of capital gains on owner-occupied housing was EUR 0.5 billion in 1999 (0.4 per cent of GDP), while that of the exemption from taxation of imputed rents amounted to EUR 0.8 billion in 1999 (0.6 per cent of GDP).[30] In addition, interest on home saving deposit accounts is still tax exempt. As a consequence, owner-occupied housing accounts for about two thirds of the residential housing stock and the rental market is underdeveloped in some parts of the country (*e.g.* in the capital area), which reduces labour mobility.

Box 4. **The Finnish dual income tax system**

Finland introduced a Dual Income Tax (DIT) system in 1993.[1] The main objectives of this radical reform were to improve the neutrality of the tax system towards different forms of financial resources and to enhance its competitiveness after the removal of the remaining barriers to international capital movements. The move to a DIT has entailed significant cuts in statutory rates on capital and corporate income, accompanied by base broadening measures.

Under a DIT system, all household income is divided into two components: capital income which includes dividends, interest income, capital gains, and rents; and labour income which includes wages, fringe benefits, pensions and social security benefits.

Taxing income from capital

Income from capital is taxed at a single proportional rate, equal to the corporate income tax rate — at 29 per cent in 2001. This feature ensures that there can be no arbitrage gains from accumulating the return on debt-financed assets within a lightly taxed corporation while deducting the interest payments against a higher personal income tax rate.

Interest payments and capital losses are normally deductible only against the low capital income tax rate, in sharp contrast with the comprehensive income tax model where they are deductible against the highly progressive marginal rate. However, when "income from capital" is negative, which is generally due to deductible interest expenses, such losses may be partially credited against tax payable on earned-income (an amount equal to 29 per cent of the loss — 30 per cent for the first dwelling — is credited against taxes payable on earned-income up to EUR 1 350 per taxpayer, plus EUR 350 per child). The maximum loss deductible, through the earned-income tax, is thus EUR 3 400 for a married couple with two children. In 1999, gross capital income amounted to EUR 6.5 billion while tax revenues on net capital income stood at EUR 1.2 billion. Capital expenses would thus amount to about EUR 2.2 billion (based on the flat capital income tax rate in 1999 of 28 per cent; the capital expense has risen thereafter due to the rate increase to 29 per cent). However, this may underestimate the true cost of capital expense deductions since interest payments can be deducted both from the capital income and from the earned-income component in Finland.

Another salient feature of the taxation of capital income is the use of imputation credits to remove the double taxation of distributed profits (first at the corporate level and then at the shareholder level) so as to ensure full neutrality across all sources of capital income at the domestic level.

Taxing labour income

Labour income (or earned-income) is subject to higher and progressive statutory rates, though generous allowances contribute to reduce average tax rates (see Box 1).

The split model for small businesses

Dividing household income into a labour and capital component requires a split model for income of those businesses where the owner also works in the enterprise. In Finland, the capital component derived from the activity of a self-employed or a partnership is calculated by applying a fixed rate of return (18 per cent) to the company's net assets, the labour component being the residual.[2] The progressive tax structure then applies to the labour component. However, it is important to note that in Finland, large tax allowances apply to the labour component only, and may introduce vertical inequities. For instance, income of companies with a low effective rate of return will be taxed at the 29 per cent flat rate (if the labour component derived from the split model is nil), while for more profitable companies, a large part of their labour income will be tax exempt, thus bringing down their overall effective tax rate. Higher progressive tax rates on the earned-income component will only phase in later, and gradually. As a result, and contrasting with other Nordic dual systems, the Finnish tax system creates an incentive to have income recorded as labour income for low to middle-income self-employed. To reduce these vertical inequities, from 2001 onwards the self-employed have the option to adopt a lower (10 per cent) rate of return thus giving the less profitable enterprises the opportunity to benefit from the generous tax allowances on the labour income component.

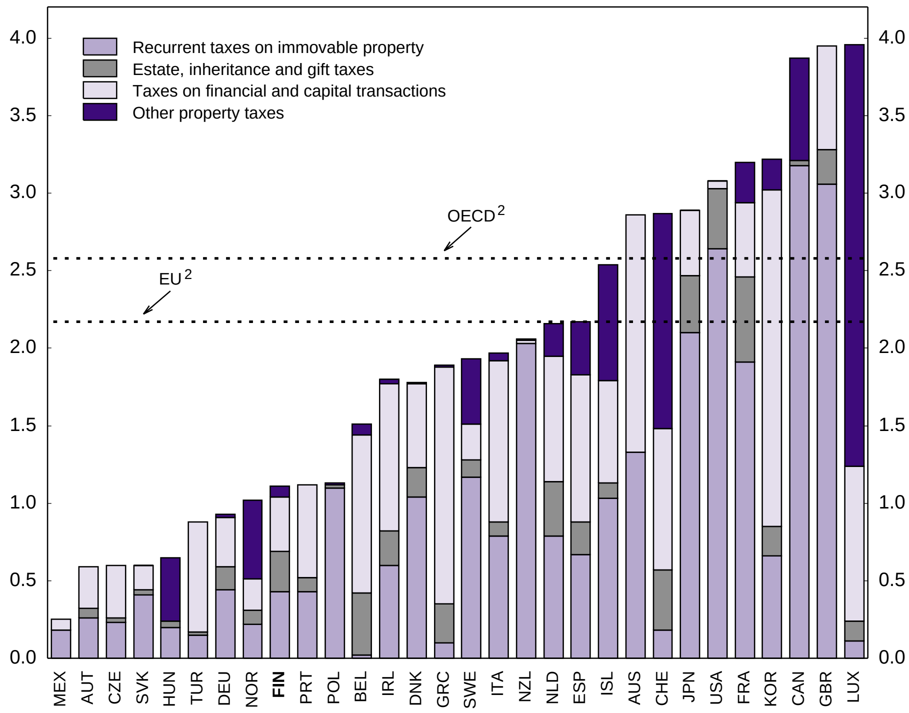
1. Denmark, Iceland, Norway and Sweden also introduced a DIT in the late 1980s and early 1990s. However, although Denmark was one of the first countries to introduce a DIT, subsequent modifications have introduced elements of progressivity in the taxation of capital income, as well as horizontal asymmetries in the treatment of positive and negative capital income.
2. Alternatively, the split of income can be implemented by imputing a wage income to the self-employed or the managers and considering the remaining income as capital income. Iceland has implemented such an income-split model. In this case however, the marginal tax rate of the self-employed equals the low rate on capital income, and the average tax rate falls with rising business income. The system thus tends to be regressive.

… while low property taxes do not lessen the favoured tax treatment for house-ownership

23. While income taxation is already favourable for housing investment, property taxation is also fairly lenient. This partly reflects an underestimation of real estate values — the assessed value of real estates for tax purposes is about 70 per cent of their market price on average, though with significant variations across the country. Rates of the real estate tax are also relatively low, despite some hikes since its introduction in 1993: they may vary within a range of 0.22 and 0.5 per cent, set by the central government, *i.e.* well below those in place in many other OECD countries.[31] Likewise, inheritance and gift taxes are low by international standards. Finland also levies a net wealth tax on financial and real assets of individuals, after deducting financial liabilities. However, bonds and savings deposits are largely tax exempt, creating non-neutralities across saving vehicles, over and above those associated with investing in housing and retirement vehicles. This tax also generates incentives for taxpayers to inflate liabilities, *i.e.* to take out loans in order to invest in tax-favoured or under-assessed assets such as real estate. The net wealth tax thus accounted for only 0.1 per cent of total tax revenues in 1998. Overall, property taxes, as a share of GDP, are significantly below the EU and OECD average (Figure 9).

Figure 9. **Property taxation: an international perspective**

Tax revenues as a per cent of GDP, 1999[1]



1. 1998 for Mexico.
2. Total property taxes; weighted average using 1995 GDP and purchasing power parities.
Source: OECD (2001), *Revenue Statistics*.

Corporate financing: double taxation issues

24. The dual income tax combined with an imputation system for dividends has improved the neutrality of the tax system towards corporate financing decisions when the investors are resident individuals. In an imputation system, distributed profits are taxed at the corporate level, while at the personal level, dividend recipients are granted a tax credit corresponding to the corporate tax already paid. It brings the overall tax wedge on financing through new equity into line with that through debt for domestic investors.[32] However, such imputation credits do not benefit most foreigners investing in a Finnish corporation — since few bilateral treaties accommodate them — and may thus discourage foreign investment.[33] This may give rise to tax-planning activities such as dividend stripping.[34] Imputation credits also discriminate against resident shareholders of foreign companies by not granting them a tax credit for the corporate tax paid in another country. For this reason, the Finnish imputation system may become questionable under the European Community tax rules which guarantee the free movement of capital and the freedom of establishment (Helminen, 2001). On the other hand, the Finnish tax system discriminates against retained earnings for a resident investor since they are taxed first at the corporate level and then as capital gains at the shareholder level.[35]

A more neutral taxation of entrepreneurial activities

25. In addition to the move towards a DIT system, measures were taken to improve the taxation of entrepreneurial income from the mid-1980s to the mid-1990s. They involved a gradual broadening of the corporate income tax base, combined with a significant cut of the statutory rate, from 60 per cent in 1985 to 25 per cent in 1993 (raised gradually to 29 per cent in 2000). Though reforming the taxation of entrepreneurial activities involved a large number of tax measures, a few salient features are worth mentioning.[36] The generosity of the depreciation rules for fixed assets was reduced, thus reducing the tax advantage for capital intensive activities, while capital gains from fixed assets (*e.g.* real estate) and securities became taxable regardless of the holding period. Specific tax incentives for heavy metal industries, the construction sector, shipping and for regional, cyclical and research activities were largely removed (Tikka, 1989). The broadening of the tax base also involved the elimination of the EUR 17 000 basic tax allowance, and the introduction of limits on the use of reserve provisions and deductions for entertainment expenses. The presumptive municipal income tax was abolished in 1991. The most decisive step however was the replacement of the dividend deduction system in 1990 — which allowed companies to adjust their taxable income through their profit distribution policy — by the imputation system for distributed dividends.[37] Overall, the average effective tax rate on entrepreneurial activities has not changed significantly as a result of the reforms and, though the statutory rate is rather low by international standards, corporate income tax revenue as a share of GDP is relatively high. The most commendable result of these reforms however was to make the effective taxation more uniform across companies involved in different economic sectors, and with different capital intensity and financing sources.

However, a few sectoral and locational non-neutralities persist…

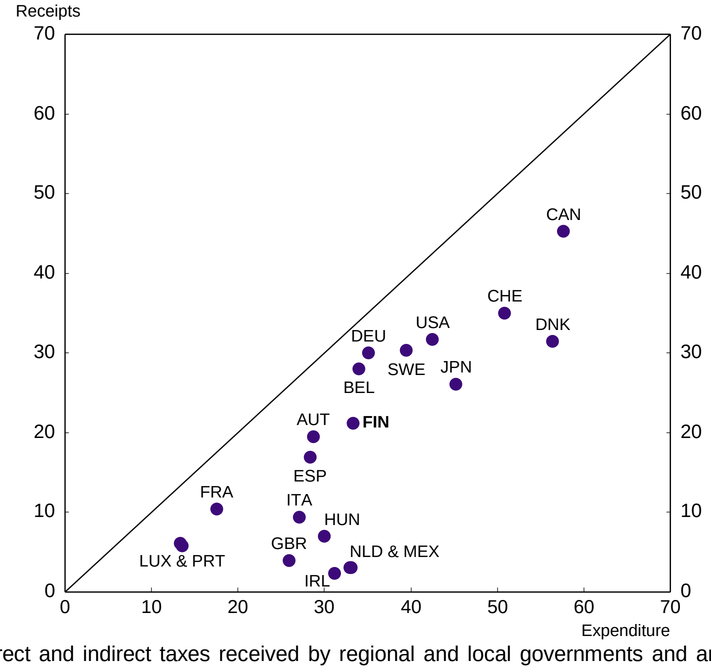
26. In international comparison, the tax code contains only a few special tax reliefs that favour certain activities and locations. One illustration is the absence of any specific tax incentive granted to research and development (R&D) activities while many other countries have recently introduced or increased such schemes.[38] However, some special regimes do exist. One of them is the Åland captive insurance regime, which allows for a reduced corporate income tax rate. This scheme is not yet active (see Box 3). In addition, some accelerated depreciation schemes for small companies investing in the so-called developing regions and the investment allowance in the shipping sector have been

considered as potentially harmful by the EU Code of Conduct on business taxation. Though tax expenditure associated with these two schemes is rather limited (EUR 5 million and EUR 0.3 million, respectively, in 1997), their existence has induced some lobbying by other sectors or regions to get specific tax reliefs. Recent tax demands from, and concessions to, the shipping industry provide an illustration.[39] Agriculture and forestry are also granted several tax privileges through the income tax system. In addition, forests and agricultural land are exempt from property tax and capital gains, resulting from the sale of agricultural or forestry property, are also tax free.

… and specific tax issues concern the taxation of small firms

27. In Finland, as in most OECD countries, the tax treatment of the self-employed is the Achilles heel of the income tax system (Van den Noord and Heady, 2001). However, while in most countries the self-employed face low effective tax rates — in particular because they benefit from more tax reliefs — some small Finnish enterprises may end up paying relatively more income tax than both the largest ones and the wage-earners. Like in Denmark, Norway, and Sweden the splitting of self-employment income requires imputing a return to the capital invested in the firm, the residual business income being regarded as earned-income (see Box 4). However, the imputed rate of return on business assets in Finland up to 2001 (18 per cent on the company's net wealth) seems high and the capital income share could be overestimated.[40] As a result, most of the income from the less profitable and/or newly created businesses has been categorised as capital income, and then taxed at a 29 per cent flat rate, impeding these businesses from benefiting from the existing generous tax allowances which apply only to the earned-income component. To reduce these horizontal inequities between self-employed and wage earners which may discourage start-ups and hinder entrepreneurship, a reform is being introduced (see Box 4).

Figure 10. **Tax receipts and expenditure by regional and local governments**[1]
Percentage share in non transfer receipts and expenditure, 1999[2]



1. Receipts include direct and indirect taxes received by regional and local governments and are expressed as a share of taxes received by the general government. Fees and charges are not included. Expenditure corresponds to total expenditure by regional and local governments expressed as a share of general government expenditure (excluding capital transfers). The country ranking in this figure does not necessarily correspond to the comparative fiscal autonomy of lower governments
2. 2000 for Finland, Luxembourg and United Kingdom; 1998 for Mexico and Portugal; 1997 for Canada, France and United States; 1996 for Ireland and Switzerland.

Source: OECD, *National Accounts*; OECD (2001), *Revenue Statistics* and the Hungarian Ministry of Finance.

Municipalities rely heavily on tax revenues to fund spending

28. The share of tax revenues in municipalities' financial resources has risen significantly since the mid-1990s, to reach 52 per cent in 2000, and the gap between their tax revenues and their spending is narrow by OECD standards (Figure 10). Concerning fiscal autonomy, municipalities have relatively large spending and taxing responsibilities (Box 5; OECD, 1999*b*). A salient feature of the Finnish tax system is the municipalities' unrestricted responsibility in setting municipal rates on labour income. In 2000, revenues from the local tax on labour income amounted to EUR 9 billion, while total direct taxes on households amounted to about EUR 20 billion. While tax rates vary across the country, tax bases are uniform and local taxes are collected by the central tax administration; both features contribute to keep collection costs at a rather low level in international comparison. Another commendable feature is the design of the tax equalisation scheme from the rich to the poor municipalities which is based on the capacity to raise tax, rather than on actual taxes collected, and thus does not invalidate incentives to adjust local tax rates to citizens/taxpayers' preferences. On the spending side, the reforms during the 1990s of the grant system have also increased the incentives for an effective use of municipalities' financial resources by replacing earmarked state grants by block grants.[41]

Box 5. **Municipalities' spending and tax responsibilities**

The Finnish government effectively relies on a two-tier system — the state and the municipalities — as provinces play a very minor role.

High decentralisation of the provision of public services

Municipalities are responsible for the provision of most basic services to citizens, including primary and secondary education, social welfare, health and specialised care, though national laws define minimum quality standards in most of these areas. They also supervise land use and building activities within their jurisdiction and are responsible for street maintenance, water supply and sewerage, co-ordinating waste disposal and energy supply, and protecting the local environment. Municipalities employed 410 000 persons in 2000 (*i.e.* about 74 per cent of public employment and 18 per cent of total employment). As in other Nordic countries (Lotz, 1999), the process of decentralisation has, however, posed some problems, such as the difficulty to provide high quality specialised services in small municipalities (about 60 per cent of the municipalities had less than 6 000 inhabitants in 1999). Thus, to reap economies of scale, municipalities often co-operate in the provision of key services, by establishing joint municipal services, *e.g.* for hospital care, and some mergers of municipalities have taken place. The government is encouraging the merger of municipalities by subsidies for preparatory work.

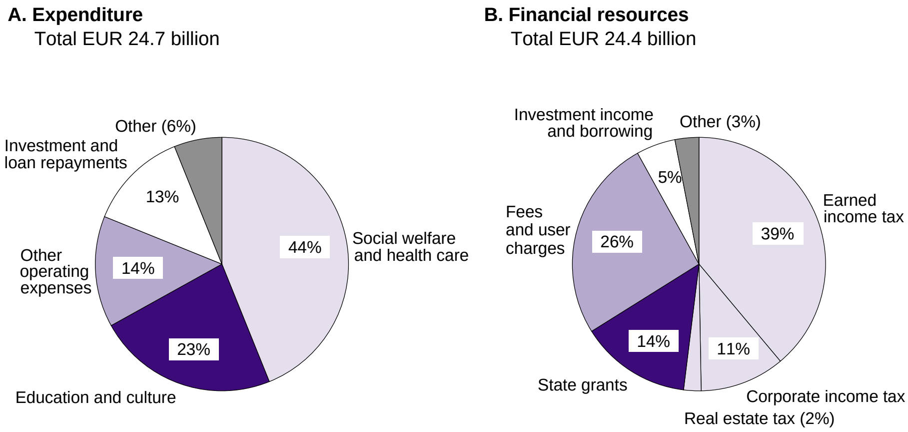
Municipalities' financial resources: a strong and increasing reliance on local tax bases

Tax revenues accounted for more than half of the municipalities' budget in 2000 (Figure 11), though with significant differences across municipalities (from 20 to 80 per cent). They consist of:

- *The local earned-income tax on individuals*. Municipalities have no power to set the base but they can set a flat rate without any limitation. In 2001, municipal tax rates ranged between 15 and 19.75 per cent.
- *The municipalities' corporate income tax share*. Municipalities receive a share of the corporate income tax paid by companies operating within their jurisdiction (the share apportioned to municipalities was set at 36.39 per cent in 2000; in the draft 2002 budget, the government proposes to cut the share to 23.33 per cent in 2002). When a company operates in several jurisdictions, the key criteria used by the tax administration to share the tax component which accrues to each municipality is the number of persons employed.
- *Real estate taxes*, as well as other minor taxes (mainly a tax on dogs). Real estate tax revenues accrue fully to municipalities but they do not have complete freedom to set the rates. The central government sets a range for real estate tax rates, which varies according to the use of land. Rates are lower for primary than for secondary residences, even though permanent residents are likely to use local services and the infrastructure more intensively. In 2000, for instance, rates were allowed to vary between 0.2 and 0.5 per cent of the taxable value for primary residences, and between 0.5 and 1.0 per cent for secondary residences and most other immovable properties. Power plants are imposed at higher rate (up to 2.2 per cent for nuclear power plants).
- *User charges and fees*. The largest part is charged on the provision of energy, water and sewerage services. Municipalities may also levy charges for social, health care and cultural services, within the limits set by law while education is free (Antolin *et al.*, 2001). However, these charges are of minor importance in funding these services (EUR 1.3 billion in 2000).

Figure 11. **Financing municipalities' spending**

Estimate for 2000



Source: Association of Finnish Local and Regional Authorities.

Uncertain revenues at the municipal level

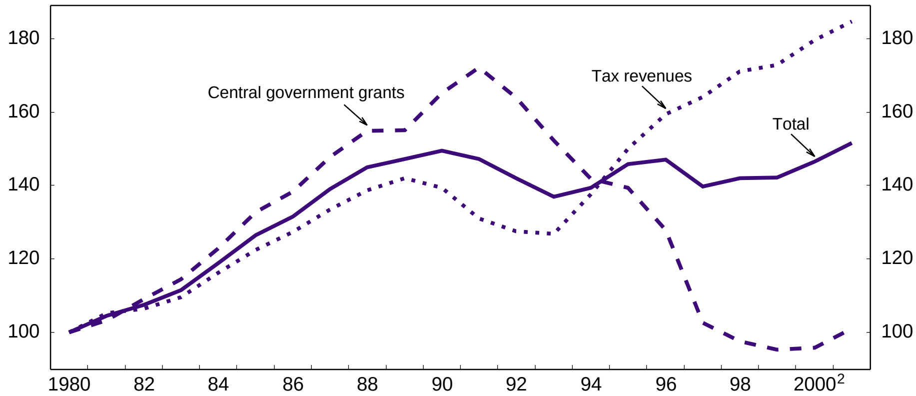
29. The heavy reliance of municipalities on rather volatile tax revenues makes it difficult to plan expenditure programmes. During the second half of the 1990s, revenues from the corporate and labour income taxes, which are highly sensitive to economic cycles, have grown substantially (Table 4). They accounted for one half of their financial resources in 2000. The maturing of stock option programmes also gave a boost to municipalities' receipts from the labour income tax. This has occurred despite the introduction of measures at central government level, which have resulted in lower tax revenues apportioned to municipalities. Recent increases in several tax allowances to the earned-income tax have narrowed the tax base while the municipalities' share of corporate tax revenues has been cut. The central government has also offset the rise in municipalities' tax revenues by reducing state grants, after already severe cuts in the first half of the 1990s during the deep recession (Box 6). Overall, financial resources of municipalities in volume terms have not changed significantly since the mid-1990s while their mix has shifted towards tax revenues (Figure 12).

Table 4. **Volatility of tax revenues**

	Tax revenues as a share of GDP (%)					Volatility over the period 1990-2000[1]
	1980	1990	1995	1999	2000	
Personal income tax	14.0	17.2	16.3	14.7	15.1	0.07
Corporate income tax	1.4	2.0	1.8	4.2	5.4	0.60
Social security contributions	7.0	9.7	12.4	11.8	11.1	0.07
Property taxes	0.7	1.1	1.0	1.1	1.1	0.06
Taxes on goods and services	12.9	14.6	13.3	14.3	13.6	0.03
Memorandum items						
Total tax revenues	36.2	44.7	44.9	46.3	46.5	0.02
Municipal personal income tax	7.2	8.8	8.5	7.8	7.3	0.07
Municipal corporate income tax	0.7	0.8	0.8	1.7	2.1	0.56

1. Volatility measured by the coefficient of variation for the tax revenue to GDP ratio.
Source: OECD (2001), *Revenue Statistics*.

Figure 12. **Finance resources of municipalities: tax revenues and central government grants**
Volume indices, 1980 = 100[1]



1. 1990 constant prices using the deflator for government final consumption expenditure.
2. Estimates for 2000 and projections for 2001.

Source: Association of Finnish Local and Regional Authorities.

An increase in financial disparities across municipalities

30. The increasing reliance on local taxes, as opposed to state grants, has also increased financial disparities across municipalities. While all municipalities have been affected by a cut in state grants (on a per capita basis), not all of them have benefited equally from the boom in tax revenues.[42] As a result, the system may fail to provide enough resources to the poorest municipalities. The growing number of municipalities running a deficit could indicate financial stress.[43] On the other hand, for the rich municipalities, there is a risk that the boom in tax revenues has given rise to spending that may be difficult to prune in more lenient times, which could lead to a deterioration in the local finances during a downturn.

Pressures to increase public spending

31. The rules governing the devolution of tax revenues to municipalities also create more pressures to increase public spending than to reduce the tax burden. While municipalities receive a share of the taxes paid by companies within their jurisdiction, they have no power to adjust the corporate tax rate. As a result, they reportedly compete to attract companies by building modern business centres and/or by offering business premises, low-priced public services (*e.g.* waste treatment) and logistic services. Limits on property tax rates imposed at the state level further hinder the municipalities' ability to achieve the right balance between a high quality of publicly provided goods and services and a higher tax. On the other hand, while municipalities do have unlimited power to set the (flat) municipal earned-income tax rate, recent surveys have indicated that the quality and price of public services, in particular in the health sector, are more important factors than tax rates in influencing citizens' location choices.[44]

32. Until recently, annual negotiations between the state and the municipalities have been practically the only instrument to ensure that municipalities' tax and spending decisions do not contradict the central government's fiscal programme. In addition, a law requiring municipalities to balance their budget over a three-year period has been introduced in 2001. However, the volatility of municipalities' tax revenues, combined with the two-year delay in redistributing these revenues across municipalities may make this rule difficult to implement. Furthermore, the law does not include sanctions in case of deviations from the rule.[45]

Box 6. **The state grant and tax equalisation scheme**

Since municipalities are responsible for many functions that involve redistribution (from the rich to the poor but also from the working-age population to the young and the old), some equalisation of resources is necessary. The tax equalisation scheme aims to reduce disparities among municipalities in their capacity to raise revenues while the state grant scheme contributes to the funding for the local provision of statutory services.

The tax equalisation system is based on a comparison between every municipality's potential tax revenues per inhabitant and the country average (potential tax revenues are defined as those that the municipality would get if it adopted the average tax rate applied in the country). If the potential tax revenues of a municipality fall below 90 per cent of the country's average, then the tax equalisation scheme raises this municipality's financial resources by redistributing tax revenues collected from wealthier municipalities (in 2000, three fourths of the municipalities were below this threshold). If it exceeds the 90 per cent threshold, the municipality contributes to the tax redistribution scheme (40 per cent of its tax revenues, starting from the 90 per cent threshold). Up to 2001, revenue equalisation across municipalities has, however, been capped. By law, a rich municipality's contribution to the tax equalisation scheme cannot exceed 15 per cent of the municipality's tax revenue. As a result, when a municipality's tax revenues exceed 144 per cent of the country average, its contribution to the equalisation scheme is brought down to 15 per cent of its total tax revenues, which is low by Nordic standards. This capping limit will, however, be removed in 2002.

Municipalities also receive block grants, based on notional expenditure needs, from the state. Notional spending on social welfare and health care is based on the age structure of the municipalities' population and some geographical criteria (*e.g.* size and density of the population). Social welfare grants also take into account the level of unemployment and health grants take into account a morbidity factor. State transfers for education are based on the number of students. Every year, state transfers are adjusted to reflect price and public sector wage developments. In spite of these rules, state grants have been cut significantly since the early 1990s, while municipalities' responsibilities have been extended, to compensate for the boom in tax revenues at the municipal level. As a result, the share of grants in total local revenues has declined substantially, from 30 per cent in 1990 to below 15 per cent in 2000.

No formal relationship exists between grants and taxes, creating uncertainties over the availability of municipalities' financial resources. In the second half of the 1990s, booming corporate income tax revenues led to cuts in state grants, *de facto* preventing excessive spending. However, there is no automatic mechanism leading to higher grants in periods of falling tax revenues. Furthermore, despite the recent reduction to two years, the delay in redistributing tax revenues collected across municipalities through the tax equalisation scheme creates additional uncertainty on the amount of resources that will finally accrue to them.

Main options for reforms

33. Though the Finnish tax system performs relatively well in balancing considerations of economic efficiency, equity and enforceability, there is scope for improvement (Box 7).[46] Profound reforms of the consumption, corporate and capital income taxation in the early 1990s have played a key role in reducing distortions in domestic markets while promoting international competitiveness. However, the taxation of labour has been reformed in a more piecemeal way and gives rise to important equity/efficiency trade-offs. Though the scope is limited, re-balancing the tax burden from labour to property and consumption tax bases would help to address some of these concerns. Tax cuts should be targeted first towards enhancing the performance of the labour market. Reducing the unemployment rate would also serve to reduce the pre-tax dispersion in income and to attenuate future economic and budgetary effects of ageing. Creating the right conditions for a sound management of public finance at the municipal level could also reduce existing pressures on public spending and thus provide more scope for tax cuts.

Box 7. **Synopsis of options for reforming the tax system**

Personal income tax

- Broaden the tax base on personal income (earned-income) and reduce statutory rates.
- Reduce the use of tax incentives to boost labour force participation and give more emphasis to tax measures to lower the cost of labour (*e.g.* cuts in social security contributions).
- Reduce tax incentives for people to retire early.
- Reconsider the pros and cons for granting generous tax incentives for pension saving. One option to reduce their generosity and increase their fairness would be to replace the existing tax allowance by a tax credit.
- Inflation-adjust tax brackets annually.

Social security contributions and benefits

- Remove existing disincentives to retain or hire older workers (in particular, the age dependency of social insurance contributions).
- Reconsider the differentiation of social security contributions by size and capital intensity of the company and introduce instead targeted cuts for low-paid workers.

Consumption taxes

- Raise the revenue-efficiency of the VAT by considering the elimination of reduced VAT rates.
- Reduce the distortions in competition between public bodies and private companies by changing the tax-exempt status of social services, requiring modifications at the EU level.

Environmentally related taxation

- Improve incentives to abate emissions by reconsidering tax reliefs granted to heavy polluters (in particular for the energy/carbon tax) while introducing well-targeted compensation schemes when competitiveness or income distribution are of concern.
- Reduce the tax advantage granted to diesel compared with gasoline.

Capital and corporate income taxes

- Reduce the generosity of the tax advantages granted to owner-occupied housing by phasing out, or at least capping mortgage interest deductions more stringently and by tightening the taxation of capital gains on house ownership. Interest received on home saving deposit accounts should be taxable as any other capital income.
- Keep the capital/corporate income tax rate competitive. In case of strong pressures due to distributional considerations, consider reducing the imputation credit for dividends, which discriminates against foreign investment.
- Abolish the tax-sharing arrangement, which assigns part of the corporate income tax revenues to the municipality where the company is located. Several options for compensating the income loss for municipalities could be envisaged.

Property taxes

- Consider raising real estate taxes, as well as gift and inheritance taxes, which are low by international standards. Abolish the current exemption from property taxes granted to forest and agriculture lands.
- Abolish the net wealth tax.

Reduce and rebalance the taxation of labour

34. Since the mid-1990s, the main tax initiatives to raise the employment rate have aimed at increasing work incentives for workers with a low earnings potential. A rise in tax allowances was the key instrument. To avoid harming work incentives too much for a specific income group, these tax allowances have progressively been extended to a wide earning span, thus raising significantly the financing cost. This has helped to raise the participation rate since the mid-1990s, from an already high level by international standards — though this partly also reflects the economic upturn. However, unemployment for groups at the margins of the labour market has remained very high (in particular for the less-educated, young, and older workers) and some high-technology companies have faced difficulties to attract and retain highly-skilled workers and could do so again in the near future. Such imbalances in the labour market would argue in favour of redesigning the tax measures targeted at improving labour market performance, towards reducing employer costs for hiring the low-qualified, and better work incentives along the whole spectrum of the earnings ladder.

Reassess the impact of the earned-income tax allowance…

35. An assessment of the EITA scheme partly depends on the weight given to distributional aspects, since this scheme is specifically targeted at raising the post-tax income of the working poor. Means-tested benefits act as a strong deterrent to labour market entry for some population groups. The EITA partly redresses these disincentives to take up a job for low-qualified earners. The EITA has probably helped to raise participation amongst the low-paid and contributed to wage moderation (Laine and Uusitalo, 2001). However, increasing the incentives for people with low earnings potential to enter the labour market will only help if firms have adequate incentives to hire. This requires that labour costs for such workers are sufficiently low to make it profitable for employers to hire them. But the objective of achieving a more egalitarian wage structure embodied in the collective bargaining system, with higher wage increases granted to low-income earners, has mitigated the EITA impact on labour costs for the low-qualified. In this context, the EITA may not be the most cost-effective scheme to raise the employment rate. In a country like Finland, the narrow income distribution, the high progressivity of labour taxes and already high participation rates also contribute to reduce the impact of employment-conditional schemes on the labour market (Bassanini *et al.*, 1999).[47] Furthermore, as the cost of this scheme is shouldered by a higher tax burden by those higher up in the earnings distribution, the impact on aggregate labour supply is uncertain because the majority of workers is in the phase-out range.

… versus cuts in statutory rates

36. Increasing the generosity of earned-income tax allowances, by narrowing the tax base, has limited the opportunities to cut statutory rates which are high by international standards. Statutory rates have an important "face-value" while the impact of the various tax allowances on the effective tax burden is less transparent. The introduction of a special scheme for foreign experts (a lower flat tax rate on their labour income) reflects the need to attract highly-qualified workers. However, it discriminates against the local work force and cannot serve to retain highly-qualified domestic employees, nor does it provide better incentives to increase work effort. Thus, enhancing work incentives, in a context of a growing international mobility of skilled workers, would argue for giving priority to streamlining tax allowances while introducing more ambitious cuts in statutory rates. Though this may increase after-tax inequality, narrowing the gap between statutory rates on capital and labour would work in the opposite direction. It would also lessen tax planning activities and attenuate difficult tax issues arising for the taxation of small businesses.

Make social security contributions more employment-friendly

37. A significant improvement in the employment rate among the less educated, young and older workers will likely require a reduction in non-wage labour costs targeted at the lower end of the income scale. Redesigning the social insurance contribution system to remove the existing discrimination against older workers has already been recommended in the previous OECD *Survey* (OECD, 2000*c*). To raise the incentives for enterprises to hire older workers, higher pension contributions, reflecting disability and unemployment risks, could be spread over the entire employed population, thus eliminating the current age-dependency of non-wage labour costs. More ambitious would be the introduction of targeted cuts in social security contributions for the low-paid, low-qualified workers. Such measures have been introduced in several EU countries (Joumard, 2001). In many cases, and in particular if coupled with measures to tackle labour market rigidities, they have had promising results, as evidenced by the strong response of employment to output growth (*e.g.* in Belgium, France, Netherlands and Spain). In Finland, given the centralised bargaining system resulting in a compressed wage structure, it can only be introduced if an agreement with social

partners ensures that cuts in contributions for the low paid actually reduce total labour cost rather than feed into higher wages.

38. In principle, targeted cuts in contributions should be limited to the non-insurance components of the social security system (minimum pension, unemployment assistance, etc.). However, the central government already contributes to the financing of some of the existing unemployment and pension schemes.[48] Another common argument against such targeted schemes is that they increase the complexity of the tax system. However, a differentiation in social security contributions already exists — by size and capital intensity of companies (see Box 2) — and may lead to harmful distortions (*e.g.* by creating threshold effects). This differentiation, partly based on the capital intensity of the company, has reportedly induced companies to use leasing arrangements, instead of buying directly their equipment, so as to pay lower social security contributions. Replacing such a system by better-targeted cuts in social security contributions may thus help to improve labour market performance without increasing significantly the complexity of the system.

Improve the efficiency of consumption taxes

39. There is scope for shifting taxation from labour to consumption, although more limited than in many other OECD countries. Higher tax rates on consumption may increase tax avoidance and evasion as evidenced by the sizeable amount of smuggling and cross-border shopping of alcoholic beverages and tobacco. Likewise, though the loss in tax revenues resulting from the use of e-commerce is perceived to be rather limited, higher VAT rates would exacerbate the potential erosion of the tax base, especially for online deliveries from businesses to consumers. Nevertheless, there is still room to raise the yield from indirect taxes. Widening the range of goods and services taxed at the normal VAT rate should be a priority. Since reduced rates reportedly do not contribute much to enhance redistributive objectives, such a move would not lead to a significant trade-off between equity and efficiency. Reconsidering the Åland islands' special tax regime (both for the VAT and tax-free sales), might also contribute to raising the efficiency of consumption taxes, even though this could raise constitutional problems. The reduction in excise taxes by 2004 to comply with EU rules will entail losses of tax revenues but it will also contribute to reducing cross-border shopping and smuggling.

Strengthen the cost-effectiveness of environmentally related taxes

40. Despite the rising importance of environmentally related taxes, Finland has not succeeded in reducing emission to GDP ratios, in particular of CO_2.[49] To contain greenhouse gas emissions, the government plans to implement a package of measures which will probably include a hike in energy taxation, though no major changes in the current structure of energy taxes is expected.[50] However, it would be important to gradually remove existing rebates for heavy polluters so as to provide the right incentives to shift to less polluting production and consumption patterns and to reduce abatement costs. If competitiveness is an issue, one option to consider would be to channel part of the environmental tax revenues back to the industry in such a way that marginal abatement incentives are not reduced.[51] The compensation scheme should then be phased out once other countries have followed suit. Alternatively, the competitiveness concern of raising green taxes may be mitigated in some sectors if green tax revenues are recycled via lower labour taxes (Honkatukia, 2000).[52] Ensuring that changes in energy taxation are announced well in advance would also help producers and consumers to plan abatement measures more efficiently.

41. Removing the tax advantage for diesel — which is large by international standards — and more generally shifting from vehicle to fuel taxation should also be envisaged. This would give better price signals to users. Reducing the tax on the purchase of new cars while taxing more heavily the use of cars would also contribute to speeding up the modernisation of the car fleet, and thus improve environmental performance. An important concern associated with the rise in fuel taxes is the potential impact on income distribution (Economic Council, 2000), in particular since poor households are concentrated in cold and remote areas (*e.g.* eastern and northern parts of Finland). However, targeted lump-sum transfers (*e.g.* on the basis of the place of residence and/or the number of children) could be implemented instead. Such compensation schemes would maintain the price signals of the tax whilst reducing the impact of the tax on household income, without creating poverty traps.

Reconsider the tax privileges granted to pension saving and home ownership

42. While empirical evidence suggests that the composition of household saving is quite sensitive to tax policy, there is little evidence that taxation has a significant impact on aggregate saving. Furthermore, existing tax advantages towards home ownership, as well as towards private pension plans, have several drawbacks. First and foremost, they hinder an efficient allocation of resources and are likely to benefit more the relatively well-off since their "tax value" is largest for high-income groups.[53] In addition, such tax reliefs may have other indirect adverse effects. In particular, a high rate of home-ownership, combined with a tight housing rental market, may reduce the geographic mobility of labour. Home-owners are less likely to move than renters due to high transaction costs, including a tax on real estate transactions, while rents have increased rapidly especially in the southern part of Finland. Tax privileges towards specific saving vehicles may also distort competition in the financial sector by favouring particular categories of providers, and they affect relative prices. In addition, tax privileges on pension saving often act as a barrier to the creation of a single European financial market since contributions to foreign pension insurance institutions are not treated the same way (Juusela, 2000).[54] One solution to increase the fairness of tax incentives towards retirement saving could be to replace the existing tax allowance associated with contributions paid by a tax credit which has the same value for all taxpayers. To reduce their generosity, and thus the distortions across saving vehicles, the value of this tax credit should be set at a lower level than the average tax value of the existing allowance.

43. To improve the neutrality of the tax system towards housing investment, mortgage interest payments could remain deductible but the income from the investment (imputed rents and capital gains) should be taxed. However, there are strong political and administrative constraints. The taxation of imputed rents is difficult to administer and unlikely to be well understood by the population. Moreover, since a large proportion of the voters also own their dwelling, getting such a change approved in Parliament would certainly be difficult.[55] In addition, introducing an effective tax on imputed rents requires a proper valuation of real estate, which is costly to update annually.[56] To reduce the tax advantages towards home-ownership, Finland could follow measures taken in several EU countries which have left imputed rents tax-exempt but have capped the amount of mortgage interest which can be deducted (*e.g.* Ireland and Spain) while France and the United Kingdom are fully phasing out mortgage interest relief.[57] As an alternative, property taxes — equivalent to taxation of imputed rents given the flat-rate capital income tax — could be raised significantly. This should however be accompanied by the abolition of the net wealth tax, which generates incentives for taxpayers to inflate their liabilities and to invest in low-taxed assets (in particular housing).

Reassess the merits of the imputation system for dividends,…

44. As political pressures to raise the corporate/capital income tax rate further are high, reassessing the current Finnish imputation model, in the light of recent developments in some EU countries, should be useful. Germany and Sweden for instance have recently reintroduced the taxation of dividends while cutting the corporate income tax rate, which has an important signalling function, particularly for foreign investors. Norway has also introduced an 11 per cent flat tax on dividends in 2001 — by reducing the imputation credit from 28 to 17 per cent — and intends to replace it in 2002 by a new system of corporate taxation (OECD, 2001*b*). Such moves away from the imputation system are mainly dictated by the need to make the tax system more attractive for foreign investors, while recognising that, in a world with relatively free capital movements and for a small, open economy, the imputation system is not a perfect solution for reducing the bias towards debt funding.[58] To reduce the discrimination against foreign investment and investors, Finland's imputation system has already been amended several times (Helminen, 2001). However, the amendments have raised the complexity of the system. A more radical approach, the reintroduction of the taxation of dividends at the shareholder level, could thus be envisaged. In the current Finnish context, it could offset the existing pressures towards new hikes in the capital and corporate income tax rate and address the redistributive concerns of the Finnish society since it would raise tax revenues mainly from the highest income groups. Meanwhile, the capital and corporate tax rates should not be raised further.

… and remove the non-neutralities concerning entrepreneurial activities

45. A fair and enforceable income tax for small businesses promotes start-ups, entrepreneurship and risk-taking. This may in turn help to create employment, which is one of the key priorities of the Finnish government. The recent change in the split model for the self-employed is an improvement in this respect as it is more favourable for start-ups and other self-employed with low earnings. However, creating an optional, and reduced, imputed rate to determine the income component to be taxed at the flat rate introduces a new threshold, leading to erratic movements in METRs and thus potential adverse effects on incentives. An alternative solution — giving sole entrepreneurs and partners the possibility to opt for the taxation of their whole income under the earned-income code, as in Sweden — may have been preferable in this regard. This would allow them to bring their tax liabilities in line with wage earners, which would reduce horizontal inequities. On the other hand, the Finnish authorities should resist demands for a special corporate tax treatment by some industries and regions which may prompt tax planning, lead to a serious distortion of competition and make the tax system more complex. While recognising that specific regional taxing powers (*e.g.* for the Åland islands) are rooted in the Constitution, and that tax privileges to some regions or industries are driven by regional development and competitiveness considerations, reassessing their relative merits would be desirable.

Assign municipalities less volatile resources to make their finances more predictable

46. Providing municipalities with more predictable revenues would help municipalities to plan their spending in a medium-term framework. This would involve reducing the volatility of municipalities' revenues by removing the share of the corporate tax devolved to them as was done in Norway in 1998.[59] This would also prevent municipalities from over-investing in business infrastructure and services to attract companies.

47. Several options to compensate for the loss of resources affecting municipalities could be envisaged. Municipalities could be given a larger autonomy in setting property tax rates, which are low by international standards and do often not reflect the use of local services and infrastructure by

the property owners. Increasing real estate taxes would also serve to mitigate the tax incentives to invest in housing and enhance the redistributive role of the tax system. The removal of the exemption of forest and agricultural land from property tax would improve the financial position of rural jurisdictions. Providing room for municipalities to exploit a larger share of the earned-income tax base, which is less volatile than the corporate income tax, could also be envisaged. The taxable units (resident individuals) would then correspond better to the ultimate beneficiaries of the municipalities' core responsibilities, *i.e.* the provision of education, social welfare, and health care services to residents. Such a move would result in important changes in the distribution of tax revenues across municipalities — in particular from business centres to residential areas — and would need to be implemented gradually. Municipalities could also be compensated through higher state grants. Finally, the impact of the tax measures adopted by the central government on municipalities' financial resources, both at an aggregate level and at an individual level, should be made more transparent and commitments on financial compensation, if necessary, should be taken more rapidly.

NOTES

1. This paper was originally produced for the OECD Economic Survey of Finland, which was published in December 2001 under the authority of the Economic and Development Review Committee. The authors, who are members of the Economics Department, would like thank the Finnish authorities for the information and assistance provided; and are indebted to Paul Atkinson, Andrew Dean, Jorgen Elmeskov, Mike Feiner, Christopher Heady, Peter Hoeller, Val Koromzay and Vesa Makkonen for valuable comments and drafting suggestions; to Desney Erb and Chantal Nicq for statistical assistance and Nathalie Macle and Celia Rutkoski for secretarial skills.

2. Qualifying foreign specialists and executives may apply for a special 35 per cent flat rate tax on their remuneration from work performed in Finland for a maximum period of 24 months, instead of the ordinary progressive taxation and social security contributions. Above an annual pre-tax income of around EUR 29 000 (Juusela, 2000), tax liabilities for "foreign key persons" are below those for nationals. In 1999, the number of foreign specialists benefiting from this special tax regime stood at only 150 but was growing rapidly (Helsingin Sanomat, 14 August 2001, online International edition).

3. Elcoteq, a company specialised in electronic equipment, has moved some of its factories to Estonia and more recently to Hungary. Nokia still has its research activities mainly based in Finland but is considering moving more of them abroad.

4. The share of alcoholic beverages consumed by Finns but not subject to Finnish taxes (either home-made or bought abroad) is already high. Hella and Mankinen (1997) estimated this share at 23 per cent in 1996, of which 60 per cent was due to imports.

5. Current rules on the taxation of services delivered online give a competitive advantage to providers established outside the EU area and, within the EU area, to those countries with a low VAT rate. This results from the fact that, for services delivered online, the VAT rate which applies is the one in place in the country where the supplier is located. However, a proposal made by the Swedish authorities during their Presidency of the Council of the European Union during the first half of 2001, if implemented, should lessen potential revenue losses for Finland. It would require vendors of online digitised products (B2C) established outside the EU to charge VAT at the rate applicable in the customer's country of residence and to reallocate tax revenues to this country. However, despite broad support of most EU countries, there is currently no agreed approach to tackling VAT on e-commerce while any decision on tax matters at the EU level requires unanimity.

6. Comparisons of tax-to-GDP ratios across countries should be made with great care. In particular, the taxation of social transfers, together with the extent to which countries provide social or economic assistance via tax expenditures, rather than direct government spending, may significantly blur international comparisons (Adema, 2000 and 2001). As an illustration, Adema (2000) estimated that in 1995 taxes and social security contributions on transfers exceeded 5 per cent of GDP in Denmark, Finland, Netherlands, and Sweden. They did not exceed 2 per cent in Belgium, Canada, and Germany; they were even lower in Australia, Ireland, United Kingdom and United States.

7. Carey and Tchiliguirian (2000) estimate that the average effective tax rate on labour stood at almost 43 per cent in Finland over 1991-97, compared with 37 per cent for the EU average, and less than 25 per cent for Japan and the United States. They also spell out methodological choices and problems with such comparisons.

8. Cuts in statutory rates have been implemented at the state level. The top earned-income tax rate has been cut by 1.5 percentage point, compared with 2 percentage points for all the other brackets, between 1997 to 2001. In its draft budget, the government proposes to cut all rates by 1 percentage point in 2002.

9. In 2002, it is set to cancel out when an individual's labour income reaches EUR 72 000, up from EUR 13 500 in the early 1990s.

10. An alternative approach would be to consider the EITA as a general tax cut. In this approach, deadweight costs would be considered smaller but the design would be seen as increasing distortions given the impact on marginal tax rates.

11. Tax brackets were frozen in 1992 and 1993. For subsequent years, the adjustment of tax brackets has often exceeded inflation developments, though the 1992-93 freeze has not been fully recouped over the 1990s. Furthermore, the adjustment is not linear across tax brackets, with a privileged treatment often granted to lower brackets. Partly as a result, the number of people falling into the three highest brackets has risen since the early 1990s (from 38.6 per cent of total taxpayers in 1991, to 43.9 per cent in 1999).

12. In addition, stock options are not granted any favourable tax treatment while they are in some other OECD countries (the taxation of stock options in place in OECD countries is discussed in Van den Noord and Heady, 2001). Nevertheless, the use of stock options has become more common in Finland since the mid-1990s. At Nokia, option use expanded from 350 key employees in 1995 to 16 000 workers in 1999 (*i.e.* 30 per cent of the workforce). Direct taxes on stock options were an estimated EUR 0.6 billion in 2000, 3 per cent of total direct taxes paid by households.

13. During the deep recession of the early 1990s, eligibility conditions for social benefits were tightened, by relying more on means-testing. As a side effect, this move may have exacerbated unemployment traps. Holm *et al.* (1999) estimated that about 15 per cent of the unemployed were unable to increase their disposable income by more than 10 per cent through employment in the early 1990s, because household transfers and childcare costs were usually means-tested.

14. The example refers to a couple with two children in the greater Helsinki area who receive the maximum compensation for housing support and when one of the parents is on labour market support.

15. Persons receiving a low pension are entitled to a special deduction to the earned-income tax. In fact, if the income consists of national pension only, no income tax is due. For pensions above this level, the tax allowance is gradually phased out.

16. The Economic and Monetary Union buffer funds in the unemployment insurance and the earnings-related pension schemes were introduced in 1999. The aim is to smooth premiums over the business cycle and to prevent pro-cyclical increases during downturns. The statutory authorised maximum size is ½ per cent of GDP for both funds. Social security contribution rates were cut; as a consequence, revenues declined by EUR 0.2 and 0.3 billion in 2000 and 2001, respectively.

17. For an overview of the tax measures implemented in other EU countries, see Joumard (2001) and IMF (2001). For an assessment of the potential impact of such schemes in the Finnish context, see Holm *et al.* (1995) and Honkapohja *et al.* (1999), cited in Kuismanen (2000).

18. The Income Tax Act provides for a maximum tax deduction on domestic work of EUR 850 in 2001.

19. See also OECD (1994).

20. While adopting the VAT, the authorities wanted to avoid a price hike for some commodities and services, and thus introduced VAT rebates. A 17 per cent reduced rate applies on foodstuffs. An 8 per cent reduced VAT rate applies on: books; medicines; passenger transport; use of sporting facilities; admissions to sporting events, cultural and entertainment performances; licence fees of radio and television; and hotel accommodation. A zero rate applies on subscriptions to newspapers and

periodicals. In addition, as allowed by the European Commission VAT Directive, education, health care and social services are exempt from VAT.

21. Taxes are levied on beverage and other packaging containers with different rates according to whether or not the container is recyclable or part of a return system.

22. The CO_2 tax on liquid transport fuels is staggered by petrol and diesel grade, with lower rates applied to low sulphur diesel and reformulated (less polluting) gasoline. There are also tax allowances to the registration car tax granted to cars with catalytic converters so as to promote abatement of nitrogen oxide (NO_x) emissions. In addition, Finland also imposes an oil damage levy for oil transported in vessels with a higher rate for those without a double bottom.

23. Like Denmark and the Netherlands, Finland exempts the following carbon emitting fuels from taxation: energy used in generation and distribution of electricity, aviation fuel, energy used by commercial fishing, as well as coal and coke used in the production of cement (OECD, 2001*c*).

24. In addition, the annual tax on diesel vehicles is much lower for lorries and vans than for passenger cars: it varies from EUR 4.5 to 10.6 per 100 kilograms (kg) for the former, up to EUR 25 per kg for passenger cars. There is also a registration car tax (nearly equal to the market price of the car). However, this may have an adverse impact by slowing down the renewal of the car fleet towards less polluting vehicles.

25. For a more detailed discussion of this issue, see OECD (2001*d*) and O'Brien and Vourc'h (2001).

26. The withholding rate on interest income was raised (in 1994) to the rate which applied to dividends and capital gains, largely reflecting the concern of a possible aggravation of the crisis in the banking sector.

27. The tax exemption for interest on bank deposits was removed in June 2000.

28. Premiums paid for a private pension insurance (own and spouse's) are deductible up to EUR 8 400 from the earned-income tax base. In 1999, households' deduction from the earned-income tax for voluntary pension premiums amounted to EUR 325 million. In 2000, eligibility conditions were tightened to reduce incentives to retire early. Voluntary premiums are now deductible (up to EUR 8 400) if the associated pension is not paid out before the age of 60 and does not lift the total pension above 60 per cent of the pensionable wage.

29. To avoid abrupt price movements on the housing market and balance sheet problems for indebted households, an additional deduction was introduced lasting for a five-year period.

30. The calculations of the tax expenditure associated with the exemption of imputed rent for owner-occupied housing are based on the State Housing Board's dwelling valuations, with a 3 per cent rate of return assumed (VATT, 1999).

31. Real estate tax rates ranged between 2.6 and 4 per cent in Denmark, 0.98 and 2.1 per cent in Germany, 0.4 and 0.7 per cent in Italy, and 0.5 and 1.2 per cent in Sweden.

32. Interest on debt is deductible from the corporate income tax base but is taxed at the individual level.

33. It was originally planned that Finland's imputation credits would be extended to cross-border dividends by bilateral treaties on the basis of reciprocity. In practice, such tax treaty rules have remained rare and have been included only in the treaties with France and Ireland (Helminen, 2001).

34. Shares held by foreign shareholders are sold temporarily to a resident, before dividend distribution, who will profit from the imputation credit. After the distribution, the sale is reversed. For some evidence on such trading for Germany before the replacement of imputation credits by the half-rate system, see McDonald (2000).

35. Norway has introduced relief for this form of double taxation by way of the so-called "opening value adjustment" method. A more simple solution to remove this double taxation would be to abolish the tax on capital gains. No tax applies in several OECD countries (*e.g.* in Austria and Germany after a certain holding period). A serious side effect of this solution is, however, that it gives scope for re-labelling income as capital gains for tax-avoidance purposes.

36. For an in-depth discussion, see Myhrman *et al.* (1995).

37. The dividend deduction system was in place up to 1990 to eliminate the double taxation of dividends. Under this system, a company did not pay corporate state tax on dividends distributed to new shares and the distributing company was entitled to deduct 60 per cent of the distributed dividends on old shares from its revenues. At the final investor level, a large part of the dividends received also remained tax free, reflecting the capital income tax allowance. Overall, about 65 per cent of distributed profits were fully tax exempt or subject to low taxation under this system (Myrhman *et al*., 1995).

38. Business expenditure on R&D in Finland as a share of GDP however ranks second in the EU and sixth in the OECD area (OECD, 2002).

39. Finnish shipping companies' tax burden was cut in 2000 when the government replaced the normal corporate income tax system by a tax on net tonnage. Other countries, in particular Denmark, the Netherlands and Sweden, have implemented similar tax incentives. In May 2001, the Finnish government extended the tonnage tax to all products and services sold on passenger vessels, such as restaurant, bar and amusement services.

40. The imputed rate of return on net business assets was originally set at 15 per cent, but the rate was raised to 18 per cent in 1997. In Sweden where the split model also applies on the company's net wealth, the imputed rate of return is set equal to the interest rate on 10-year government bonds plus a premium of 1 percentage point (Hagen and Sørensen, 1998).

41. Over 1985-92, municipalities' grants consisted almost totally of earmarked categorical matching grants. After the 1993, 1996 and 1997 reforms of the grant system, grants have been mostly formula based specific grants with no earmarking. Moisio (2000) showed that during 1993-99, the causality between local governments' revenues and expenditures was bi-directional, suggesting that taxing and spending decisions were made simultaneously. Under the previous period of matching grants, the causality ran from past expenditure to present revenues.

42. According to some estimates, about 200 municipalities (out of 450) did not receive higher tax revenues in 2000 despite the boom in tax revenues at the national level.

43. In 2000, 192 municipalities (out of 450) ran a fiscal deficit, up from 87 in 1999 (reported in *Helsingin Sanomat,* online International edition, 18 April 2001).

44. Surveys indicate that a majority of persons would be willing to pay higher tax rates if this would guarantee a better quality of public health services.

45. Municipalities can borrow without any legal restriction on domestic and international capital markets. Their loans do not benefit from an explicit state guarantee. Municipalities' borrowing is co-ordinated by the municipalities' organisation and their credit rating is better than that of the state.

46. In spring 2001, the Ministry of Finance created a working group to assess corporate and capital income taxation, while taking into account tax issues related to international competitiveness. In August 2001, the Economic Council — an advisory body comprising government ministers, top civil servants, representatives of social partners and other key organisations — created another working group to assess the need to reform the tax system, with a broader perspective. In particular, it is expected to study the impact of taxes on employment and to assess the financial basis for maintaining the welfare state. Both groups are expected to submit their report by the end of 2002, so that the proposals could be used in the public policy debate at the eve of the Parliamentary elections scheduled for spring 2003.

47. Bassanini *et al*. (1999) simulate the hypothetical introduction of a stylised Earned-Income Tax Credit (EITC) in four countries (Germany, Sweden, the United Kingdom and the United States). The results suggest that the impact on overall hours worked is likely to be positive in countries with a wide earnings distribution. However, the introduction of an EITC would not increase total labour supply in Germany and, especially, in Sweden where there could even be a fall. In fact, an increase in labour supply of low-paid workers will be compensated by a decrease in hours worked amongst those who will finance the EITC.

48. Overall, for the national pension system, the state pays 29 per cent of pension expenditure plus an annual subsidy to cover any deficit, plus a specific allowance. In total, in 1999 the state covered about 45 per cent of the costs. For earnings-related pension schemes, in 1999 the state covered 16 per cent of the costs for the self-employed, 74 per cent for farmers and 33 per cent for seamen. The state fully finances the unemployment assistance scheme and, for the earnings-related insurance, pays the cost of basic daily allowances for the first 500 days plus a subsidy for administration expenses.

49. The CO_2 emissions to GDP ratio remained broadly stable between 1990 and 1998 in Finland, while it dropped by more than 10 per cent in the European Union and the United States.

50. The decision on the set of measures to contain greenhouse gas emissions, and in particular the changes in energy taxation, are likely to be reflected in the budget proposals for 2003.

51. One example of such compensation schemes is the Swedish NO_x charge imposed on combustion plants since 1992. The charge paid by these plants is reimbursed to the payers in proportion to their share of total energy produced (Roseveare, 2001). While it does not penalise the industry as a whole, it keeps the right incentives to abate emissions since any producer with emissions lower than the industry average will receive net benefits, while those with higher emissions face a net cost. Likewise, in 2000 the French government envisaged extending the general tax on polluting activities to fossil fuels and electricity and to issue tax credits based on a percentage of past emissions (though the bill was subsequently ruled unconstitutional by the Constitutional Court).

52. Honkatukia (2000) considers the impact across sectors of a hypothetical doubling in current Finnish carbon taxes under the assumption that tax revenues are recycled via a cut in employers' social security contributions. Honkatukia analyses the net impact of higher environmentally related taxation on each sector under two alternative scenarios: one where the supplementary carbon tax is levied only on fuels and one where the supplementary carbon tax is also levied on electricity. The results show that the supplementary tax on fuels raises net taxes for the paper and transport sectors whilst the electrical and electronics industry and the private service sector gain. Under the "supplementary carbon taxes on both fuels and electricity" scenario the paper and heavy metals industries are considerable net tax payers, whilst the impact on the transport sector is lower than under the "fuel only" supplement.

53. Saving in voluntary pension funds and in home ownership tends to increase as a share of an individual's income along the income ladder. In addition, tax allowances for voluntary pensions, in a progressive system, are worth more to higher-income taxpayers than those with lower incomes.

54. Private pension insurance premiums paid to a foreign pension insurance institution are not deductible for the insured individual unless the insurance is purchased from a permanent establishment in Finland of a foreign institution.

55. By international standards, there is a relatively high share of home-ownership in Finland (about two-thirds).

56. In 2000, collection costs of the property taxes were 2.1 per cent of revenues compared to 0.7 per cent and 0.6 per cent for income tax and VAT, respectively.

57. The maximum amount of capital income loss (including interest payments) which can be deducted from labour income is equivalent to a cap on mortgage interest relief for individuals with no or very low gross capital income. However, the maximum loss deductible in this manner for a married couple with two children, at EUR 3 400 is high (EUR 1 350 per taxpayer, plus EUR 350 for one child and EUR 750 for two or more children). In addition, for individuals receiving dividends, capital gains or other forms of capital income, mortgage interest payments also contribute to reduce their tax liability on their capital income component, without any cap.

58. If companies are able to finance their investment on international capital markets, the personal tax treatment of investment income at home may not much affect their financing behaviour (for a discussion of this issue, see OECD 2000*d*). On the other hand, for small companies with limited access to foreign capital markets, the imputation system is likely to be a first best since they usually depend more on equity (largely reflecting reduced access and less favourable terms on debt financing). However, start-ups and fast growing companies tend to distribute few dividends and rely largely on retained earnings. For them, the double taxation of retained earnings becomes an important issue.

59. The need to split revenues when a company operates in several jurisdictions poses additional problems: it contributes to the delays in redistributing tax revenues to municipalities and reportedly generates some mistrust in the tax administration.

GLOSSARY OF ACRONYMS AND TERMS

APW	Average production worker
CO_2	Carbon dioxide
DIT	Dual income tax
e-commerce	Electronic commerce
EITA	Earned-income tax allowance
EU	European Union
EUR	Euro
GDP	Gross domestic product
kg	Kilogram
METR	Marginal effective tax rates
NO_x	Nitrogen oxide
PPP	Purchasing power parity
R&D	Research and development
VAT	Value added tax
USD	United States dollar

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Annex I

THE IMPACT OF AGEING ON THE BUDGET WILL BE SUBSTANTIAL IN THE LONG TERM

As highlighted in the previous *Survey*, the Finnish population will age rapidly and earlier than in many other OECD countries. The number of people aged over 65 is projected to increase already by over 50 per cent up to 2020, while the working age population (20 to 64 year-olds) is expected to drop by around 3 per cent and the labour force could start to decline already within a decade. As a consequence, the old-age dependency ratio (those over 65 years as a percentage of the working age population) will rise from the current 25 per cent to 39 per cent by 2020, the fastest rise in the OECD area. Ageing will continue thereafter, with the dependency ratio reaching 50 per cent at around 2030.

Ageing will strongly affect public finances. In the baseline scenario recently presented by the Finnish authorities (Ministry of Finance, 2001*b*),[1] public pension outlays (flat-rate national pensions and earnings-related employment pensions) are expected to rise by about 6 percentage points of GDP, somewhat stronger than on average in the OECD, to 13 per cent of GDP in 2050 (Table A1). At the same time, more health and care services for the elderly are needed, which will lead to an increase in health and social security expenditure by 4 percentage points. The rise in total old-age-related spending is projected to be the fourth steepest amongst the OECD countries. With expenditure on education falling, total public spending is projected to rise by 3 percentage points, requiring a gradual rise in the tax burden after 2020 and a gradual drop in the general government surplus. In this baseline scenario, central and local government debt is gradually heading lower from the current 44 per cent of GDP to 10 per cent in 2015, and stabilises thereafter.

Table A1. **Long-term budget scenario**

As a per cent of GDP

	2000	2010	2020	2030	2040	2050
Expenditure	46.7	42.5	45.1	48.0	49.4	50.1
Employment pensions[1]	6.7	8.6	10.7	11.9	12.4	12.5
Health care	4.2	3.9	4.6	5.5	5.9	6.2
Social services	3.9	3.6	4.2	4.9	5.4	5.7
Other expenditure	29.1	25.0	25.0	25.0	25.0	25.0
Interest payments	2.8	1.4	0.6	0.6	0.6	0.6
Revenues	53.6	46.9	46.6	49.4	50.4	51.4
of which: Employment pension contributions	7.2	8.0	9.1	10.1	10.4	10.8
Financial balance	6.9	4.4	1.5	1.4	1.0	1.3
Gross debt	44.0	18.9	9.8	9.6	9.7	9.6
Memorandum items						
Real GDP (% change)	5.7	2.3	1.1	1.3	1.4	1.3
Unemployment rate (%)	9.8	7.0	7.0	7.0	7.0	7.0

1. The employment pensions do not include central government pensions, which amounted to 1.8 per cent of GDP in 2000.

Source: Ministry of Finance (2001), *Stability Programme for Finland, November 2001 update*.

Weaker trend growth would make the ageing consequences more problematic as is illustrated by the slow growth scenario of the Ministry. Lower annual productivity and output growth would lead to substantially higher government spending (56 per cent of GDP in 2050 instead of 50 per cent). At the same time the tax burden would be higher (50 per cent of GDP instead of 46 per cent), the surplus smaller and government debt higher (35 per cent of GDP instead of 10 per cent).

Based on the long-term scenarios, a central government surplus target of at least 1½ to 2 per cent of GDP on average during the current decade has been set. This target reflects the assessment of future economic developments by the Ministry of Finance (Ministry of Finance, 2001*b*). Although the new target is reflected in the 2002 budget proposals and in the 2001 update of the Stability Programme (Ministry of Finance, 2001*c*), it does not form part of the Government Programme — which set as target an unspecified structural surplus — and hence there is less political commitment to this new target.

1. The scenario is close to the recent scenario of the OECD (OECD, 2001*e*; Dang *et al.*, 2001).

Annex II

Income distribution has widened but remains compressed

During the 1990s, the Finnish income distribution has become more skewed but remains relatively compressed compared with other OECD countries.[1] The strongest increase in disposable income has occurred at the high end of the earnings scale, because of the strong rise in capital income and the emergence of sizeable stock option revenues. As a consequence, the top decile's share in total disposable income has risen from 18.4 per cent in 1990 to 22.8 per cent in 1999 (Table A2). Income inequality, as measured by the Gini index, rose from 0.20 in 1990 to 0.26 in 1999 and is likely to have increased further in 2000 before falling back in 2001. Social transfers and taxes diminish income dispersion substantially, reducing the Gini index from 0.48 before transfers and taxes to 0.26 afterwards. With income differences widening, relative poverty has increased. Measured by the share of individuals with disposable income below 50 per cent of the national median income, the poverty rate has risen from the nadir of 2.7 per cent in 1994 to 4.1 per cent in 1999 which is probably still among the lowest in the OECD.[2] Absolute poverty, however, has declined in the second half of the 1990s as real disposable income rose by 0.8 and 1.5 per cent per year for the two lowest deciles, respectively. Moreover, since 1996, the number of households receiving income support — an indicator of difficulties in earning a livelihood — has fallen from around 12 to 9½ per cent in 1999, but has continued to be well above the pre-recession level of about 6 per cent.

Table A2. **Income distribution and poverty**

	1990	1995	1998	1999
Gini index of income inequality[1]				
Wages[2]	..	0.21	0.22	0.21
Factor income[3]	0.39	0.46	0.47	0.48
Gross income[4]	0.26	0.27	0.30	0.31
Disposable income	0.20	0.22	0.25	0.26
Households' disposable income share				
1st decile	5.0	5.0	4.5	4.4
2nd decile	6.5	6.5	6.0	5.9
10th decile	18.4	19.7	21.4	22.8
Poverty rates (% of population)				
Based on disposable income[5] less than:				
50% of median disposable income	3.3	3.0	4.1	4.1
60% of median disposable income	7.8	7.1	9.5	9.6

1. The index ranges from 0 to 1; a higher coefficient indicates a less equal income distribution.
2. Excluding income from stock options.
3. Including income from stock options.
4. Defined as the sum of factor income and transfers received.
5. Household income is adjusted by taking into account its size and composition; in a household the first adult has a weight of 1, the second 0.5 and children 0.3 each (new OECD equivalence scale).

Source: Statistics Finland (2001), *Income Distribution Statistics 1999*.

As a reaction to the widening income distribution and increase in relative poverty, the government launched a poverty package to raise income transfers for the poorest and to improve public services especially directed at the most vulnerable people, with outlays of EUR 80 million (0.1 per cent of GDP) in 2001, rising to EUR 260 million in 2002. There is the risk that these measures may increase poverty traps. The government's strategy to prevent poverty and social exclusion, however, does not only focus on the transfer system. In its view, ensuring stable output growth by proper macroeconomic management and raising productivity through education and structural reform measures are crucial to reach a higher level of employment and thereby to lowering poverty (Ministry of Social Affairs and Health, 2001).

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1. See Statistics Finland (2001), Riihelä *et al.* (2001), Burniaux *et al.* (1998) and Förster (2000). In the mid-1990s, income inequality, as measured by the Gini index, was the lowest of the examined OECD countries after Denmark and Sweden. Arjona *et al.* (2001) reports that it was the lowest in the 1990s after Denmark.

2. In 1993-95, poverty rates for selected OECD countries varied from 4.7 per cent in Denmark to 15.3 per cent in Portugal and 16 per cent in the United States (OECD, 2001*e*). The EU average excluding Austria, Finland and Sweden was 11.7 per cent.

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