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Highlights in this issue:

- **Finland is the forerunner in adjusting to the ageing of population**
- **In spite of early action, a large sustainability gap still exists**
- **Success will depend on reforms to extend working careers and increase productivity in welfare service provision**

Finland: adjusting to an ageing population

By Veli Laine and Mart Maiväli**

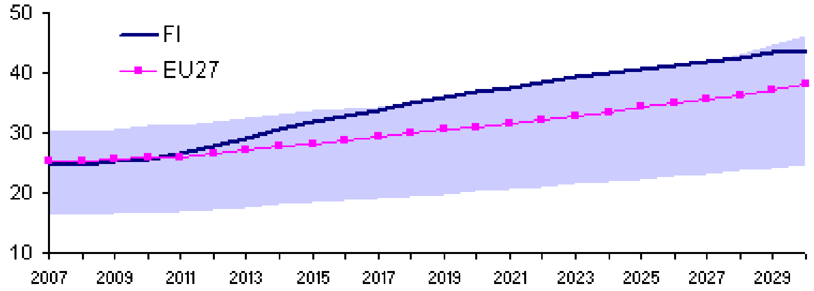
Summary

Most of the EU Member States will have to adjust in the forthcoming decades to the adverse effects of an ageing population. This is especially pressing in Finland, where the demographic shift will take place sooner and initially also more rapidly than in the other Member States. The population ageing challenge is multifaceted, having repercussions on the labour market, economic growth potential and public finances. Finland has already taken action over the past decade to prepare for the demographic shift and provides useful lessons for other Member States. Given that - even within an integrated EU - the setup of public services, the labour market and the structure of the economy show large variations among countries; the appropriate policy responses to the population ageing challenges will have to be custom designed. The main features of the Finnish strategy to counter the effects of population ageing have been extensive and long-lasting prefunding of future pension expenditures, as well as actions to postpone retirement and to increase the productivity and efficiency of ageing related services, which in the Finnish case are primarily provided by the local governments. However, given the still large sustainability gap, additional measures are needed. Further increases in the length of working lives and productivity-enhancing reforms to public services would alleviate the pressures from population ageing at both the national and the local-government levels.

The population ageing challenge will hit Finland early and strongly

Although in a European comparison Finnish public finances appear relatively strong, Finland will be one of the first member states where the adverse effects of an ageing population will kick in and start to erode the strength of public finances (Graph 1).

Graph 1: Old-age dependency ratio in Finland and the EU27



Source: Eurostat, EUROPOP 2008

* **Directorate for the Macro economy of the euro area and the EU, and Directorate for the Economies of the Member States.**

The two main parts of the Finnish welfare system are the pension system and publicly-financed services.

The Finnish welfare system consists of two main elements, the pension system and publicly-financed services, where many principal services related to ageing (like healthcare and old age care) are provided by the local governments. The projected increase in age-related expenditure is higher in Finland than on average in the EU and is mainly driven by pension and long-term-care expenditures (increasing by 2.6 p.p. and 2.5 p.p. respectively in 2060 relative to 2010), while the ratio of health care expenditure to GDP increases by 0.8 p.p. (see Table 1). Public finances will come under additional stress due to weaker tax revenues in a setting of lower economic growth potential[1].

Table 1: Age-related expenditure in Finland, EU and the euro area (% of GDP)

	Total		***Of which:***					
			Pension spending		**Healthcare**		**Long-term care**	
	2010	**Change 2010 to 2060**	**2010**	**Change 2010 to 2060**	**2010**	**Change 2010 to 2060**	**2010**	**Change 2010 to 2060**
EU-27	23.2	4.6	10.2	2.3	6.8	1.4	1.3	1.1
FI	24.7	5.9	10.7	2.6	5.6	0.8	1.9	2.5

Source: 2009 Ageing Report

The Finnish sustainability gap is mainly due to the increases in age-related expenditure.

The available long-term projection in the 2009 Ageing Report shows that, in the absence of an early and ambitious effort to consolidate government accounts and structural reforms, there would be high increases in pension expenditure, costs of ageing-related services and inevitably public debt. Rising government expenditure and prospects of an ever-increasing debt would pose an obstacle to a sustained and long-lasting recovery from the present crisis and the achievement of balanced economic growth. The crisis-related fiscal expansions and the ageing of the population raise questions about the sustainability of public finances. Sustainability relates to the ability of a government to assume the financial burden of its debt both currently and in the future. The most widely used indicator in the EU to measure the sustainability challenges that Member States face, the S2 indicator, shows the durable adjustment of the current primary balance required to comply with the infinite horizon intertemporal budget constraints, including paying for any additional expenditure arising from an ageing population. The sustainability analysis shows that on the basis of the budgetary position of 2009, the 2010 Commission services' spring forecast, and the projected increases in age related expenditure, Finland has a sustainability gap (S2) of 4.2% of GDP, which is below the EU average (7.4% of GDP).[2] This means that to put public finances on a sustainable path, Finland would need to improve its structural primary balance in a durable manner by 4.2% of GDP. In principle, this adjustment could take place via both an increase in revenues, including the pension contributions, and cuts in expenditure. Alternatively, the social protection system would have to be reformed in order to decelerate the projected increase in age-related expenditure.

The required adjustment to bring public finances on a sustainable path is over 4% of GDP.

Finland has presented a medium-term objective (MTO), which partly takes into account the implicit liabilities due to ageing. According to the 2010 spring forecast, the current MTO of a structural surplus of 0.5% of GDP is far from likely to be met in the near term, as the structural balance is forecast to deteriorate from a surplus of 0.4% of GDP in 2009 to a deficit of 1.0% of GDP in 2011. This medium-term development projected in the spring forecast would significantly increase the risks to the long-term sustainability of public finances.

Adjusting the pension system

Extensive pre-funding alleviates the pressures on public finances arising from increased pension expenditure.

Finland's earnings-related pension system is a partially pre-funded, defined-benefit system in which the benefits are determined according to the length of employment and the level of earnings. Due to extensive prefunding, pension funds have accumulated assets amounting to over 60 % of GDP in 2009. This will somewhat alleviate the pressures on financing rising pension expenditures. The pre-funding is collective and it does not directly affect the level of pension; rather it is intended to even out the pension contribution rate over time.

Private sector pensions are projected to increase significantly in relation to GDP.

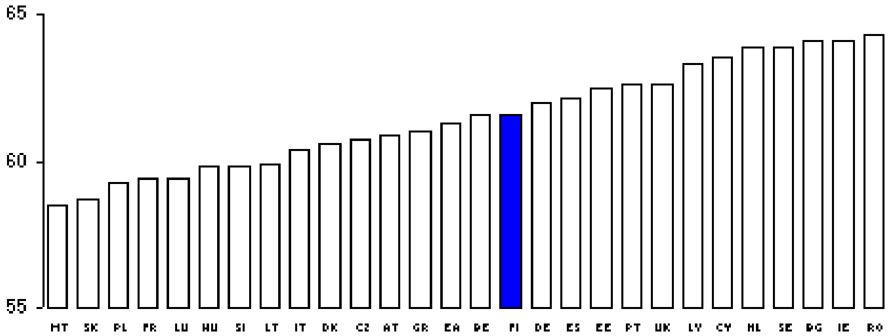
The change in pension expenditure is most rapid in the private sector pension scheme, where the earnings-related pensions in relation to GDP are projected to increase from 4.7 per cent in 2007 to 7.6 per cent in 2030, after which the rise becomes very modest. By contrast the public sector (local and central government) pensions (% of GDP) are projected to increase only slightly by 2029 and decrease thereafter. Pension reforms[3] have reduced the generosity of pensions in the public sector, where the average level of pensions will gradually converge to that of private sector.

The Finnish pension system went through an extensive reform in 2005.

A major reform in the Finnish private-sector earnings-related pension system came into effect in 2005. The reform rewarded the postponement of retirement and restricted access to early retirement, thereby resulting in increased labour supply and higher employment rates of older workers with consequently positive welfare effects (Lassila and Valkonen, 2006). The reforms aimed to curb the foreseen increase in contribution rate without endangering the adequacy of replacement rates. Due to the so called "life-expectancy coefficient", a parameter that reduces the level of new pensions as longevity increases, the new system also responds rather well to uncertain future demographics. Despite the apparent successes of raising the retirement age and curbing the required increase in contribution rates, the rise in pension expenditure is still projected to be above the EU average.

Further increases in the effective retirement age that reflect gains in longevity are being contemplated in Finland as well as in several other Member States. The effective exit age from the labour market in Finland is presently near the EU-average (Graph 2). The Finnish government and social partners are currently in talks to extend working lives by 3 years by 2025. Should these talks prove successful, this would alleviate the sustainability risks that ageing poses to the Finnish public finances. On top of savings to public pension expenditure in a medium- to long-term horizon, an increase in the statutory and effective retirement ages, together with measures reducing entry ages to the labour market, would contribute to increase the working population and stem the deceleration in potential output growth. So far the differences of opinion on the best ways to increase effective retirement age have prevented an agreement from being reached. The Finnish system has a built-in semi-automaticity, where the social partners can propose changes to the contribution rates in response to expected expenditure pressures. This, together with the funded element, largely shields the pension benefits from cuts in spite of the weakening demographics. Consequently, pension benefits are better protected than local public services from the effects of population ageing.

Graph 2: Effective exit ages in the EU in 2008



Source: EPC and COM services

Adjusting local governments

Finnish municipalities play a large role in the overall public sector, accounting for 75% of public employment.

Municipalities play a relatively large role in the Finnish economy and in the public sector. International comparisons show that the expenditure-to-GDP ratio of Finnish local governments is the third highest in the EU, surpassed only by Denmark and Sweden. In Finland municipalities have the responsibility of providing most of the public services, like healthcare, long-term care, education, social and cultural services. Consequently, they account for about 75% of general government employment (ca 20% of total national employment) and they largely determine the overall public sector employment trends. Wage costs account for about a half of municipal expenditure. Nevertheless, in terms of aggregate expenditure, municipalities spend slightly less than the central government, largely because social transfers are part of the central government budget.

Local governments are responsible for providing all major ageing-related services.

Due to the setup of public service provision in Finland, all the major ageing-related services fall under the responsibility of local governments. Output in the ageing-related services should grow to match population ageing, which would entail pressures to increase staff numbers proportionately. The Finnish Prime Minister's Office has estimated that in response to higher demand for ageing-related services, the recruitment needs in the local governments will increase by 80000 people by 2050 (assuming no improvement in the productivity of service provision). The evolution of both municipal staff numbers and wages is a significant determinant of public expenditure pressures. Over the past decade, even in the absence of population ageing costs, expenditure has already consistently grown faster in local governments than in the central government. Local government expenditure growth has accounted for close to half of the general government expenditure increases. Higher employment in public services is not only a concern from the fiscal standpoint, but also from the perspective of crowding out employment in the other sectors of the economy in a setting of declining labour supply. Projections underlying the European Commission Ageing Report indicate that by 2050, employment in Finland will decline by about 200 000 people[4], representing a fall of about 8% from overall employment. However, if public sector employment were to remain constant, the decline in private sector employment alone would be 12%.

Public employment trends, affected by population ageing, will have implications for the whole economy.

The government has in past years designed some notable productivity-enhancing reforms for both the central and the local government levels. The central government has defined ambitious targets to reduce its personnel over the medium term as part of a productivity programme, with the double aim of increasing productivity and adjusting to a shrinking workforce. It is planned to reduce central government staff by over 10% during 2007-2015 through natural attrition. The local governments, having been constitutionally granted self-governance rights, cannot be bound by similarly concrete targets set by the central government. The reorganisation of municipal services and structures is intended to take place through soft enforcement and incentives. To this end, a framework law promoting the reform of the structure of local governments and their service provision was passed by the parliament in the beginning of 2007. The reform aims to achieve an increase in productivity and efficiency through both economies of scale (forming larger municipalities) and innovations in service provision. An important facet of the reform is redesigning the state transfer system to local governments aimed at enhancing productivity and cost-efficiency incentives within the transfer system (Ministry of Finance (2008) Challenges for Municipal Finances).

Reforms directed to local governments rely on soft enforcement and improving incentives.

Currently, most progress has been made in forming larger municipal entities. The smaller municipalities are obliged either to merge with other municipalities or alternatively to form municipal partnership areas (joint municipal boards). However, as roughly one tenth of the largest municipalities account for two thirds of population and expenditure, it is not the mergers per se, but the service reforms in the biggest municipalities that will determine the overall outcome. While some concrete changes are already evident in many municipalities, for the most part the service provision reforms still have to move to the implementation phase. In practice this means various innovations in service provision, more effective use of ICT, possibly a greater involvement of the private and non-profit sectors, identification and dissemination of best practices, etc.

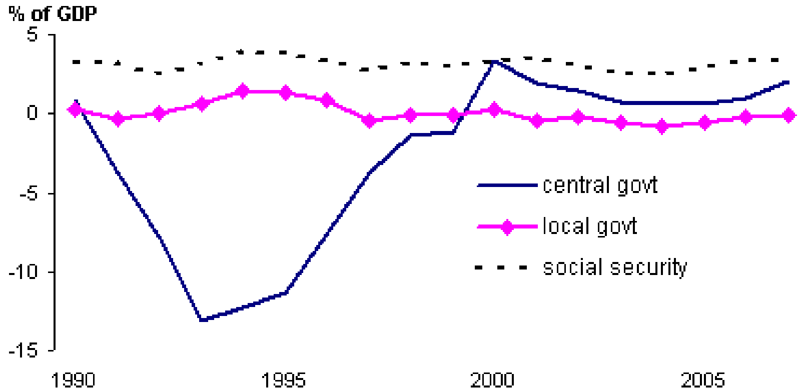
Effective progress with reforms to increase service productivity is still outstanding.

Local governments might transfer the fiscal burden to other sectors

Municipal finances are on the aggregate more stable than in the central government….

The behaviour of public finances during the recession of the early 90s provides some useful insights on how different government sectors react to short-term cyclical shocks, which might also predict longer-term trends in the face of permanent financing pressures. Notably, compared with the central government, the local government fiscal balances have been remarkably stable throughout economic cycles (Graph 3). While the central government slipped into a large deficit during the recession of the early 1990s, local governments in aggregate even reached a surplus position. The local government debt level has therefore also remained relatively small at 6½% of GDP in 2009. In contrast, the central government debt amounted to nearly 40% of GDP in the same year.

Graph 3: Net lending of local and central government and social security



Source: Eurostat

… but the relative stability of municipal deficits is not necessarily a sign of fiscal strength.

However, the relative stability of aggregate municipal deficits is not necessarily a sign of underlying fiscal strength. This stability can be explained by several factors. Most importantly, the more cyclically-sensitive revenue and expenditure items are part of the central government (which as such is a sensible allocation of risks). Local governments also have the power to take their own discretionary measures on both the revenue and expenditure sides in order to balance their finances. In effect, this is also required of local governments as they are obliged to balance their budgets over a 3-year period, though effectively with no sanctioning mechanism. Additionally, the state transfer system, also adjusted for population dynamics, equalises income across government sectors and between municipalities.

Without productivity gains at the local government level, the fiscal burden is likely to spill over to other sectors.

Expenditure pressures in local governments might lead to a rise in the general tax burden...

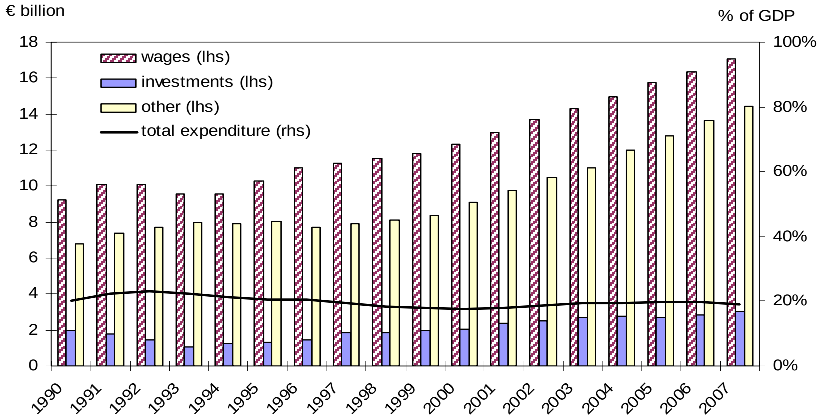
In the face of longer term fiscal strain, several adjustment mechanisms are likely to come into play. If the productivity reforms at the local government level fail, the fiscal strain might in effect be transferred to the other sectors. Judging from past experience, local tax rises have been commonly used to finance municipal expenditure pressures. In Finland, local governments have the legal right to set the municipal income tax rate without any limitations and mortgage taxes within certain nationally defined boundaries. Almost half of local government revenues come from municipal income tax. Municipal tax rates were increased consistently during periods of relatively higher expenditure needs or lower revenues (i.e. periods when more tasks were delegated to municipalities, times of insufficient financial transfers from the central government, and the economic recession of the early 1990s). Average municipal tax rates increased by over 5 percentage points from 1970 to 2008 *(*Government Institute for Economic Research (2008*)*. Over recent years, from 2005 to 2007, the relatively rapid rise in municipal expenditure resulted in a 0.75 pp. hike in the average municipal income tax, reaching 18.5% on average. Municipal tax dynamics contrast with the extensive income tax cuts at the national level. This led to concerns that the local government tax rises would undermine income tax policy at the state level and provide for an easy loophole to finance rising ageing-related expenditure (OECD 2008 and IMF 2007). The Finnish Ministry of Finance has estimated that, based on a no-policy-change assumption, municipalities would face pressure to increase their taxes by 7 p.p. by 2030 (Ministry of Finance, 2010). Furthermore, currently, the range of municipal tax rates varies by some 5 percentage points. While the state transfers to municipalities largely equalise municipal finances as they are adjusted to population structures, they cannot fully compensate for weaker regional economic potential or higher investment needs. As a result, generally the financially weaker and less populous municipalities tend to maintain higher tax rates. The differences in tax rates might create further competitive advantages for stronger municipalities in attracting taxpayers and business investment, thus undermining regional policy. On the other hand, these differences (or the foreseen pressures in municipality taxes) can act as a catalyst to merge municipalities and to seek more efficient solutions for the provision of welfare services.

On the expenditure side of their budgets, local governments appear to be able to adjust costs in the short run particularly through investment activity (Graph 4). During the economic recession in the early 1990s, local governments cut investments by 40%. This also has wider implications for the aggregate investment activity as local

… and to potentially adverse changes in budget structures.

governments account for over half of general government investments and about 8% of investments in the total economy. The flexibility in some expenditure categories avoids the build-up of debt, but also points to the risk that rising population-ageing costs might crowd out some other types of expenditure.

Graph 4: Evolution of nominal wage and investment expenditure in local governments



Source: Statistics Finland ASTIKA database

Importantly, the quality standards and prices of welfare services are generally not legally determined, thus making them subject to political priorities. In the face of fiscal constraints, both the financing and the production of some public sector services could be transferred relatively easily to the private sector and consumer fees. While this might ease pressures on public finances as the financing costs can be transferred from taxes to direct consumer fees, it would not automatically produce net economic benefits, unless the private sector provision of the services is more efficient than that of the public sector.

Conclusions

An ageing population puts pressure on Finland's public finances both through its effect on age-related expenditure and on potential economic growth. Improving the budgetary position in the medium-term and further reforms to the social security system are needed to bring public finances back to a sustainable path. Increasing the length of working lives would stem the decrease in potential GDP growth and decelerate the projected increase in age-related expenditure at least in the short- to medium-term.

The age-related expenditure pressures are distributed unevenly across government sectors, with local governments facing the strongest challenge. Apart from adjustment needs at the local government level, it will be crucial to mitigate the ageing expenses also at the level of other government sectors and the pension system, notably reducing the burden from rising pension costs and expanding the tax base by lengthening working careers. If the solution at the local government level were to fail, the local governments would most likely seek alternative ways to improve their finances and might in effect transfer the fiscal burden to other sectors. This would probably lead to higher local tax rates, a boost in the existing central government transfers, cost cuts in some other expenditure categories (for example investments), curbs in public services, rises in customer fees and privatisation of some services. Obviously, while this would avoid building up debt at the local governments and allow municipalities to fulfil the obligation to balance their finances over a 3-year period, it would not solve the problem on a national scale. The commonly used indicators, like local government deficits and debt, can thus be misleading in identifying underlying performance and fiscal strain. The central government attempts to bring about municipal service reforms through guidance, soft enforcement and incentives, allowing the local governments a high degree of self-determination. Currently the reforms are at an early stage of implementation and have in the aggregate not yet yielded notable productivity gains. Close monitoring of progress of the reforms will be required in order to make timely adjustments if the goals are not met.

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[1] Population ageing is assumed to reduce the growth potential in Finland by about 1 percentage point (European Commission and the Economic Policy Committee, The 2009 Ageing Report, European Economy 2/2009).

[2] Commission services calculations, see European Commission, Sustainability Report 2009, European economy 9/2009 for underlying methodology.

[3] In 1993 the pension accrual period, the targeted level and the retirement age were all changed in the public sector to correspond to those of the private sector.

[4] The calculations assume a gradual increase in the employment rate reaching 74.5% of the labour force by 2050.

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