

## Structural Changes and Reforms in Finland

The economic prosperity and development of Finland is a story of globalization, adaptation to the surrounding environment and strategic policy choices, which have facilitated structural reforms. The country's history of industrialization has been a national project, involving ambitious goals in the fields of economy, welfare, culture and education. The basic choice for the economic growth targets has been the opening up to the global competition.

The role of industry in Finland has been slightly different than in most comparable countries. Finland's industrialization took place a little later than elsewhere and the share of exports and manufacturing industry is still relatively large. Until the 1990s the paper and pulp industries had a dominant position. Since then a major structural change has taken place. Finnish economy experienced a severe depression from 1991 to 1993, but after that growth has recovered at a record pace and a new industrial structure, with high-tech production of particularly the Information and Communications Technologies (ICT) sector winning new positions, has emerged.

After the depression of the early 1990s major strategic policy choices and structural reforms were introduced and carried out. These involved changing the structure in the corporate and capital income taxation to make business investments more attractive. A flat and lower tax rate on corporate income, with a well defined tax base was welcomed

by the companies. An imputed tax system for the dividend income encouraged the household to invest in equity. Together with abolishment of the remaining controls of the capital movements opened up totally new opportunities for the companies to grow and internationalize their operations.

### Reforms in the 1990s

A reaction to the crisis of the early 1990s

- Getting the exploding public debt under control
  - **Cuts** in the social security expenditure
  - Continuous emphasis on education and R&D
  - Corporate and capital income **tax reforms**
  - Full liberalization of markets
  - Joining the EU (1995) and EMU (1999)
- => **Rapid structural change, strong growth, healthy public finances** in the late 1990s

Perhaps the most important decisions in the 1990s were the decisions to join the European Union in 1995 and to become a member of Economic and Monetary Union (EMU) in 1999. The basic arguments to join EMU were efficiency gains and stability. It was also realized that the old wage-setting behavior had to be modified in the new environment of low and stable inflation. This analysis was conducted also between social partners, and a common understanding emerged concerning the need for wage moderation. This change of attitudes and behavior has taken place within the old framework of labor market relations, but should be interpreted as a necessary structural change.

An important change that has taken place is the new kind of deter-

mination in controlling public sector finances. Public sector indebtedness was about to explode in the early 1990s. This development was curbed by cuts in social security expenditure, or rather by future promises of benefits. It was a common understanding that this had to be done for the nation's own sake, not because of e.g. fulfilling the Maastricht criteria.

The economic results of these policy choices and reforms have



been, for the most part, excellent and surpassed the expectations. Finland's growth numbers have been top-rate, particularly in the last half of the 1990s. The country's economic structure is more balanced than it used to be before, and new branches of industry and companies have established themselves as global players. On the other hand, the unemployment has stayed at a high level and the rate of growth has stalled in the beginning of the new millennium.

A common feature of the changes and reforms was that they were more or less forced upon the political leaders by the social and economic consequences of the depression period from 1991 to 1992. The country and its political leaders were simply facing a *cul-de-sac*, and something had to be done.

Not all structural changes that were proposed, particularly concerning the labor market, were ac-

cepted. Then, and also later e.g. when modifying the pension system, the consequences of the changes have been phased gradually into the distant future.

The latest pension reforms have been a reaction to the ageing problem. One of the main features of the reform is the introduction of a flexible retirement age – to be varied between 62 and 68, with disincentives for early retirement. Also the pension base is to be broadened to the entire working career. A life expectancy coefficient will adjust pensions in the future, but only from 2010 onwards. The true effects of the reforms have thus become diluted and phased off, and in any case remain to be seen. These observations, of course, fit well with the recent political analyses of structural reforms.

The reform has been welcomed as it will take off some of the future effective tax burden – when compared to a situation with no changes. On the other hand, it is very likely that this is not enough, and further changes will become necessary in the near future.

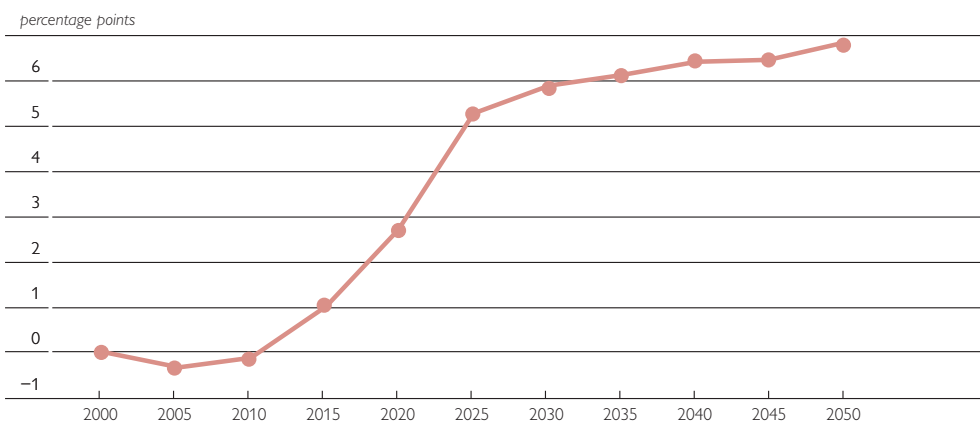
Today's challenges of more intensive global competition and rapidly ageing population put more and more pressure on the existing structures, also in Finland. New changes and reforms are needed in order to maintain an attractive economic environment to invest and work.

The Finnish business community has published its own vision of the successful Finland of the future. This comprises a competitive economic environment, innovative and motivating business life and supporting values of social equality and security. In order to reach these goals, major changes and reforms are however

**True: The Pension Contributions Will Be Smaller after the Reform**



**But: The Tax Burden Will Increase in the Future, even after the Reform**



*Source: Author's calculations.*

needed, particularly in labor markets, taxation and social security systems, as well as putting even more emphasis on the R&D and education.

The present government has understood the challenges of globalization and has for its part set up a wide strategy program, within which the consequences and possible solutions are to be analysed by the end of this year. The discussion includes academics, social partners and political leaders. This approach is very welcome, because it is likely to add knowledge and awareness of the

present day's development and challenges. On the other hand, the timetable is demanding. The speed of change is accelerating while a lot of energy is spent on discussing instead of facing the issues and acting accordingly.

One of the benefits of being a small and flexible nation is the capability to react rapidly and efficiently, if needed. This capability was last proven more than ten years ago, when major changes were introduced after the economic crisis. Another possibility would be the use of functioning and sound relations

between the social partners and politicians in order to find a common understanding for the necessary changes.

Unfortunately, the odds are that the awareness of challenges and possible crises is not at such a high level

which would facilitate serious discussion and successful introduction of reforms. If the desired reforms can be achieved only through a crisis, one can only hope that it would be a short-lived and benign one. ❧