

Finland: Selected Issues

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FINLAND

Selected Issues

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I. ENHANCING EMPLOYMENT RATES IN FINLAND: THE ROLE OF ACTIVATION STRATEGIES

A. Introduction

1. **Finland is facing a major economic challenge in the coming decade.** While the government's objective is to raise the employment rate to 75 percent in the long term, projections of the labor force's size show one of the most significant declines among OECD countries in the next 20 years. This situation calls for immediate action to further improve employment rates among older workers and young workers, two groups that suffer from significantly weaker labor market prospects than Finland's Nordic peers.

2. **Several factors call for strong activation strategies in Finland.** First, on the fiscal side, passive programs (excluding retirement) exert a significant pressure that will become more and more difficult to finance as the activity rate declines. Nonemployment¹ and unemployment benefits totaled 4.3 percent of GDP in 2001, which is the highest level in Northern Europe. Second, there are probably significant margins for activation among recipients of unemployment and nonemployment benefits. For instance, more than 50 percent of inflows into disability programs relate to muscular or psychological disorders, and almost half of the long-term unemployed "carousel" between labor market programs and unemployment. Now that the unemployment rate has come down and the economy is starting to show labor shortages, it is time to bring back gradually to activity those who are less remote from the labor market, without overwhelming the public employment services. Third, active labor market spending remains low in relation to the level of unemployment benefits and disability reciprocity. There are many possibilities to activate passive unemployment spending, while maintaining the level of expenditure per benefit recipients at reasonable levels. Fourth, the current system of unemployment and nonemployment benefits as well as benefits targeted to students, both in terms of level and duration, provides little room for substantial incentives to work at the low end of the wage distribution. A stricter stance in terms of gatekeeping, a tighter enforcement of availability requirements for work or labor market-related activities, and the development of make-work pay strategies are necessary to ensure the efficiency of generous social transfer systems.

3. **This paper investigates the possible contribution of activation strategies—in a broad sense—to improve employment rates.** The paper is structured as follows. Section B

¹ Nonemployment benefits (also called "inactive" benefits), include all income-replacement benefits (except for student allowances) which are paid to individuals of working age without work availability requirements. They are not normally paid to people who work full-time. Associated with secondary benefits (such as child allowances, health insurance and housing benefits) they provide an income to live on. They can be either insurance benefits (based on past contributions) or assistance benefits (means-tested). They can also be categorical (targeted and adapted to the needs of some groups—lone parents, disabled, etc.) or non-categorical. In this paper we only consider the two main categories of nonemployment benefits: incapacity benefits (disability and sickness), and social assistance. Other categories—maternity, parental, care, labor market leave, survivors' and old age benefits paid to individuals aged less than 65—are excluded.

briefly summarizes recent labor market developments in Finland. Sections C and D investigate respectively the limitation of current unemployment and disability benefit schemes and identify possible strategies to activate recipients. Section E focuses on strategies to boost youth employment rates. Section F discusses the possibility of using in-work benefit systems to create incentives to work at the low-skilled end of the labor market, while Section G concludes.

B. Recent Labor Market Performance in Finland

4. **Although Finland has experienced very volatile movements in unemployment and employment rates over the past 15 years, it is now broadly in line with the OECD average (Figure 1).** Following the recession of the early 1990s, the unemployment rate reached 16.8 percent in 1994 and the employment rate fell to a low of 60 percent. From 1995 onward, the recovery (with real GDP growth rates between 3.5 to 6.2 percent) allowed for a strong reduction in the unemployment rate to 7.8 percent at the end of 2006, and a rise of the employment rate to 68.4 percent. This latest employment figure leaves Finland above the OECD average at 65.5 percent, but well below other Northern European countries (2005 data; see Table 1).

**Table 1. Employment Rates in Northern European Countries
(In percent of working-age population)**

	Total		15-24		24-54		55-64	
	2005	1994	2005	1994	2005	1994	2005	1994
Denmark	75.5	72.4	62.0	62.1	83.9	80.5	59.8	50.2
Finland	68.0	59.4	39.2	27.9	81.7	74.9	52.6	33.5
Netherlands 1/	72.0	63.9	63.6	55.4	81.5	73.7	44.8	29.0
Norway	75.2	72.2	52.9	48.4	83.2	81.3	67.6	61.6
Sweden 1/	73.5	71.5	42.8	41.3	82.9	81.9	69.5	61.9
OECD total	65.5	64.0	42.8	45.7	76.0	74.5	51.8	46.1

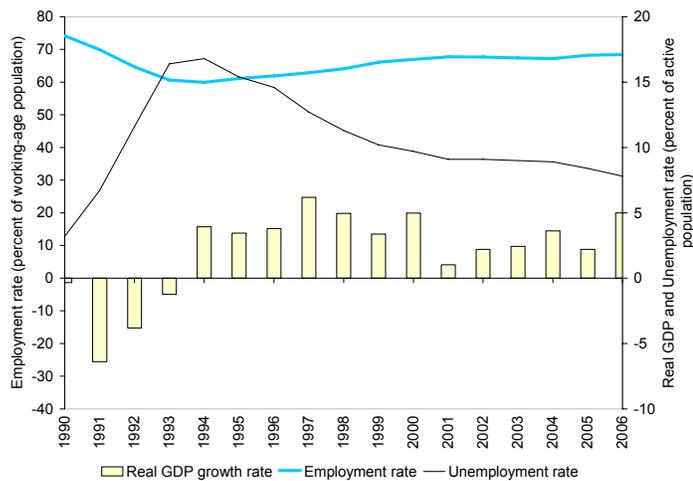
Source: OECD.

¹ 2004 data for these countries.

5. **The recent overall improvement of the employment rate hides sizable differences, especially the much lower employment rates among the young and older workers (Figure 2).** First, although the employment rate of older workers (55–64 years age group) gained 19 percentage points in 11 years (from 33.5 percent in 1994 to 52.6 in 2005) to match the OECD average—benefiting both from stronger labor demand and a set of reforms of the unemployment insurance and the early retirement schemes—it is still well below that of many other Nordic countries (although now above the EU-15 average (43.9 percent). Second, at 39.2 percent, the employment rate increased for younger workers (15–24 years age group), but the improvement is roughly half of that for older workers over the same

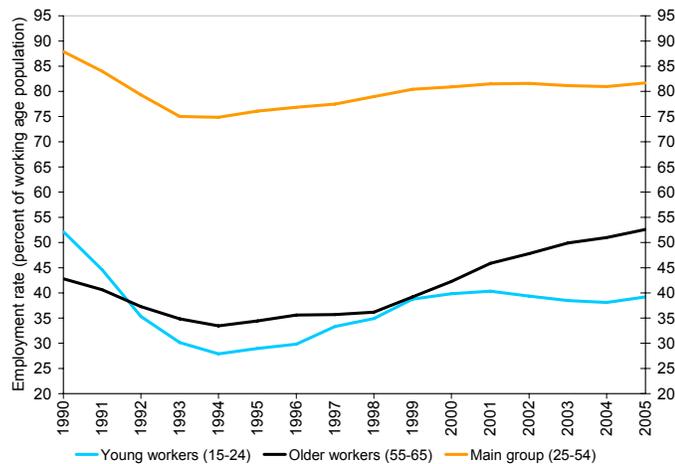
period. These developments leave Finland well behind other Northern European countries and the OECD average, although in line with the EU-15 average (39.7 percent). Moreover, in Finland younger and older males show particularly low employment and labor force participation rates compared to other Northern European economies. For instance, young men show lower participation rate (47.9 percent) and employment rate (38 percent) compared to women of the same age-group, which is usually not the case elsewhere (except, but a lesser extent, in Sweden).

**Figure 1. Real GDP Growth, Employment and Unemployment Rates, 1990–2006
(In percent)**



Source: OECD.

**Figure 2. Employment Rates by Groups in Finland
(In percent)**



Source: OECD.

6. Similarly, the unemployment rate has declined far more for middle-aged or older workers than for young workers, leaving Finland well behind other Northern

European economies (Table 2). While the unemployment rate of older workers more than halved over 11 years—from 19 percent in 1994 to 6.8 percent in 2005—(slightly above the OECD average), unemployment of the 15–24-year olds fell more slowly—from 34.1 percent to 19.9 percent—(compared to 13.3 percent for the OECD average). Even though unemployment is not the best indicator to evaluate the situation of the youth in the labor market (because of the participation in various paths in the education system, and the possibility of temporary/part-time jobs), those youths who participate in the labor market in Finland have much higher chances to be unemployed than their counterparts in Denmark (7.9 percent of unemployment in 2005), the Netherlands (9 percent in 2004), or Norway (12 percent in 2005).

Table 2. Unemployment Performances in the Nordic Countries, 1995 and 2005

	Unemployment rates						Long-term unemployment		Youth unemployment	
	Percent of civilian labor force						(12 months or more) percent of total		(under 25) percent of youth labor force	
	Total		Women		Men		Total		Total	
	2005	1995	2005	1995	2005	1995	2005	1995	2005	1995
Denmark	5.0	7.1	5.5	8.2	4.6	6.2	25.9	27.9	7.9	9.9
Finland	8.4	15.4	8.6	15.1	8.2	15.8	24.9	37.6	20.0	29.9
Norway	4.6	5.0	4.4	4.6	4.9	5.3	9.5	24.2	12.0	11.9
Sweden	7.8	9.2	7.6	8.2	7.9	10.1	18.9	27.8	22.3	19.5
OECD total	6.7	7.4	6.9	8.1	6.4	7.0	32.8	34.2	13.3	14.2

Source: OECD

Note: Unemployment rates according to national definitions.

7. **The incidence of long-term unemployment is higher in Finland than in other Northern European economies, even when the large employment /unemployment “carousel effect” is ignored (Table 2).** This may reflect problems in the public employment service (PES) performance, as the latter can be proxied by its ability to keep the incidence of long-term unemployment low. In Finland, an additional problem is that long-term unemployment is in part hidden by carousel effects, whereby people participate in active programs, renew their right to unemployment insurance, and become unemployed again a year or so later. In 2006, more than 50 percent unemployed job seekers were considered difficult to employ (long-term or repeatedly unemployed, and those becoming unemployed after a measure or being moved on to another program Ministry of Labor, 2006).

8. **Since 1998 in Finland, the share of the working-age population receiving incapacity benefits, or noncategorical social assistance, has exceeded the share receiving unemployment benefits (Figure 3).** This was also the case in 2004 in the majority of OECD

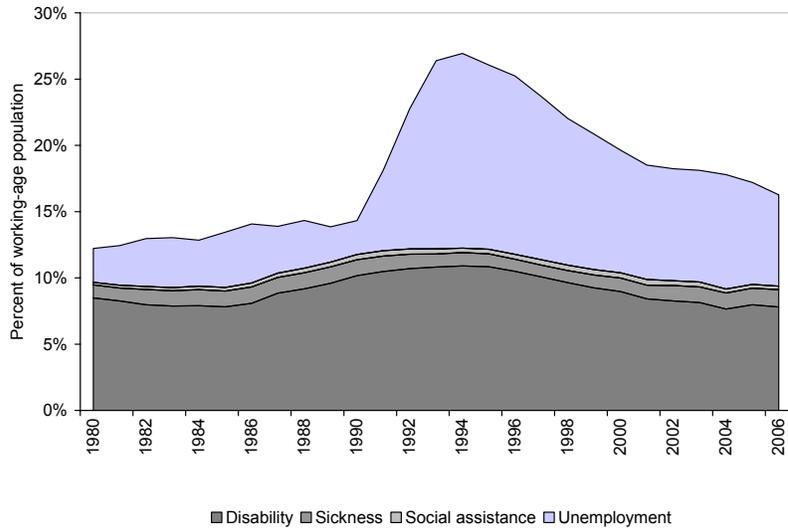
countries (Carcillo and Grubb, 2006), where the decline in the unemployment rates has often been accompanied by a rise in at least one category of nonemployment benefits.

- The share of the working-age population receiving disability benefits, which represents most nonemployment benefit beneficiaries, has been declining since 1995, but to a lesser extent than unemployment beneficiaries (the former falling by 3 percentage points, compared with almost 7 percentage points for unemployment). Incapacity (disability plus long-term sickness benefit recipients) now represents 9 percent of the working population, while noncategorical social assistance remains at low levels (0.3 percentage point; Figure 3).
- The ratio of employed to main nonemployment plus unemployment cash benefit recipients is now the highest among Northern European countries (Figure 4). Nonemployment benefit reciprocity (which includes disability, sickness and social assistance² benefit recipients, but excludes students and old-age pensioners aged below 65) plus unemployment benefit reciprocity now account for 16 percent of the working-age population (Figure 3). In 2004 (for which comparative data is available) Finland had the third-highest rate among 16 OECD countries³ (at 18 percent) after Portugal and Sweden (Carcillo and Grubb, 2006). But Sweden has a larger share of the working-age population at work. This performance can be partly explained by the Finnish labor force aging more rapidly than in any of these countries, which certainly contributes to a lower employment rate. An older working-age population on average can also contribute to higher benefit reciprocity rates, but the level of benefits and the way schemes are designed (eligibility, activation, etc.) will affect dependency on benefits.
- During the early 1990s, most of the employment adjustment cost fell on older workers. This outcome is partly explained by the existing institutional setting, which provided strong financial support to workers losing their jobs and various ways to exit the labor market before the legal retirement age (either through disability or unemployment schemes; see below). The current system of early retirement has recently been reformed, but workers aged 55 and over still have several options to retire early. The system still leaves incentives for both employers and employees using early retirement pathways to exit the labor market.

² Social assistance benefit recipients are only accounted if they do not receive income from other sources.

³ The 16 OECD countries are Australia, Canada, Denmark, Finland, France, Germany, Ireland, Japan, Netherland, New Zealand, Norway, Portugal, Spain, Sweden, United Kingdom, United States. Mostly 2004 data, except 2002 for Canada, and 2003 for Denmark.

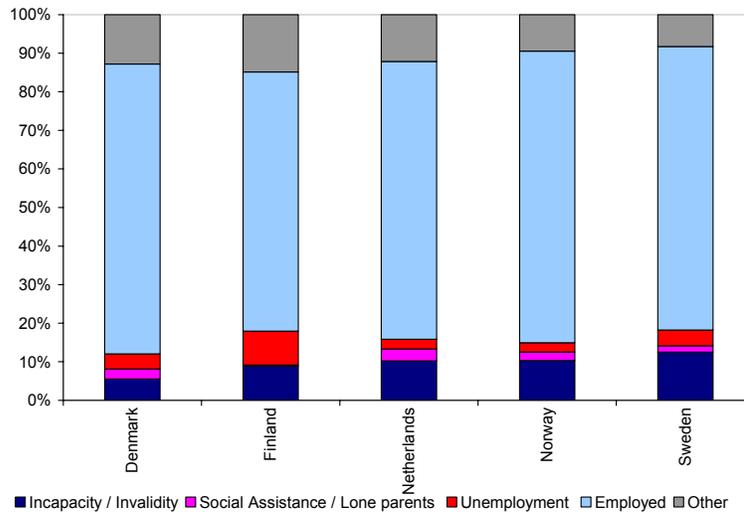
Figure 3. Recipients of Main Non-Employment and Unemployment Benefits, 1980–2006
(Cumulative; percent of working-age population)



Sources: Carcillo and Grubb (2006); and IMF staff calculations.

Note: Unemployment comprises recipients of earnings related benefits, recipients of basic unemployment allowance, and recipients of labor market support. Incapacity comprises recipients of disability pensions, of disability allowances, of individual early retirement pensions, and of sickness allowances. Social Assistance refers to the stock of social assistance recipients with no income from other sources.

Figure 4. Working Age Population Status in Nordic Countries (2003/04)
(In percent)



Sources: Carcillo and Grubb (2006); and IMF staff calculations.

C. Activating Unemployment Benefit Recipients

Background

9. **Despite the recent decline in the unemployment rate, a number of indicators suggest there is room for further improvement.** First, labor shortages are being reported in a number of sectors, as evidenced by a rising number of unfilled vacancies per unemployed (Ministry of Labor, 2006). Second, the number of vacancies relative to the number of job seekers has increased over the past 20 years, reflecting a reduction in the matching efficiency of the labor market—the Beveridge curve shifted outward in the 1980s and the 1990s (Ministry of Social Affairs and Health, 2006). Third, the share of long-term unemployed has remained at around 25 percent and is likely to be even higher, given that almost half of the long-term unemployed who entered active labor market programs return to unemployment thereafter.

10. **For the average production worker (APW), the current unemployment benefit system is very generous by international standards.** The unemployment benefit schemes now comprise three main categories of benefits. First, the basic unemployment allowance scheme, implemented by the Social Insurance Institution (Kela), is an assistance benefit. Second, the earnings-related unemployment allowance scheme, implemented by the trade union funds, is paid to fund members. The maximum earnings-related allowance is 90 percent of the daily wage (including child supplements). Both types of allowances are paid for a maximum of 500 days for those who have been employed at least 10 months over the past 28 months.⁴ Rights can be renewed by participating in wage-based programs, even if these correspond to public jobs.⁵ Third, the labor market support, which is a form of unemployment assistance (as opposed to insurance), is paid to unemployed persons who enter the labor market for the first time or who no longer receive unemployment benefits, and is administered by Kela.⁶ There is no time limit on the payment of the labor market support.⁷

⁴ The financing structure is complex: the basic allowance is funded by the government and wage earners; the earnings-related allowance is funded by the government, employers, wage earners, and fund members.

⁵ Eight months of participation is enough to renew the rights to unemployment insurance benefits, and these months can be accrued over different jobs (a wage-based measure typically lasts six months, but can be extended up to two years for hard-to-place clients).

⁶ The labor market support is a flat-rate benefit that varies according to family size and circumstances. In 2006, the maximum daily benefit was €23.16 for monthly earnings less than €253 for a single person, and €848 for a family. For the basic unemployment allowance, the rate was €23.50 a day plus child's supplement (€4.45 is paid for one dependent child, €6.54 for two, and €8.43 for three or more dependent children).

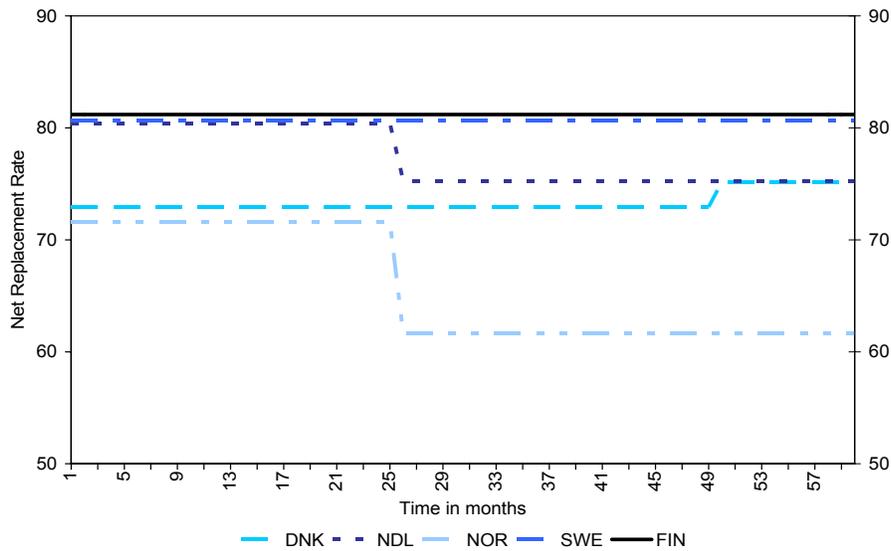
⁷ Besides these three types of benefits, workers over the age of 43 who are made redundant by production-related or financial reasons and are not offered new jobs or placed in training are entitled to a redundancy payment for loss of earnings. The size of the redundancy payment depends on the length of employment and pay.

Approximately half of the unemployed are covered by this scheme, the rest being covered by unemployment allowances. The gross replacement rate at the APW wage of the earning-related allowance is 55 percent (OECD, 2006b). But for workers with two children, including social assistance and child supplements, the net replacement rate can be about 81 percent for five years, which is the highest rate among the Northern European economies (Figure 5). Among various family types, the average net replacement rate is one of the highest in OECD member countries (Figure 6).

11. **There are also strong incentives to retire before the standard age by using the unemployment “pipeline.”** The individual’s expected annual gains from unemployment benefits display a strong discrete jump from age 57 onwards. Before the 2005 pension reform, when people entered the unemployment scheme at 55 years of age or above they could expect to receive benefits until 60 years of age, after which they would get an unemployment pension until the normal age of retirement (65 years of age). This was to be compared with a maximum duration of common unemployment insurance of 500 days, followed by a number of years of low benefits under labor market support scheme. The 2005 pension reform abolished the unemployment pension scheme for people born in 1950 or later, which means entry into the scheme should stop after 2010. The unemployment allowance is paid instead to unemployed persons up to a maximum age of 65, but recipients have the option to choose between the unemployment allowance and the old-age pension at the age of 62 or later. However, the 500-day limit on unemployment benefit reciprocity is waived for persons who are 59 years of age when the initial entitlement period expires. This means that someone entering the unemployment insurance scheme at 57 can expect to be covered until the old-age pension takes over at 62. So this reform tightens the unemployment pipeline only at the margin (Börsch-Supan, 2005). On the employers’ side (particularly large employers), there are incentives to use this unemployment channel to adjust the level of their workforce. The existing system of experience-rating concerns disability pensions and unemployment pensions, but not unemployment benefits, even those which can be received for an extended period.

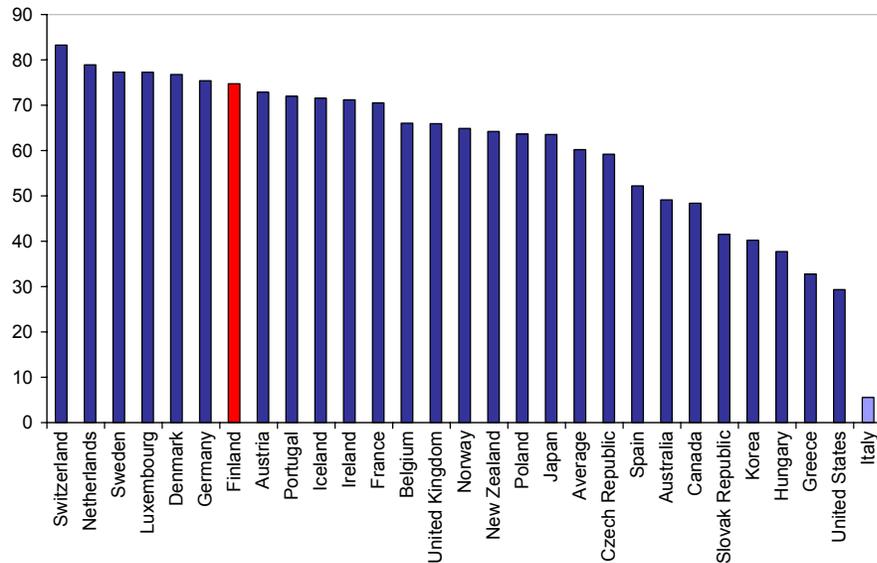
12. **Microeconomic evidence shows that reducing the possibility of extending the benefit reciprocity period can help lower unemployment duration and the risk of unemployment for older workers.** The 1997 labor market reform increased the minimum age limit for the extended unemployment benefit duration from 53 to 55 years. The two-year increase in the minimum age to enter the unemployment pipeline halved the probability of becoming unemployed and increased the transition rate out of unemployment for the group aged 53–54 (Kyyrä and Wilke, 2006). The reform also saved large amounts of benefits (approximately €100 million per age cohort).

Figure 5. Northern European Countries: Net Replacement Rate of Unemployment Benefits with Social Assistance Where Applicable, 2004 (One-Earner Married Couple with Two Children; in percent)



Source: OECD benefits and wages data set.
 Notes: Month one refers to the first month of benefit receipt, i.e., following any waiting period. In-work earnings are equal to the APW. Children are aged 4 and 6 and neither child care benefits nor child care costs are considered.

Figure 6. OECD Countries: Average of Net Replacement Rates Over 60 Months of Unemployment, 2004 (In percent; including social assistance when applicable)



Source: OECD, benefits and wages data set.

13. **Some countries went even further in closing down the pathways to unemployment pensions.** For instance, in 2003, Australia closed to new entrants the Mature Age Allowance (MAA) benefit scheme (social assistance) for 60-to-64 year olds. Now, people have to be referred to the PES and receive unemployment benefits, thereby requiring them to look for a job, or maybe to do unpaid work, or to participate in various active programs. Two years after this reform, the increase of unemployment beneficiaries aged 60 and above was only about one-third of the reduction in the number of recipients of inactive benefits.

Staffing and organization of the PES

14. **Against this backdrop, the PES needs to continue its ambitious efforts to reduce long-term unemployment and limit unemployment recurrence.** Over the past 10 years, the PES underwent several organizational reforms aimed at improving the suitability of the services provided to hard-to-place workers. A first wave of reform (1997–2000) aimed at focusing the services more on clients' needs through improved quality of service and more adapted provision of active labor market programs. The second wave, which started in 2004, has been more ambitious and aims notably at differentiating the services for the hard-to-place clients from the services for the mainstream of unemployed. Labor Force Service Centers (LAFOS) were created across the country to act as one-stop shops, associating employment and social and health services, as well as benefit administrations, after the models of the U.K. and the Netherlands.⁸ These shops will allow employment services to reach hard-to-place clients more easily and to tie benefit reciprocity to labor market availability and actions.

15. **The reform of the labor market support scheme begun in 2006 goes in this direction with early promising results.** After the creation of the LAFOS in 2004–06, providing services more focused on the hard-to-place, the distribution of benefit funding between the State and municipalities has been changed. The financing of labor market support is divided evenly between the municipalities and the state for those who have received passive support for more than 500 days. The state is responsible for the cost of activation programs. Along with new activation requirement for recipients after 180 days,⁹ this measure seems to have contributed to the decline in passive support spending over 500 days of reciprocity (a decline of 18 percent between 2005 and 2006¹⁰).

⁸ The staffing ratios of LAFOS, created in 2004–06, are not available or reliable. By end-2006, these centers had been established in 39 municipalities.

⁹ More precisely when the maximum period for receiving the unemployment benefit has elapsed and labor market support has been paid for 180 days of unemployment, or when labor market support has been paid for a minimum of 500 days of unemployment.

¹⁰ Data provided by the Ministry of Labor.

16. **Following these efforts, and the strong decline in unemployment since the mid-1990s, PES staffing now seems rather favorable with approximately 70 unemployed job-seeking clients for one staff member,¹¹ but only if we exclude some categories of clients.** This ratio is in line with EU target of 100 clients for one staff member, as well as those of some other European countries. However, if we include other job seekers registered at the employment offices who are not unemployed job seekers but potentially benefit from some services and utilize resources (i.e., people in temporary and short-term jobs, students, entrepreneurs, job seekers in labor market programs, or temporarily inactive people) the staffing ratio is less favorable at one staff member for 120 job seekers. Staffing is often pointed out as one of the key factors enabling the PES to effectively place job seekers (Grubb and Tergeist, 2006). This is because human capital-intensive strategies, such as job search assistance or “work-first” strategies (including intensive employment services, and individual case management) often have a large impact at a low cost (see, for instance, Bloom, Hill, and Riccio, 2003; and Kluge and Schmidt, 2002). It is often difficult to obtain a meaningful and comparable picture of staff ratios across countries. Nevertheless, in some countries that have achieved considerable reductions in unemployment, ratios excluding support and administrative staff are low. For instance, in the Netherlands the staff-client ratio is 1 to 60, and in the U.K., the ratio is 1 to 80 job seekers (Grubb and Tergeist, 2006).¹² However, simply increasing further the number of counselors does not necessarily improve placement performances. Creating the right incentives for performance within the PES is also important.¹³

17. **A number of countries have improved staffing ratios and the quality of services by integrating private employment service providers into the PES.** Recourse to private providers exists but is limited in Finland. There is no general strategy to extend the use of private providers notably for intensive placement. However, the prevailing view is that, by enhancing competition, the effectiveness and efficiency of services can improve:

¹¹ See Ministry of Labor, *Employment Report* (2006). This figure is based on 2797 customer service full-time staff, plus 560 staff hired on employment funds and involved in client assistance, to which we added an estimated 150 LAFOS staff. The number of job-seeking clients was 476700, that is the average number of job seekers having been registered with the employment office during the year (2006 figures, including the unemployed, but also students, some employed and some inactive), less 45800 people on unemployment pension (early retirement). This gives a staffing ratio of one staff member for 120 clients. If we consider only the “unemployed job seekers” (i.e., those not currently employed and actively seeking new employment) the average number of clients is 249500. This gives a more favorable staffing ratio of one staff member for 70 clients.

¹² These staffing ratio figures should be broadly comparable with that calculated in the case of Finland. It is the case if, as we understand, customer service staff, employees hired on employment fund and LAFOS staff accounted are indeed dealing with counseling client service, and not benefit administration.

¹³ Another measure that can contribute to improve the PES organization is profiling clients. The authorities announced recently that a profiling system will be progressively be phased in at the local PES office level.

- In Germany, the Federal Employment Agency is being redesigned, with the aim of transforming it into a service provider with private management structures, and PES intervention strategies are increasingly based on job seeker profiling.
- In the Netherlands, since 2000 for unemployment insurance, and since 2002 for social assistance, placement and reintegration services for clients who are not expected to find work within six months are in principle contracted out to private and non-profit providers. This “quasi-market” has already gone through several tender rounds and reforms to increase provider selection based on results, improve the transparency of procedures, and reduce “creaming” effects, as a result of which only more employable job seekers benefit from active measures and enhanced services (Grubb and Tergeist, 2006).
- In Australia, in May 1998 most public employment services in Australia were replaced by the Job Network, which in the first contract period delivered services through about 300 contracted organizations (OECD, 2001). Several tenders and public performance evaluations have improved placement outcomes over the years.

Intervention and its timing

18. Based on international comparisons, there seems to be room to improve the monitoring, counseling, and orientation of job seekers in Finland:

- *There are significant delays in the timing of the first interview and the creation of individual action plans.* Whereas it takes only seven days to be paid under the unemployment benefit scheme in Finland, the first interview does not take place until after one month. Thus, time is lost for potential job referrals and possible matches. In a number of countries, such as Australia, Korea, and the Netherlands, the first intensive interview takes place at registration, along with profiling and the creation of individual action plans. In Sweden, the interview and the creation of an action plan take place within 10 days.
- *Action plans are mostly established after five months of unemployment.* Such action plans seem important in the current system for they specify job search requirements, and usually involve more frequent and systematic monitoring and counseling of job search (every month) after a has been signed. The intensive job search assistance that typically accompanies the implementation of such individual action plans is often identified as the most efficient type of active programs (Kluve and Schmidt, 2002; and OECD, 2005a). A number of countries have action plans signed at the beginning of the unemployment spell (OECD, 2007). In eight countries, individual action plans should be signed at registration or within a week to a month after registration (Australia, Austria, Germany, Greece, Hungary, Italy Sweden, and the U.K.). The deadline is three months in a number of other countries— substantially shorter than the five-month threshold in Finland.

- *In Finland participation in active programs becomes mandatory (usually from the twelfth month for adults) only if specified in the client's plan.* Obligatory programs for those unemployed passing a certain threshold in their unemployment spell are implemented in a number of countries with low unemployment rates, such as Australia (after 6 months), Denmark (12 months), Sweden, (28 months) and the U.K. (18 months). Nevertheless, similarly to these countries (except Australia), Finland has recently set up a lower threshold for young workers¹⁴ (three months, compared to six months in Denmark and the United Kingdom, and three months in Sweden).
- *The ratio of direct referrals to existing job vacancies seems low* and to have decreased since 1999 (around one referral per unemployed person per year, Ministry of Labor, 2006). Direct referrals can be a useful way to check the availability for work, given that some contacts are established with potential employers.

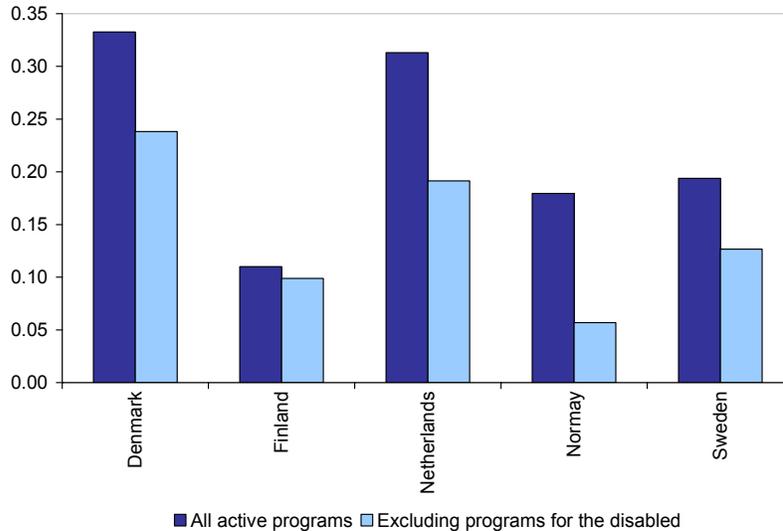
Possible activation strategies

19. So far, activation programs affect only a small share of the labor force in Finland and are not sufficiently targeted to the hard-to-place clients:

- *In 2004, approximately 3.5 percent of the labor force was enrolled in an active program* (excluding programs for the disabled and the sick), while 13.4 percent of the labor force was receiving passive unemployment and early retirement benefits (OECD, 2006a). This ratio of 1 to 4, which has only risen very slightly in recent years, is well below that of other Northern European countries (almost 1 to 1 in Denmark and the Netherlands, and almost 1 to 2 in the U.K.).
- *This lack of participation is also reflected in expenditure, with approximately 0.8 percent of GDP spent on active labor programs.* In 2004 (see Statistics Finland, 2005, and Ministry of Labor, 2004 and 2005), wage-based measures accounted for approximately half of active measures (a decline from 70 percent in the early 1990s); training accounted for the remainder, with a shift toward private sector subsidies. This is low compared to the number of people under unemployment and rehabilitation benefits (0.1 percentage point of GDP per point of labor force under active and passive labor market programs), especially when compared with other Nordic countries (see Figure 7).
- *The share of long-term unemployed in active programs is only about 20 percent.* This ratio could increase in the future, since activation requirements have recently been

¹⁴ The recent implementation of a national "Youth Guarantee Scheme" aims at setting an action plan for all young unemployed within the first three months of benefit reciprocity and finding an active alternative to passive benefit reciprocity. The latest figures show that now approximately 70 percent of young people have been treated, and the target is 95 percent before end-2008.

Figure 7. Nordic Countries: Active Labor Market Program Expenditure in 2004
(Percentage points of GDP spent per percentage point of labor force in labor market programs)



Sources: OECD labor market program data set; and IMF staff calculations.

made mandatory for a minimum duration of 12 months over 24 months after 500 days of receiving unemployment benefits. The low participation in active measures can be explained by the fact that most long-term unemployed are older workers benefiting from job search exemptions. Approximately half of the subsidies were targeted to the long-term unemployed, and 11 percent to the youth. However, a substantial low-pay wage subsidy for employers was created in 2006 for workers aged 54 and over, and will continue until 2010. The subsidy will amount to between 37 and 81 percent of the APW.

20. **By increasing incentives to exit unemployment benefits, strategies that make participation in ALMPs mandatory after some time under benefits can raise unemployment benefit outflows (Bassanini and Duval, 2006; Betcherman and others, 2004; and Kluge, 2006).** Several countries have enforced, with some success and to various degrees, mandatory participation for long-term unemployed:

- In Denmark, for instance, the obligation to participate in labor market programs that was applied to *all* unemployed people was progressively tightened. Initially, in 1994, this obligation started after four years of unemployment, but was progressively reduced to one year in 1999. Monthly rates of entry to employment tended to stop falling and then began to rise about six months before participation in programs was scheduled to become compulsory (OECD, 2005a).
- Australia and the U.K have also made participation in employment programs (Work for the Dole in Australia; employment options in New Deal for 25 Plus in the U.K.) mandatory for the long-term unemployed who engage in no other activities. However, actual participation rates in the programs remain quite low, thereby containing the

potential cost of these measures, as well as the risk of locking job seekers into activities that potentially leave little time to look for a job (a typical limit of long-term/intensive programs).

21. **Also, an efficient system of sanctions can substantially leverage the impact of active labor market policies.** Refusal to participate in mandatory active programs, or evidence of insufficient job search, should be discouraged by a system of credible sanctions. International evidence supports the idea that sanctions, associated with mandatory activities and control of work availability, usually enhance job search intensity.¹⁵ A number of studies (Geerden and Holm, 2007,2004; Rosholm and Svarer, 2004; and Graversen, 2004) have documented the positive motivation effects of mandatory participation in active programs in Denmark on unemployment benefit recipients (recipients tend to exit unemployment before having to participate in programs, knowing that, in case of refusal, sanctions will be enforced). Since 1997, the refusal of a job offer or a mandatory active program in Finland can in principle entail the suspension of benefits for two months. However, the reported lack of job offers in the context of activation programs also makes availability tests and possible sanctions quite rare. An additional problem is that mandatory participation is enforced only after 500 days only if mentioned in a signed action plan, and that job offers are rarely referred to job seekers. The State budget for activation programs in 2008–11 should decrease slightly, which may hinder efforts to raise the activation ratio among the unemployed (currently 25 percent).

22. **Finnish and international microeconomic evidence suggests that reorienting programs toward job-first approaches and subsidized jobs in the private sector can help the unemployed return to employment.** However, direct employment programs in the public sector appear detrimental to employability, and training programs should be used with caution. The degree of job orientation of training can also have an impact on job entries and the recurrence of unemployment, based on international experiences. Against this backdrop, the Finnish training system for the unemployed merits further investigation to yield firm conclusions. Nevertheless, international experiences, and own evidence from Finland, point to some preliminary conclusions:

- *In Finland, programs tend to be more and more oriented toward training, with a decline in public job subsidies.* Participants were initially split evenly between training and wage-based measures, evidencing a rise in the prevalence of training measures (which represented about 30 percent of caseloads in the early 1990s). However, wage-based subsidies were progressively redirected toward the private

¹⁵ Lalive, van Ours, and Zweimuller (2005) show that sanctions and warnings can have a significant impact on re-employment probabilities in Switzerland for unemployment insurance recipients. Abbring, Van den Berg and Van Ours find similar results in the Netherlands. Van den Berg, Van der Klauw, and Van Ours (2006) find substantial effects following the introduction of a sanctions system for welfare benefit recipients in the Netherlands in the 1990s.

sector, with 62 percent of persons under wage subsidies in 2004 working in the private sector. Public employment schemes remain important, though, within public firms, the central government, and municipalities.

- *Some recent microeconomic studies show that, in Finland, wage subsidy programs targeted to long-term/low-skilled unemployed do not seem to have large substitution effects, promoting employment among subsidized firms.* (Venetoklis and Kangasharju, 2003; and Hämäläinen and Ollikainen, 2004, for Finland).
- *That targeted wage subsidies schemes are more effective than other programs in improving participants' employability is supported by an extensive literature on various programs in other countries.* For instance, Rosholm and Svarer, (2004), show that programs other than those targeted to private employment tended to increase unemployment duration in Denmark in the 1990s. Kluve (2006), based on the results of a large number of econometric studies of the impact of active programs in various countries, finds that it is the very nature of the program that determines its effectiveness, more than other external factors (macroeconomic, institutional, etc.). Notably, wage subsidies can help improve the employability of participants, whereas public job creation programs are rarely effective and often detrimental to participants' employment prospects.
- *On-the-job training might be one of the most effective forms of training, for it combines work experience and contacts, with immediately useful knowledge.* The usefulness of work-oriented training programs has long been recognized in some European countries.¹⁶ Increased employer contacts during training programs improves employment outcomes. This has been suggested in particular by several studies evaluating training programs in Denmark (Munch and Skipper, 2003) or Sweden (Johansson and others, 2000, Sianesi, 2004, Carling and Richardson, 2001; and Richardson and van den Berg, 2001), including for long-term unemployed (Carling and Richardson, 2001).
- *Job search-oriented training can also be effective in reducing the recurrence of unemployment.* Short-duration training involving skills assessment, designing of personal projects, intensive interviewing, and help on job searches can actually improve the quality of job matches (Crépon and others, 2005).

¹⁶ For instance, on the basis of individual surveys over two years, Bonnal and others (1997) evaluated the impact of programs containing a high degree of on-the-job training in the private sector (alternating training and work periods) and concluded that this kind of contract was more beneficial (with increased transitions to regular employment) to the skills of the young unemployed (the traditional target of this kind of program) and more beneficial than other kinds such as public employment.

D. Activating Sickness and Disability Benefit Schemes

Background

23. **The share of sickness allowance and employment disability pension recipients who claimed benefits for musculo-skeletal and mental health diseases has strongly increased over the past 10 years** (Ministry of Social Affairs and Health, 2006). The number of compensated sickness allowance days rose by approximately 40 percent between 1997 and 2004, with mental health and behavioral problems the leading cause of the increase, followed by musculo-skeletal and connective tissue diseases. Since long-term sickness is the first pathway to disability status,¹⁷ it is not surprising that, over the same period, the caseload of employment disability pension recipients claiming benefits for the same reasons increased in similar proportions. So, the growth of disability benefit caseloads has implied an increasing share of recipients claiming benefits for reasons that in the past were less frequently compensated for and could often be compatible with continuing employment. Notably, the proportion of psychiatric disorders as a reason for granting disability pensions has steadily risen since the late 1980s, with major depression playing an increasingly important role. As shown by a number of studies, entering formal employment status may improve the sense of well-being and social integration among people with both physical and mental disabilities, and work-first approaches can help manage the most common musculo-skeletal disorders (Carcillo and Grubb, 2006).

24. **The Finnish sickness allowance system, quite generous in comparison to other OECD countries, contributes to a high rate of absenteeism.** In the current system, a certificate is needed from the first day, but employees can receive 70 percent of their wage (for low to average wage levels) for a maximum duration of one year.¹⁸ This is more generous than in Denmark (50 percent for one year), but less generous than in Sweden (80 percent for an unlimited time period), or in Norway (100 percent for one year), and similar to the Netherlands scheme (which, however, limits maximum duration to two years). The level and duration of benefits have a large impact on absentee rates. Bonato and Lusinyan (2004) estimate an elasticity of absences to the level of benefit close to one in Sweden. Consequently, Finland had in 2004 the fifth-largest number of lost days per worker in the OECD, behind Sweden, Norway, France, and Belgium (with approximately 15 days a year per full-time equivalent worker, OECD, 2005a and 2005c). In the current system, employers pay full wages for the first 10 working days of sickness only. They are also held financially responsible for part of the cost of disability benefits under the existing

¹⁷ In Finland, high sickness absence is associated with job termination (among permanent employees) and subsequent work disability pension for older workers (Virtanen and others, 2006).

¹⁸ Since the beginning 2007, the possibility to return to work after a long period of sickness has been made easier by the introduction of a part-time sickness allowance, as a voluntary arrangement between employer and employee, and for any person who has been on sick-leave for an uninterrupted period of at least 60 days and has received sickness allowance.

experience-rating system. However, employers do not face costs for the full spell under sickness, on which they can probably exert more control than on disability.

25. The decline in disability benefit recipiency has certainly been helped by recent reforms, but disability schemes still include the possibility of early retirement.

The main features of the disability scheme are as follows:

- *There are currently three types of disability pensions, including one for early retirement.* First, a universal (assistance) disability allowance (income-tested) covers people assessed with a permanent incapacity for suitable employment for a limited or an indefinite period.¹⁹ Second, an employment disability pension is payable to persons aged 18 to 63.²⁰ Third, an individual early retirement pension may be granted on disability grounds on less stringent medical criteria than the regular disability pension to persons aged 60 to 64. The last two pensions are related to past earnings, and the amount paid is based on the past contributions.²¹ Both types require medical examinations, but the test is less stringent for the second category of pensions and now emphasizes even more occupational factors when evaluating the disability than before the 2004 reform (EIRO 2007). Besides, normal employment disability pensions require applicants to have been under sickness allowance for a year, whereas this is not a condition to benefit from the individual early retirement scheme.
- *Disability pensioners can now “try their wings” in the open market.* In 1999, the government introduced the possibility of beneficiaries suspending their pensions from a minimum of six months to a maximum of two years, and, since 2002, for five years, to get a job or look for a job in the open labor market (with the possibility of receiving rehabilitation benefits in the search/transition period).
- *Efforts to promote rehabilitation have increased over the past 15 years.* In 2004, approximately 85,000 sick or disabled people were receiving rehabilitation, more than double those receiving services in 1990.
- *The disability scheme is a first pathway to earlier retirement, but it is likely to become less easy to access because of recent reforms.* The age limit for an individual’s early retirement pension was raised from 55 to 58 in 1994, and from 58 to 60 in 2004. The 2005 pension reform abolished the individual early retirement scheme for people born in 1943 or later. However, it “softened” at the same time the disability insurance scheme by introducing “social factors” along health factors for

¹⁹ The full amount lies between €390 and €464, according to marital status and municipality.

²⁰ The pension is payable after the maximum sickness allowance period has been paid, and is partial when the loss of working capacity is between 40 percent and 59 percent.

²¹ The rules can be found at http://ec.europa.eu/employment_social/missoc2001/sf_part5_en.htm.

older workers (age 60 and above) when assessing eligibility for a disability pension (Börsch-Supan, 2005).

Improving gatekeeping

26. **Further reform, including increasing the financial responsibility of employers, could be necessary to improve gatekeeping and prevent older workers from falling first into sickness leave and then into more long-term disability schemes.** Exits from disability schemes owing to either recovery or work resumption are usually very low (about 1 percent a year or less, for all but two countries, OECD, 2003a). Therefore, it is necessary to “filter” as much as possible entry into disability schemes, notably by controlling sickness benefits. Increasing the financial responsibility of employers can be one strategy. In Finland, there are currently no legal regulations for the continuation of payment of salaries by employers, but only a waiting period of nine days for the employee before receipt of benefits.²² Some countries have made employers more financially responsible for paying the first months of sickness benefits:

- Since 1995, in the U.K., entitlement conditions have been tightened with new medical tests and 28 weeks of full pay borne by the employers before benefits start to be paid.
- Sweden has followed the same path: since 1992, employers have had to pay for the first 14 days of sickness and since 2005, employers are required to contribute up to 15 percent of benefits for the rest of the sickness spell, unless the individual is working part-time or is engaged in rehabilitation activities.
- Employers in the Netherlands are now required to pay sick workers their last wage for a maximum of a year and at least 70 percent of that wage the second year. Also, they have been responsible (since 2003) for the rehabilitation of sick employees. If they fail to do so, they can be sanctioned by having to pay sick employees their full wage for more than one year.

27. **After the workers’ disability status has been established, it becomes critical to make sure this evaluation is sound and that the disabled person is retested as frequently as necessary.** In Finland, regular retesting is not systematically carried out by the administration, except upon renewal of temporary status. Several countries have reinforced assessment procedures (notably by providing pensions on a temporary basis only) and tightened eligibility criteria for nonfully disabled people in the recent past:

- In Italy, beginning in 1984, disability status has been systematically retested after three and six years, and permanent benefits were granted to fully disabled people. This was followed by a strong decline in disability caseloads. The access rules for a

²² http://ec.europa.eu/employment_social/missoc2001/sf_part3_en.htm

noncontributory benefit program were tightened in 1988, and retesting of certain beneficiary groups led to benefit losses of 25 percent among the tested cases in 1996.

- In the Netherlands, in the mid-1990s, all recipients below age 45 (including those who had previously been granted a permanent benefit) were retested, leading to reclassifications or loss of benefits in one-third of all cases (OECD, 2003b).
- In the U.K., the 1998 reform that launched the “New Deal for Disabled People” (NDDP) introduced frequent reviews of disability status, and an assessment of review frequency at each renewal. More important, benefit recipients are assigned a personal advisor who is in charge of the evaluation process focusing on what kind of work people can do rather than on the work they cannot do.
- In Austria, since 1996, and in Germany since 2001, disability benefits have been granted only on a temporary basis in order to reassess work ability, unless someone is 100 percent disabled, thereby allowing for frequent retesting.
- In Australia, eligibility criteria were tightened in 1991 and in 1997; in 1998, a new claim assessment model was introduced, as was a stricter assessment process. In 2003, an additional reform changed the inability-to-work test from a 30-hour-a-week test to a stricter 15-hour-a-week test. Besides, it introduced the obligation to consider the labor market generally and not locally in claim assessments for those aged less than 55 years. Since July 2006, anyone renewing a claim has to follow a comprehensive work capacity assessment.

Requiring availability for the labor market

28. **In parallel, several countries have strengthened work or work-related activity requirements (including rehabilitation) for disability benefit recipients and somewhat tightened eligibility conditions.** The most effective measure against long-term benefit dependency appears to be a strong focus on early intervention and pathways that favor all options other than benefit reciprocity (Carcillo and Grubb, 2006). In practice, in Finland once rehabilitation has been unsuccessful (after a sickness spell) recipients are rarely brought back to employment. Only a few make use of the possibility to return to work without losing, at least in part, their benefit entitlement. Indeed, the share of people receiving partial benefits is low. Activation requirements are seldom applied in practice. Instead, availability for active labor market programs or work-oriented interviews have had promising effects in a number of countries.²³

²³ In principle, disability pensions cannot be paid before rehabilitation has been considered. To prevent disability, pension institutions provide rehabilitation services. Before making a disability pension determination, the pension institution has to make sure that the applicant's prospects of rehabilitation have been investigated. The extent to which this is effectively done would need to be verified. In case of rehabilitation, benefits are paid

(continued...)

- In 2003–04, Denmark abolished partial disability benefits and required people to take a “flex-job” instead, that is, subsidized public and private full-time jobs targeted to people with permanently reduced work capacities. Denmark experienced a decline in disability recipients by 20 percent between 2000 and 2005.
- In Australia, in 2006, many disability beneficiaries able to work at least part-time were transferred mainly to the unemployment scheme. This represents a potential increase of nearly one-third in the total number in unemployment but the ex post increase is likely to be much smaller. Specific employment services, called Disability Open Employment Services, have been dedicated to deal with the partially disabled, which helps make activation requirements effective and credible.
- Tougher requirements have been in force since 2003 in the U.K. with the creation of six “Pathways to Work” pilots, which should be implemented nationwide in 2008. New claimants must attend six work-focused interviews within six months, as well as agree to an action plan including a step-by-step procedure to improve their employability, including training. Failure to agree on an action plan or participation in subsequent monitoring interviews can lead, in principle, to benefit reductions. Outcomes from the pilots suggest a more favorable impact on caseloads than the existing voluntary program (the NDDP).²⁴

In contrast, as noted above, availability for active labor market programs or work-oriented interviews does not seem to be a major features of the Finnish disability schemes, once rehabilitation has been unsuccessful.

E. Improving Labor Market Participation of the Young

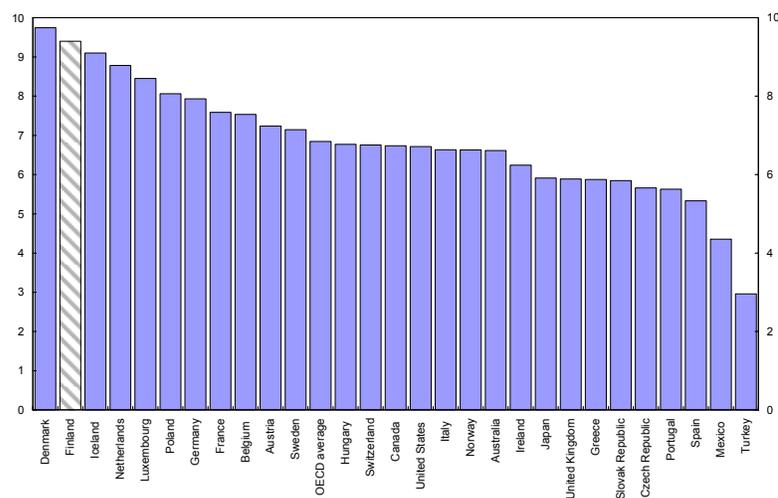
29. **The average graduation age of tertiary level students in Finland is the second highest among the OECD countries.** On average, Finnish university students complete their bachelor’s degrees at the age of 27, after studying 6.5 years at the university, and expected years in education are the longest in the OECD after Denmark (Figure 8). This overly long duration of studies can be a problem for the economy and the public finances in several respects: it decreases the level of educational resources available per student, and it postpones the transition to the labor market, thus reducing labor supply and decreasing tax revenue. The latter point is partly mitigated in Finland by the fact that students often work part-time,

in addition to the disability ones. Details on rehabilitation allowances can be found at http://ec.europa.eu/employment_social/missoc2001/sf_part5_en.htm

²⁴ A recent study suggests that pilot areas are getting twice the number of recorded job entries as other areas. Moreover, following the initial work-focused interview (WFI) after eight weeks, between 15 and 20 percent of people enroll in some program, with over 10 percent joining the NDDP. This compares with the very low 2 percent national take-up rate (<http://www.dwp.gov.uk/mediacentre/pressreleases/2004/nov/iad-3011-ibr.asp>).

although in proportions similar to other European countries.²⁵ However, most of these jobs seem to provide little income,²⁶ and their role in fostering experience relevant for future career appears limited, although more documentation would be useful.

Figure 8. OECD countries: Years Expected in Education for 15-29 Year Olds, 2004



Source: Eurostat.

30. Several reforms have already been tried, with limited success, to create incentives for universities and students to reduce time spent in higher education.

Universities now receive a part of their funding based on the number of completed degrees they achieve. The student financial aid system was also comprehensively reformed in the 1990s. The maximum duration of student aid was cut from seven years to 55 months, and student aid was slightly reduced. Students who started higher education in the 2005–06 academic year or thereafter are eligible for a student loan tax deduction if they complete their studies within the normal timeframe, and if they have more than €2,500 in outstanding higher-education debt at the end of their studies.

31. At end-2005, for a student in higher education aged 18 or above, the monthly support could amount to €460 a month, supplemented by €300 from guaranteed loans. Based on 2005 data, the student grant is €259 a month (maximum) for someone living alone.

²⁵According to an European comparative study, 65% of all higher education students were working in Finland around 2005, compared to 66 percent in Germany, 67 percent in Austria, 69 percent in Ireland and 58 percent in the UK. In the Netherlands the proportion is much higher at 91 percent (Hochschul-Informations-System, 2005).

²⁶This is true compared to other European countries for which the information was available in 2005 (Hochschul-Informations-System, 2005)

This grant can be paid for up to 70 months, of which 55 months (almost five years) can be used for higher education.²⁷ This does not take into account housing supplements, which total 80 percent of the monthly rate of charge with a cap of €252. An interest allowance paid by the government can cover all the interest due on the loan if the student's taxable income does not exceed €775 a month (for a single individual without children). Higher-education-student-loan principal repayments are tax deductible for ten years following graduation, and for up to 30 percent of the amount of debt exceeding €2,500. According to the current government program, the study grant should be increased by 15 percent and the earned income ceiling beyond which entitlement to the grant is lost by 30 percent. In 2000, the housing allowance component was already raised so that it would cover 80 percent of the rent. These measures, if not accompanied by other incentive measures, are not susceptible to decrease the average time-to-graduation in the future.

32. This system places a heavy burden on the public finances, and, with a large portion of the working age population receiving student benefits, it could be reformed to make students more financially responsible.

- Some 330,000 students (9.4 percent of the population in the 15–64 age class and 50.5 percent of the 15–24 aged population) benefited from government aid in 2005, which is close to the number of disability pension recipients. Study grants and housing supplements are government-financed benefits. The cost of student benefits was €728 million, equivalent to 20–30 percent of the unemployment benefit expenditures. Besides, the free higher education in Finland, under which loans are not used to pay for tuition fees, does not encourage students to choose disciplines that offer the best employment possibilities.
- Possible reforms include an increase in the share of guaranteed loans in the overall support provided to students, and a decrease in the maximum number of years before repayment starts, or during which additional grants can top up the loan component. Also, increasing the loan component in exchange for having students pay even a small share of higher-education costs could encourage them to choose degrees that would improve their employability.²⁸

33. Students' financial burdens and demonstration-of-progress requirements have increased over the past few years in many countries (OECD, 2005b). Tuition fees are not levied in Denmark, Germany, or Sweden. These countries have increased grants and loan

²⁷ Students are eligible to work, but the monthly income limit to receive the grant is €505 if aid was received that month, and €1515 for months when aid was not received.

²⁸ The offer of education to students also helps them reorient their choices. In that connection, the creation of a polytechnic system, aimed at upgrading vocationally oriented education and catering for changing local needs, probably helped to match the changing needs of the labor market in the 1990s.

facilities, but conditions have become tighter in them (and also in the Netherlands) by linking grants/loans to academic progress. In recent years, in some countries where tuition fees exist (Australia, Belgium, France, the Netherlands and the U.K.), tuition rates have risen to maintain resources per student in the face of increasing enrollments. This has also happened in the U.S. and New Zealand, where tertiary education institutions are free to set fees. Some countries (Belgium, the Netherlands, and the U.K.) have decreased student grants and increased loan facilities, while New Zealand and Australia have both substantially increased loan facilities.

34. Well-targeted wage subsidies could help improve employment outcomes by expanding employment experience opportunities:

- In Finland, unemployed youth benefit less from wage subsidies than from other programs (11 percent of people employed on subsidized jobs in 2004 are young). Targeted subsidies might, however, help young workers acquire initial job experience and connect them with the labor market, notably in the context of one of the highest minimum labor costs for young and apprentice workers within the OECD (Johansson, 2006).
- Wage subsidies, especially aimed at the private sector, could indeed improve employment outcomes. Hämäläinen and Ollikainen (2004) find for the 1995–2000 period that these schemes increase the probability of employment by some 6-8 percentage points over the two years following entry in the program, even though subsidies are provided only for six months. The impact tends to persist, in contrast to labor market–training programs.
- These subsidies might be a better option than offering training. Youth practical training (shorter in duration, less expensive, oriented toward basic skills) has no significant impact on labor market careers in Finland (Hämäläinen and Ollikainen, 2004), in line with international experience (Cahuc and Zylberberg, 2004).

35. However, wage subsidies should be targeted to young people possessing low levels of education or encountering serious problems entering the labor market.

Otherwise, these subsidies could become very expensive. Accordingly, the government has recently announced a new program of targeted payroll tax cuts targeted to the young, especially in favor of private sector employment. Other reforms could also be envisaged, notably of the financing of higher education, and of the design of minimum wage floors.

36. High labor costs at the low end of the wage distribution, like those observed in Finland (Johansson, 2006), typically deter employment prospects of young workers (Cahuc and Zylberberg, 2004; and Abowd and others, 1999). While a revision of the way in which minimum wage tariffs are negotiated would be useful in any case, activation strategies, such as in-work benefits/tax credits, could also help mitigate the effects of wage compression (see below).

F. Boosting Incentives for Work at the Low End of the Market

37. **Work-pay provisions, such as tax credits, can be an effective tool to induce job seekers to accept low-wage job offers.** These provisions have become a substantial part of low-wage employment policies over the years, especially in the U.S. and the U.K., where they reach, respectively, 20 percent and 5 percent of all households. In several countries (e.g., Australia, Belgium, Canada, France, Germany, the Netherlands, and New Zealand), social assistance schemes are supplemented or replaced by targeted schemes to combat inactivity traps and lower implicit marginal tax rates.

38. **Overall, evaluations tend to show that these provisions can benefit recipients and encourage them to consider some job offers that they would not have considered otherwise, such as part-time jobs (Grogger, 2003).** However, their impact is not straightforward. In terms of welfare, employment and earnings, it depends on various factors, such as the amount and the timing of payment, etc. Notably, policies should be devised to increase incentives to work for job seekers or previously inactive individuals without creating disincentives to work for those already holding jobs. Besides, some evaluations show that, for temporary bonuses, the impact tends to diminish after payments end, unless additional support services are provided during the employment period to help people retain their jobs.

39. **In principle, a substantial but well-targeted tax credit could work as equivalent to a minimum wage targeted to poor families.** Such a benefit scheme would make up the difference between a family's wage and a specified income level and would progressively be phased out above this level, thus increasing the net hourly wages for all families supported by jobs paying below a certain level (MaCurdy and McIntyre, 2004). This instrument could perform better—in targeting poor families for instance—than typical minimum wage laws or minimum wage floors. In case wages floors are negotiated, this instrument could limit the pressure to raise low wages, because take-home pay would increase in other ways for those who need it. Such a credit could also increase the flexibility of effective wage floors across sectors, especially in Finland where the cost of labor at the low end of the labor market is one of the highest in the OECD (Johansson, 2006).

40. **In Finland, work is not very attractive for workers benefiting from unemployment benefits and other social transfers** (Figure 9). A single individual working at 67 percent of the APW with no children will face an effective marginal tax rate of 85 percent on out-of-work benefits upon accepting employment. A couple, with two children and one earner only, will face a marginal tax rate of almost 100 percent. This is high compared with other OECD countries. The existing tax credit in Finland is small and does not compensate for a significant share of the benefits lost after resumption of work. The maximum allowance was about €440 a year in tax savings in 2002, which represents 1.6 percent of the APW wage. This instrument is not very well targeted, since maximum earnings when the benefits are phased out represent 270 percent of the APW wage (OECD, 2005a, Chap. 3). When in-work benefits are very low they cannot lead to significant increases in employment rates. Benefit levels and withdrawal rates depend on where the margins for increasing labor supply are (an increase in the number of hours worked or an

increase participation), the distributional goals of governments, and the distribution of wages, among other factors.

41. In countries where work-pay programs were found to increase labor supply, amounts were more substantial and targeted more toward the low end of the wage distribution than in Finland²⁹ (figures are for 2002):

- In Ireland, the family income supplement, targeted to families with children, represents up to 32.5 percent of the APW and is completely phased out at 79 percent of APW.
- In the U.K., the working family tax credit makes up 35 percent of the APW and is phased out at 110 percent of the APW.
- In the U.S., the earned income tax credit makes up 13 percent of the APW with two children and is phased out at 103 percent of the APW.

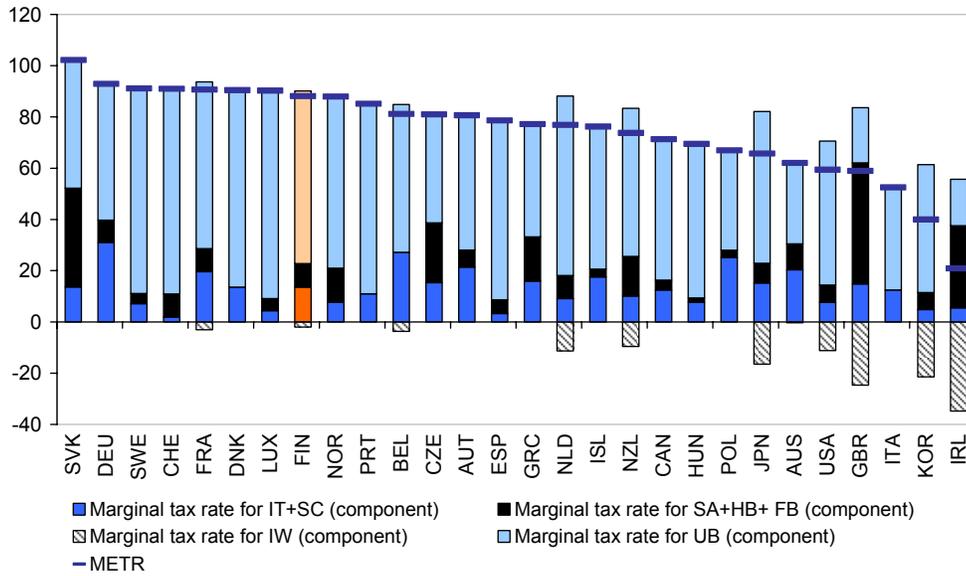
42. Although large work-pay programs are not common in the OECD, some countries have intensified these measures in recent years:

- In France, the “Prime Pour l’Emploi” (PPE) is a general tax credit for low-income earners that more than doubled on average in 2006 (representing now approximately 5 percent of the APW). However, high minimum wage levels and a high density of workers at the low end of the wage distribution tend to limit the rapid expansion of this type of policy, because its direct cost for public finances tends to be large in such circumstances.
- Ireland launched an in-work benefit program in 1993 targeted to hard-to-place benefit recipients, called the Back-to-Work Allowance Scheme (BTWAS, aiming at single parents, long-term disability benefit recipients, long-term unemployed, and other social welfare recipients). This is an employment benefit, payable only after work has resumed and based on previous nonemployment benefit levels, that decreases over time. Some evaluation results showed that although this kind of instrument can also help people return to employment, the effects tend to disappear after the three year-period of the benefit (Ronayne, 1996). Similar instruments, notably in France, yield the same results.

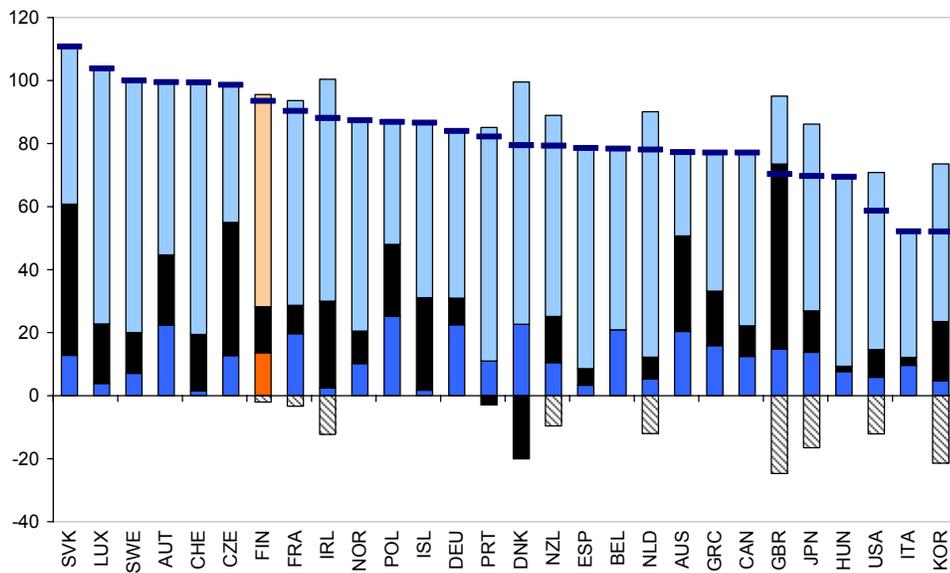
²⁹ The authorities have recently announced the creation of a committee to prepare reforms of tax and benefit systems to stimulate incentives to work as well as labor demand.

Figure 9. Attractiveness of Work Compared With Unemployment and Other Nonemployment Benefits

Single Parent Case, Wage Before Unemployment = 67 percent APW, 2002



One-Earner Married Couple, Two Children and Spouse Inactive, Wage Before Unemployment = 67 percent APW, 2002



Unemployment = 67 percent APW, 2002

Source: OECD benefits and wages data set.

Notes: IT: Income tax; HB: Housing benefits; SC: Social security contribution; FB: Family benefits; SA: Social assistance; IW: In-work benefits; METR: Marginal Effective Tax Rate

G. Conclusion

43. **Finland could follow the example of a number of OECD countries, where the introduction of activation strategies has been followed by sizable reductions of unemployment and an acceleration of reemployment, with a significant decrease in benefit reciprocity caseloads.** This was the case in Denmark, Ireland, the Netherlands, Australia, and New Zealand, with little evidence of substitution or displacement effects. Finland could improve in-work benefits and increase employment rates in the coming years, by following similar strategies. As for unemployment this would require the following:

- Improving job search assistance and monitoring—“work-first” strategies—which can have a greater impact on reemployment rates at a relatively low cost than long-term programs, such as training or job creation measures. The timing of PES intervention could also probably be improved.
- Referring job seekers more systematically and in a more direct manner to vacancies can help reduce the risk of prolonged unemployment and act as a work test. This requires, however, a good information system and a sound knowledge of employer needs, so that referrals are not irrelevant.
- Making compulsory participation in other active labor market programs systematic after a period of unsuccessful job search can help reduce the risk of either long-term unemployment or labor market withdrawal, while motivating those who can exit unemployment before the program starts to do so. In any event, in order to avoid lockup effects on those who participate in these intensive programs, it is desirable to allow time for job searches during the duration of the program. In the case of Finland, this could require developing the availability of active programs, notably for the long-term unemployed and young people, with a focus on work-first approaches and wage subsidies aiming at the private sector, rather than training.
- Phasing out gradually the unemployment (early retirement) pension and requiring that older job seekers be available for work as other unemployment benefit recipients, while, at the same time, envisaging the provision of further job search services.

44. **Also, gradually bringing a portion of sickness and disability benefit recipients back to work or work-related activities, on a full- or part-time basis, would be advisable.** However, the PES should not become overloaded with “transfers” of formerly inactive recipients, and individuals more remote from the labor market should not be transferred so quickly that the process simply translates into a rise of unemployment duration. Several complementary strategies could be pursued to this end:

- Restricting entry into long-term sickness and disability schemes (gatekeeping) with a strict control of sickness leave, while making firms financially responsible the first few months of leave, can help. Similarly, disability status could be made conditional on tight controls on access and retesting of health conditions, while benefit payments could also be

conditional on a continued monitoring of health conditions. Eventually phasing out the possibility of retiring early through the disability pension should also be considered.

- Enforcing—for those with remaining working capacity—availability requirements for work or active programs, at least on a part-time basis. This can include intensive work-focused interviews or rehabilitation measures. But it can also be achieved by simply transferring some clients to the unemployment benefit program, albeit recognizing some constraints on their work capacity and thus providing special services.

45. Additional measures could leverage labor market availability requirements and participation in active programs, for the long-term unemployed, disability benefit recipients, and young people:

- In-work bonuses and tax credits could be developed, especially given the generosity of social transfers and the lack of incentives to resume work at the low end of the wage distribution.
- For young people specifically, recourse to student grants could be gradually limited, and the loan component of student financial support raised, in order to increase the incentives to work and make more market-oriented educational choices.

46. These options would definitely require further investigation, both in terms of technical feasibility and cost analysis. All of them would also certainly demand strong political momentum to be implemented. However, the experience of other countries shows that these strategies can result in higher employment rates in the medium run.

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