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The Labour Market in Finland: Institutions and Outcomes

Juhana Vartiainen

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F O R E W O R D

The state of the labour markets and labour market institutions has become a key issue in European economic and political debates. The Prime Minister's Office has commissioned this essay on the Finnish labour market, with the aim of providing interested foreigners with a concise introduction to Finnish labour market institutions and outcomes. The text was written in spring 1998. It benefitted considerably from comments by Martti Hetemäki, Seppo Leppänen, Jussi Mustonen, Pertti Parmanne, Jaakko Pehkonen, Jukka Pekkarinen, Antti Romppanen, Tuire Santamäki-Vuori and Pentti Vartia. I am grateful to all of them for having made their time and expertise available. Needless to say, any remaining errors are my responsibility. I am also grateful to Iiris Koskela-Näsänen from the Prime Minister's Office and Irmeli Honka and Aila Mustonen from the Labour Institute for Economic Research, all of whom helped me in preparing the book and its figures for print. I also thank the English Centre in Helsinki for having corrected my English.

Helsinki, June 1998

Juhana Vartiainen

C O N T E N T S

EXECUTIVE SUMMARY

In the aftermath of the unfavourable economic conditions of the 1990s, labour market institutions and employment issues have become a major topic in European policy debates. Finnish labour market institutions are in many respects peculiar and interesting. Workers and enterprises are comprehensively organised. The wages of most employees are regulated by collective agreements, and wage bargaining is often co-ordinated at national level. Furthermore, the social partners often conduct discussions with government officials, be it on matters of wages, social policy or labour law. As a result, wages as well as unemployment insurance schemes and employment regulations reflect this tripartite approach to decision-making.

Such consensual institutions are not common in Europe at present, and many economists and politicians feel that labour markets must be comprehensively liberalised. Yet, judging from recent experience, the performance of Finnish labour market institutions is in many respects encouraging. True, unemployment is still high after the severe recession of the early 1990s, but employment has recovered rapidly during the last three years and unemployment has declined – in contrast to many other European countries. This positive development has undoubtedly been enhanced by the moderate wage settlements that have been concluded in the 1990s. Thus, assuming no major adverse economic shocks, Finland has a fair chance of returning, within the next 5 to 10 years, to the high employment rate that has been characteristic of Finland and the other Nordic economies throughout the postwar period. Finnish institutions cannot and should not be transplanted to other countries, but the Finnish experience suggests that many different kinds of institutions may after all be part of the European economic and political palette.

Many difficult challenges lie ahead, however. In the euro area, inflation will be low and wage increases should not exceed the pace of productivity growth if the economy's currently favourable competitive position is to be maintained. A co-ordinated system of wage bargaining like the one operated in Finland can, however, prove unstable. If profitability and demand diverge significantly between economic sectors, it may prove difficult to enforce low nominal wage increases. Moreover, with low inflation, flexibility in real wages will presuppose increasing flexibility in nominal wages as well. It will be interesting to see whether flexibility can be increased within the current system of wage agreements or whether it will lead to increasingly local wage bargaining at the expense of the comprehensive collective agreements.

Long-term unemployment also remains a major problem despite the decline in overall unemployment. At present, more than 5 per cent of the labour force can be classified as long-term unemployed. Tackling that problem will be politically difficult in all scenarios and may well require reforms in the system of taxes and transfers.

1 INTRODUCTION

This booklet introduces the reader to the Finnish labour market, its main institutions and recent outcomes. Although many European economies at present share similar employment problems and challenges, labour markets and their way of working differ from country to country, and there is no single European labour market model. A closer look at the Finnish labour market also reveals many particular and idiosyncratic characteristics. The Finnish labour market displays many typically Nordic traits, but its mechanisms and institutions are in many respects quite different from those of, say, Sweden and Denmark. The description given here highlights both the achievements as well as the weak spots and future challenges of the Finnish labour market model. It is offered neither as an advertisement nor as a crisis story.

Side by side with a general description of the Finnish labour market, the discussion will be structured around four themes familiar from European policy debates. First, the issue of **flexibility** must be kept in mind in any commentary related to labour market issues. How flexible is the Finnish labour market and what would be a realistic assessment of structural unemployment? Second, many Finnish labour market institutions have a corporatist character and can be understood and analysed by relating them to the economic and political literature on **social corporatism**. Third, all European countries must in the 1990s ponder the adequacy and impact **of active labour market policy**, and Finland is no exception. This booklet attempts to supply a description of active labour market policy in Finland and a tentative assessment of its efficiency.

Finally, we place special emphasis on the **historical developments which have unfolded in the 1990s**: the collapse in output, the spread of mass unemployment, and the subsequent economic recovery. How do Finnish labour market outcomes compare to their European counterparts in the light of this recent chapter of history?

Finnish “corporatism”

Finnish labour market policy is the result of an interplay between organised agents and the government. Thus, Finland provides an example, par excellence, of a *corporatist* political and economic system. The term corporatism, or “social corporatism”, although often associated with sinister historical connotations, was in the 1980s coined by economists and political and social scientists to denote political and economic systems that rely on social concert between organised economic agents. In corporatist countries, labour market parties and other important economic and political actors are comprehensively organised and co-operate in wage bargaining and eventually even matters related to social policy. Although social partnership of this kind is often regarded as outdated, this essay argues that such co-operation has undoubtedly helped the Finnish labour market to recover from the deep recession of the early 1990s.

In the case of Finland, such co-operation has deep historical roots. As early as in the 1930s, the management of monetary policy had already acquired corporatist characteristics, and these were reinforced by the management of the war economy. Finland came out of the Second World War in a vulnerable position between the rival power blocs of international politics. Immediately after the war, the Soviet Union exacted a heavy war indemnity which required the rapid build-up of industrial production. That challenge was tackled as a co-operative effort between the state and the business community. The organisation of industrial production was entrusted to a joint committee of civil servants, private industrialists and bankers. This starting point led to a programme of state-sponsored industrialisation and the build-up of a corporatist structure that was actively encouraged by the state. In a political climate such as this, the political decision-makers sought to integrate trade union organisations with governmental decision-making. It was also thought that the trade unions would moderate their wage claims if a larger share of savings and investment were undertaken by the state.

The 1950s in particular was a period in which wages as well as prices were to a considerable extent regulated within a system of political bargaining. Typically, the state would encourage wage contracts with low wage increases and would then also regulate the prices of basic agricultural products such as milk. At the same time, it invested heavily in state-owned companies while the monetary authorities channelled low-interest funding into industrial investment.

Thus, many key economic decisions have been taken within an informal network encompassing the leaders of powerful business corporations, the monetary authorities at the central bank and leading civil servants and government officials. As the trade union movement grew stronger, it was gradually absorbed into the established decision making institutions without causing any major upheavals. The comprehensive unionisation of Finnish workers was not resisted by the state. On the contrary, it was actively encouraged by the authorities in the 1960s, when the unionisation rate increased from under 40 per cent to almost 80 per cent. From the point of view of the state authorities and the employers, the inclusion of workers in a corporatist structure was a safeguard against communist influence and a means of containing potentially dangerous political pressures. In economic terms, it was seen as a means of controlling wage inflation and distributive shares and of minimizing industrial disputes. A concrete expression of this official acceptance of trade union organisation was the introduction of tax relief on union membership fees in 1967.

Many of these institutions and political practices seem quite outdated today, on the eve of a new millennium. Yet, as we shall see in subsequent chapters, it is interesting that Finland has again resorted to co-ordinated wage settlements and dialogue between government officials and labour market parties as the economy has been in the process of recovering from depression.

Moreover, economic policy is frequently discussed within the confines of the *Economic Council*, a consulting body of the social partners and government officials. Within the confines of the Council, leaders and other officials representing various interest organisations and the Ministry of Finance and other government bodies can meet and discuss the state of the economy and topical problems in economic policy. The Council has no formal powers unto itself, but provides a forum in which decision-makers and their expert consultants can meet with representatives of the business community and trade unions. The *Incomes Policy Information Commission*[1] is a specialist body appointed under the auspices of the Council to gather detailed wage data enabling labour market organisations to agree on a common description of current and recent labour market developments in each round of bargaining.

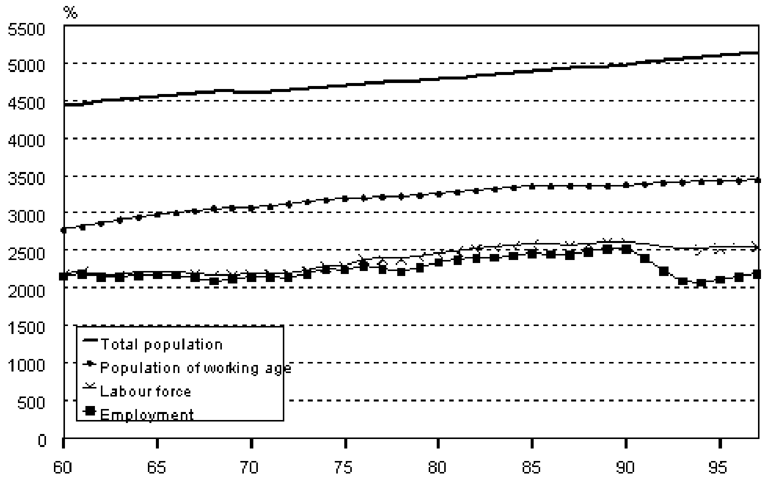
This booklet emphasises the peculiarities of Finnish corporatism. There are, however, many countries with somewhat similar institutions, making the line between public and private decision-making less clear cut than in Anglo-Saxon political culture. In Europe, at least Austria, Germany, Switzerland, the Netherlands and the Scandinavian countries display corporatist characteristics, although every country and every political system has its own idiosyncratic traditions. Another historical comparison can be made with Asian countries such as Japan or, among the newly industrialised, Taiwan and Korea, in which the mobilisation of the economy=s productive inputs was also to a large extent dependent on the interplay between powerful state officials and organised economic agents.

Of course, corporatist arrangements are subject to political and philosophical controversy, and it would be hazardous to try to predict the course of Finnish economic institutions over a longer time span. In the short and medium term, as is explained below, the need to adapt the economy to low inflation and EMU membership has probably increased the willingness to rely on incomes policies instead of comprehensive labour market deregulation.

Basic facts about the Finnish economy

As of early 1998, the seasonally adjusted size of the labour force amounted to 2.52 million people, of whom 2.19 million were employed and about 330 000 unemployed[2]. **Figure 1.1** shows trends in the total population, the working age population, the labour force and employment from years 1960 to 1997. **Figures 1.2** and **1.3** in turn show the overall participation rate and employment rate.

Figure 1.1. Total population, population of working age (15-64), labour force and employment in 1960-1997, thousands.



We see here that the ratio of employed people to the working age population has consistently been higher than the EU average, but that the depression of the 1990s led to a sharp drop in employment and to a rise in unemployment (see below). By and large, the Finnish labour market performed well in international comparison until the severe economic slump of the early 1990s. The evolution of the labour force is related to the demand for labour, and the collapse of labour demand led to the shrinkage of the labour force as well. Furthermore, as shown by Figure 1.3, the proportion of employed people

Figure 1.2. Participation rate (ratio of labour force to working age population), Finland and EU, 1973-1996.

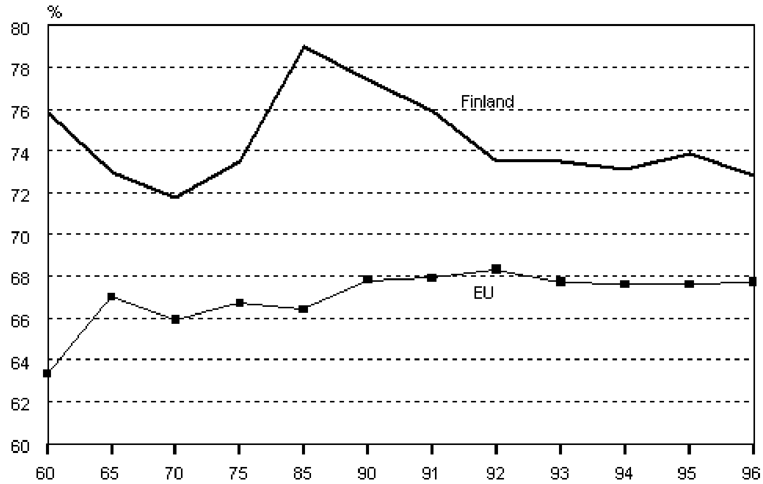
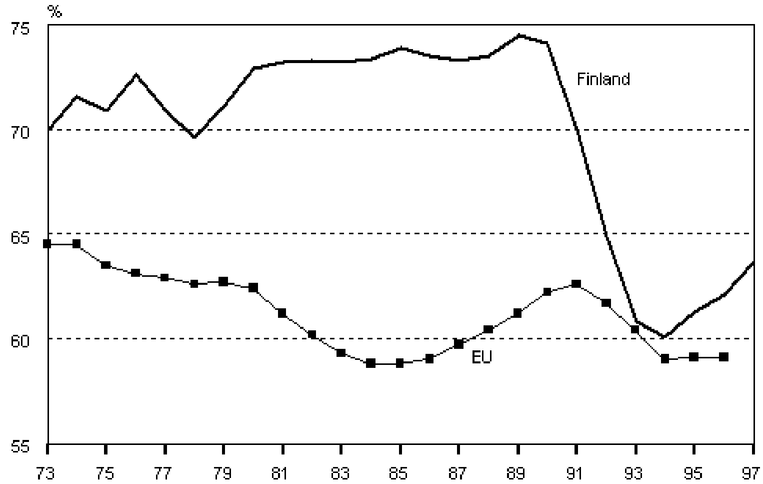


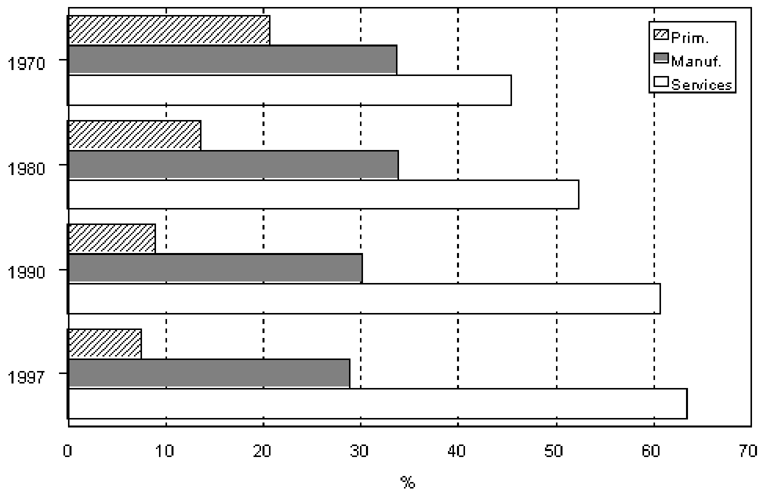
Figure 1.3. Employment rate (ratio of employed people to working age population), Finland and EU, 1973-1997.



in the total population aged 15-64 dropped sharply. By now, the economy has started a swift recovery and these trends have been reversed, but the number of employed people is still, as confirmed in early 1998, about 12 percent below its previous peak level of 2.47 million (1990 average).

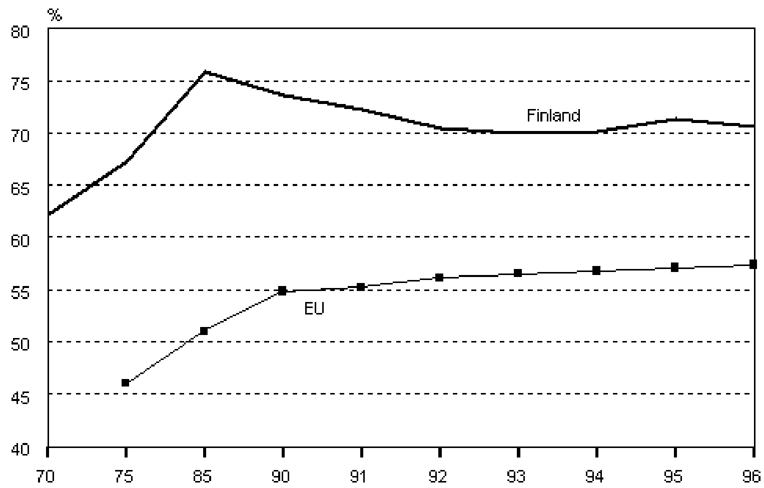
Figure 1.4 displays the **sectoral distribution** of employment. The primary sector now accounts for only 7 per cent of employment. The share of industry has shrunk as in many other OECD countries, and employment in the tertiary sector has expanded. However, about one-fifth of the Finnish population is still employed in manufacturing industries[3].

Figure 1.4. Percentual employment in primary production, manufacturing and service sector, years 1970, 1980, 1990, 1997.



The public sector now accounts for about a quarter of total employment. This figure is higher than the EU average, but lower than those of other Nordic countries. As in other Nordic countries, the female participation rate is high in international comparison. This is shown in **Figure 1.5**, which shows trends in the female participation rate in 1970-96. This reflects Nordic values, which in principle assign both genders an equal role in work and family life. The labour market, however, remains clearly segregated according to gender. Women still take care of many tasks that were traditionally the responsibility of the family. From the 1960s onwards, the expansion of local government services in the fields of health, education and care for the old also paved the way for women's more active participation in the labour market. In 1995, women accounted for 75 per cent of local government employment.

Figure 1.5. Women's participation rate (ratio of female labour force to female population of working age), Finland and EU average, 1970-96.



Female unemployment has normally been lower than male unemployment, but the deep recession of the 1990s has increased unemployment amongst women more sharply than amongst men. Thus, the male and female unemployment rates have converged quite closely in recent years.

The depression of the 1990s

The figures above as well as many other comparisons given later reveal a stark contrast between historical averages and the present state of the economy. This is explained by the fact that the 1990s have been an altogether unusual decade as far as economic growth and stability are concerned. In the early 1990s, the Finnish economy was hit by an exceptionally severe adverse economic shock. The cause of the contractionary shock of the early 1990s was a combination of external factors and domestic policy failures. The domestic economy had overheated by the end of the 1980s, resulting in a large balance of payments deficit. Liberalisation of financial markets had led to extremely low saving rates, increased private and corporate indebtedness and a bubble in asset prices. At the end of the 1980s, a first attempt was made to establish a fixed exchange rate policy. This led to tighter monetary policy from late 1989 onwards.

As the unsustainability of the macroeconomic position and asset prices became apparent, the asset bubble burst and households and firms increased their savings rate dramatically. At the same time, the international business environment became less favourable. Trade with the Soviet Union ceased and other export markets for Finnish metal and forestry products weakened. The Finnish currency depreciated by about 30 per cent, Finnish GDP shrunk by a total of 13 per cent from 1990 to 1993, and unemployment soared from 3 to 16.5 per cent within the span of only three years. Recovery began in 1994.

At present, Finland's economy is still recovering from the depression. Thus, growth has been very rapid (5 to 6 per cent annually) over the last couple of years (1996 and 1997), but unemployment is still high, at around 12 per cent. In the course of time, growth will inevitably return to more normal levels, and hopefully the rate of unemployment will also come down to a more acceptable figure. Thus, the observer must bear in mind that the economy is hardly in a normal equilibrium as yet.

The discussion is structured as follows. Section 2 describes at some length the country's wage bargaining institutions and the basic collective agreement framework that governs wage setting. Section 3 takes up another major determinant of the labour market outcome, namely the unemployment insurance system. Section 4 examines, in turn, the main instruments of active labour market policy that have been and are used in Finland. Sections 2 to 4 contain both historical descriptions of institutions and assessments of future challenges. Finally, in section 5, we give a condensed analysis of the labour market outcomes of recent years, focusing especially on the recovery from the deep recession of the early 1990s and on the structural characteristics of the Finnish unemployment problem at the turn of the 21st century. This section also analyses the medium term macroeconomic and microeconomic problems related to the labour market.

Throughout the discussion, we have included *close-ups*, boxes that supply more detailed background information on selected topics. This essay is designed as a concise introduction; hence, as a rule, no detailed references to the various sources are given, although a short list of related publications is provided at the end of the book.

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[1] "Tulopoliittinen selvitystoimikunta", often abbreviated as "tuposeto".

[2] As we will see in chapter 5, many alternative measures of unemployment can be computed.

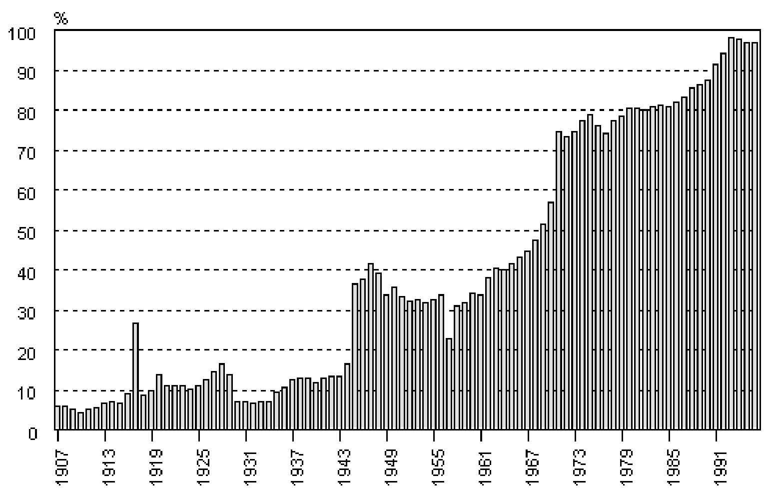
[3] The share of exports (which are mainly manufactured products) in aggregate output has increased in the 1990s and now amounts to about 40 per cent, from a level of 25 per cent in the late 1980s.

2 LABOUR MARKET INSTITUTIONS

2.1. Trade unions, employer organisations and wage bargaining

The Finnish labour market is comprehensively organised. The right of association is guaranteed in the Constitution, and by 1997 about 80 per cent of the salaried labour force belonged to unions. Similarly, employer organisations are fairly comprehensive. As shown in **Figure 2.1**, this comprehensive unionisation is a product of the postwar period and the decade 1965-1975 in particular, a time when the organisation of workers into unions was actively promoted.

Figure 2.1. The percentage of workers and employees belonging to unions, 1907-1997**.**



Wage bargaining

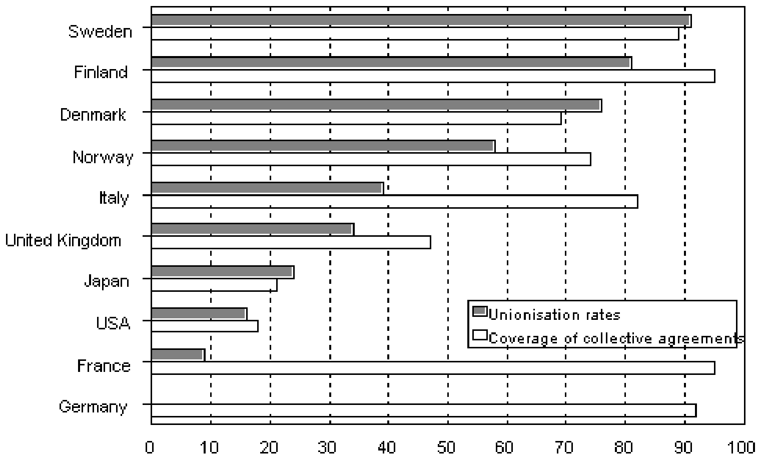
Finnish trade unions have in principle explicitly endorsed the need to base wage increases and wage differentials on productivity. Although Nordic and Finnish wage bargaining is often characterised as being centralised, the legal basis of wage contracts lies in *collective agreements* that usually cover the wage-earning or salaried employees of a particular industry or sector. Workers paid on an hourly basis and salaried employees usually have separate collective agreements.

A typical collective agreement contains the basic principles and norms that govern the use of manpower in the industry in question. In particular, it usually contains a set of minimum tariff wages at different job-complexity levels and educational levels. Thus, there is no minimum wage legislation as such, but the minimum tariff wages of each collective agreement set an effective floor for wages.

Finnish labour law at present stipulates that the minimum provisions of collective agreements be extended to non-signatory parties as well, provided that the collective agreement is regarded as being adequately representative. Since agreements are sectoral, the minimum wage provisions vary from industry to industry. Most collective agreements also grade the minimum provisions by age, so that young workers under 18 can be paid lower wages than other employees. The high unionisation rate together with the provisions of Finnish labour law suggest that collective agreements have good coverage in Finland; recent OECD comparisons indicate that about 95 per cent of all employer-employee relationships are regulated by collective agreements. Note, however, that although the Finnish unionisation rate is exceptionally high by international standards, the coverage ratio is less exceptional, since the real impact of collective agreements usually tends to be stronger than would be implied by the crude unionisation rate, even in economies where the latter is low. This is confirmed by **Figure 2.2** which depicts, respectively, the unionisation rate and the coverage of collective agreements in selected OECD countries.

Whether the minimum tariff wages are directly binding or not depends on the profitability and personnel policies of the individual firms, however. In some firms and some industries, the level of pay is normally above the minimum tariff, whereas some other sectors - like, traditionally, the public sector - cling quite closely to the minimum recommendations set forth in collective agreements. Inasmuch as the tariff wages constrain employment, the impact is likely to be felt most acutely by younger workers. A recent survey of Finnish labour markets concludes that there is indeed some evidence of this, although the overall quantitative impact is not very large.

Figure 2.2. The rate of unionisation and the coverage of collective agreements in selected OECD countries in 1995, %.



In each round of wage bargaining, the collective agreement plays a twin role in the determination of wages. The wage bargain contains an agreement on a general wage increase, most often a percentual one, that is to be applied to all wages and salaries. At the same time, each wage bargain also updates the tariff wages by a certain amount.

The general wage increase is usually interpreted as an across-the-board increase of all wages and salaries. The final impact of the wage bargain depends crucially on that general wage increase. It is also affected by at least two factors. First, what the individual unions and their employer counterparts agree on the structure of tariff wages and salaries affects the pay of employees according to whether their baseline pay is near to the tariff level. Thus, if tariff levels are increased by more than the general increase, the final impact is usually greater than the general increase if a large proportion of workers were earning a wage somewhere near the tariff level.

The other important factor is *wage drift*, i.e. the actual increase of wages in excess of the contractual increase. Wage drift has been an integral part of wage dynamics in all Nordic countries, Finland included. Wage drift has partly undermined the co-ordinated efforts at wage moderation, but it has also provided an element of microeconomic and inter-sectoral wage flexibility, since wage drift has obviously responded to company-specific profitability and even individual performance.

Wage drift is not easy to measure, nor to define unambiguously, since the composition of the labour force, job contents and the job market are in the midst of continuous structural change[1]. As a rough estimate, wage drift has accounted for about one third of all nominal wage increases. Generally speaking, there has been somewhat less wage drift in Finland than in Sweden and Norway, economies with similar collective agreement systems. This is probably at least partly due to the 'tight' collective character of the Finnish wage bargaining system. The general wage increase has usually been applied across the board, so that individual companies have been able to resume normal management after having increased all wages and salaries by the specified amount. Thus, once the collective agreement has been signed by the individual (sector) union and its employer counterpart, the workers have been immediately bound by an industrial peace clause, and an explicit endorsement of the agreement at the company level has not been deemed necessary.

By the same token, there have been hardly any genuinely local wage bargains. This has probably contributed to rigid structure of relative wages, but it has also played a role in restraining local wage drift, which economists often attribute to local bargains in which the workers at company level try to extract more than the general contract increase. Econometric evidence also suggests that wage drift, although responsive to market conditions, does not annihilate the steering hand of the general wage increases. Thus, even if accompanied by some positive drift, the co-ordinated wage increase has been a powerful determinant of the final wage increase.

On the other hand, however, it has been impossible (and perhaps not even desirable) to eliminate wage drift altogether. Wage drift as a general increase in all wages is a nuisance for attempts at wage moderation, but drift has been one way of adjusting relative wages in an otherwise rigid system of wage bargaining. Managers desiring to remunerate and encourage their best workers have thereby been able to adjust relative wages to some extent at least, while the general increase has corresponded to the unions' preferences for uniform wage increases. Thus, the system has been a compromise between different aspirations: those of employers for differentiated wages at the local level, and those of unions for a general and comprehensive control of wages.

Although the Finnish wage bargaining system is often characterised as being centralised, there is no formal legal basis for overall, economy-wide centralisation of wage bargaining. However, the central organisations of blue-collar workers and salaried employees have often played an important role in co-ordinating the wage demands of their member organisations. They cannot negotiate agreements that would legally bind their member unions or employer federations. Yet many bargaining rounds have started with a preliminary negotiation between the central organisations. That negotiation, when successful, has then produced a recommendation for wage increases. The individual unions have then, each in turn, rallied to that central framework agreement - or rejected it, in which case negotiations have been conducted separately.

Close-up: labour market organisations

The central trade union organisations are as follows. On the employee side, the largest federation is the Central Organisation of Finnish Trade Unions (SAK) which at present represents about 1.1 million blue-collar workers. Its largest member unions are the metalworkers' and local government workers' unions. Most of the SAK's members are paid on an hourly basis, either a straightforward wage per hour or piece rates. Salaried employees are represented by the Finnish Confederation of Salaried Employees (STTK), with a membership of about 650 000. The most important member groups of the STTK consist of employees in the health sector and the public sector.

Employees with a college or university education are mainly represented by the Confederation of Unions for Academic Professionals in Finland (Akava). Akava membership is at present around 325 000, roughly two thirds of whom are employed in the public sector.

On the employer side, the employers in the manufacturing industries have played a leading role in matters related to wage bargaining and labour market policy. At present, about 5 600 companies are represented by the Confederation of Finnish Industry and Employers. The Confederation's member companies employ about 470 000 people and account for more than 75% of the nation's industrial value added and export income. Practically all export companies in Finland belong to the Confederation. Service sector employers are represented by the Employers' Confederation of Service Industries (ECSI), comprising about 7 300 member firms with a combined total of about 280 000 employees. Central and local government are important employers, and the labour market representatives of the Finnish Lutheran Church are normally also included as an employer partner in wage negotiations.

The government has often been directly or indirectly involved in these negotiations. Of course, the state does not generally bargain about wage increases in the private sector, but its officials have often assumed a brokering role. These government 'brokers' have tried to encourage a moderate settlement and to facilitate the bargaining process and offer incentives for moderation by using tax and social policy instruments. That tradition goes back as far as the 1950s and 1960s and is traditionally called "incomes policy". The state and local government are also important employers, of course, but they have not in general assumed a leading role in the wage bargaining rounds.

Consultation between the state and the labour market organisations is not formally and institutionally established. Thus, the coordination of wage bargaining among the labour market parties and between the labour market parties and the state rests on an informal basis, and co-ordinated and uncoordinated wage rounds have alternated in Finnish economic history. When there is no willingness for coordination, the trade unions and employer organisations conclude deals to cover their own sector. Economic theory predicts that wages and wage increases are in general higher when there is no coordination, and that prediction is by and large borne out by Finnish experience.

Close-up: theories of wage bargaining

Since the 1980s many economists have studied the relationship between wage bargaining institutions and wage and employment outcomes. In particular, the role of trade unions and coordination of wage bargaining have been investigated, both theoretically and empirically. One tentative conclusion of this economic literature is that strong trade unions tend to raise wage claims and thereby exacerbate unemployment. However, if trade unions co-ordinate their action and are able to agree on wage moderation, this effect can be mitigated. Thus, in an economy with large and powerful trade unions, there is an economic rationale for co-ordination of wage bargaining.

This can best be understood by reference to the incentives for wage moderation at the different levels of wage bargaining. If bargaining is conducted with individual employees or within the confines of one company, incentives for wage moderation are strong, since high wages lead directly to higher costs and hence weaker employment prospects within the company in question. Trade unions that cover an entire sector are, then, in a stronger position. Their high wage increases generally lead to higher costs in the entire sector, and it is more difficult for consumers to substitute products from other sectors for the products of that sector. In other words, the incentives for wage moderation are stronger at individual or company level than at industry level.

With national wage settlements, however, these incentives become stronger again, since a large central union or a group of large sectoral unions understand that increased wages translate as higher prices, which affects the workers' purchasing power or the economy's competitive position. Moreover, central organisations are able to take into account the policy reaction of the government and central bank. An individual union probably takes fiscal and monetary policy as given, whereas central bargainers can in principle foresee the reaction of the policymakers to their wage claims. For example, high wage increases may be met with higher interest rates, and increasing unemployment leads to higher taxes to finance unemployment allowances.

The above scenario is, of course, highly simplified. In an open economy, the advantages of coordination vis-à-vis sectoral bargaining are less clear cut, although similar qualitative results hold. These simplified results also find some support from empirical economic studies. Many econometric analyses suggest that the strength of the trade unions - as measured by the rate of unionisation, for example - tends to affect employment adversely, so that increasing unionisation raises the rate of unemployment. However, there is also econometric support for the notion that this adverse effect can be partly or even completely offset by wage coordination.

In various classifications of wage bargaining systems, Finland undoubtedly belongs to the centralised category, although coordination of wage bargaining rests on no formal legal basis. Economists and political scientists have tried to construct indices to classify countries according to the degree of coordination of their wage bargaining system. In such classifications, countries like Denmark, Norway, Sweden, Austria and Germany usually emerge as co-ordinated cases, together with Finland. Note, however, that the degree of coordination also depends on the employers. That, in turn, introduces an element of coordination into Japanese wage bargaining, for example.

To sum up, the Finnish wage bargaining system can be characterised as a four-tier one. At national level, the central organisations of employers and employees conduct discussions, both bilaterally and with state officials. If a framework agreement emerges, the individual unions negotiate their collective agreements accordingly. Even without any framework agreement, the collective agreements determine the core wage parameters for each branch of industry. The collective agreements are then applied locally. In many cases, this takes place quite mechanically, since the employers can just add the general increase to all wages. Thus, in standard parlance, the Finnish labour market parties have never spoken of "local bargains" per se.

However, it can always happen that the local application of the collective agreement does not transpire quite so automatically. The workers and the employer then conduct discussions at company level, where the workers are represented by their chosen shop steward. Finally, of course, provided the requirements of the collective agreement are met, the firm and the individual employee can agree on any individual arrangements they wish; for example, the company may want to provide added incentive to certain workers in the form of wage increases in excess of what their fellow workers are granted.

It has also often been the case that the prospective framework agreements negotiated by the central organisations have not gained enough support. When this happens, each union enters a deal on its own terms.

The central organisations also often discuss issues of social insurance like unemployment and sickness benefits as well as the pension system.

Dealing with disputes

There is a formal conciliation system that is binding in the sense that any party intending to initiate an industrial dispute has to notify the relevant conciliator in advance and then participate in a mediation process. The state provides the services of a permanent National Conciliator. When a collective agreement is in force, both of its signatory parties are required to maintain industrial peace. Employers or associations of employees can be fined for violating that obligation. When collective agreements expire, the wage-earner party can go on strike and the employer party can resort to lockout measures to exert pressure on the other side.

Although pay bargaining appears to be quite consensual and co-operative, Finnish labour relations have traditionally been ridden with conflicts. From the 1940s to the 1970s, the incidence of industrial disputes was rather high by international standards. Industrial relations have been contentious and subject to political and ideological contradictions. These tendencies were for much of the postwar period exacerbated by the fact that many prominent trade unions were politically divided between Social Democrats and Communists, in contrast to other Nordic countries.

By now, however, such ideological confrontations have receded and industrial disputes have become much less common. Moreover, there are even signs of a better personnel-management dialogue emerging at local level. During the 1990s, the number of industrial conflicts has fallen sharply, but, of course, this is what one would expect to happen in an economy with an unemployment rate peaking at over 16 per cent. In the 1980s and 1990s, industrial conflicts have tended to emerge more frequently in the public sector. This reflects the fiscal pressures on central and local government as well as the increasingly competitive environment in which private sector firms have to operate.

2.2. Outcomes

Macroeconomic outcomes and employment

Labour market institutions are the decisive factor in the determination of structural employment and unemployment, but labour market outcomes are in the short and medium run affected by general macroeconomic developments and macroeconomic policies. Thus, actual unemployment fluctuates with macroeconomic conditions.

Like many other European countries, Finland has a history of inflationary and devaluation-prone monetary policy. From 1950 to 1980, average inflation as measured by the change in the consumer price index was 7 per cent. That was clearly higher than the present target inflation levels adopted by European central bankers, but comparable inflation rates were of course typical for many other European countries, too.

Financial markets and exchange rates were regulated until the 1980s. Finnish inflation can be seen as a spiral of devaluations and domestic cost increases, boosted by export cycles, accommodating monetary and exchange rate policy and the aspirations of the unions. Finnish exports have traditionally included a lot of relatively price-volatile commodities like paper, pulp and base metal products. When exports have grown rapidly, the economy has boomed, and costs in general B and wage costs in particular B have increased. When export growth has slowed down, this has deprived the economy of its competitiveness. The cost problem has then been typically addressed by letting the Finnish markka devaluate, thereby sustaining the profitability of export firms.

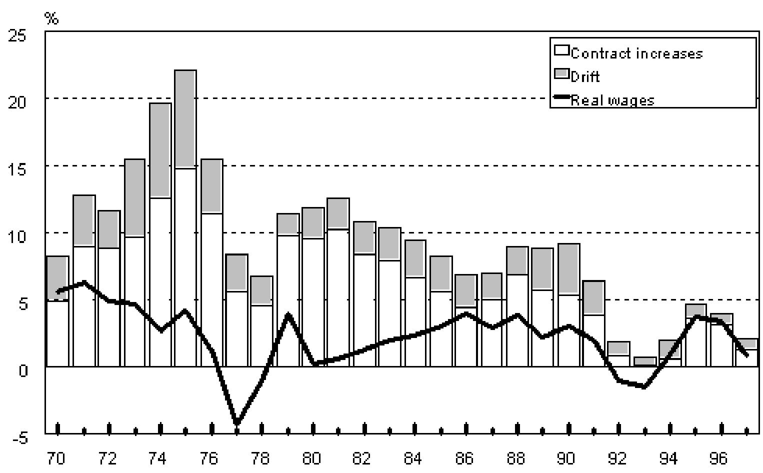
The regime of accommodating exchange rate policy was based on rationed financial and exchange rate markets. Although the Finnish economy was typically somewhat more volatile than other comparable economies, the employment and growth outcomes were at least satisfactory during that period. The open unemployment rate was generally low, never exceeding 8 per cent. Although the economy experienced clear recessions in periods like the late 1950s and mid-seventies, unemployment did not become a major long-term problem.

As is well known by now, increasing integration, deregulation of financial and currency markets and spiralling inflation expectations made devaluation-prone and inflationary monetary policy regimes unsustainable. The 1990s thus became a decade of monetary discipline. As in many other countries, economic policy authorities were towards the end of the 1980s determined to reorient monetary policy to a low inflation environment and thereby enable Finland to join the European single currency. A first attempt to peg the markka to the ecu was made in June 1991. That peg, however, turned out to be unsustainable in the depression of the 1990s, in particular because the overheating of the economy in the late 1980s had generated a large current account deficit. After devaluation and subsequent floating, the markka was fixed to the European Exchange Rate Mechanism in October 1996, as part of the country's endeavour to participate in the European single currency project.

Corresponding to that new policy orientation, nominal wage increases did come down, in comparison with earlier decades, in the post-recession wage settlements of the 1990s. **Figure 2.3** depicts the nominal increases in the economy's wage index over the period 1970-1997. In the 1990s, co-ordinated attempts at wage moderation have in general resulted in lower wage increases than uncoordinated collective agreements. The last two wage rounds, conducted in autumn 1995 and autumn 1997, delivered annual contract increases of the order of 1.8 and 1.3 per cent, respectively, whereas the corresponding figures for the uncoordinated bargains of 1994 and 1995 were 2.5 and 5.

Thus, the Finnish centralised wage bargaining system has, in its own way, been adjusting to new circumstances. Economic recovery started in 1994. Fuelled by strong growth and moderate nominal and real wage increases, employment has increased at a rate of about 1.5 percent of the labour force annually. Correspondingly, the open unemployment rate has declined from its peak of 16.4 per cent to about 12 per cent by April 1998[2]. High unemployment slowed down wage growth with a lag. In the mid-1990s, the rate of growth of real earnings was boosted by the drop of inflation to about zero. The last two bargaining rounds have shown an increasing trend toward wage moderation. Many difficult challenges lie ahead, however, and we will return to them below.

Figure 2.3. Yearly increases in the index of nominal wage costs[3] yearly, itemized as contract increases plus wage drift, along with real wage increases, 1970-1997.



Microeconomic outcomes

Co-ordinated wage bargains can in principle serve as an instrument for redistributive ambitions within the wage bargaining system. Thus, centralised wage bargaining is often associated with *solidaristic wage policy*, the endeavour to compress the distribution of wages via direct wage bargains.

Such ambitions have been particularly pronounced in Finland's neighbouring country, Sweden. In Finland, however, the trade unions have not nurtured as far-reaching ambitions for wage equality inasmuch as wage bargaining is concerned. Compared with Sweden, Finnish trade unions have been readier to accept wage differentials based on differences in skill and productivity. Thus, the distribution of pre-tax wages in Finland does not stand out in international comparison as particularly compressed. This is indicated by **Table 2.4**, which depicts some conventional measures of wage dispersion: the ratio of the upper limit of the earnings of the ninth decile to the upper limit of the earnings of the fifth decile (D9/D5), and similar ratios between the earnings of the fifth and first and ninth and first deciles. We see that

Table 2.4. Measures of earnings dispersion in selected countries, 1994 (1993).

	D9/D5	D5/D1	D9/D1
Japan	1.85	1.63	3.02
Netherlands	1.66	1.56	2.59
New Zealand	1.76	1.73	3.04
Portugal	2.47	1.64	4.05
Sweden	1.59	1.34	2.13
Switzerland	1.68	1.58	2.65
United Kingdom	1.86	1.78	3.31
United States	2.07	2.10	4.35
Australia	1.75	1.64	2.87
Austria	1.82	2.01	3.66
Belgium	1.57	1.43	2.25
Canada	1.84	2.28	4.20
Finland	1.70	1.40	2.38
France	1.99	1.65	3.28
Germany	1.61	1.44	2.32
Italy	1.60	1.75	2.80

Source: OECD Employment Outlook 1996.

Finland does not stand out either as an economy of particularly high nor of particularly low dispersion. Furthermore, changes over time in individual pay differentials have been quite modest during the last two decades.

Similarly, recent OECD comparisons of earnings by level of education show that earnings premia due to university education are not low by international standards.

These comparisons specifically examined the distribution of pre-tax incomes. A look at after-tax wages and incomes reveals that the tax and redistribution system has quite a substantial effect on the final distribution of incomes, so that Finland, together with Sweden, usually emerges as one of the most egalitarian economies in international comparison. Thus, Finland has a strongly distributive system of taxes and income transfers, whereas the wage bargaining system proper has been less concerned with redistribution. This distinguishes Finland from Sweden, but is reminiscent of Austria, another fairly corporatist European economy[4].

One would in general expect co-ordinated wage systems to generate wage distributions which are less responsive to sectoral prices and productivity parameters. Although the evidence is scant, some existing studies seem to confirm this. For example, inter-industry wage dispersion has normally been higher in the United States than in Germany and the Nordic countries[5]. Inter-sectoral wage differentials in Finland are lower than in the US economy but higher than in other Nordic economies like Sweden and Denmark[6].

Over time there has been some variation in these differentials as well. Wage dispersion between industries dropped sharply in the 1970s, but has since then increased again. In 1994, disparities in the average hourly earnings between the main sectors of industry were still lower than in the early 1970s. Underlying such movements, however, mutually offsetting movements in relative wages have taken place. Decentralised bargaining rounds are usually expected to result in greater differentiation of pay increases, and this seemed to be the case at least at the 1994 pay round[7].

2.3. Flexibility

When politicians talk about labour market *flexibility*, they usually mean the ability of the labour market to allocate the economy's labour resources efficiently and sustain high employment. In economic literature, flexibility is defined more narrowly as the speed at which wages and other relevant variables respond to increased unemployment. If increased unemployment leads to an immediate decline in wage growth or even a decrease in wages, wage setting can be characterised as flexible. If, by contrast, wages do not adjust downwards even in the presence of unemployment, wages are said to be rigid. If wages are rigid, equilibrium unemployment tends to be high.

Furthermore, we have to distinguish between *real* and *nominal* wage flexibility. Real wages matter for employment and the workers' purchasing power, and when we use the term flexibility, we in fact mean real wage flexibility most of the time. However, it is an empirical fact that nominal, money-denominated wages are more or less sticky in the short term in many economies. Economic research has not come up with a definitive explanation of money wage rigidity, but theorists have suggested many plausible economic mechanisms that generate stickiness in money wages. It has been shown that it is attractive for workers to conclude nominal, unindexed wage contracts with their employers. If economic conditions and the rate of inflation are stable, a nominal wage contract implies a fairly certain income stream for employed workers. Demand shocks can lead to fluctuations in employment, but these tend first and foremost to affect junior workers and not the majority of insider workers.

Nominal rigidity is exacerbated by the fact that the wage contracts of different employee groups tend to be, as expressed in economists= jargon, Astaggered@, i.e. they overlap and are not concluded simultaneously. When one union bargains over a new wage contract, it often bases its demands on the recent wage contracts concluded by other unions and is therefore reluctant to accept lower wage increases, even if economic conditions have changed. Thus, the fact that many unions pay attention to relative inter-sectoral differentials can create nominal inertia in wage setting.

Finally, the level of the money wage plays a symbolic role for many workers, so that it is psychologically easier to accept a cut in purchasing power if it occurs because of an increase in prices instead of a cut in the money wage. People tend to resist money wage cuts, whatever the underlying economic and psychological mechanisms are. For the same reason, personnel managers do not like to cut wages.

There are not many international comparisons of nominal stickiness, but those that have been carried out suggest that nominal stickiness has been no less typical for Finland than for other comparable economies.

Nominal rigidity, in turn, has made it attractive in some situations to manipulate the real wage through active monetary policy. Nominal rigidity is therefore at the heart of stabilisation policy debates. If there were no nominal stickiness at all, monetary policy would have no effect on employment, since all wages would immediately adjust to whatever changes in price level the policymakers might want to induce. In practice, this has not been the case, and Finnish monetary and exchange rate policy has relied on recurrent devaluations to sustain profitability and jobs in the export industries.

Thus, for example, the deep recession of 1991-1993 was tackled by letting the currency depreciate by about 30 per cent and abandoning the ecu peg of the markka. This swiftly improved the competitiveness of Finnish industries and helped to re-establish economic growth within a couple of years. Similarly, accommodating monetary policies were used in the mid-1970s to check the growth of real wages and sustain the profitability of exports.

What about Finnish real wage flexibility, then? Unfortunately, different econometric studies suggest very different results, making it impossible to give a reliable overall assessment. By and large, it seems that Finnish real wage flexibility has not deviated significantly from that of other OECD economies, at least not for the worse. If one looks at long-term macroeconomic data, it seems clear that a fairly collectivistic wage-setting system coupled with accommodating exchange rate policies have made it possible to adjust real wages quite effectively in some situations. Thus, thanks to the soft exchange rate policies of the Keynesian era, countries like Sweden and Finland often stand out as economies with good short-term real wage flexibility. The experience of more recent years is more difficult to interpret, however.

Whatever the underlying truth in this historical evidence might be, the most critical question concerns the future evolution of wage flexibility and its relationship to inflation and new European monetary conditions. As argued above, real wage flexibility has in Finland's case to some extent at least been achieved by active monetary and exchange rate policy. Furthermore, it has been enhanced by the high rate of inflation. Thus, when the economy has entered a recession, markka devaluations, coupled with co-ordinated incomes policies, have usually been a fairly effective way of adjusting wage costs in the open sector.

This has normally also been reflected in the functional distribution of income. With annual inflation rates between 5 and 10 per cent, it has therefore been possible to keep growth in real earnings low or even negative without having to decrease nominal money wages. Since high inflation has meant more variable inflation, the growth of real earnings has also been unstable. As shown in Figure 2.3, for example, real earnings shrunk in the mid-1970s and early 1990s without money wage cuts. One of the central challenges is to adapt the economy to lower inflation without increasing real wage rigidity. In other words, *higher nominal flexibility is needed if only to keep real wage flexibility at previous levels*. We shall return to this issue in chapter 5.

Thus far, we have been concerned with the responsiveness of average wages to unemployment, but flexibility has other dimensions, too. A well-functioning labour market must make average wages respond to overall unemployment, but it should also allow the adjustment of relative wages according to performance. Thus, managers like to establish incentive schemes and intra-firm wage differentials to increase the productivity of their personnel. This presupposes that firms have some freedom to adjust the relative wages of their personnel, and it may in some instances require the opportunity to cut some individuals' wages. Of course, actual wage cuts affect work morale adversely and are seldom a preferred instrument of personnel managers, but firms in general desire to be able to design their own wage systems. The Finnish wage bargaining institutions have imposed certain constraints on that freedom, but, as argued above, wage drift has provided one outlet for any resultant pressures.

Similarly, transitory and asymmetric shocks that affect the relative profitability of the different industries in different ways, can also lead to temporary wage differentials in well functioning labour markets. In the presence of nominal rigidities, lower inflation can also affect these flexibility mechanisms. We shall return to these points in the concluding chapter.

Regulation of other work parameters

In accordance with the tripartite principle of corporatism, much of Finnish labour law has been developed co-operatively by employers' and employees' representatives and the state. Many laws have typically been introduced in response to conflicts, rather than as a result of unprompted government initiative. However, in recent reforms aiming at relaxing employment protection, the government has adopted a more active role.

Employment protection

Compared to other European countries, regulation of labour contracts in Finland does not stand out as particularly stringent nor as particularly lax. As to rules for dismissal, ending an indefinite employment contract presupposes advance notice on one side or the other. The notice period for dismissals increases with tenure: the shortest pre-notification period is one month for contracts that have been in force for less than a year, whereas it is six months if a post has been held for over 15 years. Employees must be consulted on collective dismissals. Temporary layoffs are possible, up to 90 days, within a 14-day notice period. Many labour market organisations have agreed on other rules that have been incorporated in the collective agreements. In the recession of the early 1990s and even since, employers have been cautious in their hiring decisions, and this has been reflected in the increase of fixed term employment contracts. Note, however, that fixed-term contracts often increase when there is high turnover and abundant reallocation in the labour market, since new labour contracts often imply probation periods and thereby are by definition temporary. In the late 1990s, the growth of ordinary "permanent" labour contracts has more or less matched the growth in overall employment.

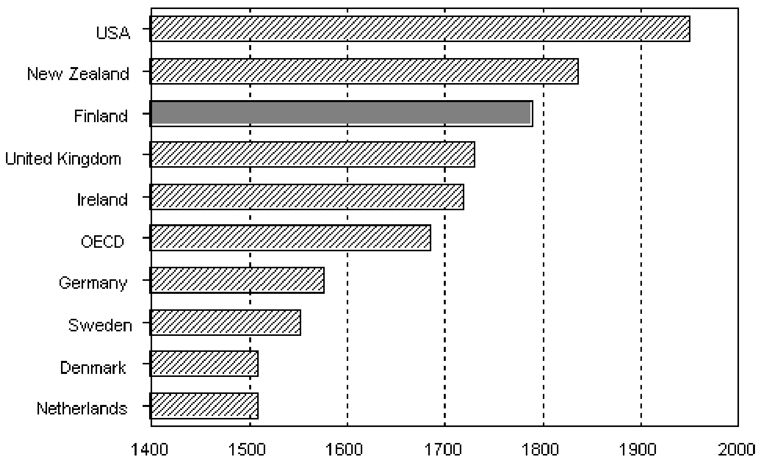
Note also that the share of fixed-term contracts in Finland has always been comparatively high because of labour practices in the public sector. Private sector behaviour does not deviate from other countries in this respect.

Regulation of working time

As in the case of employment protection, working hours are regulated by a general law that is supplemented by the various collective agreements. Under the Working Hours Act, there are upper limits of 8 regular working hours per day and 40 per week. The Act lists the kind of companies and jobs in which the employer can even out regular working hours over an extended period, e.g. 80 hours over 2 weeks or 120 hours in 3 weeks. Using a schedule drawn up in advance, the employer can allocate up to 48 hours a week, as long as the weekly average does not exceed 40 hours. Overtime comprises the time in excess of regular hours, for which extra must be paid. The premium for daily overtime is 50% for the first two hours and 100% for each following hour. Working hours legislation is largely mandatory, but national labour market organisations can agree on deviations from the law, even where this may be disadvantageous to some employees. Most sectors, however, have collective agreements prescribing shorter regular hours, usually between 35 and 38 per week. International comparisons reveal that average working hours per year in Finland do not stand out as being particularly short (see **Figure 2.5**). The incidence of part-time work has always been very low in Finland.

The Working Hours Act was recently reformed and brought closer in line with EU regulations. The maximum number of overtime hours has been set at 330 per year, while the weekly rest period was increased to 35 hours, averaged over 14 days. Daily rest periods were set at 11 hours and working hours, in the period, to 9. Many other reforms of labour time legislation have recently been underway.

Figure 2.5. Average working hours per year in selected countries.



During the 1990s, some important changes have taken place in the pattern of working hours. During the recession, paid overtime work decreased, but unpaid overtime work increased. Overtime work has continued to increase even during most of the economic recovery period since 1994.

Every expectant or nursing mother is eligible for a maternity allowance of 263 working days. Fathers are also entitled to an equal amount of paternity leave, but most of those who exercise their entitlement are on leave for less than a month. Employees also have the discretionary right to child-care leave, study leave or leave for other personal reasons. Recent governments have encouraged arrangements for more flexible working time.

[1] In principle, pay increases due to new tasks, new skills or new employer-employee matches should not be included under drift.

[2] These unemployment figures are from Statistics Finland. As we will describe in the last section, the way of measuring unemployment has gone through many changes in the recent years and many different measures have been used in the economic debate on unemployment.

[3] “Ansiotasoindeksi” in Finnish.

[4] Note, however, that there are some signs of slightly increasing income dispersion in recent years.

[5] See Bertil Holmlund and Johnny Zetterberg: Insider effects in wage determination. European Economic Review 35 (1991), p. 1009-1034.

[6] Economists disagree on the desirability of such differentials. Conventional human capital theory implies that wages should primarily reflect the abilities and characteristics of the employees. Wage differentials between sectors and firms but across similar jobs and persons are then interpreted as resulting from rent-seeking and insufficiently efficient markets. However, it is of course difficult to control for all intervening variables. Furthermore, whatever the economy’s equilibrium, fluctuating wage differentials can be useful as the economy encounters various shocks.

[7] Of course, greater differentiation of pay changes need not automatically increase the dispersion of the wage structure.

3 UNEMPLOYMENT INSURANCE AND OTHER PASSIVE MEASURES

In modern parlance, labour market policies are often divided into “passive” and “active” measures, with unemployment benefit schemes belonging to the former and other measures like retraining and vocational counselling to the latter. This section provides a brief description of the Finnish unemployment insurance schemes.

Basic structure of schemes

Like wage bargaining institutions, the unemployment insurance system also displays corporatist characteristics in the sense that labour market organisations are involved in organising and administering unemployment insurance. The system has evolved in a piecemeal fashion as a combination of insurance and assistance. Traditionally, unemployment allowance has consisted of two parts: the **earnings-related unemployment allowance** and **basic unemployment allowance**.

Most trade unions have a separate unemployment insurance fund, to which its employed members pay regular contibutions[1] . Membership of insurance funds is voluntary. The funds pay out an unemployment insurance benefit scaled in proportion to previous earnings.

The basic unemployment allowance, however, is administered by the Social Insurance Institute and financed entirely by central government through tax revenues. It is thought of as a basic minimum income during unemployment and should in principle be available, for a limited time span, to all individuals registered as unemployed job-seekers.

In 1996, a new element called **labour market support** was added to the policy measure mix. Labour market support is available to those who are not eligible for benefits or whose benefits have been exhausted. It is in principle geared to encourage the recipient to re-enter the normal labour market. Thus, a person receiving labour market support may participate in, and may even be required to participate in apprenticeship training, labour market training, rehabilitation or practical on-the-job training, but, in the last case, without an employment contract and pay. On the other hand, labour market support is paid for an unlimited period of time, although it becomes means-tested after initial period of 180 days[2]. During that initial period, as a rule, labour market support is equal in amount to the basic allowance. At present, a large flow of job-seekers is leaving the basic unemployment allowance scheme for the labour market support scheme.

In recent years, about 60% of those receiving unemployment benefits have been paid earnings-related benefits. That figure is clearly lower than the overall rate of unionisation in Finland. The lower coverage of earnings-related unemployment insurance is attributable to several mechanisms: first, selection in the incidence of unemployment (the rate of unionisation is lower among those groups of workers, like the young and those in irregular jobs, who have a higher-than-average risk of unemployment); second, the selection imposed by the clause that requires applicants to have a prior employment record; and third, and most importantly the exhaustion of benefits.

Eligibility and duration

The detailed provisions of the unemployment benefit schemes have reflected macroeconomic conditions and have therefore been changed several times. In the 1980s, when unemployment was low, the maximum duration of earnings-related benefits was gradually increased. In the 1990s, this trend has been stopped. Since the beginning of 1992, the level and compensation percentage of unemployment insurance benefits has been lowered, and subsequent amendments have introduced more strigent qualifying conditions.

Eligibility for the basic unemployment allowance depends on one's employment history. Under present requlations, the applicant must be employed for at least 10 months during the previous 24-month period in a job where the regular working time was at least 18 hours per week and pay conformed to existing collective agreements. That same condition applies to the duration of membership in an unemployment insurance fund.

The earnings-related unemployment allowance and the basic unemployment allowance are both paid for a maximum period of 500 working days without any means-testing. If the recipient is still jobless after that period, he or she drops out of these schemes and goes on to labour market support, initially for a period of 180 days without means-testing, and then for an unlimited period with means-testing. Throughout that process, the recipient is in principle obliged to accept job offers mediated to him/her by the public employment office. During the first three months of unemployment, this condition is less stringent, i.e. the recipient is not required to take a job that does not match his or her professional skills. After those initial three months, the beneficiary has to accept any full-time job as long as the pay complies with collective agreements and pay minus travel expenses exceed unemployment benefit. These conditions also mean, in principle, that the beneficiary should be prepared to migrate to another part of the country, although there is disagreement concerning the effectiveness of that condition. Of course, in practice, the implementation of these requirements depends on the staff resources of the public employment service and the actual supply of vacancies.

Applicants who fail to meet the employment record requirement can re-qualify by working for a stretch of 10 months or participating in labour market training for 24 months. This means that the system does not have a fixed time limit, and the individual can in principle enter the benefit system many times over.

Levels and replacement ratios of benefits

To give a rough idea of the generosity of these allowances, the average monthly amounts paid out in 1997 were as follows[3]:

earnings-related unemployment allowance[4]: FIM = 4,620.-

basic unemployment allowance: FIM 2,537.-

labour market support: FIM 2,408.- .

For the sake of comparison, the mean monthly wage for 1997 of a male blue-collar worker (SAK member) in manufacturing industry was about FIM 9,860, and that of a female worker about FIM 8,200; the mean salary of state employees was FIM 12,114 in 1996, while that of local anthority workers was FIM 10,851. Looked at this way, the level of benefits does not appear to be very high, but one must of course bear in mind that the final outcome depends on the entire package of social transfers and allowances (see below).

The average replacement ratio of earnings-related unemployment insurance has been around 60% in the 1990s. **Table 3.1** reports the replacement ratio of basic unemployment assistance (i.e. basic unemployment allowance or labour market support in Finland) in a number of countries in 1991. These figures show that the replacement ratio in Finland was not particularly high by international standards in the early 1990s[5].

How does the Finnish unemployment insurance system appear in international comparison and in the light of relevant economic theory? Unemployment insurance increases the well-being of the unemployed, but economists and policymakers have been concerned with the incentive and wage setting effects of unemployment insurance. Generous unemployment benefits may in principle affect the motivation of the unemployed to seek new job opportunities, and, by improving the well-being of the unemployed, they may also boost the wage claims of the unions. However, most empirical studies suggest that such adverse effects might not be quantitatively very significant.

Table 3.1. The replacement ratio of unemployment assistance in selected countries (gross benefit as a percentage of mean wage and 2/3 of mean wage)

	% of mean wage	% of 2/3*mean wage
Austria	42	45
Belgium	34	52
Canada	19	30
Denmark	38	58
Finland	24	36
France	23	34
Germany	35	37
Greece	30	30
Ireland	31	46
Netherlands	39	59
Portugal	34	52
Sweden	29	44
United Kingdom	22	41
Average	31	43

Source: OECD.

Many theoretical and empirical studies also suggest that unemployment insurance systems could ideally be fairly generous, provided that they are not open-ended. Thus, even a high replacement ratio may not have an adverse effect on the labour market if the level of benefits decreases with time and if it is clear that eligibility will expire at some point, save for a provision guaranteeing basic income support. Furthermore, the effect of unemployment benefits on wage claims and unemployment depends on whether the benefit level is indexed to the wage level and on the transparency of the costs of unemployment insurance.

A general employees' unemployment contribution was introduced in 1994, and the trade unions must under the present system take into account the effect of higher wage claims - through unemployment - on the insurance contributions payable by their employed members.

The above comparisons between benefit levels and average wages in certain occupations do not suggest that it is more be attractive to live on benefits instead of working. The relevant comparison, however, depends on the entire package of transfers and benefits to which the recipient is entitled and on the taxation of wage incomes. That package depends on many individual parameters such as number of children, housing conditions, accumulated wealth, age and health, so that it is quite difficult to describe the situation in simple terms. Comparisons of the disposable income of typical households experiencing unemployment with those of other households suggest that unemployment leads to a drop in disposable income of about 5 to 25 per cent.

Thus, the final impact of unemployment insurance schemes can only be deduced by analysing the entire system of taxes, benefits and transfers. In Finland, the unemployment insurance system has undergone so many reforms over recent years that it is as yet impossible to assess the impact of the schemes. Most econometric studies of the impact of unemployment benefits date from the 1980s and may therefore offer but limited indication of the future performance of the system. Moreover, the results yielded by those studies that do exist are quite difficult to interpret[6].

Clearly, much depends on the success of the labour market support scheme. That scheme has been designed to encourage participation in the labour market, and it has no fixed time limit. Thus, its long term structural impact will depend crucially on how the replacement rate of labour market support will evolve and how effectively the labour administration can encourage and compel the unemployed to seek and accept jobs while they are in the scheme. In principle, stricter requirements on vocational and geographical mobility should also be introduced.

The replacement ratio of the basic allowance/labour market support scheme depends on the fact that the level of these benefits has been tied to the consumer price index. This in principle causes a slight decreasing trend in the replacement ratio, since general productivity growth implies that wages grow faster than consumer prices. In the long run, however, the generosity of the benefit schemes is a matter of political discretion, and one might expect it to adjust to overall macroeconomic conditions and to conditions prevailing on the labour market.

As to the macroeconomic impact of unemployment insurance schemes, the depression of the 1990s led to explosive growth in these expenditures. The following table gives a rough idea of total unemployment expenditure in each category. The ratio of all benefits to GDP peaked in 1993 at 4.35 per cent. At present, the share of the labour market support scheme in all unemployment insurance expenditure is expected to go on growing, as many unemployed drop out of the other two schemes.

Table 3.2. Unemployment insurance benefit expenditure: basic allowance, labour market support and unemployment insurance, million FIM, 1985-1997.

Year	Type of Benefit			Total	Per cent of GDP
	Basic Allowance	Labour market support	Unemployment insurance		
1985	1163		1620	2783	0.84
1986	1323		1928	3251	0.92
1987	1406		2034	3440	0.89
1988	1267		2098	3365	0.77
1989	906		1906	2812	0.58
1990	860		2217	3077	0.60
1991	2321		5678	7999	1.63
1992	4464		10879	15343	3.22
1993	6789		15176	20965	4.35
1994	5133	1307	14855	21295	4.16
1995	2706	4089	13001	19796	3.60
1996	944	5326	12958	19228	3.33
1997	825	5117	11846	17789	2.88

Unemployment pensions

An **unemployment pension scheme** has been in operation alongside the unemployment allowances system. It was introduced in 1972, and its aim was to provide income security for the long-term unemployed aged 60?64 whose period of unemployment allowance had expired. In order to qualify for the pension, claimants were to have been employed for at least five years during the previous 15-years period and to be entitled to an employment pension. It is paid at a rate equal to the disability pension to which the claimant would have been entitled had he or she become disabled instead of unemployed.

In the favourable economic conditions of the 1980s unemployment pensions were seen as one means of alleviating unemployment and encouraging industrial restructuring through withdrawal by older workers. The qualifying age limit was accordingly lowered to 55?59 years. By the mid-1980s, the number of people in the unemployment pension scheme had rapidly increased and the scheme had consequently become quite costly; in 1987, when the number of recipients was at its peak, the figure corresponded to 2.7 per cent of the labour force. Subsequently, stricter eligibility criteria were introduced and the qualifying age limit was gradually returned to 60. The number of unemployment pension recipients has decreased since then, as the large claimant stock of the 1980s has been channelled into other pension schemes and the influx into the scheme has died down.

In 1997, about 1.5 per cent of the labour force was on unemployment pension. The recipients of unemployment pension are excluded from unemployment figures, and the influx into the unemployment pension scheme - amounting to about half a per cent of the labour force in 1996 - effectively represents an exit flow from the labour force, since recipients of unemployment pension return to the labour force only in extremely rare cases.

Close-up: Finnish employment pension schemes

Finnish employment pension schemes are another peculiar institution which reflects the half-private, half-public character of Finnish corporatism. Pension insurance is compulsory, i.e. the employer is required to provide pension insurance for all employees. The actual insurance arrangements, on the other hand, are co-ordinated by several large private sector insurance companies[7]. Again, the combination of compulsory, statutory insurance and non-public decentralised provision and organisation of insurance makes Finnish pension institutions different from those of most other countries. The present system is based on the Employees' Pensions Act (TEL) that came into effect in 1962. Of course, employment pensions are not the only pension scheme; most importantly, the public sector provides a national basic pension as a baseline.

The employer can in general sign a contract with any of the registered pension insurance companies, and the insurance company then invoices the employer on the basis of his wage bill. The payment is subject to some variation according to the size of the firm and its contractual arrangements, but on average it is about 20 per cent of the employee's salary. In the future, the formal incidence of the pension payment will be split between the firm and the employee.

Most of these funds have traditionally been invested in loans to private sector businesses. Indeed, another peculiar characteristic of the employment pension fund system has been the system of re-borrowing of pension funds that developed within the private sector employment pension scheme. This allowed firms to pay their contributions by signing debt contracts, and it was also possible for them to apply directly for loans from the employment pension funds. In the last few years, however, pension fund portfolios have been reorganised (favouring government bonds, for example) and re-borrowing has become a less common practice. In the longer term, the portfolio composition of pension funds might undergo a thorough change as investment opportunities are liberalised and the entire euro area becomes a potential market for investment.

Total pension expenditure in 1994 was FIM 72 billion or about 14 per cent of GDP. Of this sum, 41 per cent was paid out by the employment pension system. Total funds administered by the employment pension system amount to about 35 per cent of GDP. High real interest rates have increased these assets considerably during the 1990s. As to its robustness, the system can be characterised as partly funded, since annual return on capital provides only part of the annual pension outlay, whereas the rest is financed on a pay-as-you-go basis. In the long run, it is realistic to assume that about 20-30 per cent of pension expenditure could be financed from fund capital. There has recently been serious discussion about the desirability of increased funding. Economic considerations would warrant a more fully funded system, but it is also clear that funds of such magnitude, if not extremely decentralised, would present a formidable concentration of economic and even political power. However, as the country's demographic structure is bound to become more unfavourable in the 21st century, there is current agreement that the pension funds should be increased.

[1] The employee has the right to join a UI fund without joining the union, however.

[2] The 180 days rule in fact applies to those individuals who have been on unemployment benefit schemes and drop out of them into the labour market support scheme. For those who enter the labour market support scheme directly, the support is means-tested from the outset.

[3] To ease comparison with other countries, note that one DM is now set to correspond to FIM (Finnish markka) 3.04 according to the bilateral conversion rates ageed upon by European Union officials. Thus, one FIM is roughly equivalent to a third of a Deutschmark, and one euro will correspond to about FIM 6 from the start of 1999.

[4] These allowances are usually defined per day, and the monthly figures have been obtained by multiplying the daily allowance by 21.5; the same formula is used the payment of the allowance.

[5] The pre-unemployment wage income of the unemployed is in general below the average wage income of the entire pool of workers, so that a mere comparison of benefits to mean wages might give a misleading picture of the real replacement ratio.

[6] For example, one study found a strong negative effect of the replacement rate on the duration of unemployment among the recipients of basic unemployment allowance. Similarly, panel data studies suggested that people eligible for unemployment insurance benefits had a much higher probability of becoming employed than recipients of basic unemployment allowance. Such results probably reflect selection mechanisms and cannot readily be interpreted as corroborating causal mechanisms.

[7] The biggest ones are Varma-Sampo and Ilmarinen.

4 ACTIVE LABOUR MARKET POLICY

Although the recent crisis has shifted the emphasis of labour market policy to income support, the main focus of Finnish labour market policy has historically been on active measures designed to support employment. Various measures were used in the 1950s and 1960s and even before that to support employment selectively in industries and geographical localities threatened by unemployment. The policy was not based on a sophisticated model of the economy, but was, instead, motivated by straightforward and pragmatic considerations[1] . In the 1950s and 1960s, Finnish industrial policy by and large had an étatist character, and it was quite natural in those circumstances for the government to take a direct role in organising production. In the 1950s and 1960s, "labour market policy" consisted mostly of attempts by the local authorities and central government to provide jobs through public works such as road and railway building sites. The state?s unemployment insurance system was not introduced until the 1960s. Direct measures were used extensively even in the recession of the mid-seventies.

From the 1960s and 1970s onwards, however, the Finnish style of active labour market policy converged towards that of most other OECD countries. Labour market training was established as part of active labour market policy as early as 1966. Direct organisation of production was gradually replaced by subsidised employment, which was in turn augmented considerably in the recession of the mid-1970s. The Employment Act of 1971 shifted the emphasis of labour market policy towards training and other supply measures.

In most European countries today, active labour market measures consist of labour market programmes that are not directly connected with the organisation of productive activity but are instead designed to assist different groups of unemployed people in various ways: by improving their skills, by helping them in their job-searching efforts and by counselling them in their choice of vocation and location. Recent OECD recommendations concentrate on measures to increase the supply of labour. This corresponds to shifts in dominant economic doctrines. By now, most economists believe that the proper scope of active labour market policy is in measures to promote labour supply as well as proper matching between supply and demand.

The same gradual shift of emphasis towards labour supply measures has occurred in Finland, too, although the favourable economic conditions of the 1980s made it politically feasible to increase the public authorities? statutory responsibility to employ. Thus, during the 1980s, various statutory measures were gradually augmented at the expense of discretionary programmes. The 1987 Employment Act, introduced at a time of full employment, committed both central and local government to providing temporary jobs or training for young people under 20 years of age and for the long-term unemployed. This was meant as a measure of last resort, but it reflected the situation in the 1980s, when unemployment was low and it was politically easy and economically inexpensive to upgrade the ambition of employment schemes. Although the obligation to employ was lifted in 1993, the 1987 Act laid down the basic structure of active labour market policy that is still operative even now.

The Act did not translate into high coverage of active measures, however; at their height in 1989 about 35 per cent of all unemployed job-seekers were either in training or employed in subsidised jobs.

These statutory obligations were lifted in the harsher economic conditions of the 1990s. However, the same conditions led to a marked increase in active labour market policy expenditure. Furthermore, under conditions of high unemployment, the division of labour market policies into “active” and “passive” measures has become somewhat less clear-cut, since subsidised employment and labour market training can be used to meet employment record requirements for the long term unemployed.

Employment subsidies

At present, the two main forms of active labour market policy are *employment subsidies* and *training schemes*. Both policy forms have consisted of many different elements. In the early 1990s, there were almost 20 different forms of employment subsidy, each having evolved on an idiosyncratic basis. During the 1990s, the complexity of the system and the rigidity of the related rules were increasingly at odds with the magnitude of the unemployment problem.

The employment subsidy schemes were changed in April 1995, with the number of schemes being reduced to five. The system was rationalised in other ways, too. Stricter conditions were introduced for granting subsidies to enterprises, and the amount of the subsidy relative to wages was lowered.

The main employment subsidy scheme is a *wage subsidy* that can be granted to employers and enterprises both in the public and the private sector when they hire an unemployed person. When paid to a private firm, the subsidy covers only a part of wage costs. After the reforms of 1995, private enterprises are required in exchange for the subsidy to sign a contract of employment of indefinite duration or to provide apprenticeship training, or, for people with poor employment opportunities, to provide other training and rehabilitation. Training is monitored by the employment offices.

In the 1980s, the average number of people employed through wage-subsidy measures amounted to about 33 000, or about 1-1.5 per cent of the labour force. The number peaked at twice that level in 1994 and 1995, after the general collapse in employment and output. Chapter 5 will outline the Finnish manpower balance and the role of employment subsidies in the recovery.

Another scheme is the *part-time pay supplement* designed to encourage job-sharing. The supplement can be paid to a person who voluntarily changes from full-time to part-time work. The employer is then required to hire an unemployed person as replacement. The pay replacement rate is 50 per cent, with a ceiling defined for the pay supplement, and the maximum duration is twelve months. A somewhat similar arrangement is the *job alternation scheme*, which subsidises an employee's absence for studies, training or personal needs, provided that the employer recruits an unemployed person as part of the arrangement (though not necessarily into the same job slot).

A registered unemployed job-seeker who has a feasible business idea is eligible for counselling and financial assistance when setting up a new business. The latter is called *start-up grant* and is paid for a maximum of 10 months. It amounts to between FIM 2,500 and FIM 4,500 and is not intended to provide capital but to cover living expenses during the initial set-up phase.

Labour market training

Labour market training is primarily vocational training designed for the unemployed and those at risk of becoming unemployed. Trainees are selected by local labour authorities, and, since 1990, the authorities have been free to commission training from any provider. Job-related training is mainly the responsibility of employers, but training can also be purchased jointly by local labour authorities and employers, in order to meet specific company needs. The administration of labour market training is coordinated by the labour administration, education authorities and the Ministry of Trade and Industry.

Training has increasingly been targeted at those groups of people who run a particularly high risk of unemployment. The scope of training has also been extended to help those interested in entrepreneurship and self-employment. About 10% of those who have completed labour market training have participated in entrepreneurial training. Attempts have also been made to combine training and start-up grants.

People who take part in labour market training are eligible for training allowances. Members of unemployment funds receive earnings-related training allowances equal to unemployment insurance benefits. For non-members, the training allowance is not means-tested and is equal to the basic unemployment allowance. The cost of labour market training schemes was about FIM 2.4 billion in 1995 when the number of beneficiaries amounted to about 90 000 people. A typical training programme lasts about four months.

Apprenticeship training is a new scheme linked to youth education. The labour administration supports apprenticeship training by paying employment subsidies to employers, in addition to normal government compensation for the costs incurred.

Schemes to promote work sharing

During the past few years, three special schemes have been launched to promote work sharing: *the job alternation scheme*, the *part time pay supplement scheme* and *the 6+6 hour day shift model*.

Outcomes

Economic studies of active labour market policy have sought to determine the benefits and costs of various policy measures. This reflects the fact that such schemes have gradually become a key focus of European policy debates. In European politics in general, since monetary and fiscal policy have increasingly been steered by objectives other than employment, selective and active labour market policy have come to occupy an important role in the fight against unemployment.

Conclusive evaluation of different active measures is made difficult by the fact that the impact of various measures depends on the economic environment and the state of the labour market. For example, measures that encourage mobility and job-seeking efforts are effective if there is a reasonable supply of vacancies and the unemployment problem depends, to some extent at least, on a mismatch between supply and demand. Similarly, vocational training can be effective if it can be designed to respond to employers' demand for skills. Furthermore, the final effect of active measures depends on the behavioural reaction of economic agents such as the trade unions who set the wages, the unemployed job-seekers themselves and the firms who hire them. For example, active employment creation can alleviate the risk of unemployment and thereby increase the wage claims of the unions, or employment subsidies can in fact crowd out regular unemployment, so that, for, example, employers use subsidies to recruit individuals they would have recruited anyway.

Consequently, adequate evaluation studies should be based on sophisticated theoretical considerations as well as a wealth of comparative macroeconomic and microeconomic data. Against that background, it is not surprising that international studies of the effectiveness of active labour market policy measures have yielded rather contradictory results. Notwithstanding any misgivings that economists might have, a consensus has emerged within the EU during the 1990s on the fact that labour market expenditures should increasingly be reallocated from passive to active measures. In the EU countries, the share of expenditures for active measures in all labour market expenditures has traditionally been about 30 per cent, Sweden being the notable exception with a much higher figure. Even in Finland, that share had by the end of the 1980s increased to about 50 per cent.

Broadly speaking, international surveys of the effectiveness of different measures suggest that *vocational counselling and job brokering* as well as *training* seem to generate positive results, whereas subsidised job creation emerges as the more doubtful policy option. However, even Finnish studies have yielded widely different results, so that a somewhat agnostic attitude is warranted.

Finnish studies have by and large indicated somewhat more positive effects of active measures than has been typical for studies conducted in other countries. The evaluation of employment subsidies and training schemes have produced mainly positive outcomes. No significant effect on wage setting has been identified. Furthermore, there is even some indication that measures have improved the matching of supply and demand on the labour market. Some crowding effects have been identified, but these have been quantitatively neagligible. Some studies also indicate that active labour market policy decreases labour mobility by making it easier for the unemployed to avoid migration and apply to various labour market training courses.

[1] In Europe, the intellectual and political origins of active labour market policy can be traced back to the Beveridge Report and Swedish trade unions' labour market programmes. Gösta Rehn, one of the architects of the Swedish labour market model, believed that active policy was needed to encourage mobility of workers from contracting firms and industries to expanding ones.

5 RECOVERY FROM THE RECESSION AND FUTURE ECONOMIC PROSPECTS

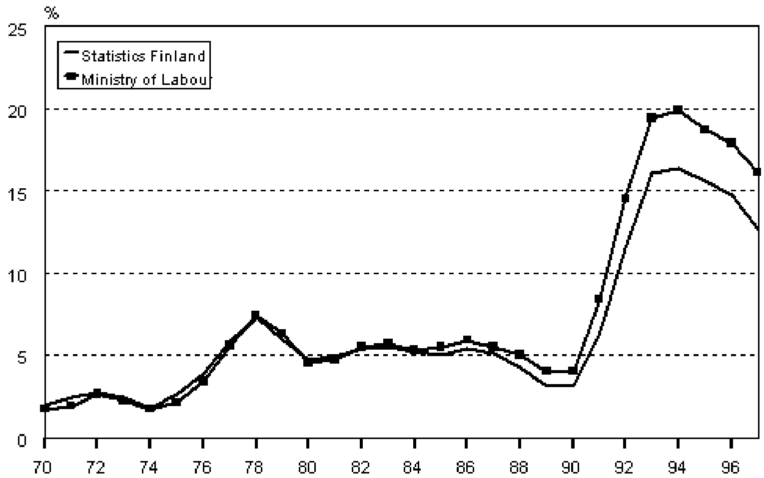
This section presents a more detailed analysis of the labour market trends of the 1990s and considers some of the problems and challenges likely to face Finnish labour market institutions in the future. We first characterise the evolution of the manpower balance in the 1990s and try to disentangle the different ways of looking at the current unemployment problem. We also look at the composition of unemployment and the increasing trend towards long-term unemployment and try to assess future trajectories for unemployment and collate the existing evidence on the present structural unemployment rate. We then summarise the discussion on the various structural reforms that have been proposed as measures to combat structural unemployment. Finally, we discuss the medium-term macroeconomic prospects from the point of view of the labour markets and incomes policy.

Employment and unemployment in the 1990s

The depression of the 1990s led to a huge increase in unemployment, unprecedented in Finnish and European peacetime history. From the top employment year, 1989, employment dropped by 450,000 persons or about 17.6 per cent. Consequently, the unemployment rate soared from 3.5 to 16.5 per cent. From 1994 onwards, the economy has been recovering and employment has increased again. In 1997, average employment was about 115,000 (or 4.6 per cent) above the 1994 rate. At the same time (from 1994 to 1997), the average yearly GDP growth rate has been 4.9 per cent. Thus, high growth has increased employment again, althought the economy is still very far from full employment.

The unemployment rate, as calculated by Statistics Finland, has dropped from 16.4 in 1994 to 12.6 in 1997 and is expected to drop further to about 10.9 per cent by 1998. **Figure 5.1** depicts this internationally comparable unemployment rate from 1970 to 1997.

Figure 5.1. Unemployment rate, 1970-1997, Statistics Finland rate and Ministry of Labour rate.



Evaluations of the unemployment problem are made difficult by the fact that there are many alternative ways of measuring unemployment. Moreover, the unemployment rate is influenced by the extent of active labour market policy measures and changes in the size of the labour force. The statistics Finland unemployment figure is based on the monthly Labour Force Survey, which is a repeated panel sample comprising about 12 000 people. There have been structural reductions in the unemployment figure from the third quarter of 1997 onwards, due to changes in the criteria used to define unemployment[1]. The present accounting system corresponds to EU standards.

The Ministry of Labour collects comprehensive data on the unemployed job-seekers registered at local labour administration offices. Normalised with the labour force, these data generate another unemployment figure that has usually, though not invariably, been higher than the official unemployment rate. For the sake of comparison, that rate is induded in figure 5.1.

Labour force survey data also permit the computation of another notion of unemployment, namely the “wide” rate of unemployment, which includes so-called *hidden unemployment*. An individual is included in the hidden unemployment category if he or she would in fact be prepared to accept a job within two weeks but has nonetheless not sought work actively. The reasons given by respondents for not actively seeking work fall into two categories: first, the individual may be “frustrated” into thinking that he/she would not get a job anyway; and, second, other reasons such as study or child-care commitments have made non-seeking the favoured option, although the individual would in fact accept a job offer if presented with one.

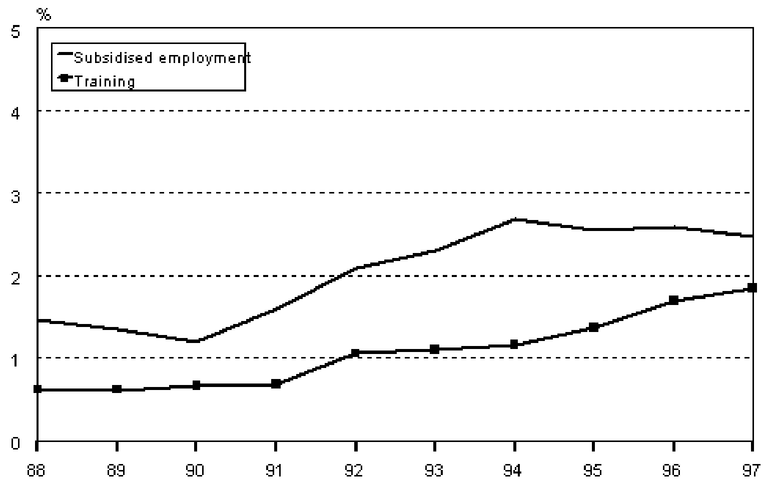
Figure 5.2 depicts the “wide” rate of unemployment which includes hidden unemployment[2] together with the official unemployment rate. Recall also that about 1.5 per cent of the labour force were on unemployment pension in the mid-1990s, as explained in the previous section. Recipients of unemployment pension are not included in the wide unemployment rate.

Figure 5.2. The unemployment rate and the wide unemployment rate.

Active labour market policy schemes and training create further ambiguity in calculating the real unemployment rate. Increases and decreases in the number of individuals included in subsidised employment and training affect the open unemployment rate, and economists disagree on the extent to which such changes can be interpreted as a genuine improvement or weakening of the labour market. That evaluation also depends on the real economic effect of the active labour market policy schemes.

The share of the labour force in either training or subsidised employment is depicted in **Figure 5.3**. Roughly speaking, the number of individuals in subsidised employment has varied between 60 000 and 70 000 in 1994-1997, and that of individuals in training between 20 000 and 50 000. From December 1994 to December 1997, the overall number of individuals in active labour market policy schemes increased from 102 800 to 120 500. Consequently, the improvement of employment by about 115 000 during that time is not primarily attributable to an increase in active measures.

Figure 5.3. The share of the labour force in subsidised employment and training.



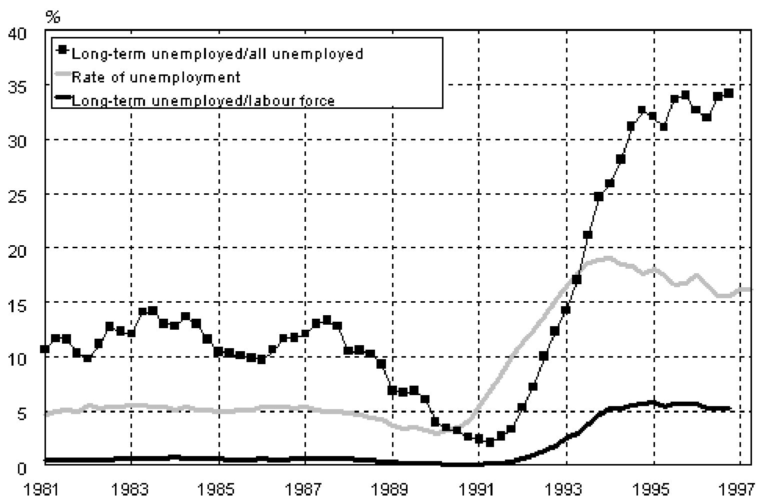
Whatever one's assessment of the real rate of unemployment, all measures of unemployment yield a similar picture of the change for the better that has occurred from 1994 onwards. Employment has increased rapidly and unemployment has fallen.

As economic recovery has proceeded, it has become increasingly clear that the structure of unemployment is rapidly changing, with an increasing trend toward long-term unemployment and joblessness amony women. Unemployment among the young and the better educated is, in contrast, falling at a rapid pace. **Figure 5.4** depicts long-term unemployment as a proportion of total unemployment. The proportion of long-term unemployment in total unemployment is not particularly high in Finland compared to other OECD countries, but the high overall unemployment rate implies that the number of long term unemployed is high relative to the labour force.

Long term unemployment indeed emerges as the main structural problem in the Finnish economy. Unfortunately, the experience of many other countries suggests that as employment spells become more prolonged, it becomes more difficult it to deal with them effectively. OECD studies also show that long-term unemployment is primarily a problem affecting older workers: the incidence of long-term unemployment increases with age in all OECD countries, save Greece and Italy. In most European countries, long-term unemployment is also a regional problem, since it tends to be concentrated in areas that typically suffer from high unemployment in general. This pattern is less clearly visible in Finnish statistics, however, since active labour market policy measures tend to cut unemployment spells in regions of high unemployment.

Economic studies of long term unemployment suggest that there is a self-fulfilling mechanism in prolonged unemployment: all things being equal, the longer the spell of unemployment, the lower is the probability of the individual concerned finding work. The connection between the generosity of the unemployment benefit system and the length of unemployment spells has also been investigated.

Figure 5.4. Rate of unemployment, rate of long term unemployment and the long-term unemployed as a proportion of all unemployed.[3]



Although not enough is known about the mechanisms underlying long-term unemployment, it seems likely that specific and probably expensive policy measures are needed to deal with the problem effectively. At present, in spring 1998, there are about 120 000 individuals who have been unemployed uninterruptedly for over one year. That is about 4.8 per cent of the labour force, which sets a lower limit on the decline of overall unemployment in the short and medium term. Recent projections of long-term unemployment put the proportion of the long-term unemployed at around 15?20 per cent of all unemployed in 2005, with the overall unemployment rate at around 7 per cent.

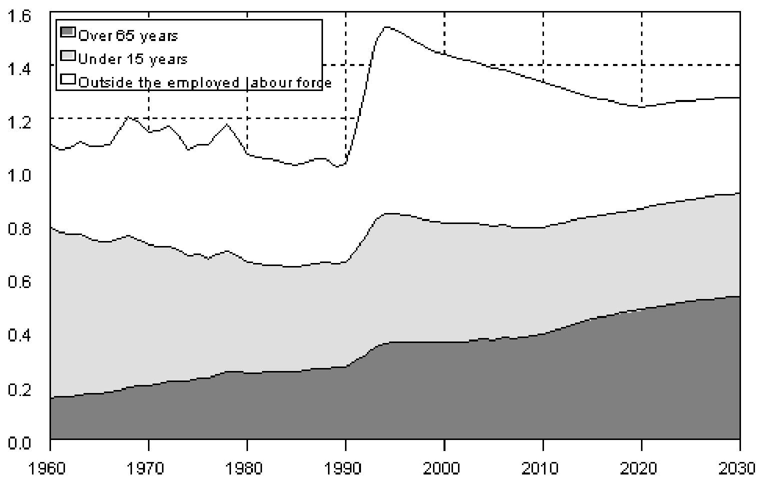
Moreover, such figures - as well as those detailed in **Figure 5.4** - probably underestimate the magnitude of the long-term unemployment problem, since it is possible for individuals to alternate between various measures and spells of unemployment. Largely because of this, the incidence of long-term unemployment is probably higher than the above figures would indicate. For example, if we could count the number of different individuals who have at some time during the past year fulfilled the criteria for long-term unemployment, the figure could amount to perhaps 8 per cent of the labour force[4], instead of the estimated 5 per cent.

The pool of the long term unemployed is affected by time, since it consists mostly of senior individuals whose average mortality and pension rate are higher than those of the rest of the labour force. But it is also affected by the menu of labour market policy measures designed to keep the individual active. An interesting and somewhat discouraging trend of recent years is the orientation of active labour market policy programmes away from the long-term unemployed and away from areas worst affected by long-term unemployment. At the end of 1994, the share of the long term unemployed in the total population of individuals encompassed by active measures was about 40 percent, but by 1997 less than 30 per cent, although the relative proportion of the long-term unemployed in the total population of unemployed people has not been decreasing (see Figure 5.4).

Thus, somewhat paradoxically, at the same time as aggregate demand for labour is increasing and it is becoming easier for most unemployed job-seekers to find work, the focus of active measures is turning away from those groups most in need. Of course, this has hardly been the effect desired by the labour authorities - and it points to the need to design even more selective and tailor-made ways to keep the long-term unemployed active.

This is a major and yet unanswered challenge for the future, especially as the ratio of the active to inactive population is going to be, after the turn of the millennium, clearly less favourable than was the case from 1960 to 1990. **Figure 5.5** displays the projected evolution of the proportion of passive to active people. From that figure we see clearly how the depression of the 1990s pushed out a significant part of the Finnish labour force - a loss which could become permanent if the return of the long-term unemployed to active working life cannot be successfully encouraged.

Figure 5.5. The ratio of inactive to active population, projection to year 2030.



At present, more than half of people aged between 55 and 64 are on a pension. That unfavourable statistic reflects the pension arrangements introduced under the more favourable economic conditions of the 1980s. Throughout the Finnish labour market, "getting rid" of senior workers by arranging a partial or full pension well before the age of 64 became a standard tactic of personnel management that appears much less appropriate in the present economic circumstances. Of course, alleviating the problem will also require measures to make work a more attractive option than retirement for senior workers. The solution to this problem is by no means straightforward. Productivity grew exceptionally fast in Finnish manufacturing industry in the first half of the 1990s, as firms were faced with high interest rates and the threat of unemployment increased the risk for workers of not fully pulling their weight. Thus, from 1991 to 1994, labour productivity in manufacturing increased about three times faster than that of Finland's main competitors[5]. As productivity has grown, occupational strain and stress have also increased, as suggested by both casual observation and more systematic studies.

The proportion of passive to active individuals disguises the fact that the age structure of the latter group will change. The "baby boom" generation born in the late 1940s will be in their 50s in the early years of the new millennium and will start to retire after 2010. New generations of employees will almost invariably be smaller than the retiring generation, which will lead to an increase in the mean and median age of workers. This could exacerbate unemployment problems and decrease professional and geographical mobility. Already at the turn of the millennium, a large part of the labour force will be of an age at which mobility is already fairly low. Of course, the "greying" of the population is a Europe-wide phenomenon, and Finland is no exception.

Another noteworthy feature of the labour market during economic recovery is the increase in employment relationships characterised as "atypical", like fixed term or casual employment. That trend, too, is common to most EU countries in the 1990s. In Finland, temporary jobs now account for about 14 per cent of male employment and 20 per cent of female employment. These figures are high by EU standards (only in Spain are they higher), but temporary labour contracts have always been more prevalent in Finland, largely because of public sector arrangements.

Temporary jobs have become somewhat more common in the private sector in the 1990s. This reflects employers' caution despite the advent of economic recovery, and the large pool of unemployed persons has so far made it feasible for most firms to avoid committing themselves to fixed, full-time employment contracts. When the labour market tightens, this trend is likely to cease as employers become more aware of labour shortages. This is to be encouraged, since most economists consider temporary jobs a mixed blessing. Although temporary contracts make it possible for firms to reduce the risks related to hiring, the widespread use of fixed term contracts does not motivate personnel or the firm to invest in firm-specific skills, and it can foster tensions between regular and temporary employees. In particular, those economies in which temporary jobs are prevalent do not in general boast higher rates of employment.

Structural and actual unemployment

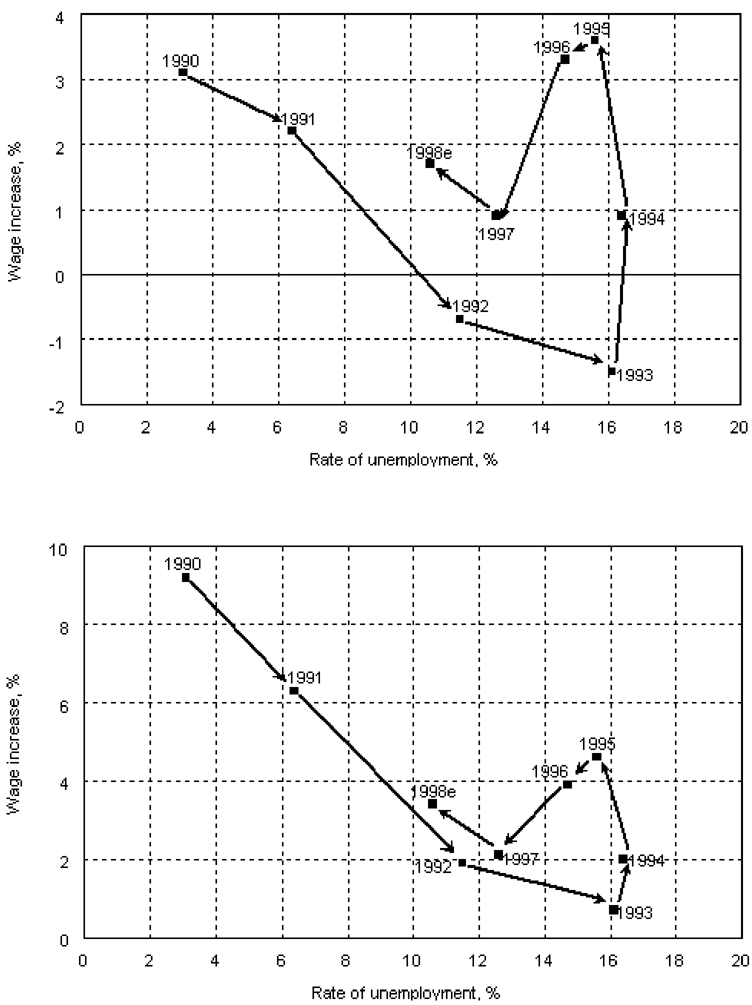
What about overall employment, then? As is apparent from figures 5.1 and 5.2, unemployment has been coming down and there are no immediate macroeconomic constraints to limit further improvement. Finland now has a very large current account surplus - amounting to 6.3% of GDP in 1998 - due to the sharp drop in domestic demand and subsequent recovery that has been based on a very rapid increase in manufacturing exports. Furthermore, as Finland is entering the euro area, the external balance of the economy is going to lose its short-term relevance. Similarly, inflation has for several years remained around its target level and there would be no need to put monetary brakes on the economy - even if that were possible: Finland is entering the euro area, and whatever happens to domestic costs in Finland is not going to affect European monetary policy. Many hope that participation in the euro area will on the whole lead to a more stable pattern of economic growth.

Thus, it is reasonably likely that Finnish unemployment can in the medium term converge to its structural level. The most recent estimates of the NAIRU[6] suggest a level of about 7 to 8 per cent with unchanged policy parameters, although previous studies have generated higher estimates. Thus, there would still be room for a drop of about 4 per cent in unemployment from its predicted 1998 average of 11 per cent. Whether and how fast that happens depends on economic growth, of course. At present, in 1998, the Finnish economy is growing healthily, at an annual pace of 4 to 5 per cent, and there are no immediate obstacles to growth.

Once unemployment has dropped to the neighbourhood of the NAIRU, new obstacles and challenges vill emerge. As pointed out above, the long-term unemployed might at present make up as much as 5 to 8 per cent of the labour force, and that group will constitute the hard core of the unemployment problem, for which it is difficult to find an effective remedy.

Furthermore, a co-ordinated wage bargaining system is inherently unstable. To keep the economy on a high growth path, pressures for wage inflation must be controlled. We noted in chapter 2 that the pace of nominal wage growth

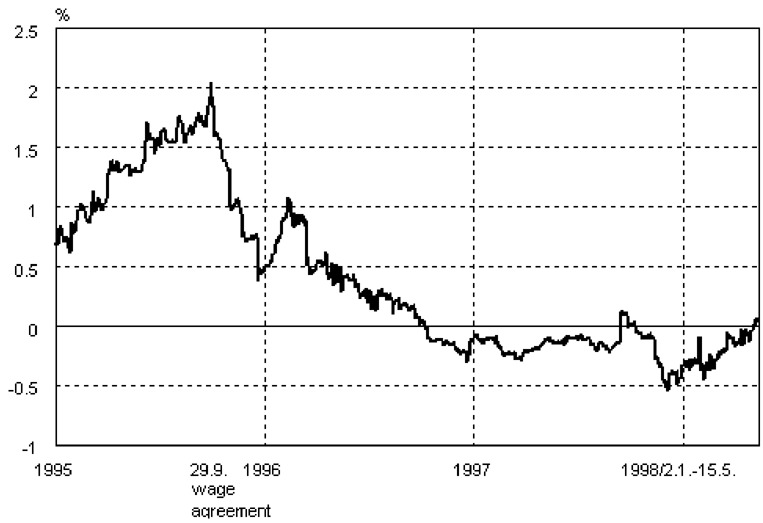
Figure 5.6. Unemployment and real (upper panel) and nominal (lower panel) wage increases in the 1990s.



had slowed. The wage-unemployment nexus of the 1990s is further illustrated in Figure 5.6. That figure clearly illustrates how the last two co-ordinated bargaining rounds have brought wage setting to a level more consistent with history and satisfactory employment growth, after the bout of wage inflation in the aftermath of the deepest phase of the recession. Another powerful illustration of the usefulness of co-ordinated wage bargains is provided by **Figure 5.7**, which shows the economy's short term interest rate differential vis-à-vis Germany. A co-ordinated wage bargain was concluded in September 1996, and it led to a substantial drop in inflation expectations and interest rates. In the dramatic economic conditions of the 1990s, such comprehensive wage agreements have worked quite well.

If there is general agreement about the necessity for wage moderation, such an incomes policy is perfectly feasible - but it can be jeopardised by many things, not least wage rivalry between industries and between sectors.

Figure 5.7. Short term interest rate differential with Germany, daily observations.



Within the single currency area, the risk of excessive wage growth is accentuated by the fact that there are no immediate warning signals that would constrain wage growth. In earlier monetary policy regimes, the current account usually weakened when domestic costs increased, which sooner or later led either to a tighter money supply or to cost adjustment through devaluation. Similarly, in recent years when the markka has been floated and the central bank has set an inflation target, it has been clear to union leaders that excessive wage claims would almost immediately lead to higher interest rates. Such a signal will be absent from the single currency policy regime. To keep unemployment low, the trade unions and workers must understand the direct connection between wage claims and employment. Indeed, many economists reckon that employer behaviour and even goods markets will change to make that connection swifter and more transparent, so that higher wages will almost immediately lead to less employment. Yet that connection may also be blurred by other shocks. If wages increase excessively in a booming economy, the (slower) adverse effect on employment may not be immediately apparent.

This is an obvious medium term problem for the Finnish economy, which at present enjoys high growth and reasonably good export competitiveness. Besides fiscal instruments, the burden of keeping the economy stable will therefore at least partly rest on incomes policy, the peculiarly Finnish policy tool. Whatever the role and feasibility of comprehensive and collective wage agreements, it seems useful, therefore, to continue to pursue wage moderation over the next 5-10 years or so. Thus, the absence of macroeconomic constraints on growth can also mean that considerations of long-term competitiveness may not be appreciated to a sufficient extent.

Such concerns may be exacerbated by inter-union rivalry. Indeed, one major future challenge is how to accommodate low nominal wage growth with the need for wage differentiation across sectors. In particular, it is expected that export firms operating in volatile markets and exposed to euro-dollar fluctuations will experience greater fluctuation in profitability than the rest of the economy. In the past, export profitability was stabilised through active exchange rate policy, whereas export shocks will in the future be more confined to specific sectors and industries.

Thus, labour market conditions in the different sectors of the economy might increasingly deviate from each other, placing open sector firms in greater need of wage flexibility. This could pose grave problems for the co-ordination of wage bargaining. It is in general quite difficult to implement co-ordinated wage contracts that would be able to differentiate pay increases between sectors. Furthermore, unions pay close attention to the accumulated wage drift of other sectors.

Manufacturing output, primarily for export, is increasing rapidly at present, and in the course of time it will becomes increasingly likely that bottlenecks will emerge and the industry will have to increase its wage costs to attract qualified labour. A possible consequence of this could be the emergence of inter-union rivalries, especially since employees in the open sector have enjoyed generous pay rises than the rest of the economy.

Consequently, if the export industry enjoys a sustained boom, its wages may drift rapidly upwards and its workers may increase their wage claims relative to the rest of the economy. Such wage inflation may well spread fairly rapidly to the rest of the economy.

When, on the contrary, export industries do less well, their wage costs should adjust downwards, but other sectors of the economy may be less flexible. Thus, if there are close wage links between sectors, strong wage growth in one sector may boost wages elsewhere in the economy, but, taking into account the overall downward stickiness of wages, the possible downward adjustment of a volatile sector is not likely to have similar repercussions.

One way of addressing this problem within the present bargaining framework would be to introduce more flexible forms of remuneration into the collective agreements or the company-specific employment contracts of export firms. To some extent, such a development is already under way: there has been an increase in profit-sharing arrangements in the metal and engineering industry at least. Such pay forms have played an extremely limited role in Finland, but they may become more relevant in some export industries. In the metal industry, the overall share of performance-related pay has risen to about 2 per cent of the aggregate wage bill. This share is still low by international standards, but it implies a clearly increasing trend. Furthermore, there are some indications that the same increase can be used to explain the relatively low wage drift that has been observed during the last couple of years. Thus, it may be the case that the pressure for wage drift that has traditionally fed into baseline wages has now to some extent at least been absorbed by performance-related pay. This is a positive development, since profit-related pay is more flexible in an economic downturn, and it is also easier for workers in other sectors such as retailing and the public sector to accept the increase of such pay forms in export firms, rather than drifting baseline wages[7] .

How can flexibility be increased?

The above discussion concerned relative wage differentials between sectors. But there are also other aspects to wage flexibility. As discussed in chapter 2, the sensitivity of wages to unemployment determines the economy's level of equilibrium unemployment.

Chapter 2 described the tight, centralised character of the Finnish wage bargaining institutions. The wage bargaining system has been a relatively centralised one, with comprehensive collective agreements and co-ordinated wage bargains prevailing most of the time. For most of the post-war period, real wage flexibility has been achieved by using accommodating exchange rate policies.

In the new monetary conditions, the wage bargaining institutions must be adapted to low inflation and devaluations will not be available to accommodate increases in wage costs. Most of the future challenges are related to the fact that a wage bargaining system accustomed to higher inflation will have to function in an economic environment of significantly lower inflation. With a multi-tier wage bargaining system, this may turn out to be difficult. At the same time, local wage flexibility should increase, at least in those export firms that operate in volatile markets and are exposed to increasingly intense global competition.

These twin challenges pose a problem for the tight, collectivistic wage bargaining system. The problem can be portrayed as a contradiction between two objectives, that of average wage moderation and that of microeconomic wage flexibility. In order to keep average wage growth within the limits of productivity growth and keep the level of wages compatible with high employment, coordination of wage bargains and a fairly "tight" collective agreements framework will be useful in the future, too. As we argued above, wage drift has probably been contained by the fact that local bargains have played a minor role in Finland. Collective agreements have maintained industrial peace and thereby checked local conflicts and local drift. To successfully adjust to low inflation, these inhibitive characteristics of the bargaining system should be preserved.

On the other hand, local wage flexibility seems to require increasing scope for local bargains and wage setting that takes into account local conditions. If an individual firm's competitive position changes for the worse, it could be useful to have the possibility to freeze or even cut wages, at least temporarily. With a binding collective agreement, that could prove difficult.

To sum up, the challenge is to increase local wage flexibility while preserving the inflation-containing characteristics of the wage bargaining institutions. If wages become more responsive to company-specific profitability, they may be adjusted downwards more readily when employment is threatened. By the same token, however, they will also increase in times of strong demand. This may jeopardise aggregate wage moderation, however, since wages are in general sticky downwards and, furthermore, there surely exist strong wage links between companies and between sectors.

One obvious question is whether present labour market regulations permit nominal wage decreases in firms that are presented with a difficult economic situation. In the light of present labour law, this is a matter open to many interpretations, and many disputes have been settled on case-by-case basis. Of course, both parties have to respect the existing collective agreement, and, once all wages have been updated by the general across-the-board increase, the employer is compelled to pay the increased wages. If the firm's revenues drop drastically, it can ask its workforce to accept pay cuts. Pay cuts can always be implemented individually if the individuals in question accept them, but in many cases it seems that the firm's workforce must be unanimous in accepting a general pay cut in order for it to take effect. Similarly, if an entire industry is in crisis, it has not been entirely clear whether a collective agreement that contains a cut in pay can overrule existing individual employment contracts and maintain industrial peace at the same time. The legal framework for pay bargaining, however, is currently in the process of being modernised.

Alternative scenarios

Wage bargaining institutions cannot be chosen or directly steered by economic policymakers, and it is impossible at this stage to predict the future course of these institutions. In the short term at least, it seems useful to keep the option of wage co-ordination alive and functioning. As to the need to increase microeconomic wage flexibility, one can imagine at least two possible trajectories, according to how the increasing pressure for local wage flexibility will affect the status and scope of collective agreements.

First, one can imagine that increasing pressure for flexibility might simply lead to collective agreements with *lower coverage* . Some firms will want to bypass the collective agreements, especially if their level of technology allows them to pay wages and salaries in excess of what the minimum tariff rates stipulate. Furthermore, they might establish internal pay schemes that allow downward adjustment of wages in unfavourable conditions. This would mean that collective agreements gradually lose their significance, proving incompatible with the need for flexibility. This is a development familiar from many other European countries.

However, another conceivable scenario is that collective agreements will gradually *incorporate* the requirement for flexibility. This would mean that the labour unions include a provision for flexible wage items in the terms of the collective agreements or agree on general rules of the game for local wage flexibility. For example, unions operating in a volatile sector may want to agree on flexible wage components in the terms of the collective agreement. These may include wage components related to some profitability or market indicator. More simply, the labour market parties may agree to temporarily abstain from holiday allowances or other extras that are otherwise part of the pay package specified in the collective agreement.

The latter scenario would probably correspond more closely to union aspirations, whereas one would expect employers to show more sympathy for the former alternative. As mentioned above, there has been an increased use of profit-sharing arrangements in some export industries, although these have traditionally played a very limited role in Finnish labour relations. Although profit-sharing schemes are increasing, the share of such payments in the aggregate wage bill still amounts to less than one percentage point of the economy's aggregate wage bill. Increased profit sharing is nevertheless a scenario that should not be ruled out in the future of the Finnish business community.

One practical reform of the present wage bargaining framework that would enhance flexibility would simply be to focus the across-the-board wage increase on the minimum tariff wage and let the individual worker and his/her employer agree on whatever is paid in excess of that. Recall from section 2 that the wage increase included in the collective agreement plays a twin role: it affects the tariff wages but is in general added to the actual wages and salaries, even if these have originally exceeded the tariff wage level. If the base year wage exceeds the minimum tariff wage, there would be no automatic obligation for the employer to apply the general increase[8]. Another alternative would be to subtract the worker's accumulated wage drift (during the last wage agreement) from the automatic wage increase.

In practice, the final outcome might be a mixture of elements from both scenarios. Different economic sectors may also diverge with respect to the bargaining framework. Traditionally, under the soft exchange rate regime, economic policy has often been aimed at stabilising and safeguarding the profitability and employment of export firms and thereby controlling the current account balance as well. Thus, there was no need for nominal wage flexibility in export firms, but the implied active monetary policy was felt throughout the economy.

In the euro area, those export firms that sell price-volatile products and that deal a lot in dollars will have the greatest need for flexibility nominal costs. In the rest of the economy, however, economic conditions will probably be more stable than hitherto, since economic policy will not be reacting to swings in the economy's external balance. Thus, the need for adjustment may be felt quite unevenly in the economy, and the challenge of nominal flexibility might ultimately be confined to some export firms. Consequently, we might see new kinds of flexible wage arrangements emerging in export firms and export industries, while sheltered sectors and the public sector might stick to more traditional pay bargaining.

In normal economic conditions, of course, there rarely arises any need for drastic wage cuts. However, that is not the case if an exceptionally severe recession hits the economy. This is unlikely, but may occur if Finland's main export sectors encounter a slump simultaneously, possibly after a boom during which asset prices have been inflating. Since currency adjustment will be ruled out, comprehensive cuts in labour costs would be necessary. With devaluation ruled out, a comprehensive wage settlement with a nominal wage freeze or even wage cuts should be attempted. Taking into account how sensitively unions react to relative differentials, a co-ordinated wage agreement is probably the only practical way of implementing such wage policies.

Whatever the future role of comprenensive collective agreements, it is useful to continue measures for wage moderation in the medium term. As indicated by Figure 5.6, the most recent pay rounds have been relatively moderate. At this stage at least, moderation seems easier to maintain with coordination. This probably has a lot to do with the fact that Finnish and Nordic trade unions pay a great deal at attention to relative differentials. Even drastic wage cuts can be acceptable to the rank and file, provided that the average member is assured that everybody else is in the same boat.

Buffer funds

The accumulation of labour market buffers is a new and interesting initiative negotiated by the labour markets parties. Although no concrete plans exist as yet, the employer and employee organisations have agreed on the desirability to accumulate capital in funds like the unemployment insurance funds. According to this idea, those funds would be accumulated by collecting higher payments in times of high growth and high employment. In recessions, this would give room for lowering indirect labour costs by running down the buffer stocks.

Other policies for lower equilibrium unemployment: taxes and labour mobility

Equilibrium unemployment also depends on institutional characteristics other than just wage bargaining institutions. The tax wedge is obviously one determinant of employment and unemployment. Taxes that affect the cost of labour are exceptionally high in Finland by EU standards, although different measures of the wedge suggest somewhat different pictures. Lowering labour taxes is therefore one natural policy objective, although the room for manoeuvre is restricted in the short term for fiscal reasons. Another possible policy direction would be a progressive restructuring of indirect labour costs, in order to alleviate the problems experienced by older, poorly educated workers.

Labour mobility is another factor that affects equilibrium unemployment. The geographical and professional mobility of labour appears to be somewhat lower than in most other EU countries, and it should also be encouraged with properly designed policies. Those policies may, however, come into conflict with regional policy objectives that have traditionally been quite ambitious.

Further reading

Labour Market Studies: Finland. *European Commission*, Employment & Labour Market series 1, Luxembourg 1996.

Pekkarinen, Jukka, and a team of experts (1997): Finland and EMU. *Prime Minister's Office*, Helsinki 1997.

Pekkarinen, Jukka, Matti Pohjola & Bob Rowthorn (eds.): Social Corporatism: A Superiov Economic System? Clarendon Press, Oxford 1992.

[1] According to the new standard, a person must have been seeking work in some way during the previous month to be registered as an unemployed job-seeker. Statistics Finland had until May 1998 applied other criteria in the case of those job-seekers who sought work at the employment offices. In those cases, before May 1998, it used to be sufficient to have sought work in the previous 3 months to qualify as an unemployed job-seeker, and before 1997 the condition was even longer, namely 6 months. The new criterion excludes from the unemployment pool those people who have not been seeking work during the previous month, so that the revised but internationally comparable unemployment figures are lower than the previous figures of Statistics Finland. Thus, the reader can expect to encounter different and higher unemployment figures when looking at pre-1998 material. See the discussion on hidden unemployment below.

[2] As is apparent from the previous footnote, the recent change in the definition of unemployment has shifted people from open to hidden unemployment.

[3] The unemployment figures used to compute these curves correspond to a former definition of unemployment, so that they do not match the curves of Figures 5.1 and 5.2.

[4] No such completely reliable statistics exist, however.

[5] However, productivity per labour unit and capital unit in Finland have traditionally been lower than the EU or OECD average, and the country still clearly lags behind the technologically most advanced countries.

[6] NAIRU, or “non-accelerating inflation rate of unemployment” is what most economists mean when they talk about structural or equilibrium unemployment. The NAIRU is the level of unemployment at which inflation does not accelerate or decelerate but remains constant. If unemployment drops below the NAIRU, the economy is prone to enter an inflationary spiral, whereas wage and price inflation declines when unemployment is above the NAIRU level.

[7] Note that economists are sceptical of profit-sharing as a general solution to the need for flexibility. This scepticism is based on both theoretical considerations and empirical observations. Yet the most important theoretical objections to profit-sharing might not be valid in the Finnish case. The main theoretical criticism of profit-sharing schemes is based on a model of firm-specific wage bargaining. If wage bargaining is conducted in individual companies, it is futile to designate a part of the wage as profit-related pay, since the bargainers are able to see through this arrangement and will anyway ask for their part of the cake, regardless of initially agreed profit-sharing parameters. This criticism might not be valid in the Finnish case, however, since there are hardly any firm-specific bargains. Thus, profit-sharing cannot be ruled out as a partial solution at least to the rigidity problem.

[8] To take an example, suppose that the tariff wage is set at FIM 60 per hour, but the individual in fact works in a high-technology firm and happens to earn FIM 75 per hour. Suppose also that the Metalworkers' Union and the Federation of the Metal and Engineering Industry agree on a general wage increase of 3.0 per cent. Under the present system, the employer must, as a rule, increase the worker's wage by 3.0 percent to FIM 75 + 2.25 = FIM 77.25 per hour, but, once this is done, the worker and his colleagues are bound by the collective agreement and cannot refuse to work or threaten to strike. The alternative, then, would be to apply the 3.0 per cent increase to the tariff wage and let the local parties bargain freely about the individual's final wage increase in the case of a worker whose base wage exceeds the tariff wage to start with. In our example, the employer may offer something less than the FIM 77.25 per hour if the firm is doing badly, whereas the worker might ask for more if the firm is doing well. In such a setting, it would of course be crucial whether the workers would be bound by a peace clause even under such negotiations. Such bargaining schemes come in many variants, of course, and the final outcome is very much up to the actions of the labour market parties.