Ministry of Finance

UNOFFICIAL TRANSLATION

STABILITY PROGRAMME FOR FINLAND

November 2002 update

1. Economic policy objectives and premises

1.1. Economic policy objectives

The primary economic policy goal of this Government, nominated in spring 1999, has been to improve employment. This has called for the adoption of an economic policy fostering stable economic growth, improving the functioning of the product, capital and labour markets and creating an internationally competitive operating environment for capital market activity and entrepreneurship.

By introducing comprehensive reforms in job creation and by boosting central government finances, provision is being made for the financial spending pressure in general government caused by the ageing of the population. Efforts have been made to enhance the efficiency of the labour markets through reforms in the tax regime and social security systems to improve employment and encourage independent initiative. Similarly, the pension schemes have been revised so that there is more incentive to stay in working life longer than before.

Strong public finances form an increasingly more significant foundation for economic stability and growth in today's euro area conditions. To this end, efforts have been made to ensure a surplus in central government, allowing for government debt to be reduced. The target set in the Government Programme was to secure a structural financial surplus (as defined in national accounts terms) in central government to reduce the central government debt-to-GDP ratio below 50 per cent during the government tenure ending in 2003. Privatisation proceeds are allocated primarily to the redemption of government debt and to promote R&D activities.

A Government Resolution reached in spring 2000 specifies that the impact of privatisation proceeds is to be excluded when assessing central government debt developments. The Government expressed in the General Strategy and Outlook section of the 2002 Budget Proposal that the central government surplus should amount to 1½ to 2 per cent of GDP on average during the current decade. This would make it possible to reduce central government debt sufficiently to secure sustainable public finances in later years.

The Government target set for central government debt was reached already in 2001. The target surplus, instead, has proven difficult to maintain owing to a significant slowdown in economic growth. The Government observed in the General Strategy and Outlook section of the 2003 Budget Proposal that budgetary position is falling clearly short of the target surplus in 2002 and 2003. The Government also points out that, with the starting position having become weaker, the significance of strict expenditure discipline and structural measures to strengthen the functioning of the markets and public sector is highlighted when making provision for the spending pressure caused by the ageing of the population.

One of the aims in the Government Programme is to keep central government spending constant in real terms at the 1999 Budget level over the whole term of office. Actual spending stayed within the Government decisions on spending limits up until 2002, when expenditure clearly exceeded the planned spending limits. Central government spending in the 2003 Budget Proposal roughly corresponds to the spending limits set for 2003. However, the expenditure level in the 2003 Budget Proposal exceeds the 1999 Budget level entered in the Government Programme by about EUR 1 billion in real terms. This is partly accounted for by cuts in taxable statutory social security contributions, with the revenue loss to the social security funds being replaced by resources from the Budget.

In its Programme, the Government committed itself to making provision for cuts totalling around EUR 1.7 – 1.8 billion (about 1½ per cent of GDP) in income taxes and social security contributions during the government's tenure in office. The focus in taxation would shift towards capital and property taxes and environmental taxes, instead. The tax burden was eased altogether by approximately EUR 2.8 billion between 2000 and 2002, of which about EUR 2.4 billion consists of cuts in taxes on labour.

In the General Strategy and Outlook section of the 2003 Budget Proposal the Government underlines the importance of prudence in tax policy decisions, as tax receipts have become more sensitive to cyclical fluctuations, making developments in tax revenue more uncertain. The Budget Proposal includes proposed tax cuts in earned income amounting to EUR 315 million. It is difficult to assess the size of the tax cuts in fully unambiguous terms. The tax rate of wage earners in the medium income bracket is calculated to come down by a good 2 percentage points from 1999 to 2003. In line with the Government Programme, the emphasis in the 2003 Budget Proposal is more on taxes on energy.

This government's tenure ends in spring 2003. The government will give the overall spending limits for 2004-2007 in spring 2003 before the end of the government period. Following the 2003 general elections and the appointment of a new government, the ministries will prepare for the possibility of revisions in the spending limits when drawing up their action plans and when formulating their operating and financial plans.

1.2. Broad economic policy guidelines

The Broad Economic Policy Guidelines (BEPGs) document is the key instrument for coordinating economic policies in the European Union. It is proposed in the 2002 BEPGs that the following should be Finland's fiscal policy priorities:

- avoid significant deviation from the medium-term spending guidelines of keeping government expenditure in real terms at the level of 1999; to this end adhere tightly to the budget's expenditure target of 2002 and adopt the necessary expenditure reducing measures in the budget for 2003;

- improving the budgetary discipline at local government level by establishing an enhanced surveillance mechanism to the recently adopted regulation requiring local governments to aim for budgetary balance in their finances in the medium-term; and

- continue with determination the ongoing process of pension reform, in particular adopt and implement at an early stage the envisaged changes in the pension formula by taking into account the increasing life expectancy and extending the period of calculation for pensionable earnings to the whole work career.

Finland's main priorities in the labour markets should be to reduce the high level of structural unemployment and to continue to increase the efficiency of labour market policy. To make work pay, the benefit schemes should be reviewed and the high marginal effective tax rates of low wage earners in particular should be lowered. Finland is encouraged to continue increasing the efficiency of active labour market programmes and to refocus them to the needs of those most prone to the risk of long-term unemployment.

Within the context of the product markets Finland should enhance competition in public service provision at the local level via increased participation of the private sector and competition between public service operators, to further reducing the time required for registering a new company to facilitate business creation and to give the Finnish Competition Authority powers to apply the EC Treaty Articles on competition legislation.

The Government's economic policy is in line with the recommendations for the economic policies of the BEPGs. Despite a weaker international and domestic economic outlook, the surplus in general government will be kept high, at over 2 per cent of GDP even in the weakest year.

Government economic policy measures related to recommendations on public finances and structural policy are described in greater detail in later sections of this Stability Programme and in the report on structural reforms[1] drawn up in November 2002.

1.3. Finland's 2002 Stability Programme Update

The Stability and Growth Pact, specifying the Treaty, establishes that Member States shall adhere to a medium-term objective for budgetary position of close to balance or in surplus.

In the 2001 update to Finland's Stability Programme, the Government maintained an aim of keeping a general government surplus of 2 to 2.5 per cent of GDP over 2002-2004. The programme fell short of the minimum target of a 1.5 per cent surplus in central government finances,

[1] Product and Capital Market Reforms in Finland, Ministry of Finance, November 2002.

which is why the Government stated in connection with the spring 2002 discussions on spending limits that it would seek means of reaching a structural surplus in central government by 2003. The Government observed in connection with the decisions on spending limits that in order to continue reducing central government debt and to make provision for the pressure on public expenditure caused by the ageing of the population, achieving a structural surplus in central government finances remains a key aim of the government. This calls for not only strict budgetary discipline but also structural reforms in the public sector and the labour market. The ongoing pension reforms play a central role in this context.

Despite slack economic growth and growing expenditure, the balance in general government is expected to be slightly better in 2002 and 2003 than estimated in the 2001 Stability Programme update. The surplus-to-GDP ratio in general government is expected to edge up by about 1 percentage point in 2002 and by around ½ percentage point in 2003 in relation to the 2001 Stability Programme update. The higher-than-anticipated surplus in 2002 is accounted for by tax revenue having grown faster than envisaged. Central government is now anticipated to stay in a slight surplus in 2002 and 2003.

Although the financial position in general government is expected to be better in 2002 and 2003 than previously forecast, notably the decline in stock market sensitive tax revenue which followed the fall in share prices will weaken public finances in relation to earlier years. The financial surplus in general government will edge down by about one percentage point on 2002 to 3.8 per cent of GDP. The surplus-to-GDP ratio is anticipated to continue falling in 2003 and 2004 but to start rising slightly after that. The surplus in general government is projected to amount to 2.8 per cent of GDP in 2006.

In line with the requirements established in the Stability and Growth Pact, the government will take every corrective action it deems necessary should the materialisation of the Stability Programme objectives be significantly jeopardised.

1.4. Processing the Stability Programme in Finland

The Stability Programme update for 2002 was drawn up after the 2003 Budget Proposal was submitted. The Stability Programme update is in accordance with the Code of Conduct endorsed by the Council in July 2001. The Programme will be delivered to the EU bodies within the agreed time frame (15 October – 1 December 2002) once it has been handled in the Government plenary session as stipulated in the Government Rules of Procedure. The Stability Programme update will be submitted to Parliament for in-formation, as in earlier years.

General elections will be held in Finland in spring 2003, when a new Government will be appointed. Hence the Stability Programme is non-binding for 2004, 2005 and 2006.

2. Economic situation and outlook

2.1. Recent developments and short-term outlook

The sluggish global economy, which has persevered for longer than anticipated, has had repercussions on the Finnish economy too. In the wake of seven years of robust economic growth, total output increased by a mere 0.7 per cent in 2001. This was based on reasonable growth in domestic demand and an increase in service production. The contribution of net exports was negative for the first time since 1989. Economic growth is expected to amount to 1½ per cent in 2002, mainly building on private consumption, while foreign trade is expected to boost growth only slightly.

With economic growth remaining subdued for the second year in a row, labour demand will cease to grow and the average unemployment rate is anticipated to rise slightly, up to 9.2 per cent. The number of employed people is expected to remain at the same level as in 2001 and the employment rate to decline slightly to 68 per cent. The rise in consumer prices has decelerated to below the euro area average this year, and the outlook in inflation is moderate.

In 2003, growth in total output is expected to accelerate to 2.8 per cent as international demand gradually recovers. Over a third of the increase will be accounted for by brisker exports and the rest by domestic demand, particularly private consumption. Domestic growth potential is fairly good, as business competitiveness as well as the financial position in both companies and households is reasonably good. Notwithstanding the anticipated boost in growth, the average unemployment rate is envisaged to continue rising marginally and the employment rate to edge down slightly. Price rises are assumed to stay at 2 per cent if wage settlements remain moderate.

Economic prospects for 2003 are rather uncertain. It is possible that the expected strengthening in the US economy could fall through again, meaning that growth potential in the international and the Finnish economy alike would weaken. The main uncertainties from the viewpoint of total output are related to the rate of recovery in the information and telecommunications markets and in developments in demand in forest products around the world.

The economic growth estimates and factors affecting growth up until 2003 as presented in Table 1 are based on the Economic Bulletin released by the Ministry of Finance on 8 November 2002, and the estimates on international developments are the same as those published by the Commission in November 2002.

1. Growth and associated factors

	2001	2002*	2003*	2004**	2005**	2006**
GDP growth at constant market prices, %	0.7	1.6	2.8	2.6	2.5	2.4
GDP level at current market prices, EUR bn	136.0	140.5	146.2	151.5	157.6	163.7
GDP deflator, % change	3.0	1.6	1.3	1.0	1.5	1.4
HICP, % change	2.7	2.1	2.0	1.0	2.0	2.0
Employment[1], % change	1.4	0.2	-0.1	0.4	0.4	0.3
Labour productivity[2], % change	-0.6	1.8	2.9	2.2	2.1	2.1
Unemployment rate, %	9.1	9.2	9.4	8.9	8.5	7.9
Sources of growth: percentage changes at constant prices						
1. Private consumption expenditure	1.1	2.5	2.5	2.8	2.6	2.4
2. Government consumption expenditure	2.1	2.4	1.4	0.9	0.9	0.9
3. Gross fixed capital formation	2.5	-0.6	0.6	1.9	1.9	1.6
4. Changes in inventories as a % of GDP	0.1	-0.3	0.1	0.0	0.0	0.0
5. Exports of goods and services	-2.2	1.9	4.5	4.2	4.0	4.0
6. Imports of goods and services	0.1	1.4	3.2	3.6	3.5	3.4
Contribution to GDP growth, % points						
7. Final domestic demand	1.8	1.6	1.6	1.9	1.8	1.6
8. Changes in inventories	0.1	-0.3	0.1	0.0	0.0	0.0
9. Net exports	-1.1	0.4	1.0	0.8	0.7	0.8
Assumptions (Commission)						
Short-term interest rate (3-month money market)	4.2	3.3	2.8	3.2	-	-
Long-term interest rate (10-year government bonds)	5.0	4.8	4.4	4.7	-	-
USD/EUR exchange rate	0.90	0.94	0.98	1.0	-	-
EU-15, GDP growth, %	1.5	1.0	2.1	2.7	-	-
World import volumes, excluding EU, %	-1.7	3.2	6.8	7.4	-	-
Oil prices, (Brent, USD/barrel)	23.6	25.5	24.1	22.5	-	-

[1] National accounts.

[2] GDP growth at market prices per person employed at constant prices.

Sources: Statistics Finland and Ministry of Finance.

2.2. Medium-term macroeconomic scenario

The assumptions in the medium-term macroeconomic projections in this paper are that both the global and the EU economy will develop as envisaged in the Commission's short-term forecast drawn up in November 2002 (Table 1). The medium-term estimates for 2004 to 2006 are based on surveys into longer-term growth prospects in the economy. The fact that the population of working age in Finland will cease to grow and that the average participation rate will fall as the population ages will have a crucial impact on economic growth. Labour supply will consequently decrease. The number of employed people is calculated to slightly increase, however, as the unemployment rate is assumed to fall. With growth in employment shifting more towards the labour-intensive service sector, productivity growth is anticipated to slightly slacken. Real wages are expected to evolve in line with average growth in productivity, and expenditure and revenue developments in central government are assumed to evolve as outlined in sections 3 and 5 of this Programme.

The projection assumptions are that the world economy will continue to recover and that economic growth in the EU will be close to 2.5 per cent between 2003 and 2004. This will also fuel growth in Finnish export demand, so that the volume of exports is estimated to grow by about 4 per cent a year between 2004 and 2006. This means that business investment will increase. With unemployment expected to be reduced and real wages to increase, household income will grow. The favourable income developments and positive economic momentum, in turn, will boost demand in consumption.

Despite the prevailing economic uncertainties and longer-term challenges, growth prospects in the Finnish economy are fairly good in the medium term. Finland's production structure focuses on competence in areas of high technology, where long-term growth potential is better than average. Should the next rounds of wage negotiations remain moderate, domestic demand will not become an impediment to economic growth either. With growth in the global economy accelerating, these fundamentals provide good opportunity for exports to recover.

The markets of Finnish market enterprises are also expanding, as demand in health care and nursing services is growing along with the ageing of the population. The potential for improving productivity by means of new technology has so far not been fully exploited in domestic production activities. If this can be carried out successfully, it would be possible to achieve more output growth, even though labour supply is calculated to start falling in the near future as the baby boom generations reach retirement age.

If the international economy evolves favourably in the medium term and domestic cost developments remain moderate, based on the assumptions made in the scenarios, average economic growth would amount to around 2½ per cent a year between 2002 and 2006. This is a faster rate of growth than in the past few years but clearly slower than in the latter half of the 1990s. The employment rate would stay more or less unchanged in the range of 68 per cent up until 2006 and unemployment would edge down to about 8 per cent.

In addition to the baseline scenario, slower and faster growth scenarios were also drawn up. These are presented in section 5.1. of this Programme.

3. General government: balance and debt in 2002-2006

3.1. Fiscal policy strategy

With a view to fostering stable economic growth which can boost job creation, the key fiscal policy objective in the Government's economic policy is to create a structural surplus in central government finances. Carrying out the objective builds on four-year central government spending limits that are approved annually and on the annual budgets that are drawn up on the basis of them. The spending limits for the period between 2003 and 2006 were approved on 14 March 2002. Based on these limits, total expenditure in central government will slightly decrease in real terms between 2004 and 2006. To stay within the spending limits, the next government will need to ensure much slower growth in central government expenditure than between 1999 and 2003, when spending in the ministries increased in nominal terms by about 4 per cent a year. Real spending grew by approximately 2 per cent a year.

Within the Stability Programme, central government spending for 2002 is in line with the Budget and the two supplementary budgets. Central government expenditure for 2003 is based on the 2003 Budget Proposal and it is assumed to stay within the spending limits between 2004 and 2006. New decisions on spending taken since March 2002 and precisions in the spending estimates caused by changing economic prospects have been taken into account in the expenditure. As a result, central government spending figures in the Stability Programme update will show somewhat faster growth than those in the 2002 decision on spending limits.

In the Programme, central government revenue in 2002 and 2003 is in line with the November short-term forecast. Beyond 2003 the tax revenue estimates were drawn up on the basis of the medium-term macroeconomic scenario. The revenue estimates make provision for reductions in taxes on production and imports as of 2004, deriving from changes in certain tax bases. With economic integration expanding and deepening during the projection period and with international tax competition becoming tougher, pressure on earned income and capital taxes is mounting. An anticipated fall in some indirect tax receipts was taken into account in the estimates. However, the exact extent and timing of tax pressure is very difficult to assess. Corporate income tax revenue was reduced in the medium-term scenario on the basis of tax competition whereas it was not taken into account in the estimates on labour taxation (more details on tax pressure are found in section 5.2).

The administrative structure of Finland's general government consists of the central government administration, local government administration (comprising municipalities and federations of municipalities) and the social security funds. Although private insurance companies mainly handle Finland's employment pension system, it is classified – owing to its statutory nature – under social security funds belonging to general government.

The projections for local government finances are based on the estimates of the Advisory Board for Municipal Economy and Administration and on the above-described macroeconomic scenario. Changes taking place in the finances in the relations between central and local government are described in section 7.2. The financial position in the social security funds builds on macroeconomic developments, drawing on existing legislation and on forthcoming amendments.

3.2. General government balance and debt

The surplus-to-GDP ratio in general government will clearly fall in the next few years. In 2002, the surplus is estimated to decrease to 3.8 per cent of GDP, which is almost half the level recorded in the peak year of 2000. In 2004, it is forecast to further decline to 2.1 per cent, but to edge up to 3 per cent towards the end of the projection period.

Central government finances, having consistently shown a surplus since 2000, are anticipated to fall into deficit during the review period in this Stability Programme. A small revenue surplus will still be recorded in central government in 2002 and 2003, but with tax revenue decreasing, central government will go into deficit in 2004 and

2. General government budgetary developments, % of GDP

	2001	2002*	2003*	2004**	2005**	2006**
Financial balance						
General government	4.9	3.8	2.7	2.1	2.6	2.8
Central government	2.0	0.9	0.3	-0.5	-0.2	0.0
Local government	-0.4	0.0	-0.4	-0.3	-0.4	-0.4
Social security funds	3.3	2.9	2.8	3.0	3.1	3.2
General government						
Total revenues	52.0	51.3	49.9	49.1	49.0	48.9
Total expenditures	47.1	47.5	47.1	46.9	46.4	46.1
Financial surplus	4.9	3.8	2.7	2.1	2.6	2.8
Net interest payments	0.7	0.4	0.1	0.2	0.0	-0.1
Primary balance	5.6	4.2	2.9	2.3	2.6	2.7
Components of revenue						
Taxes	32.6	32.4	31.2	30.2	30.0	29.8
Social security contributions	12.5	12.2	12.0	12.2	12.3	12.5
Other revenues	6.9	6.8	6.7	6.7	6.7	6.7
Total revenues	52.0	51.3	49.9	49.1	49.0	48.9
Components of expenditures						
Collective consumption expenditure	7.6	7.7	7.7	7.6	7.6	7.6
Individual consumption expenditure	13.5	13.8	13.9	13.9	13.9	14.0
Social income transfers	16.6	16.8	16.6	16.6	16.5	16.4
Interest payments	2.7	2.5	2.4	2.3	2.2	2.1
Subsidies	1.5	1.5	1.5	1.5	1.5	1.5
Gross fixed capital formation	2.6	2.5	2.3	2.2	2.2	2.1
Other expenditures	2.7	2.7	2.7	2.7	2.6	2.6
Total expenditures	47.1	47.5	47.1	46.9	46.4	46.1

Sources: Statistics Finland and Ministry of Finance

3. General government debt developments, % of GDP

	2001	2002*	2003*	2004**	2005**	2006**
Gross debt level, % of GDP	43.4	42.5	41.9	41.9	41.4	40.7
Change in gross debt, %	-0.6	-0.9	-0.6	0.0	-0.5	-0.7
Contributions to changes in gross debt, %						
Primary balance	-5.6	-4.2	-2.9	-2.3	-2.6	-2.7
Net interest payments	0.7	0.4	0.1	0.2	0.0	-0.1
Impact of nominal increase in GDP	-1.6	-1.4	-1.7	-1.5	-1.6	-1.6
Stock flow adjustments	5.9	4.3	3.8	3.6	3.8	3.7
- Public sector consolidation 1)	1.9	0.7	0.3	0.2	0.2	0.2
- Privatisation receipts	0.0	-0.9	-0.3	-0.3	-0.3	-0.3
- Net accumulation of financial assets	4.0	4.5	3.8	3.7	3.9	3.8
Implicit interest rate on debt	5.9	5.8	5.8	5.4	5.5	5.3

[1] The employment pension funds are assumed to reduce their investments in central government assets by EUR 1.0 billion in 2002, by EUR 0.5 billion in 2003 and by EUR 0.3 billion in 2004 to 2006

Sources: Statistics Finland and Ministry of Finance.

2005[2]. The position in central government is predicted to be in balance in 2006.

Local government went into deficit in 2001, when growth in tax revenue slowed down considerably from the previous year's record rate and spending accelerated. Local government is expected to be in balance in 2002. It is forecast to remain in a slight deficit between 2003 and 2006. Central government transfers to local government in current expenditure comprise a halved index adjustment based on the new obligations imposed by central government and on the rise in costs. With the revenue base becoming more uncertain and expenditure pressure mounting, local government finances will be tight the next few years. Differences in the financial positions between individual municipalities will remain large. However, the medium-term balance obligation compels municipalities to maintain their finances roughly in balance over a three-year planning period. To this end, revenue in local government has been made less sensitive to cyclical fluctuations and better budget monitoring is being developed. Moreover, local authorities are making concerted efforts to enhance their operating modes (cf. section 7.2).

The financial surplus in the social security funds is set fall slightly in 2002 and 2003 as a result of cuts made in social security contributions, but once they are raised again in 2004, the surplus will rise to approximately 3 per cent of GDP. The surplus in the social security funds will be accumulated in the statutory earnings-related pension funds, while the finances in the other social security funds, namely the Social Insurance Institution and the unemployment insurance fund, is mainly based on the pay-as-you-go system. With health insurance expenses growing fast and the health insurance contributions payable by pensioners having been lowered, central government on-budget funds to the Social Insurance Institution will increase in 2003. The unemployment insurance fund will fall into deficit in 2003 owing to reductions in unemployment insurance contributions. The deficit will be covered by releasing financial reserves from the 'EMU buffer' included in the fund. All in all, apart from the earnings-related pension institutions, the social security funds will be more or less in balance over the review period.

The market value of the assets in the statutory earnings-related pension funds amounted to 50 per cent of GDP at the end of 2001. The buffer funds, which were motivated by Finland's participation in Economic and Monetary Union and which were set up within the social security funds, reached their full level ahead of schedule. The maximum in the buffer accumulated within the equalisation fund of the private sector earnings-related pension scheme corresponds to 2½ per cent of the annual payroll in the private sector, while the buffer which has been accrued in the unemployment insurance fund corresponds to annual earnings-related unemployment benefit expenses corresponding to an unemployment rate of 3.6 per cent.

From the viewpoint of the funding of social protection, the years 2003-2006 are a time for preparation because, with the population ageing, the situation will weaken rapidly after the period under review. The longer-term challenges facing the national economy and public finances caused by the ageing of the population are discussed in more detail in section 6 and the appendix.

The debt-to-GDP ratio in central government is estimated to be reduced by approximately 15 percentage points to about 41½ per cent by the end of this government in 2003, but if the effect of privatisation proceeds of government assets is excluded, it would amount to around 46½ per cent in 2003. The central government debt-to-GDP ratio is forecast to edge down to 39 per cent over the projection period. The stock of debt in local government is growing marginally, but no significant changes are anticipated in the debt-to-GDP ratio by 2006.

With the earnings-related pension funds reducing investment in Treasury bonds and with the earnings-related pension funds in central government growing, the general government debt-to-GDP ratio will decrease only slightly. General government gross debt is calculated to range around 40 per cent of GDP in 2006, i.e. only 3 percentage points down on the level recorded at

[2] If the incomes policy settlement for 2003-2004 contracted by the central labour market organisations on 18 November 2002 is widely approved in the union-level negotiations, the government will make a commitment to lower taxes and adopt measures to improve employment. The measures would weaken central government finances by EUR 100 million at an annual level, about 0.07 per cent of GDP. The impact would be smaller in 2003. The majority of the increase in spending would be fixed-term, with permanent expendit ure increases amounting to EUR 24 million, i.e. 0.016 per cent of GDP.

the end of 2001. Growth in national product will reduce the general government debt-to-GDP ratio by altogether 8 percentage points between 2002 and 2006. The surplus in general government will accumulate in the form of net growth in other financial assets, as illustrated in Table 3, as the surplus will be accrued almost entirely in the earnings-related pension funds.

3.3. Structural balance in public finances

The cyclically adjusted structural balance in general government is expected to be roughly the same over the review period as the projected general government balance (Table 4).[3] The cyclical factor, which is assessed by factoring out business cycle effects by means of the deviation from the trend in total output, is calculated to be in the range of zero during the projection period. Although output grew slowly in 2001 and is expected to be slack in 2002 too, the calculation shows that the level of production has merely returned to the trend level, as the slowdown in output growth was preceded by several years of faster-than-average growth. With growth in production anticipated to stabilise in the range of 2½ per cent between 2003 and 2006, it means that in the computations it will stay on the path of potential output growth. Since the level of production was still well over the trend level in 2001, it would appear that in 2002 the structural balance would weaken less than the actual balance.

Trend deviation is a rough means of gauging the effect of cyclical fluctuations. A particular problem in Finland is that this type of measurement fails to take into account the fact that the tax base grew temporarily when asset values rose. This means that the exceptional increase in tax revenue generated by the in rise in share prices suggests an improvement in the computed structural balance, so that Finland's structural balance is overestimated especially for 1999 and 2000 and to some extent for 2001 (owing to the lag in tax collection) merely on the basis of a temporary increase in revenue. The structural balance estimates over the period covered by this Stability Programme do not include this misrepresentation.

[3] The estimates make use of the HP-filter technique trend method presently employed by the Commission in calculating potential production. The calculations were also made using the Commission's new production function method. The calculations do not differ significantly from those using the HP-filter technique, but do include some problems in the case of Finland. The computations have illustrated that it is essential to further develop the NAIRU model used when estimating structural unemployment.

4. Cyclical developments, % of GDP

	2001	2002*	2003*	2004**	2005**	2006**
1. GDP growth at constant prices	0.7	1.6	2.8	2.6	2.5	2.4
2. General government financial balance, % of GDP	4.9	3.8	2.7	2.1	2.6	2.8
3. Interest payments, % of GDP	2.7	2.5	2.4	2.3	2.2	2.1
4. GDP trend, %-change	3.2	3.0	2.9	2.8	2.7	2.7
5. Deviation from GDP trend, % change	2.1	0.5	0.3	0.2	-0.1	-0.1
6. Cyclical budgetary component, % of GDP	1.3	0.3	0.2	0.1	0.0	-0.1
7. Cyclically-adjusted balance, % of GDP	3.7	3.5	2.5	2.0	2.6	2.9
8. Cyclically adjusted primary balance, % of GDP (2 - 6 + 3)	6.4	6.0	4.9	4.4	4.8	5.0

Sources: Statistics Finland and Ministry of Finance.

4. Sensitivity analysis and comparison with last year's programme

4.1. Risks in economic developments and impact on public finances

Economic developments projected in this Stability Programme involve considerable risks even in the short term. Growth in the global economy could prove slower than forecast, as recovery in the world economy remains uncertain. The fact that the information and telecommunications sector plays such a significant role in the Finnish economy creates uncertainty in domestic economic developments. It is particularly difficult to predict how demand in these products will evolve. Growth potential in the field could improve appreciably, but much weaker developments are not to be excluded either. Thus, developments in the Finnish economy could prove weaker or stronger than the projection in the Stability Programme depending on the business cycle in one branch of industry.

The risks in the medium term are related to employment and productivity prospects. The baseline scenario for public finances presented in the Stability Programme is based on the assumption that the ageing of the population and a concentration in growth towards the service sector, where productivity is low, will slow down medium-term productivity and growth compared with developments in the late 1990s. Growth could prove even weaker if for instance the pension reform fails to discourage entry into retirement to the extent assumed in the baseline scenario and if growth in productivity slows down more than projected. On the other hand, growth could prove to be faster than in the baseline scenario if the productivity and employment rates rise. In this context, higher productivity in the service sector plays a particularly significant role. To boost productivity in the service sector, it is not so much a case of introducing new technology as the ability to adopt and apply existing technological applications. By improving the functioning of the labour markets, by creating better incentives in the tax and social security schemes and by making the education system more effective, the employment rate could be raised.

The below figures present the impact a slow growth and fast growth scenario would have on the financial balance and debt in general government. The two alternatives are based on a mechanical assumption where production growth deviates in one or the other direction by one percentage point from the baseline scenario.

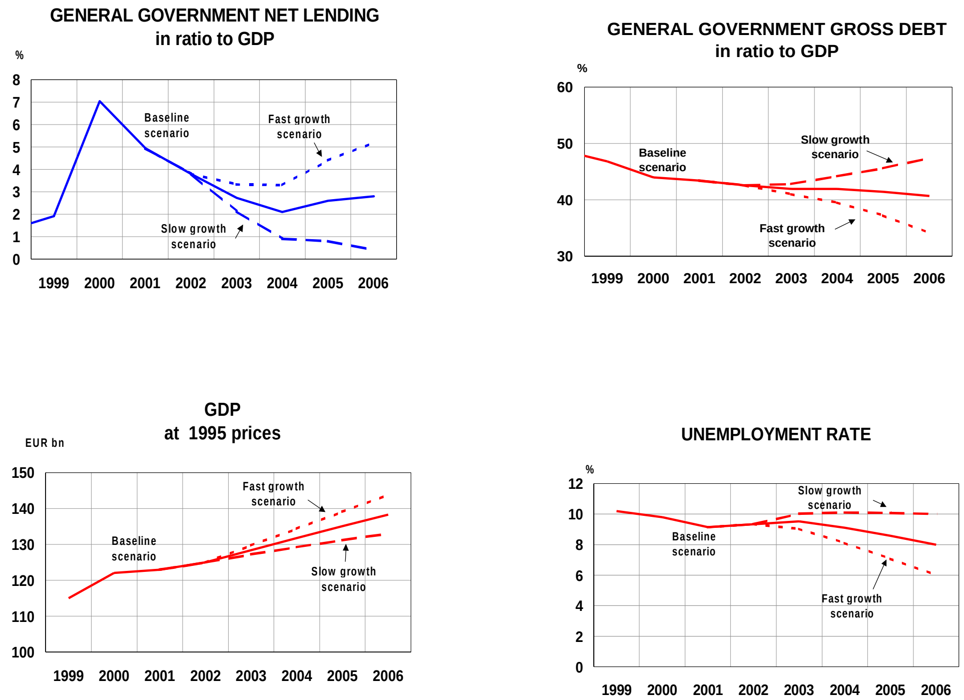
In the slow growth alternative, production growth would average around 1.5 per cent between 2003 and 2006, and the unemployment rate would be over 10 per cent. General government would remain in surplus throughout the review period, but central government would show a deficit. The debt ratio in central government would start rising, making longer-term prospects weaker due to the ageing of the population.

The more favourable alternative shows that economic growth would range around 3.5 per cent on average and the unemployment rate would fall below 6 per cent. In this scenario the general government surplus would be over 5 per cent of GDP and central government would also show a surplus (Figure1).

The sensitivity of public finances to fluctuations in interest rates was estimated using calculations where the interest rate level was allowed to diverge, from the beginning of 2003, by one percentage point either upwards or downwards from the baseline. In the high interest rate alternative, total output and employment - which are important for the balance in public finances – would diverge very little from the baseline scenario and the balance in general government would be only nominally weaker than in the baseline. In the slow interest rate alternative, general government developments would be only slightly better than in the baseline. A one percentage point change in interest rates has less impact on the balance in public finances than does a one percentage point deviation in economic growth.

In the light of these calculations, general government would stay in a surplus even if economic growth turned out to be somewhat slower than assumed in the baseline scenario. A higher-than-anticipated interest rate level would not lead to a deficit in general government either.

Figure 1. General government net lending, general government gross debt, GDP growth and unemployment rate in the scenarios



Sources: Statistics Finland and Ministry of Finance.

4.2. Comparison with last year's Stabili ty Programme update

In 2001, economic growth slowed down almost exactly as envisaged in the Stability Programme update for 2001 (Table 5), where GDP was predicted to grow 0.6 per cent in 2001 as opposed to the 0.7 per cent preliminary estimates in the national accounts. Developments on the labour markets were also close to the projection. Likewise, the surplus in general government was nearly the same as had been predicted, forecast at 4.7 per cent of GDP in the Stability Programme and recorded at 4.9 per cent in 2001.

The economic outlook for 2002 remains more or less the same as assumed in last year's update. However, the general government surplus in relation to GDP is now anticipated to be a good one percentage point higher, the central government surplus-to-GDP ratio to be around ½ percentage point larger and the surplus in the social security funds to be slightly better than forecast in the 2001 update. Local government also promises to reach balance as opposed to the previously predicted deficit.

The larger-than-anticipated general government surplus in 2002 is accounted for by faster growth in tax revenue and social security contributions than previously forecast. Receipts in corporate income taxes, in particular, decreased less than assumed a year ago. General government expenditure in relation to GDP, instead, has evolved as predicted.

The growth forecast for 2003 has not changed from the 2001 estimate either, whereas the medium-term projection is now expected to prove weaker than earlier anticipated. Economic growth is envisaged to be slightly slower in 2004 than estimated in the 2001 update. This is based on the fact that the international economy has been slow to recover and that the forecast for medium-term growth potential is now more cautious. The growth projections for 2005 and 2006 roughly correspond to the medium-term trend in growth.

The surplus in general government in 2003 is assumed to be somewhat better than estimated in last year's Stability Programme update. This is because the surplus for 2002 has been revised upward, which raises the starting level in revenues for 2003. In 2004, the general government surplus is expected to prove smaller than previously predicted, mainly because expenditure is expected to grow faster and also because tax revenue is estimated to be somewhat lower than previously forecast. The general government debt-to-GDP ratio is likely to be reduced at a slightly slower rate than envisaged in last year's update.

5. Divergence from previous Stability Programme update, % of GDP

	2001	2002*	2003*	2004**	2005**	2006**
GDP growth						
Previous update (2001) %	0.6	1.6	2.7	3.0	-	-
Latest update (2002) %	0.7	1.6	2.8	2.6	2.5	2.4
Difference, % points	0.1	0.0	0.1	-0.4	-	-
General government financial balance						
Previous update (2001) % of GDP	4.7	2.6	2.1	2.6	-	-
Latest update (2002) % of GDP	4.9	3.8	2.7	2.1	2.6	2.8
Difference, % points	0.2	1.2	0.6	-0.5	-	-
Gross debt levels						
Previous update (2001) % of GDP	42.7	42.9	43.0	41.8	-	-
Latest update (2002) % of GDP	43.4	42.5	41.9	41.9	41.4	40.7
Difference, % points	0.7	-0.4	-1.1	0.1	-	-

Sources: Statistics Finland and Ministry of Finance.

5. General government revenue and expenditure

5.1. Government policy

The government's key fiscal policy objective has been to bolster general government finances in order to make provision for the impending ageing of the population. By restricting growth in spending and by adopting tax policies that enhance job creation, central government debt has been reduced and the financial base in public services strengthened. Likewise, allocating more resources to education has boosted economic growth potential. Special emphasis has been placed on combating poverty and social exclusion. Creating incentives to stay in working life longer before retiring has enhanced longer-term growth prospects.

5.2. General government revenue and taxation

The general government revenue ratio is anticipated to fall from 52 per cent in 2001 to 49 per cent in 2006. Tax revenue is forecast to grow slower than nominal GDP over the whole of the period reviewed in this Stability Programme. The average tax ratio, i.e. the proportion of taxes and social security contributions in relation to GDP, will come down especially in 2003 and 2004, when tax accrual in corporate income and production and imports are set to fall substantially. The erosion in the tax base is expected to also slow down growth in tax revenue in 2005 and 2006.

Income and property taxes will increase by a good 2 per cent in 2002. Certain tax remittances from 2001 will boost tax receipts next year whereas lower tax scales and higher tax deductions will reduce tax revenue by an estimated EUR 0.7 per cent (0.5 per cent of GDP). This year, a larger share of corporate income tax yield will go to central government than last year, as the apportionment allocated to local government was lowered at the beginning of the year. Central government, in turn, abolished the system of VAT refund redemptions collected from local government. The joint effect of these two changes is neural in local government. Tax receipts on production and imports will continue to grow slightly slower than private consumption. Overall tax revenue is anticipated to grow by 2.6 per cent in 2002.

With the basis for charging social security contributions having been lowered, revenue in contributions is not expected to grow in 2002. The unemployment insurance contributions of both employers and employees were brought down by 0.3 percentage points, the health insurance contributions of pensioners by 0.8 percentage point, the national pension contributions of employers by about 0.5 percentage point and the employment pension contributions of employees by 0.1 percentage point. The employment pension contributions of employers in the private sector rose by 0.1 percentage point and those of local authorities by 0.4 percentage points. Owing to a lower basis for charging contributions, the ratio of social security contributions to GDP will fall slightly in 2002.

Tax revenue is anticipated to grow only slightly in 2003. Income and property tax receipts are expected to decrease on the previous year, as the accrual in corporate income taxes is set to fall substantially. Taxes on production and imports will also grow slower than the tax base. Cuts in income taxes will reduce tax revenue only slightly. The 2003 Budget Proposal suggests lowering all marginal tax rates in central government by 0.3 percentage point and raising the income thresholds in the tax scales by 1 per cent. In addition, both the standard deduction for work-related expenses and the earned income allowance levied in municipal taxation will be raised. Altogether, the tax cuts account for about 0.2 per cent of GDP at an annual level[4].

To offset the cuts in taxes on labour, the 2003 Budget Proposal advises raising taxes on energy and the environment. Taxes on liquid fuels, electricity, coal, natural gas and peat will be increased by around 5 per cent. Numerous local authorities are also planning to raise municipal taxes and taxes on immovable property in 2003 to improve

[4] If the incomes policy settlement for 2003-2004 contracted by the central labour market organisations on 18 November 2002 is widely approved in the union-level negotiations, the government pledges to lower taxation so that marginal tax scales would come down by 0.5 percentage points, the maximum standard deduction for work-related expenses would be raised and unemployment insurance contributions would be lowered from 0.4 per cent to 0.2 per cent.

their financial situation. The average income tax rate in municipalities is calculated to increase by ¼ percentage point.

The accrual in social security contributions is set to grow at about the same rate as the wage bill in 2003, as no significant changes in the basis for charges are forthcoming. Employment pension contributions are expected to be raised slightly whereas unemployment pension contributions are assumed to be further lowered. This reduction will be funded by releasing reserves from the buffer fund. It was agreed in connection with the Budget Proposal that the extra health insurance contribution payable by pensioners would be discontinued.

Tax receipts from alcoholic beverages and tobacco are expected to decrease in 2004, when Finland's transition period for free import of alcohol and tobacco from other EU Member States terminates. As a result, tax revenue is calculated to fall by EUR 1.2 billion (nearly 1 per cent of GDP) by 2006.

Tougher international tax competition related to broader and deeper economic integration will hamper growth in tax revenue in general, which in turn will slowly erode the tax base. Taxes payable to Finland by companies, in particular, are expected to decrease over the review period.

In line with the Government Programme, taxes levied on wages have been brought down annually between 2000 and 2003 by a sum equivalent to around 2 per cent of GDP. The average tax wedge of wage earners (i.e. the ratio of income taxes, social security contributions payable by employers and employees and VAT to labour costs) has decreased, as the bases for levying taxes and contributions have been eased during this government period. The tax wedge for low-income brackets has been reduced by about 2.7 percentage points down to 53 per cent since 1999 and for high-income brackets by 2.1 percentage points to around 63 per cent.

In spite of these tax cuts and changes in the tax structure, the tax wedge remains high from the viewpoint of job creation. Indeed, taxes on labour should be further lowered, and international tax competition creates pressure to ease the taxation of highly qualified professionals. The assumption in the Stability Programme is, however, that inflation adjustments will be the only changes to be made in income tax scales between 2004 and 2006. Earnings-related pension contributions are assumed to rise slightly each year between 2003 and 2006, so that provision can be made for the forthcoming growth in pension expenditure. As part of the pension reform, the labour market organisations agreed to raise the prefunding rate of earnings-related pensions until 2013.

5.3. General government expenditure

The ratio of general government expenditure to GDP has fallen almost uninterruptedly since the early 1990s. Tough budgetary discipline and brisk economic growth have helped to lower the expenditure-to-GDP ratio by about 15 percentage points since the peak level of the early 1990s. The spending rate is expected to cease falling during this Stability Programme period.

Public spending will grow faster than total output in 2002. Central government spending is estimated to increase faster than in earlier years, in part owing to growth in social transfers and in local government financing. Nearly half of the increase in spending is accounted for by changes in accounting practices, which are related to changes in the financial relations between central and local government (detailed description presented in the 2001 Stability Programme update).

Central government on-budget spending exceeded by almost EUR 1 billion the spending cap set out in the 2002 Government Programme, which was to keep expenditure constant in real terms at the 1999 Budget level. The comparison makes allowance for changes in the Budget recording technique, changes in the tax bases that give rise to various current transfers within general government (central government transfers to the Social Insurance Institution), and expenditure against which revenue has been received from the EU.

Spending in local government will also continue growing fast in 2002, with notably consumption expenditure growing fast. Benefits and allowances disbursed by the social security funds are set to grow by 5 per cent. Earnings-related pension expenditure will increase as a result of a substantial rise having been made in the pension index. Part-time pension expenditure and health insurance reimbursements will also grow rapidly.

General government expenditure is expected to grow by over 3 per cent in 2003. Spending in central government is calculated to be up by 4 per cent, with especially income transfers, mainly pension expenses and transfers to local government and social security funds growing. Real growth in central government consumption is likely to be modest, and interest expenses will continue decreasing. The 2003 Budget Proposal shows that expenditure is more or less in line with the spending limits established for 2003.

The ratio of local government expenditure to GDP is anticipated to decrease in 2003, as municipalities are expected to reduce investment owing to a tight financial position. Improvements in social security services provided by local authorities will be reflected in terms of growth in consumption and in central government transfers to local government. Expenditure in the social security funds, instead, will grow slower in 2003 than in 2002, because the index adjustment in pensions will be smaller next year. On the other hand, rising unemployment will increase unemployment benefit expenses. Health insurance reimbursements are also anticipated to continue growing fast.

The ratio of general government expenditure to GDP is forecast to fall between 2004 and 2006. A key assumption in the Stability Programme update is that spending in central government will not exceed the spending limits decided in spring 2002, which include the impact of decisions taken since spring 2002. This means that in order to keep within the spending limits, any new expenditure items would have to be financed by cutting expenses in existing items or by terminating some functions and through greater efficiency and reorganisation. Based on the spending limits, central government expenditure would remain at the 2003 spending level in real terms.

The expenditure-to-GDP ratio in local government is projected to remain more or less unchanged. Spending pressure in local government will be great in the next few years, but with the general financial outlook in local government weakening, growth in expenditure will be restrained. Moreover, local authorities have set up projects aimed to make service production more effective and the cost structure lighter. A number of projects to create new joint municipalities are also underway.

The structure of public expenditure is not expected to change much over the projection period. The public expenditure-to-GDP ratio will rise marginally, as more funds are being allocated to health care and social services. The overall proportion of social transfers is calculated to fall to some extent, as better job prospects will reduce unemployment expenditure in the latter part of the review period. This will offset the growth in old-age pension expenses generated by an increase in the number of pensioners. Investment expenditure is predicted to grow slightly slower than GDP. The ratio of subsidies to nominal GDP is forecast at 1.5 per cent throughout the review period.

6. Sustainability in public finances

6.1. Measures to foster sustainability

The impending rise in costs caused by the ageing of the population and the narrowing down in the revenue base resulting from labour force supply cast a shadow over Finland's longer-term public finances. The ageing effect will be reflected in economic developments quite shortly, as pension expenditure will accelerate and the labour force will decrease in about 5 years' time, once the baby boom generations born just after the war reach retirement age.

Provision for the financial and expenditure pressure caused by the ageing population has been made by

- bolstering central government finances by means of strict spending policy,
- prefunding for future pensions,
- fostering growth potential in the economy.

By ensuring a structural surplus in central government and by reducing government debt, room for manoeuvre has been made so that the expenditure growth and weaker revenue base caused by the ageing of the population does not lead to a new rise in the central government debt ratio. The prefunding of earnings-related pensions has made it possible to considerably ease the pressure to raise pension contributions in the future. Reforms in the tax and social security schemes have been used to perk job creation and encourage individual initiative. By investing in competence and by fostering entrepreneurship and innovation, efforts have been made to boost economic growth, and more efficient and better quality services in the public sector serve the same purpose.

While agreement was reached on a large part of the broad pension reform already in November 2001, the social partners finally endorsed the whole pension package in September 2002. The aim of the reform is to improve sustainability in public finances. The government drew up legislative proposals on the basis of the settlement reached with the social partners for reforming the employment pension system in the private sector in a very stringent time frame and the proposals were submitted to Parliament already in October 2002. The Parliament's aim is to pass the bills during the current government period (ending in spring 2003). Negotiations to revamp the pension systems in the public sector are still in progress, with a view to reaching agreement towards the end of the year or early next year. The aim is to contract an agreement along the same lines as the settlement in the private sector. These legislative proposals should be submitted to the new Parliament shortly after the general elections in the spring.

Main elements in the reform:

• The early retirement schemes (individual early retirement and unemployment pension) will be discontinued, to be replaced by a flexible old-age pension. Those aged between 62 and 68 are eligible for this option. After the age of 63 only old-age or part-time pensions are granted.

• The minimum age in the 'unemployment pipeline' will rise by two years from the current 55 to 57 and the maximum age will rise from the existing 60 to 65. The rise in the maximum age in the unemployment pipeline partly replaces the unemployment pensions, which are to be discontinued.

• The minimum age of eligibility for part-time pension will rise from 56 to 58.

• The integration (60 per cent pension ceiling in relation to earnings) of private earnings-related pensions will be discontinued.

• Old-age pension will accrue at a rate 1.9 per cent a year between the ages of 53 and 62 and by 4.5 per cent a year between 63 and 67 instead of the ordinary 1.5 per cent. This means that those with a long work history will be able to accumulate a much higher pension than on current terms.

• The present rule for computing pensionable wages where the last 10 years at work are used as the basis for computation will be replaced by a system of average wages, which takes earnings for the whole work history into account. The index used to adjust earnings to the level prevailing at the time of retirement will be modified from the existing 50/50 index to one where the weight of the wage and salary index is 80 per cent and that of the consumer price index 20 per cent.

• Adjustments made in earnings-related pensions will start using one index instead of the current two. The weight of wages in the index is 20 per cent and that of prices 80 per cent. National pensions (basic pension insurance) will be adjusted once a year using the consumer price index.

• A mechanism where pension security is adjusted to changes in life expectancy will be introduced to eliminate the increase in earnings-related pension expenses arising from longer life expectancy.

• To offset the rise in employment pension contributions caused by the baby boomers retiring, the prefunding of pensions will be stepped up from 2003 onwards for a fixed period of time. The aim of the extra prefunding is to raise the ratio of pension funds to the wage and salary bill by 7.5 percentage points by the year 2013 (in relation to the baseline scenario).

In addition to the pension reform, the social partners reached agreement in November 2001 on a comprehensive revamping of the unemployment insurance system designed to further boost sustainability in public finances. Legislative proposals related to this were submitted by government to Parliament in August 2002. Most of the changes in both the pension and unemployment insurance systems will come into force at the beginning of 2005, although some of the reforms will take place in 2003, when for instance the minimum age of eligibility for part-time pension will rise by two years and unemployed people with a work history of at least 20 years will be entitled to earnings-related daily unemployment allowances with an increment for 130 days of unemployment[5]. This is intended to replace the earlier system of redundancy payment.

The pension and unemployment security reforms will clearly improve financial incentives to stay in work longer than before and bolster the sustainability of public finances in the longer term, for instance by considerably reducing long-term pressure to charge higher earnings-related pension contributions (described in more detail in Section 6.2). These reforms notwithstanding, to secure long-term sustainability in public finances, there is a need to maintain a sufficiently large surplus in general government this decade to reduce indebtedness and to make provision for financing growing expenditure caused by the ageing of the population.

To safeguard sustainable public finances in the longer term, it is also necessary to raise the employment rate. The government's employment policy aim has been to raise the employment rate to close to 70 per cent during the government's tenure in office. The average rate of employment has risen by about 1.5 percentage points since 1999 and is forecast to be 67.6 per cent in 2003. Despite several years of sustained economic growth and reforms to improve the functioning of the labour markets, the employment rate is still lower than prior to the deep recession of the early 1990s. The fact that the employment rate stopped rising in 2001 is partly because economic growth slackened and partly because the pension reforms and other structural changes will take full effect with a certain delay. Changes in the age structure of the population will also slow down improvement in the employment rate in coming years. It remains a major challenge to be able to raise the employment rate of the older working population on the one hand and that of the younger age groups (aged between 15 and 24) on the other. The government will pursue with measures to boost the employment rate in 2003.

In Finland, people with low education are more susceptible to unemployment than is the case in other EU Member States. To ease structural unemployment, the government is taking measures to improve labour skills. More labour market training of longer duration leading to occupational qualifications is being offered to the unemployed in areas where there are labour shortages. Those in employment are being offered training provided in the form of joint projects between the labour authorities and employers to enhance the job prospects of older workers and those with lower qualifications. Moreover, subsidised employment schemes will

[5] If the incomes policy settlement for 2003-2004 contracted by the central labour market organisations on 18 November 2002 is widely approved in the union-level negotiations, the government pledges to extend the maximum duration of the earnings-related allowance to 150 days.

provide more training for those who find it difficult to find a job and guidance is being made more readily available when seeking training.

Furthermore, by expanding the use of labour market support as an active employment subsidy, the government aims to ease structural unemployment. A three-year pilot project will be introduced in 2003 where a wider group of people on labour market support will become eligible for the combined subsidy after a shorter spell of unemployment.

One of the government measures to encourage people to postpone retirement is to find active employment on the normal labour markets for those aged between 55 and 59 who became unemployed in 2000 or later, and where necessary, by providing more training and rehabilitation. To combat long-term unemployment and to change the nature of the early retirement path, the labour administration is introducing measures to find active employment for the unemployed in these conditions.

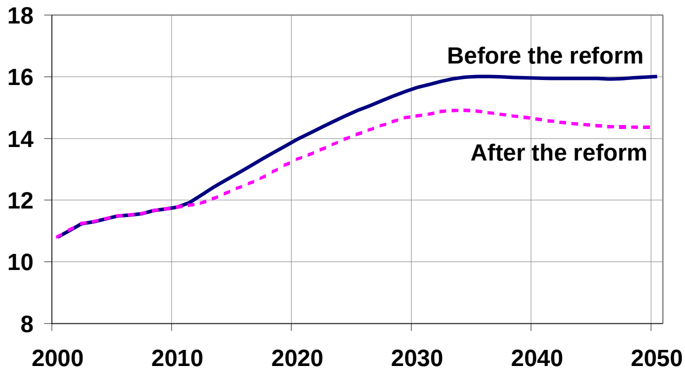
Services in the labour administration are being revamped by creating a service network. The service process is being improved so that soon much of all tasks related to advice on jobs, training and unemployment insurance can be supplied either electronically or as teleservices.

6.2. Sustainability scenarios

The economic policy challenges Finland faces in the longer term relate to the ageing of the population and the resulting contraction in the labour force and growth in public expenditure. By 2020, Finland will have undergone the fastest change in the structure of the population within the EU Member States. The elderly dependency ratio, that is the ratio of people aged over 65 to the population of working age (20 to 64), will climb from 25 per cent in 2000 to 39 per cent in 2020.

However, Finland has already made provision for these challenges by means of prefunding a substantial amount of future pension expenditure, by reducing public indebtedness and by revamping the tax and social security systems to make work pay. Thanks to the prefunding of earnings-related pensions and with central government finances having been boosted, the financial assets of the public sector already exceed public debt. The market value of the assets in the statutory earnings-related pension funds amounted to 51 per cent of GDP at the end of 2001. If computed using the current funding principles, it is calculated to reach over 80 per cent by 2030.

Figure 2. Pension Expenditure % of GDP



Sources: The Central Pension Security Institute and the Ministry of Finance

The comprehensive pension reform adopted in September 2002 will clearly foster sustainability in public finances. It is estimated to lower the ratio of pension expenditure to GDP by 1½ percentage points in the long term (Figure 2) compared to the baseline scenario[6].

Long-term sustainability in public finances is expected to improve to a large extent because the positive incentives brought about by the pension reform are expected to improve employment much more than previously envisaged. The employment rate is forecast to rise from the current 67½ per cent to 73 per cent by 2050, in other words about 4 percentage points more than assumed in the earlier baseline scenario.

Together with a stronger financial base, the long-term sustainability of public finances and the pension system is enhanced especially by the increase in the funding rate and the fact that changes in life expectancy are taken into account in pensions.

The pension reforms cut the need to raise earnings-related pension contribution rates by half. While earnings-related pension contributions (in relation to wages) were earlier estimated to rise from the current average of 22 per cent to over 30 per cent in the long term, the estimate has now fallen to about 26 to 27 per cent of wages thanks to the pension reform.

The Ministry of Finance drew up new sustainability scenarios for general government in November 2002 (Appendix), where the impact of the pension reform was taken into account in pension expenditure and employment. The ratio of acute health care and long-term care expenditure to GDP was estimated to grow by 3 percentage points in the long term. The tax rate was assumed to edge down to 42.3 per cent in 2004 and to remain unchanged from then on.

In the scenario, public finances would stay in surplus until 2035, with the surplus being accumulated in the statutory pension institutions. The rest of general government – that is central and local government – would be roughly in balance until 2015, after which the balance would weaken and indebtedness would take an upward turn (more details in the Appendix).

Finland's strategy builds to a large extent on increasing net financial assets in general government in the next two decades in order to create room for expenditure increases due to the ageing of the population. The growth in public spending (weakening primary balance) can to some extent be financed by means of growing investment proceeds. The large current account surplus (7 per cent of GDP) reflects stronger balance sheets both in the private and public sector.

There is the risk of considerably weaker developments should the real rate of return on the pension fund assets fall well short of the 4 per cent used in the scenarios or should general government finances become considerably weaker for cyclical reasons in the next few years, for instance. There is also the risk that the anticipated positive effect of the pension reform on employment may fail to be fully materialised and that expenditure on acute health care and long-term care may grow faster than expected. A further risk is whether the tax rate of 42.3 per cent used in the calculations is viable in the light of international tax competition.

[6] Estimates drawn up in 2000 in the Economic Policy Committee's working party addressing the question of the ageing of the population.

7. Other factors with an impact on public finances

One of the government's key economic policy objectives is to strengthen the conditions for sustainable economic growth by implementing structural reforms on the product, capital and labour markets. Main measures in business and industrial policy involve ways to enhance the functioning of the markets, to improve the operating conditions of enterprises and action to boost market access and the competition environment. The Government also aims to ensure that the principles of environmentally sustainable development are systematically taken into account in the different sectors of society.

7.1. Developing the product and capital markets and public service production

The Broad Economic Policy Guidelines for 2002 observed that due to its peripheral location in the European Union, the Finnish economy is potentially less exposed to international competition than most other Member States. Consumer price levels are among the highest in the European Union, which is partly due to the relatively high degree of market concentration in some sectors, such as the media and retail distribution.

The Finnish transposition rate of internal market Directives is among the highest in the EU and telecommunication and electricity markets have been fully liberalised. Finland is one of the best performers in the European Union in the field of the transition to the knowledge-based economy.

The government has introduced a number of reforms to improve the functioning of the product, capital and labour markets. Finland has made determined efforts to open up the markets to competition. Free and fair access to the markets is essential for ensuring a competitive business sector. Well-functioning markets encourage companies to become innovative, to invest in new business areas and to create more flexible modes of operation.

The aim of competition policy is to improve the functioning of the markets. Finland's national legislation on competition complies with Community legislation in practise, and the fact that opportunity to apply Articles 81 and 82 of Community legislation has been lacking does not make Finnish competition policy any weaker[7]. The project for modernising Community competition rules (amendments to Article 17/62) is still in progress. Finland considers it unnecessary to make any changes before the Community reform project has reached its final form and the full extent of legislative amendments becomes clear. Finland is prepared to carry out the legislative reforms at short notice if necessary.

The Market Court, a new special court of law, started operating in March 2002. The new court can prohibit the use of restrictive trade practices and order payment of sanctions. It also has tasks relating to the surveillance of corporate acquisitions. In addition, it can overturn decisions on public procurement, amend procurement procedures or order payment of indemnity.

Public procurement markets in Finland have been opened to competition. National legislation requires public procurement units to use competitive tendering for procurements even in cases where procurement falls below the Community threshold value.

There are no legal barriers to competitive tendering in the provision of public services in local government. Local authorities are free to arrange services as they choose. The question of creating more competition in service production has recently attracted more attention, particularly in view of the shrinking labour force and the rapidly ageing population creating a greater need for services. Various experimental systems, development projects and government measures aiming to remove barriers to competition have been introduced to make service production more open to competition. For example, value added taxation was revised in early 2002 in order to enhance tax neutrality in local government procurement of health care and social services.

[7] Product and Capital Market Reforms in Finland, Ministry of Finance, November 2002.

To promote entrepreneurship a project on entrepreneurship was set up in 2000, one example being a portal providing a payment service system for small employers which is currently being created under the auspices of the project. The service system allows small employers to manage all their responsibilities as employers in a centralised manner without the need for any other reporting to the authorities. The system will be launched in September 2003.

In Finland the network industries have been opened up to competition with the exception of railway traffic. The EU's internal railway transport will be opened to competition on 15 March 2003. Market deregulation has cut the price level in telecom services and electricity in particular. According to various surveys, the quality of network services in Finland is high.

The legislation governing the banks and securities markets has been revised and a draft bill drawn up to enhance the operational framework of the Financial Supervision Authority (FSA). Banking legislation has been amended to conform more closely to the legislative regime governing limited companies and cooperatives. Legal provisions similar to those in the Companies Act and the Cooperatives Act have generally been applied in mergers, break-ups and dissolutions of commercial banks and other limited company credit institutions, cooperative banks and other cooperative credit institutions and savings banks since the beginning of 2002. In addition, the concept of securities has been made more flexible.

Reports on measures to promote competition in the statutory employment pension system were completed in 2002. The aim is to make the system more efficient and the rate of return on employment pension assets more lucrative. Follow-up work will be carried out on the reports. The government presented draft legislation in October 2002 on making financial supervision more effective.

7.2. Institutional development of general government – financial relations between central and local government

To consolidate local government finances and to secure funds for basic public services, the government took measures to make municipalities less dependent on revenue from corporate income taxes in 2002, which are sensitive to cyclical fluctuations and difficult to anticipate. In the same connection the system of VAT refund redemptions from local government was discontinued. The Budget Proposal for 2003 suggests a further lowering of the local government apportionment of corporate tax revenue, because the new VAT system was not applied for a full tax year when it was introduced. The aim is to make the apportionments permanent through legislation using the apportionments applied in tax year 2003 as a basis. These changes, which are to the advantage of central government, together with the changes towards cost-neutral financial relations between local and central government means that the financial differences between individual municipalities will be levelled off, since the proportion of cyclically sensitive and unevenly distributed corporate taxes in municipal tax revenue will be reduced.

Within the context of the reform process underway in central government, the government adopted the concept of programme management as a key means for steering government activities, especially in implementing and supervising the Government Programme. The purpose of policy programmes is to ensure that intergovernmental objectives and projects are implemented effectively. The programmes build on government negotiations and the Government Programme. The intergovernmental policy programmes are drawn up on the basis of 3 to 5 key government policy objectives presented in the Government Programme.

The policy programmes are tied up with the process of formulating and handling the Budget. The size of appropriations allocated to the programmes is decided in connection with the process of drawing up the spending limits for the Budget. The annual decision-making, monitoring and assessment of the programmes is linked to the spending limits procedure so that the government deals with the programmes as an entity and the resources for each programme once a year when the decisions on overall spending limits are being made. Appropriations allocated to the programmes are classified under the main titles for the ministries taking part in the programme.

A coordinating minister appointed in connection with the government negotiations is responsible for the organisation and political steering of the intergovernmental policy programmes. Coordinating ministers are government members who, in addition to the existing tasks in their administrative sector, bear managerial responsibility for implementing the policy programme.

Appendix

Long-term sustainability in general government

A sustainability scenario for general government was drawn up by the Ministry of Finance in November 2002, where the impact of the pension and unemployment security reforms were taken into account in public spending and GDP. The starting point in the scenario is 2006, in other words the year in which the medium-term projection ends. The scenario extends to the year 2050 and is based on Eurostat's population projection drawn up in 2000, which was used as a 'baseline scenario' in the EU exercise[1]. All the economic assumptions are the same as in the EU exercise apart from the employment rate, which is expected to evolve much more favourably than in the EU exercise thanks to the pension reform (cf. Table 1). GDP would be about 6 per cent higher at the end of the projection period (2050) than was earlier estimated. The pension reform will have a positive effect on employment because the early retirement schemes will be phased out gradually and because accelerated pension accruals and longer life expectancy have been taken into account in pensions, encouraging people to work longer before retiring. The employment rate was 67.7 per cent in 2001.

1. Employment rate between 2010-2050, %

	EU exercise	New forecast	Change
2010	68.0	68.7	0.7
2030	69.0	72.5	3,5
2050	69.0	73.2	4.2

The impact of the employment pension reforms in the private sector on pension expenditure and GDP was taken into account in the new pension expenditure forecast. Since the employment pension reform in the public sector is still under discussion, no new forecast was drawn up for the public sector. The ratio of pension expenditure to GDP is 1½ percentage points lower by 2050 in the new forecast compared with the earlier projection.

It was assumed that spending on acute health care and long-term care would evolve along the same lines as in the EU exercise. The ratio of other public expenditure (excluding interest expenses) to GDP was assumed to remain unchanged from 2007 onwards. Interest expenses and income were derived from general government gross debt and financial assets using a 4 per cent real interest rate for both debt and financial assets.

The tax rate was kept constant (at 42.3 per cent) from 2004 onwards. Actuarially determined earnings-related pension contribution rates were allowed to rise and other taxes were correspondingly lowered. The ratio of earnings-related pension contributions to GDP would rise by about 2 percentage points by 2030 under the existing pension prefunding regulations.

Calculated on the basis of these assumptions, the public sector would stay in surplus until 2035. The surplus would be accumulated in the statutory pension institutions, where the annual surplus would amount to 3½ per cent of GDP in the first part of the review period but would decrease to 2½ per cent by 2050. The ratio of pension institutions' financial assets to GDP would rise to over 80 per cent in 2030 and would stay virtually unchanged from then onwards.

The rest of general government – central and local government – would be close to balance until 2015, after which a deficit would start growing at a steady pace, so that by the end of the projection period (2050) it would reach 4 per cent of GDP.

[1] Estimates drawn up in 2000 in the Economic Policy Committee's working party addressing the question of the ageing of the population.

Public finances would be the most robust in 2025, when the ratio of net financial assets to GDP would be at its highest (Figure 2). The public debt-to-GDP ratio would drop to 31 per cent in 2020, after which it would start growing, reaching 78 per cent by the end of the projection period. The estimates for the whole of general government are presented in Table 2 and in Figures 1 and 2.

Even though the primary balance is set to weaken once spending starts growing fast owing to the ageing of the population, general government will stay in surplus until 2035. The growth in public spending (weakening in primary balance) can partly be financed with growing investment proceeds.

The estimates are sensitive to the initial situation and to the real interest rate used in the computations, for instance. The starting point in Finland is good compared with many other EU economies, with the surplus in general government estimated at 2½ per cent of GDP in 2006. The situation in Finland is also good because the financial assets in the public sector exceed gross debt thanks to the partial prefunding of pensions. Finland's position therefore differs from that in most EU economies, where gross debt in the public sector exceeds financial assets.

2. Long-term public finances, % of GDP

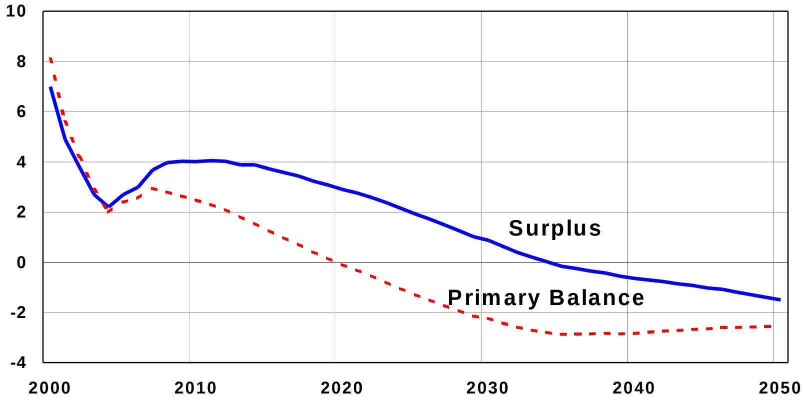
	2000	2010	2020	2030	2040	2050
Overall expenditure	46.7	45.6	47.6	50.4	52.0	53.1
Pensions	10.7	11.7	13.3	14.7	14.6	14.4
Acute health care	4.6	4.9	5.2	5.6	5.7	5.8
Long-term care	1.6	1.9	2.2	2.7	3.3	3.3
Interest expenses	2.8	2.1	1.9	2.4	3.4	4.6
Other expenditure	27.0	25.0	25.0	25.0	25.0	25.0
Overall revenue	53.7	49.6	50.5	51.3	51.4	51.6
Taxes and statutory social security contributions	46.9	42.3	42.3	42.3	42.3	42.3
employment pension contributions	7.2	8.3	8.8	9.3	9.3	9.2
Capital consumption	2.3	2.2	2.0	2.0	2.0	2.0
Other revenue (mainly investment proceeds)	4.5	5.1	6.2	7.0	7.1	7.3
Financial surplus	7.0	4.0	2.9	0.9	-0.6	-1.5
Primary balance[1)]	8.1	2.5	-0.1	-2.3	-2.7	-2.5
Net financial assets2[)]	4.0	32.5	52.9	52.7	35.8	16.2
Gross debt	52.5	35.4	31.1	40.5	58.2	77.8
Assumptions						
Labour productivity % change	2.8	2.2	1.8	1.8	1.8	1.8
Employment rate, %	66.9	68.7	71.2	72.5	72.8	73.2
Unemployment rate, %	9.8	7.0	7.0	7.0	7.0	7.0
Real interest rate, %	2.0	4.0	4.0	4.0	4.0	4.0
Inflation, %	3.4	2.0	2.0	2.0	2.0	2.0

1) Financial balance before net interest expenses.

2) Financial assets minus gross debt.

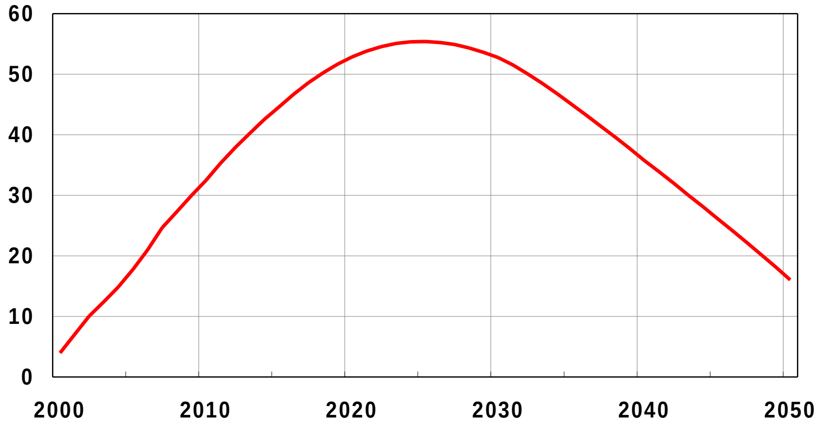
Sources: Statistics Finland, the Central Pension Security Institution, Ministry of Finance.

Figure 1. General Government Finanial Balance
% of GDP



Source: Ministry of Finance

Figure 2. General Government Financial Assets, net
(Financial Assets - Gross Debt) % of GDP



Source: Ministry of Finance