Ministry of Finance

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Contents

INTRODUCTION AND SUMMARY

Through the decisions it has taken, the Government has sought not only long-term sustainability but to strengthen domestic demand in 2003-2004, when the global economic trend was for the most part still weak. Towards the end of 2004, exports too have begun to bolster the growth in output, and employment too, which has neen stuck at the same level for a couple of years now, is slowly on the rise. Despite sizeable tax cuts, the financial position of general government has remained good, and central government finances are in surplus, too. Bringing about an upturn in the employment trend in order to keep the funding pressures resulting from population ageing in check will nevertheless be crucially important for realising the Government's economic policy objectives over the longer term.

A commitment to medium-term stability has shored up consumer confidence, and companies' growth prospects have strengthened as well. In order to foster the positive trend, the incomes policy agreements that will come to an end at the beginning of next year need to be continued through an integrated incomes policy and tax settlement that will bolster the competitiveness of the national economy and make work pay. An agreement of this scope has, however, not been finalised yet at the unionlevel.

Tougher international competition as a result of innovations in countries with high productivity but especially via the cost competition of developing countries furthermore calls for pushing ahead with structural reforms that will increase the productivity and flexibility of the economy.

The Stability Programme update is based on the Budget Proposal for 2005 that was prepared in September and furthermore draws on the related economic policy decisions and estimates of the economic trend.

The paramount objective of the Government's economic policy is to put 100,000 more people in employment by the end of the electoral period 2003–2007. Finland would then reach the employment rate objective according to the Lisbon Strategy ahead of time. Even if the country is slightly behind schedule, it will still be possible to reach the objective before the end of the decade. Of the Lisbon objectives, the employment rates for women and ageing employees have already been reached. A fairly large number of jobs have indeed been created, but structural adjustment entailing lost jobs, especially within industry, has weakened overall employment as of summer 2004. Towards the end of the year the employment situation will nonetheless improve, and the economic growth will support employment in the latter years of the Government's term of office.

To ensure the favourable trend, the Government will continue its economic policy of promoting stable economic growth, improving market efficiency and ensuring an internationally competitive operating environment for business. The Government's fiscal policy objective is to maintain strong central government finances and to make sure they are in balance (as measured in national accounting terms) in the end of its term of office.

The sustainability of central government finances will be reinforced, in particular, by the new procedures adopted in 2003 on spending limits and the policy of expenditure restraint adopted within its framework. The structural reform of pension systems that will enter into force in 2005 will furthermore improve the long-term sustainability of public finances and it is expected to raise the average retirement age.

The surplus in general government finances will strengthen somewhat in 2004, to an estimated 2 per cent of gross domestic product. It is estimated that the surplus-to-GDP ratio will also remain on average at around two per cent in the latter part of the Stability Programme period. This surplus is slightly less than would be necessary in order to achieve the economy policy objectives, because in the baseline of the Stability Programme update the growth in employment will fall short of the target set in the Government Programme. The deterioration of the balance will have repercussions particularly for central government finances. On the other hand, the baseline scenario of average GDP growth at 2½ per cent is a cautious estimate.

If the Government succeeds in its economic policy of supporting growth and reinforcing stability, and if the international economy throws up no surprises, it should be possible to raise the employment rate beyond the figures of the baseline scenario and thereby to strengthen central government finances.

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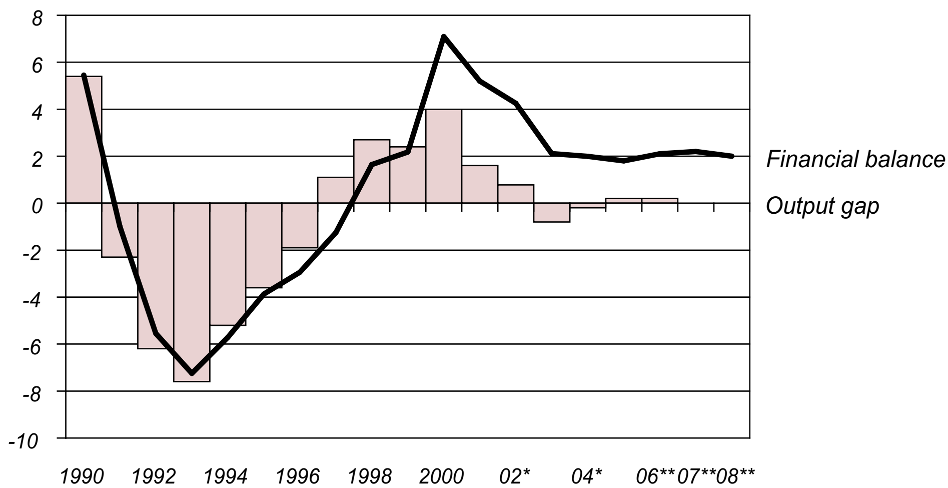
On 29.11.2004, the Finnish labour market central organisations reached agreement on comprehensive incomes policy settlement. A precondition for the implementation of the settlement is its approval at union level by mid-December. With the implementation of the settlement, the average rate of wage increase would in 2006 and 2007 slow down by approximately one percentage point compared to the estimated rate given in this programme, provided that the wage drift remains at the present level.

The Government has on 30.11.2004 for its part committed itself to tax reductions and certain expenditure decisions strengthening the economy's growth ability. Apart from the budget for 2005, the settlement is conditional and requires that the negotiation settlement will gain sufficient support at union-level negotiations[1)]. In 2005, the taxation of earned income will be eased by approx. 350 million euros (0.2% of the total production) compared to what was proposed in this programme. The settlement will prevent the winding up of withholding taxes, and its effect on the balance of the public economy will remain relatively modest..

If the negotiation settlement will be implemented in union-level agreements, the Government will relieve income taxation in 2006 and 2007 in total by nearly 1.4 billion euros (nearly 1% of the total production). In addition, annual inflation adjustments will be made on taxation. Part of tax reductions planned for the years 2006 and 2007 have been included in the calculations of this programme[2)]. Taking also account of the slowdown of increase in the level of costs resulting from the wage settlement and the positive effects of tax reductions on employment, the implementation of the reached negotiation settlement would weaken the balance of the public sector in 2007 by approximately 1/3 percentage points of the total production, as compared to the estimate included in this programme. During the same period, employment is expected to improve by 1½ per cent compared to the basic line of the stability programme.

Figure 1. GDP diviation from potential output and general government financial balance from GDP



1) As a result of the conditionality the impact of the agreement on the economic development and on the public finances has not been taken into account in the calculations provided in this programme.

2) In the Finnish tax system tax brackets are adjusted annually to avoid fiscal drag. Due to technical assumption of a stable tax rate part of the tax reductions has been anticipated in the calculations provided in this programme.

1 ECONOMIC POLICY OBJECTIVES AND PREMISES

1.1 General

The greatest challenge for economic policy is to raise the employment rate and to lower structural unemployment in a situation in which globalisation has made competition harder than ever and the age structure of the population is weakening. The paramount objective of the Government is to put 100,000 more people in employment by the end of the electoral period 2003–2007. To achieve this, the Government will continue its economic policy of promoting stable economic growth, improving market efficiency and ensuring an internationally competitive operating environment for business. The Government's fiscal policy objective is to maintain strong central government finances and to make sure they are in balance (as measured in national accounting terms) in the end of its term of office.

Reaching the objectives calls for continuing this year's stepped-up economic growth on a fast-growth track over the next few years. A positive factor is that the fall in the number of jobs that has lasted for well over a year has come to a halt and job creation has headed upwards towards the end of the year. Nonetheless, the ongoing structural change, particularly within industry, will keep unemployment high and increase the need for greater labour market flexibility and adaptiveness. On the other hand, strong general government finances have made it possible to go beyond automatic stabilisers towards the use of active fiscal policy to stimulate the economy and support employment in a manner that concurrently supports structural adjustment over the longer term and boosts long-term growth potential.

During 2003 and 2004, households' purchasing power has been maintained and increased by lowering the tax on labour, and confidence in the trend in the domestic economy has been strengthened, whilst supporting longer-term economic growth potential by improving incentives to work. The tax cuts have been geared towards the earnings of people in the low and medium income brackets, but benefits have also been revised so that they encourage people to stay on in employment longer than they do at present.

The reform of corporate and capital income taxation that will come into force at the beginning of 2005 will play an important role in ensuring competitiveness. At the same time as the tax rates are lowered, the corporate and capital income tax rates will move farther apart. In dividend taxation, a shift will be made from the so-called avoir-fiscal system to a classical system in which domestic and foreign holdings are in the same position with regard to tax. Concurrently, the taxation of voluntary pension insurance will change so as to encourage people to stay on in employment for a longer time.

A key factor in bolstering the sustainability of central government finances is the adoption of new procedures, at the beginning of the government's term of office, for setting spending limits and the expenditure restraint decided upon in connection with them. The spending limits adopted impose an absolute ceiling for around three-quarters of State budget expenditure, including the supplementary budgets over the next three years. Expenditures that vary with cyclical fluctuations or automatic funding mechanisms, such as unemployment security costs and the funded portion of national flat-rate pensions and sickness insurance, are not included in this. The impacts of changes in principles governing these expenditures too, are counted under the binding spending limits. Debt interest payments and EU budget expenditure flowing through the Finnish Budget are also excluded from the overall spending limits.

The Government Programme is aimed at balanced central government finances (as measured in national accounting terms) in the end of the electoral period, at which point there should be an overall surplus in general government finances equivalent to around three per cent of GDP. Cyclical or other short-term deviations from the path of balanced central government finances are permitted in so far as they do not jeopardise the overall reduction of the central government debt ratio.

The Government is committed to taking steps to cut expenditure and to taking other corrective action if the central government deficit threatens to rise above 2¾ per cent of total output. Such a threat does not, however, appear imminent because central government finances have remained in surplus, nor will the deficit that is forecast for next year be major in amount. The gross general government debt-to-GDP ratio will decline by almost a percentage point to 44¾ per cent in 2004 and then to 43½ per cent in 2005, and the declining trend will continue over the entire period of the Stability Programme.

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. Sharing as they do common interests with respect to economic policy, the Member States need to streamline their economic policies in line with the principles of an open market economy that is based on free competition and favours efficient resource allocation. The recommendations for broad economic policy guidelines in 2003–2005 are divided into three main areas where needs for reform will be examined: macroeconomic policies oriented towards growth and stability, economic reforms aimed at raising growth potential, and means of strengthening sustainable development.

The section on Finland in the 2003 BEPG document highlights the country's high unemployment rate, which is thought to be mainly structural, as well as the low employment rate for older workers. These two factors, together with lengthy periods spent in education and the ageing population, are considered a major obstacle to the attainment of the Government's employment targets. Another issue raised in the document is the high price level in Finland.

According to the document, the major challenges facing Finland are 1) to reduce the high level of structural unemployment and to increase the employment rate of older workers and 2) to enhance competition in certain sectors and improve the efficiency of the public sector. Finland is specifically recommended to:

1) - Improve incentives in tax and benefit systems further to make work pay, in particular by addressing their combined effects on older workers; continue to reform the eligibility criteria; improve the administration of benefit systems and target the tax measures on low-paid labour.

- Make sure that the wage and salary trend better reflects the development of productivity with a view to improving the job prospects of low-skilled unemployed persons.

2) - Competition will be stepped up in networked sectors and within non-commercial services.

- Make further efforts to increase the efficiency of the public sector by improving the framework conditions for increased competition, promoting the benchmarking of efficiency and through increased use of public tendering.

- Improve mechanisms to help control spending and ensure compliance with rules on expenditure.

The Government's economic policy is in line with the recommendations put forward in the BEPGs. The economic policy measures taken by the Government in respect of the recommendations concerning general government finances and structural policy are described in closer detail in the subsequent chapters of this Stability Programme as well as in the report on Product and Capital Market Reforms in Finland adopted by the Government in October 2004.

1.3 Finland's 2004 Stability Programme update

The present Stability Programme update is based largely on the Budget Proposal for 2005 that was submitted to Parliament in September 2004 and on the Economic Bulletin that was updated at the beginning of November. The programme's estimate of economic growth in 2004 is more favourable than in the previous Stability Programme update, mainly because of stronger-than-expected domestic demand and an uptick in the pace of global economic growth. The estimate of total output for 2005 is a bit higher than the previous one both in its level and its rate of growth. Economic growth is nevertheless forecast to slow slightly during 2005.

Thanks to stronger economic growth, the balance in general government finances this year will be slightly better than forecast in the previous Stability Programme update. The ratio of the surplus in general government finances in 2004 is estimated to be just under half a percentage point greater than that stated in the Stability Programme update for 2003, but it will be slightly weaker in 2005. In 2004 the financial position of central government will be affected not only by income tax cuts but also by substantial cuts in tax rates on alcoholic beverages in an attempt to shore up the tax base in the wake of EU enlargement. Nonetheless, central government finances will be in balance and show stronger fiscal position than was projected in the 2003 Stability Programme update.

According to the Stability and Growth Pact which complements the EU Treaty, Member States shall adhere to the medium-term objective of a budget position that is in balance or in surplus. The financial position in general government will remain clearly in surplus. In 2008 the surplus in general government is expected to stand at 2 per cent of GDP.

In accordance with the obligations of the Stability and Growth Pact, the Government will undertake corrective measures if achievement of the Stability Programme objectives is jeopardised.

1.4 Administrative consideration of the Stability Programme in Finland

The Stability Programme update for 2004 was drawn up after the 2005 Budget Proposal was submitted. The Stability Programme complies with the Code of Conduct endorsed by the EU Council in July 2001. The document will be delivered to the relevant EU bodies within the agreed time frame (15 October – 1 December 2004) once it has been approved by the Government in plenary session. As in earlier years, the Stability Programme update will be submitted to Parliament for information.

2 ECONOMIC SITUATION AND OUTLOOK

2.1 Recent developments and short-term outlook

The world economy has remained sluggish for longer than expected in the early years of the new millennium, with repercussions for the Finnish economy, as for others. Following the period of brisk growth in the latter half of the 1990s, for three years running GDP growth came in at an average of just under two per cent. This year growth will speed up to 3¼ per cent and next year as well it will reach about three per cent. Output growth has been sustained mainly by household consumption and investment in housing, whereas exports and business sector investments have shown slow growth.

Next year, growth in consumption will slow down, but the revival of exports coupled with a strengthening in corporate capital spending will kick in to support growth. A continued benevolent growth spiral depends on both the trend worldwide and the future trend in pay levels and costs. Providing that good incomes agreements are reached and that purchasing power can be ensured without jeopardising competitiveness, the growth in total output can continue roughly in line with the growth in production potential up to the end of the programme period.

Notwithstanding slow economic growth, the unemployment situation has not weakened significantly, though there have been substantial job losses, especially within industry. The fall in employment has bottomed out this year, but over the full year the number of people in employment will be slightly below the level registered in 2003. The proportion of employed people within the working age population (15-64-year-olds) will decline to 67.1 per cent this year, but will rise to close to 67½ per cent in 2005.

The pace of the rise in consumer prices has moderated markedly this year and the price level on average will remain nearly unchanged, or clearly lower than was forecast in the Stability Programme for 2003. At the same time, Finland's relative price level will approach the EU average, though it will still remain high. Inflation, however, will quicken again in 2005, when the effects of lowering the prices of alcoholic beverages recede and

1. Growth and associated factors

	2003	2004*	2005*	2006**	2007**	2008**
GDP growth at constant market prices, %	2.0	3.2	2.8	2.4	2.2	2.0
GDP level at current market prices. EUR bn	142.5	147.5	153.2	159.0	164.5	170.0
GDP deflator. % change	-0.1	0.2	1.0	1.3	1.3	1.3
HICP. % change	1.3	0.2	1.4	1.8	1.8	1.8
Employment 1). % change	-0.3	-0.3	0.5	0.4	0.1	0.1
Labour productivity2). % change	2.3	3.5	2.3	2.0	2.0	1.9
Unemployment rate. %	9.0	8.8	8.5	7.9	7.6	7.3
Sources of growth: percentage changes at constant prices						
1. Private consumption expenditure	4.3	3.0	2.1	2.1	2.0	1.9
2. Government consumption expenditure	1.6	1.4	1.5	1.5	1.2	1.4
3. Gross fixed capital formation	-2.1	3.5	3.0	2.1	1.7	1.3
4. Changes in inventories as a % of GDP	0.4	0.0	0.0	0.0	0.0	0.0
5. Exports of goods and services	1.1	3.3	4.1	3.5	3.0	3.0
6. Imports of goods and services	2.6	2.0	2.7	2.7	2.3	2.3
Contribution to GDP growth. % points						
7. Final domestic demand	2.1	2.5	1.9	1.8	1.6	1.5
8. Chantges in inventories	0.4	0.0	0.0	0.0	0.0	0.0
9. Net exports	-0.4	0.8	0.9	0.6	0.6	0.6
Assumptions (Commission)						
Short-term interest rate (3-month money market)	2.3	2.1	-	-	-	-
Long-term interest rate (10-year government bonds)	4.1	4.2	-	-	-	-
USD/EUR exchange rate	1.13	1.23	1.24	1.24	-	-
EU-15. GDP growth. %	1	2.5	2.3	2.4	-	-
World import volumes. excluding EU. %	10.3	11.6	8.8	8.3	-	-
Oil prices. (Brent. USD/barrel)	28.5	39.3	45.1	40.1	-	-

1) National accounts.

2) GDP growth at market prices per person employed at constant prices

high crude oil prices raise the consumer price index. The balance on current account will remain substantially in surplus and Finland will have net foreign receivables in 2005 of about 8 per cent of total output.

Fiscal policy this year, as measured in terms of the change in the surplus in general government finances, will be roughly neutral, but the recent tax cuts will nevertheless boost purchasing power of wage-earning households by about one percentage point. This year the structural surplus in general government finances will remain largely unchanged in relation to GDP, but temporarily it will weaken slightly next year.

With the revival in international demand, foreign trade will further support the growth in production alongside domestic demand, but in 2005 the growth in total output will slow down to just under 3 per cent, from 3¼ per cent this year. During 2006 and 2008 growth is estimated to continue at a rate of about 2¼ per cent. The unemployment rate will remain on a descending curve over the same period, but the employment rate will remain below the 70 per cent target.

The economic outlook for 2005 is still comparatively good, though the risks of a slowdown in growth have increased, particularly as regards raw materials prices, with the high price of crude foremost, but also in view of a possible slowdown in economic growth in the United States in a corrective adjustment to public finances and foreign balance.

The estimates of economic growth and associated factors in 2004-2005, as presented in Table 1, are based upon Ministry of Finance forecasts that were published in November. The estimates of international growth for 2004-2006 are in line with the initial assumptions of the forecast published by the Commission in October 2004.

2.2 Medium-term macroeconomic scenario

The medium-term macroeconomic projections offered here are based on the assumption that both the global and the EU economy develop in line with the Commission's short-term forecast published in October 2004 (Table 1).

The medium-term projections for 2006-2008 are based on surveys of longer term growth prospects in the economy. One of the key factors impacting long-term economic growth is that the population of working age will cease to grow by the end of the decade. Even before that, however, the population available for work will begin to dwindle, in spite of the fact that the age of exit from the labour market is expected to rise from the present level of about 60 years of age. The number of people in employment will nevertheless still increase due to factors such as the fall in unemployment. Growth prospects are furthermore affected by Finnish companies' investments, both at home and abroad.

It is anticipated that productivity growth will more or less follow the long-term historical trend, albeit at a markedly slower rate than in the 1990s now that growth in employment is focused on service industries with lower-than-average productivity increases and the technology-led structural change is losing momentum. Real earnings are expected to increase in line with the growth in productivity. The projections for expenditure and revenue in general government are estimated to develop in the manner described in chapters 3 and 5.

The projections are based on the assumption that global economic growth cools off slightly from the level of 2004. The slowdown will stem from the high price of oil and the foreseeable need to rein in economic policy in fast-growth countries. It is estimated that economic growth in the EU area will be to about 2½ per cent in 2005. Global demand is expected to begin to show up more prominently in Finland's exports too, as has been reflected, significantly, in the good export expectations across industry. The volume of exports is estimated to grow by about 3½ per cent a year in 2005-2008.

Export growth will be limited by the fact that industry, especially the domestic electronics sector, is expected in future to increase its production more outside Finland, where it is closer to the end-product markets than it is at home. The profitability of Finland's pivotally important electronics industry is weakened by the decline in export prices, which is particularly evident in mobile phone exports. Export prices across the entire economy are expected to slide. This, coupled with the foreseen increase in import prices, signifies a continuous weakening in the exchange ratio and a slow erosion of the current account surplus, albeit from a very high level.

Growth in investment is expected to remain subdued, partly because investments in sites abroad will account for a substantial share of prospective investments. With unemployment expected to fall and real earnings set to increase, household income will rise. The favourable earnings trend and the positive complexion of the economy will maintain consumption demand, though in 2004 the effect of the special factors driving fast growth is indeed expected to diminish.

Notwithstanding the persisting economic uncertainties and longer term challenges, the growth prospects for the Finnish economy are fairly good in the medium term. Despite shrinkage, the current account balance will be in substantial surplus, interest-bearing foreign net debt will be negative and the price competitiveness of exports will still be above the long-term average, though globalisation will exert a lot of pressure. Finland's production structure is concentrated in areas of high technology know-how, where international competition has become tougher. On the other hand, the substantial investments made in human capital are a major asset.

Also domestic markets are expanding because there is mounting demand for health care and nursing services, for instance, as the population grows older. Domestic production has not yet taken full advantage of the potential offered by new technology for improving productivity.

If the international economy develops favourably in the medium term, as expected, and if domestic cost trends remain moderate, average economic growth between 2004 and 2008 will come to around 2½ per cent a year. This would be a much slower rate than in the latter half of the 1990s. The employment rate is expected to settle in at around 67½ per cent, while the declining labour supply will bring down the unemployment rate to less than 7½ per cent.

In addition to the baseline scenario, slower and faster growth scenarios have also been drawn up for this programme. These are described in chapter 4.1.

3 GENERAL GOVERNMENT: BALANCE AND DEBT IN 2004 - 2008

3.1 Fiscal policy strategy

By boosting employment and reducing central government indebtedness the aim is to prepare for mounting expenditure pressures on public finances as well as the tax reduction pressures resulting from population ageing and globalisation of the economy. By the same token, the goal over the next few decades is to avoid creating an unreasonable financial burden for future generations. The narrow room for manoeuvre within general government will be used with great discretion in the form of moderate tax cuts and increases in expenditure that will improve the economy's growth potential and support the welfare system. At the same time the structures of general government will be developed with a view to greater sustainability and efficiency.

In order to secure sustainable central government finances, it is necessary to reduce the central government debt-to-GDP ratio. The central government is seeking to bring its finances into balance at the end of the electoral period, as measured in national accounting terms. The spending limits for the 2004–2007 period were approved in May 2003. Based on these limits, total expenditure in central government may increase by nearly one per cent a year in real terms on average during 2004–2007, with most of the increase coming in 2004. The Government is committed to cutting expenditure and to taking other corrective action if the central government deficit threatens to rise above 2¾ per cent of total output.

In the estimates made in this programme, central government expenditure will be in line with the Budget and the three Supplementary Budgets in 2004. The central government expenditure estimate is based on the Budget Proposal in 2005, and in 2006–2007 central government expenditure is assumed to comply with central government spending limits. Spending beyond those limits is estimated on the basis of assumptions concerning economic trends.

3.2 General government balance and debt

The general government surplus will rise to an estimated 2 per cent of gross domestic product in 2004. The surplus ratio is estimated to stay around two per cent in 2005 and towards the end of the Stability Programme as well.

Central government finances will be in balance in 2004, but drop into a slight deficit next year, as measured in national accounting terms. Direct tax revenue will be reduced by the changes to the bases of corporate and capital taxation. From the beginning of next year, the corporate tax base will be lowered from 29 per cent to 26 per cent and the capital tax base from 29 per cent to 28 per cent.

Other tax cuts in addition to the inflation adjustment to the tax brackets are not proposed for the taxation of earned income in 2005, but if there is a moderate incomes agreement, this will afford room for lowering the income tax. The labour market situation will be assessed later on, and based on the outcome, the Government will decide on any new tax cuts. Interest expenditure will decrease further next year.

Local government will remain in deficit in 2004 even if the growth in expenditure slows down, because there will be but minor growth in tax revenue. In 2005 the municipalities' financing situation will improve on the back of an upswing in tax revenue and a moderate trend in expenditure. Local government finances will nevertheless be in deficit. Mounting expenditure pressures will keep the municipalities' financial situation tight over the next few years and there will continue to be large differences in the financial position from one municipality to the next. Nonetheless, local governments are required to maintain their finances at least roughly in balance over a three-year planning period. A big challenge over the next few years is the accelerating pace of retirement and the concurrent increase in the need for service provision.

The financial surplus of the social security funds will rise somewhat in 2005 and 2006. The surplus of the social security funds comes from the employment pension funds. The financing of the other social security funds – the Social Insurance Institution and the Unemployment Insurance Fund – is based for the most part on the pay-as-you-go system and these funds are close to balance. 2005 will see the gradual start-up of the extensive employment pension reform that will have significant repercussions for expenditure starting in 2005. The main reforms are: flexible retirement age (62–68 years), the transition to a single index, abolishment of the pension ceiling, a so-called accelerated accrual and introduction of an increased pension premium for ageing employees.

The market value of the investments made by the private employment pension funds will be about 57 per cent in relation to total output at the end of 2004, an increase of over 6 percentage points on 2000. The buffer funds that were motivated by Finland's participation in Economic and Monetary Union are full. 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 that has been accrued in the Unemployment Insurance Fund corresponds to annual earnings-related unemployment benefit expenses equal to an unemployment rate of 3½ per cent. As far as social security funding is concerned, the period from 2005 to 2008 remains one of preparation: with the continuing ageing of the population, the situation will deteriorate rapidly after the period under review. The long-term challenges for public-sector finances and the national economy as a result of population ageing are examined more closely in chapter 6.

Central government debt as a ratio of GDP has fallen by a total of 5½ percentage points in the period from 2000 to 2004 and indebtedness will remain on a declining trend up to the end of the programme period. General government gross debt is expected to drop to around 41 per cent of GDP in 2008, or by about 4 percentage points from the level at the end of 2004. The surplus in general government will accumulate in the form of net growth in other financial assets, as illustrated in Table 3, since the surplus will be accumulated almost entirely in earnings-related pension funds.

3.3 Structural balance in public finances

Based on current projections, the Finnish economy is close to its potential output level. Finland's potential output has been estimated in this Stability Programme update by means of the production function method that has been developed by the EU Commission. The growth in the economy's potential output is estimated to be just over 2½ per cent in 2004 and it is judged to hold steady at around 2½ per cent over the programme period (Table 4).

Because the forecast total output is close to the economy's potential, cyclical factors have but a small impact on the equilibrium of general government finances. The effect of the output gap on the cyclical sensitivity of public sector finances is gauged by applying OECD income and expenditure elasticity estimates. The cyclically adjusted financial surplus in general government finances is estimated at 2,1 % of gross domestic product in 2004 and 1,7 % in 2005. According to forecasts, fiscal policy will be fairly neutral, or slightly stimulatory in 2004 and 2005, whether analysed on the basis of the change in cyclically adjusted net lending or the cyclically adjusted primary balance (net lending + interest expenses).

2. General government budgetary developments, % of GDP

	2003	2004*	2005*	2006**	2007**	2008**
Financial balance						
General government	2.1	2.0	1.8	2.1	2.2	2.0
Central government	0.2	0.0	-0.5	-0.4	-0.3	-0.6
Local government	-0.5	-0.4	-0.3	-0.2	-0.1	0.0
Social security funds	2.4	2.4	2.7	2.7	2.6	2.6
General government						
Total revenues	50.7	50.5	50.3	50.6	50.5	50.5
Total expenditures	48.6	48.5	48.4	48.5	48.4	48.5
Financial surplus	2.1	2.0	1.8	2.1	2.2	2.0
Net interest payments	0.2	-0.2	-0.3	-0.2	-0.2	-0.2
Primary balance	2.3	1.8	1.6	1.9	1.9	1.7
Components of revenue						
Taxes	32.3	31.8	31.5	31.4	31.4	31.3
Social security contributions	12.2	12.3	12.6	12.9	12.9	12.9
Other revenues	6.2	6.4	6.2	6.2	6.2	6.2
Total revenues	50.7	50.5	50.3	50.6	50.5	50.5
Components of expenditures						
Collective consumption expenditure	7.9	7.9	8.0	8.0	8.0	8.1
Individual consumption expenditure	14.5	14.6	14.7	14.8	14.9	15.0
Social income transfers	17.2	17.3	17.2	17.2	17.1	17.1
Interest payments	2.0	1.7	1.6	1.7	1.7	1.7
Subsidies	1.4	1.3	1.3	1.3	1.2	1.2
Gross fixed capital formation	2.9	2.8	2.7	2.7	2.6	2.6
Other expenditures	2.9	2.9	3.0	2.9	2.8	2.8
Total expenditures	48.6	48.5	48.4	48.5	48.4	48.5

3. General government debt developments, % of GDP

	2003	2004*	2005*	2006**	2007**	2008**
Gross debt level, % of GDP	45.6	44.6	43.4	42.5	41.7	41.1
Change in gross debt. %	3.0	-0.9	-1.3	-0.8	-0.8	-0.6
Contributions to changes in gross debt. %						
Primary balance	-2.3	-1.8	-1.6	-1.9	-1.9	-1.7
Net interest payments	0.2	-0.2	-0.3	-0.2	-0.2	-0.2
Impact of nominal increase in GDP	-0.9	-1.6	-1.7	-1.6	-1.5	-1.4
Stock flow adjustments	6.0	2.6	2.3	2.9	2.8	2.7
- Public sector consolidation	2.3	0.3	0.0	0.0	0.0	0.0
- Privatisation receipts	0.1	0.6	0.3	0.3	0.3	0.2
- Net accumulation of financial assets	3.5	1.7	2.0	2.6	2.5	2.5
Implicit interest rate on debt	4.4	3.8	3.6	3.9	4.0	4.2

4. Cyclical developments, % of GDP

	2003	2004*	2005*	2006**	2007**	2008**
1. GDP growth at constant prices	2.0	3.2	2.8	2.4	2.2	2.0
2. General government financial balance, % of GDP	2.1	2.0	1.8	2.1	2.2	2.0
3. Interest payments, % of GDP	2.0	1.7	1.6	1.7	1.7	1.7
4. Potential GDP, % change	2.6	2.6	2.4	2.4	2.3	2.0
5. GDP output gap	-0.8	-0.2	0.2	0.2	0.0	0.0
6. Cyclical budgetary component, % of GDP	-0.5	-0.1	0.1	0.1	0.0	0.0
7. Cyclically-adjusted balance, % of GDP	2.6	2.1	1.7	2.0	2.1	1.9
8. Cyclically-adjusted primary balance, % of GDP	4.6	3.8	3.3	3.6	3.8	3.7

4 SENSITIVITY ANALYSIS AND COMPARISON WITH LAST YEAR'S PROGRAMME

4.1 Risks in economic developments and their impact on public finances

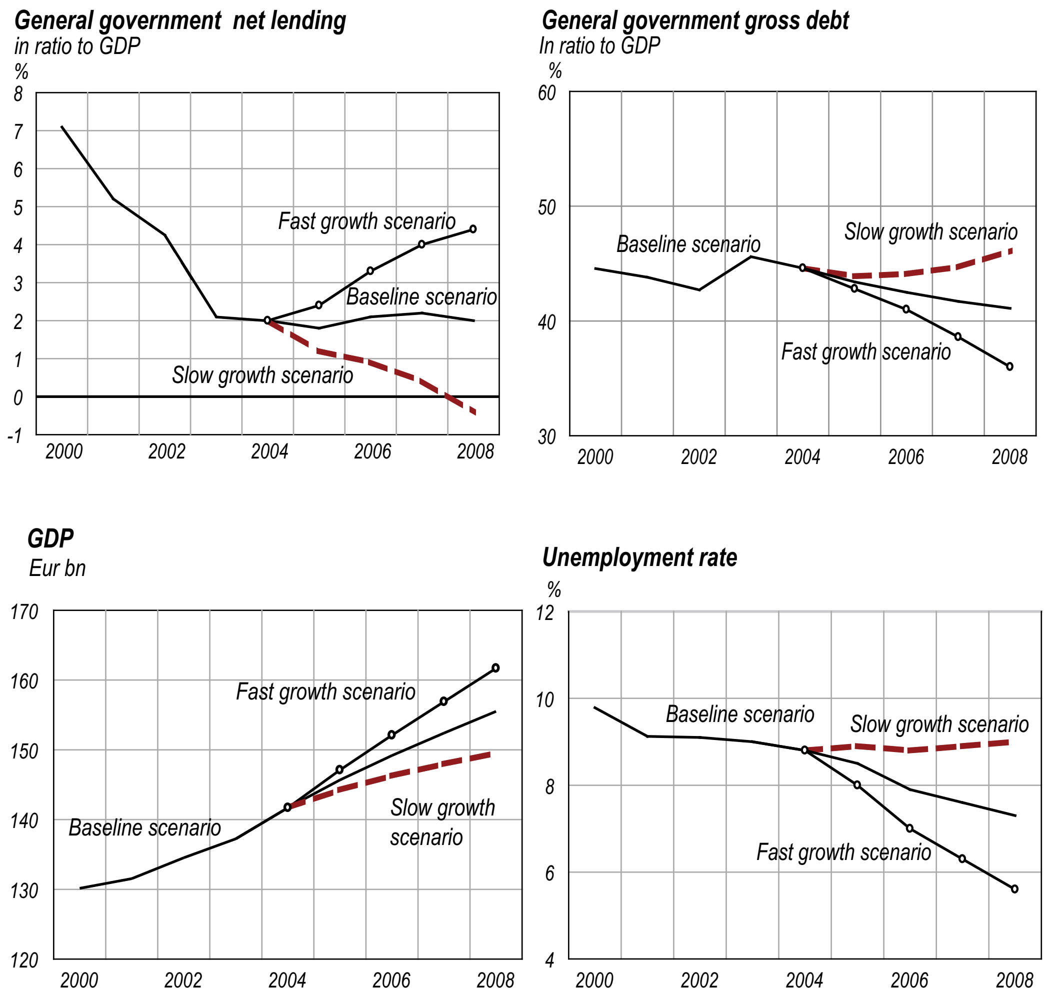
The economic developments projected in this Stability Programme involve certain risks, even in the short term. In 2004 economic growth will clearly exceed previous forecasts, but with respect to 2005 and 2006 there are forecasting risks in both directions. Economic growth may turn out to be faster than has been forecast if the targeted broad-based incomes agreement is reached and the general trend outside Finland is better than forecast. On the other hand, a prolonged period of commodities prices at their current high level, especially prices of crude oil, will weaken prospects for the international economy. On top of this, uncertainty about the timing and means of correcting the structural financial imbalances in the United States economy and also regarding the sustainability of economic growth in the euro area will reinforce doubts that weaker economic growth lies ahead. A factor that adds to uncertainty about the domestic economic trend is the important position within the Finnish economy of information and communications technology products that face intense competition globally.

The uncertainties regarding the mid-term growth outlook centre on employment and the development of productivity. The population of working age (15-64) will begin to shrink by the end of the decade. The numbers available for work will begin to decline even earlier, as the average age at entry into the labour market is slightly over 20 and the age at exit around 60 years. Although the structural reforms carried out will push up the exit age by an estimated 2-3 years, it will not be until the next decade that their impacts will really begin to be seen.

By contrast, the economy still has abundant unused labour reserves in the form of both open and hidden unemployment. Growth may well be faster than the projections of the baseline scenario if productivity and the employment rate can be raised. Apart from maintaining vigorous growth in overall productivity, this will require production investments in new fields, this in a situation where structural adjustment in the IT industry, for instance, is leading to the relocation of production outside Finland. It is also important to improve productivity in the service sector, including public services. Employment, for its part, can be raised by further improving the effectiveness of the labour market, by improving incentives in tax and benefit systems to make work pay, and by making the education system more effective. Stepping up competition policy is a further way of boosting productivity.

The figure below illustrates the impacts of slower-than-baseline and faster-than-baseline growth upon the financial balance and debt in general government. The calculations are based on the assumption that production growth deviates by one percentage point in either direction from the baseline scenario.

Chart 2



In the slow growth alternative, production growth would average around 1.5 per cent between 2005 and 2008, and the unemployment rate would stay at around 9 per cent. General government finances would remain in surplus throughout the review period. The debt ratio would start rising, undermining longer term prospects due to population ageing.

In the more favourable scenario, economic growth would rise to almost 3.5 per cent on average and the unemployment rate would drop to 5½ per cent. In this scenario the general government surplus would increase to around 4½ per cent of GDP.

4.2 Comparison with last year's Stability Programme update

The previous Stability Programme update for 2003 predicted GDP growth at 1.4 per cent, whereas current preliminary data put the figure at 2.0 per cent. The main labour market indicators were nearly in line with the forecast, as was inflation. The surplus in general government was 2.1 per cent of GDP, compared with the prediction of 2.2 per cent in the previous Stability Programme update.

The view of the economic trend in 2004 has also changed from the previous Stability Programme update. The uptick in economic growth at the beginning of 2004, driven by strong domestic demand and coinciding with the start of a global boom, will raise GDP growth to 3.2 per cent, from the 2.7 per cent estimated in the previous Stability Programme. VAT receipts, which have increased thanks to the strong growth in household consumption, will furthermore raise the general government surplus-to-GDP ratio by 0.3 percentage point above the previous estimate, putting it at 2.0 per cent.

The central government's financial position will be in balance and central government debt will remain roughly unchanged in euro terms in 2004. The ratio of overall public sector debt to GDP will remain approximately in line with the previous Stability Programme update.

The growth estimate for 2005 has been raised only slightly from the level envisaged in autumn 2003. Economic growth has started off from a somewhat higher level but at a more moderate pace. It is predicted that the surplus in general government in 2005 will be somewhat lower than anticipated in last year's Stability Programme update. In 2006 the surplus in general government is estimated to be on a par with the previous estimate. The general government debt-to-GDP ratio is lower than envisaged in last year's update and will continue to decline.

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

	2003	2004*	2005*	2006**	2007**	2008**
GDP growth						
Previous update (2003) %	1.4	2.7	2.5	2.4	2.4	-
Latest update (2004) %	2.0	3.2	2.8	2.4	2.2	2.0
Difference. % points	0.6	0.5	0.3	0.0	-0.2	-
General government financial balance						
Previous update (2003) % of GDP	2.2	1.7	2.0	2.1	2.2	-
Latest update (2004) % of GDP	2.1	2.0	1.8	2.1	2.2	2.0
Difference. % points	-0.1	0.3	-0.2	0.0	0.0	-
Gross debt levels						
Previous update (2003) % of GDP	45.1	44.8	44.9	45.0	44.6	-
Latest update (2004) % of GDP	45.6	44.6	43.4	42.5	41.7	41.1
Difference. % points	0.5	-0.2	-1.5	-2.5	-2.9	-

Stability programme update, november 2003
Stability programme update, november 2004

5 GENERAL GOVERNMENT REVENUE AND EXPENDITURE

5.1 Government policy

The Government's fiscal policy objective is to maintain strong central government finances. This is essential if public finances are to cope with the financial implications of population ageing over the next few decades without placing an unreasonable tax burden on future generations. Sustainable central government finances are also essential if the Government is to have adequate fiscal leeway to ensure economic growth under all circumstances. Achieving these objectives calls for lowering central government debt as a ratio of gross domestic product, excluding cyclical deviations.

5.2 General government revenue and taxation

Central government revenue in 2004-2005 is in line with the 2004 forecast in November. Beyond 2004, tax revenues are estimated on the basis of the medium-term macroeconomic scenario. An inflation adjustment of only 2 per cent to the tax scales for wage and salary income is proposed for next year. The assumption otherwise is that annual tax cuts will be made to keep the tax rate unchanged. The reform of corporate and capital taxation that will come into force in 2005 has been taken into account in the revenue estimates.

With economic integration expanding and deepening and with international tax competition getting stiffer during the programme period, there is also mounting pressure on wage and capital income taxation. It is nevertheless very difficult to estimate precisely the magnitude and timing of tax pressure.

Administratively, general government in Finland consists of central government administration, local government administration (comprising municipalities and federations of municipalities, including the Åland provincial administration) and social security funds. Although the employment pension system is mainly run by private insurance companies, it is classified (among other reasons because of 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 macroeconomic scenario described above. The development of the financial position of social security funds is determined by macroeconomic trends on the basis of current legislation and forthcoming amendments.

General government revenue as a ratio of GDP will remain roughly unchanged in the early years of the Stability Programme period, above all due to the fact that the tax cuts will come in the first years of the Government's term of office, though there will be a small rise in the level of income-based revenue in the latter years of the period.

Revenue from income and wealth taxes will increase by about 2 per cent in 2005. Central government tax revenue will decrease slightly from the previous year because corporate tax receipts will be smaller than they were a year ago. Within personal taxation, the increase in the tax base will accelerate slightly in step with rising employment, thereby lifting the revenue of local administration and the social security funds. The changed bases of corporate and capital taxation will reduce tax revenue by 0.6 billion euros (just under ½ per cent of gross domestic product). Taxes on production and imports will rise by 3½ per cent.

As a result of changes in tax bases, the tax rate for earned income will rise on average by ½ percentage point in the medium income bracket. Overall tax revenue is estimated to increase by 3½ per cent in 2005.

During the period from 2000 through to 2004, taxes levied on wages were reduced by a sum equivalent to around 3 per cent of GDP. Wage earners' average tax wedge (i.e. the share of labour costs represented by income taxes, social security contributions payable by employees and employers and value added tax) decreased with the easing of the bases for levying taxes and contributions. In 2000-2004, the tax wedge fell by 4 percentage points and since 1995 by 5½ percentage points. In the low income bracket the tax wedge was reduced by an estimated 4.4 percentage points and in the high income bracket by 3.7 percentage points. In 2005 the narrowing in the overall tax wedge will come to a halt unless new changes are made to the tax bases.

In spite of these tax cuts and changes in the tax structure, the tax wedge is still quite hefty from the standpoint of job creation, and ways should be found to lower labour taxation further. Apart from general employment considerations, international tax competition is creating pressure to ease the taxation of highly qualified professionals. The assumption used in the Stability Programme is that in 2006-2008 changes will be made to the income tax scales so as to prevent a tightening of taxation.

Earnings-related pension contributions are expected to rise somewhat in 2005-2008 so that provision can be made for the impending rise 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 by 8½ percentage points since 1995. In 2004 the figure stands at about 48½ per cent, where it is expected to stay through to the end of the programme period. Public expenditure will grow at the rate of gross domestic product both in 2004 and 2005. Social benefits and allowances as well as consumption expenditure by the municipalities will grow substantially.

Basic central government spending (expenditures excluding interest payments) is estimated to increase markedly in real terms in 2004. Interest payments will decrease by more than a tenth. About half of this is attributable to increases in appropriations required by current legislation and decisions made during the previous electoral period, while the other half is due to increases in spending decided upon in connection with the Government Programme and to compensations payable to other public sector tax recipients on account of cuts made in earned income taxation.

In the 2005 Budget Proposal, central government expenditure is up 1½ per cent on the appropriations in the 2004 Budget Proposal. Appropriations in the Budget Proposal total 37.6 billion euros, of which interest payments on central government debt amount to 2.4 billion euros. Appropriations for the administrative domains (expenditure excluding interest payments) will be up 2½ per cent, but this will be offset somewhat by the 12 per cent decrease in interest expenses.

The proposed spending increase in 2005 is in line with the front-loaded policy for increases in appropriations that was agreed in the Government Programme, with the fastest increase in expenditure centring on 2004. The Government has adopted a precisely formulated programme for the development of welfare services and income transfers, in which the additional resources made available will be allocated as effectively as possible with a view to supporting job creation and the growth potential of the economy.

In order to achieve its employment targets, the Government will be implementing a broad package of measures aimed at supporting entrepreneurship and employment. These measures will comprise education policy, R&D investments, tax policy, support for incomes policy settlements, a reform of labour policy, as well as two policy programmes that cut across administrative lines.

To keep unemployment from rising, the Government has stepped up its active labour policy measures during the first years of the budget planning period and launched a cross-administrative employment programme aimed at breaking the hard core of unemployment. These measures have included the establishment of labour service centres that span administrative boundaries, the aim being to smooth the entry into work or training of jobseekers who are in the most difficult situation. In addition, means testing for labour market support has been eased with regard to the earnings of spouses, and subsistence allowances have been raised in order to counter unemployment and poverty traps.

The Government will start the process of bringing forward the commencement of higher education and providing funding for completed study units in order to speed up entry into working life. At the same time the student financial aid system will be developed with a view to providing stronger incentive for graduation. Working in close consultation with labour market organisations, the Government will also be looking into ways in which to postpone retirement by encouraging older employees to stay on in employment and by reducing incentives for employers to get rid of older employees.

The State Budget for 2005 will bring a slight improvement in the position of local government finances. According to the basic services programme that was approved alongside the Budget, the growth in the municipalities' expenditure is forecast to slow down to at 4 per cent in nominal terms. Investment is estimated to hold steady at about the 2004 level.

The increase in expenditures by the social security funds will slow down to roughly the rate of GDP. The pension reforms that have already been made will start kicking in with the effect of retarding the growth in pension expenditure, inflation adjustments to pensions will be exceptionally minor and unemployment will decline, even though the age brackets entering retirement are getting larger. There will be a further rapid increase in sickness insurance compensation.

The ratio of general government expenditure to GDP will remain nearly unchanged in 2005-2008. The Government Programme sets out, quite explicitly, the main principles of income transfers over the current electoral period, i.e. through to 2007. The overhauled central government spending limits procedure will also facilitate the management of public spending.

There is considerable spending pressure in local government, but growth in expenditure will be restrained by the general weakening of the financial outlook in local government. Local authorities have also set up projects aimed at improving the efficiency of service provision and reducing structural costs. Furthermore, projects are under way to create new joint municipalities.

6 SUSTAINABILITY IN GOVERNMENT FINANCES

6.1 Measures aimed at fostering sustainability

Longer term public finances are overshadowed by the impending rise in costs due to population ageing and by the decline of the revenue base resulting from the dwindling labour supply. Provision for coping with the financing and expenditure pressures which general government will face as a consequence of population ageing has, however, been made, notably by means of tighter strings on central government expenditures, by reducing indebtedness, prefunding for future pensions and reforming pension schemes as well as by fostering growth potential in the economy.

The structural surplus in central government and the reduction in government debt have helped to create room for manoeuvre so that the growth in expenditure and the weakening of the revenue base caused by the ageing of the population will not lead to a new rise in the central government debt ratio and/or the tax rate. The prefunding of earnings-related pensions has helped considerably to ease the pressures to raise pension contributions in the future. Tax and social security schemes have been revised with a view to encouraging individual initiative and employment. Steps have also been taken to boost economic growth by investing in knowledge and know-how and by supporting entrepreneurship and innovation. Improving the efficiency and raising the quality standards of public services serve the same purpose.

Pension schemes have been reformed and updated on several occasions over the past ten years. The most recent comprehensive package of reforms will be phased in primarily from the beginning of 2005. The aim of these reforms is to provide incentives for older people to stay on longer in employment and to postpone retirement in the longer term by at least three years. However, some of the reforms have already been put in place during 2003 when, for instance, the minimum age of eligibility for part-time pension increased by two years. The most important elements of the reform are as follows:

- Early retirement schemes will be discontinued and replaced by a flexible old-age pension: persons aged between 62 and 68 are eligible.

- The accelerated accrual rate (at 4.5% a year) in the 63-68 age bracket is intended to encourage people to stay on longer in employment.
- The removal of the pension ceiling (at 60% of income) pursues the same objective.
- A mechanism whereby pension security is adjusted to changes in life expectancy will be introduced to eliminate the increase in earnings-related pensions expenses arising from longer life expectancy.
- To offset the rise in employment pension contributions, the prefunding of pensions will be stepped up as from 2003 for a fixed period.
- In the future, pensions will be determined according to the individual's entire employment history instead of the present 10-year rule.

Sustainability in public finances is strengthened not only by the pension reform, but also by the overhaul of the unemployment insurance system: most of these changes will also be taking effect from the beginning of 2005. The most significant reform is the decision to raise the minimum age in the 'unemployment pipeline' by two years from 55 to 57 years. As from the beginning of 2003, an earnings-related unemployment allowance has been paid out to people with a work history of at least 20 years, with an increment for 130 days of unemployment. This replaced the previous redundancy payment system.

Introducing a flexible retirement age will bring a change compared with the previous system in that several age brackets will now be able to retire on an old-age pension, which in the first year of the reform (2005) will probably increase the number of pensioners. In the long term, however, the reforms of pension and unemployment security will bring a marked improvement in the economic incentives to stay on in working life for a longer time than at present, and they will strengthen the sustainability of public finances, notably by reducing significantly the pressures to raise employment pension contributions (see chapter 6.2 for details).

6.2 Sustainability scenario

The initial year of the sustainability scenario is 2008, i.e. the year when the medium-term projection ends. The scenario extends up to 2050. The scenario is based on the national population estimate, which differs most from the Eurostat (1999) population estimate for Finland in respect of life expectancy. A scenario according to the Eurostat population forecasts for 2004 is not yet available.

The economic assumptions used in the scenario runs approximately parallel with those in the previous Stability Programme update. The employment rate is assumed to rise to about 72 per cent and the unemployment rate to fall to about 4 per cent in 2030. Labour productivity is estimated to grow by 1.75% annually as from 2010. As a departure from the previous Stability Programme, the real interest rate is set at 3.5%; the same real interest rate assumption applies to both debt and investments made by the pension funds.

Age-linked expenditures have been taken into account more comprehensibly than previously in the population ageing scenario prepared for the EU Economic Policy Committee. Social and health services comprise not only acute and long-term healthcare but also children's daycare. Unlike the previous scenarios, the new projections also cover sickness insurance expenditure, on which population ageing has a major impact.

Because the scenarios are based on the assumption that Finns will live to an older age than was estimated previously, it is clear that the pressures for increasing public spending will be greater than was stated in the previous Stability Programme update. Pension expenditure as a ratio of gross domestic product is estimated to rise from 10.7 per cent in 2000 to just over 15 per cent in 2050.

The assumption applied in the projection for social and health services expenditure is that productivity in providing the above-mentioned services will not grow at all, but it is estimated that the salaries and wages of public sector employees will follow the same ascending trend as productivity in the economy as a whole. Expenditures on social and healthcare (incl. sickness insurance) in relation to total output are estimated to rise from 8.8 per cent in 2000 to about 13½ per cent in 2050, an increase of 4½ percentage points. The projection for education expenditure was taken from the calculations prepared by the EU Economic Policy Committee.

Unemployment expenditure will halve in relation to total output because the unemployment rate is assumed to fall to 4 per cent. Other public expenditure (excl. interest payments) is assumed to remain constant as a ratio of GDP. Interest expenses and income were derived from the gross debt in general government and gross financial assets, applying, as from 2015, the same 3.5 per cent real interest rate assumption to both the debt and financial assets.

The overall tax rate was held constant (44.3 %) from 2008 onwards. Actuarially determined earnings-related pension contribution rates were allowed to rise, whereas other taxation was lowered. Thanks to prefunding, the long-term pressures to increase employment pension contributions will come to about half of the rise in pension expenditure. In the projection the pressure for raising employment pension contributions was estimated at just over 2 per cent of GDP.

Calculated on these assumptions, in the so-called baseline scenario general government finances will fall into deficit in 2021. The employment pension funds will run a surplus throughout the entire period of the prognosis, the annual surplus being about 2½ per cent of GDP. The financial assets of the employment pension institutions as a ratio of GDP will rise from the present figure of more than 50 per cent to about 70 per cent in 2050. The rest of general government finances – the central government and the municipalities together – will run a deficit throughout the prognosis period. The deficit will increase from near balance in 2008 to 5 per cent of GDP in 2030 and then grow to nearly 10 per cent in 2050.

6. General government in the long run, % of GDP

	2000	2005	2010	2020	2030	2040	2050
Overall expenditure	46.7	48.4	49.0	51.5	54.6	56.9	59.3
Pensions	10.7	11.6	12.5	14.3	15.5	15.4	15.2
old-age pensions	7.2	8.0	8.9	11.2	12.4	12.3	12.2
Social and health care services	6.7	7.4	7.7	8.4	9.4	10.0	10.1
Sickness insurance	2.1	2.5	2.7	3.0	3.1	3.2	3.3
Education	6.1	5.8	5.6	5.6	5.6	5.5	5.4
Unemployment	1.7	1.7	1.7	1.4	1.0	0.8	0.8
Interest expenses	2.8	1.7	2.1	2.1	3.3	5.3	7.8
Other expenses	16.6	17.7	16.7	16.7	16.7	16.7	16.7
Overall revenue	53.7	50.2	50.9	51.6	51.7	51.8	52.0
Taxes and social security contributions	46.9	44.1	44.3	44.3	44.3	44.3	44.3
Other revenue	6.8	6.1	6.6	7.3	7.4	7.5	7.7
Financial surplus	7.1	1.8	1.9	0.1	-2.9	-5.1	-7.3
Financial assets and debt							
Pensions funds´ consolidated assets	39.0	49.0	52.0	58.9	61.8	63.8	66.2
Other financial assets[1)]	12.2	10.1	9.4	6.6	4.7	3.3	2.4
Financial assets, total	51.2	59.1	61.4	65.5	66.5	67.1	68.6
Gross debt (consolidated)	44.6	43.5	39.6	41.5	62.8	101.2	147.6
Net financial assets[2)]	6.6	15.6	21.8	24.0	3.7	-34.1	-79.0
Assumptions							
Labour productivity growth	2.8	2.0	1.8	1.8	1.8	1.8	1.8
GDP growth	5.1	2.9	1.6	1.4	1.4	1.5	1.6
Participation rate (Male 20-64)	81.4	80.6	80.6	81.2	81.3	81.3	81.3
Participation rate (Female 20-64)	75.7	76.0	76.0	76.6	76.7	76.7	76.7
Overall participation rate (20-64)	78.6	78.5	78.5	79.1	79.2	79.2	79.2
Unemployment rate	9.8	8.5	7.6	5.3	4.0	4.0	4.0
Real interest rate	2.0	2.5	3.5	3.5	3.5	3.5	3.5
Inflation	3.4	1.8	2.0	2.0	2.0	2.0	2.0

1) Mainly cash reserves of central and local government; this item has been kept constant during the whole period.

2) Financial assets minus debt.

The aggregate debt of central government and the municipalities in relation to total output will rise from 40 per cent in 2008 to about 62 per cent in 2030 and to over 147 per cent in 2050. Under the baseline scenario, central government and municipal finances will not be on a sustainable basis without adaptive measures. In the calculation the position of central and local government finances is weakened by the lowering in their tax rate, which is due to the fact that the overall tax rate was held constant whereas pension contributions were allowed to rise. The overall deficit in general government will go over the 3 per cent mark in 2031. The final results of the projection are shown in table 6.

In addition to the baseline scenario, a sensitivity analysis was made on the assumption that labour productivity within social and healthcare services will increase by 0.5 per cent annually and that this increase in productivity will reduce expenditure to the full extent. All the other assumptions were kept the same as in the baseline scenario. In this alternative, the growth in expenditure for social and healthcare services as a ratio of GDP will only be about a third of the growth under the baseline scenario and general government finances will be in substantially improved balance. At no stage will the deficit exceed the 3 per cent limit.

6.3 Pension fund assets

Finland's employment pension system is a partially pre-funded, defined benefit system in which the benefits are determined according to the length of the employment history and the level of earnings. The pre-funding is collective and it does not affect the level of the pension; rather, it is intended to even out the pension contribution rate over time. Wit-

7. Financial assets of Employment pension institutions (sector 13141) , million euros

	2000	2001	2002	2003
A. Non-consolidated liquid financial assets				
AF.21 Currency	0	0	2	0
AF.22 Transerable deposits	134	241	256	257
AF.29 Other deposits	276	228	880	379
AF.331Short term bills	1 279	2 125	1838	2 320
AF.332 Long term bonds	29 559	30 202	32 312	32 821
AF.34 Derivatives	105	20	80	111
AF.511 Quoted shares	15 347	13 016	10 518	13 807
AF.52 Mutual fund shares	323	3 093	2 740	4 693
Total	47 023	48 925	48 626	54 388
% of GDP	36.1	36.0	34.8	38.2
B. Liabilities of general government (sector 13) to pension funds (sector 13141)				
AF.331 Short term bills	20	5	29	26
AF.332 Long term bonds	10 322	6 887	4 830	4 666
Total	10 342	6 892	4 859	4 692
% of GDP	7.9	5.1	3.5	3.3
C. Consolidated liquid assets of pension funds (sector 13141) (= A-B)				
AF.21 Currency	0	0	2	0
AF.22 Transerable deposits	134	241	256	257
AF.29 Other deposits	276	228	880	379
AF.331 Short term bills	1 259	2 120	1 809	2 294
AF.332 Long term bonds	19 237	23 315	27 482	28 155
AF.34 Derivatives	105	20	80	111
AF.511 Quoted shares	15 347	13 016	10 518	13 807
AF.52 Mutual fund shares	323	3 093	2 740	4 693
Total	36 681	42 033	43 767	49 696
% of GDP	28.2	31.0	31.3	34.9
D. Total assets (sector 13141)				
Non-consolidated total assets	60 737	62 480	63 570	69 290
% of GDP	46.6	46.0	45.5	48.6
Consolidated total assets	49 179	54 667	57 781	63 737
% of GDP	37.8	40.3	41.3	44.7

Source: Statistics Finland: Financial statistics hin the National Accounts framework, the pension funds in the private and municipal sector are counted as social security funds. By contrast, the State pension institute is part of central administration. The tables 7-9 show the non-consolidated and consolidated market value of the pension funds in 2000-2003.

8. Market value of the investments made by the State pension institute

	2000	2001	2002	2003
		million euros		
Non-consolidated assets	3 843	4 427	4 841	5 795
Consolidated assets	1 522	1 686	3 099	4 549
		% of GDP		
Non-consolidated assets	3.0	3.3	3.5	4.1
Consolidated assets	1.2	1.2	2.2	3.2

Source: State pension institute.

9. Market value of the investments made by Employment pension instutions (sector 13141 and the State pension institute)

	2000	2001	2002	2003
		million euros		
Non-consolidated assets	64 580	66 907	68 411	75 085
Consolidated assets	50 701	56 353	60 880	68 286
Consolidated liquid assets	38 203	43 711	46 866	54 245
		% of GDP		
Non-consolidated assets	49.6	49.3	48.9	52.7
Consolidated assets	38.9	41.5	43.6	47.9
Consolidated liquid assets	29.3	32.2	33.5	38.1

Source: Statistics Finland: Financial statistics and State pension institute

7 OTHER FACTORS WITH AN IMPACT ON PUBLIC FINANCES

7.1 Developing product and capital markets and public service production

According to the Broad Economic Policy Guidelines for 2003, the major challenges facing Finland are to reduce the high level of structural unemployment and to increase the employment rate of older workers; and on the other hand to enhance competition in certain sectors and improve the efficiency of the public sector.

The Government has implemented and launched several reforms aimed at improving the functioning of the product, capital and labour markets.

The objective of the Government's competition policy is to improve market functioning. Of late, the competitive environment has been improved by carrying out structural reforms and increasing the scope of the competition authorities. The Act on Competition Restrictions has been reformed by harmonising Finland's national competition regulations with the EU's competition rules. In future, competition policy is to be integrated more consistently into economic policy as a whole.

The employment programme too is linked to overall structural policy. Measures prescribed in the employment programme have been implemented across administrative lines in collaboration with different ministries. The main areas have been structural reform of labour services, the preparation of an education and social guarantee for young people, anticipation of adult education needs as well as improvement of the quality and impacts of education and training. The labour policy programme is described in greater detail in the national action plan for employment that was drawn up in October 2004.

With a view to improving productivity within public administration, the Government has launched a programme of productivity measures in which each administrative domain will draw up a productivity development programme. Implementation of the development programmes will be included in the spending limits and budget proposals beginning in 2005–2007. One aim of the development of the local government financing and central government transfer system is to improve the incentives which the systems offer for developing the productivity of public services. The reform of the system of central government transfers to local government will come into force from the beginning of 2006.

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