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STABILITY PROGRAMME FOR FINLAND

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Contents

INTRODUCTION AND SUMMARY

The population in Finland is ageing faster than in any other EU country, and this is causing various tensions in the labour market and general government. Ageing presents a formidable challenge particularly for the sustainable funding of general government: on the one hand there are growing expenditure pressures in pension and welfare services, but at the same time the growth of national income and the tax base is slowing down as the labour supply decreases. The importance of productivity as a growth factor is increasingly evident. On average, productivity has increased rapidly, but in many areas of the national economy the figures are less than impressive.

The Finnish Government's response to these challenges is through a consistent and long-term policy of supporting sustainable growth of employment and boosting productivity. Aimed at greater predictability in economic policy and sustainability in fiscal policy, this policy line has been complemented by tax and other measures designed to improve business competitiveness and employment opportunities. At the same time, these measures have served to support long-term wage agreements and stability in the labour market. A stable and predictable operating environment supports decision-making by businesses and private households.

Sustainability requirements are particularly significant in the context of efforts to prepare for the pressures that population ageing and the declining size of age groups of working age will exert on general government finances. Securing balanced general government finances in the longer term will require mutually supportive reforms of income transfer and service systems, proper allocation of public sector resources and assigning task priorities. It is important that there is the flexibility to reallocate resources from one task area to another according to changes in the population age structure and the regional structure and according to the new priorities of service needs.

This Stability Programme update is based on the Government's decision on central government spending limits in 2006-2009, the Budget Proposal for 2006 that was issued in September, and related economic policy decisions and projections of economic trends.

Labour disputes in forest industry in 2005 and their related impacts had the effect of cutting into this year's growth. Given the low level of comparison, figures for 2006 will show much stronger growth: GDP growth next year will exceed 3 per cent, even though the growth cycle is slowing in the wake of the boom in 2004.

Mid-term economic growth will be hampered above all by constraints in the supply of labour, continued slow growth of production capacity over the past few years and the relocation of industrial production. In these conditions, economic growth is slowing appreciably over the medium term. Indeed over the next few years economic growth will be almost exclusively based on productivity growth. In the medium term Finland's economic growth will be slowed by the ageing of its population and the consequent decrease in the supply of labour. Demographic change is sweeping across Finland at a particularly fast rate, and therefore it will have significant impacts on economic growth even in the medium term.

Employment has begun to improve after long periods of sluggish development. New jobs have been created especially in service industries. At the end of the programme period, unemployment will stand at just over 6 per cent. If there is no marked increase in the age of retirement, the employment rate will remain at just over 68 per cent over the next few years.

Over the next four years the overall surplus in general government will stand at around 1½ per cent of GDP, but that surplus will be wholly attributable to social security funds as both central government and local municipalities have slipped into deficit. It is predicted that public sector EMU debt relative to GDP will slowly edge down towards the 40 per cent mark. Finland will continue in the medium term to meet the Stability and Growth Pact objectives in respect of the surplus in general government finances and indebtedness.

1 ECONOMIC POLICY OBJECTIVES AND PREMISES

1.1 General

The main challenges now facing economic policy in Finland are presented by changes in the population's age structure and regional distribution, the advance of globalisation and rapid technological progress. The production and business structure must be constantly upgraded to make sure that the economy remains competitive.

The main goal of the Government's economic policy is to reduce unemployment and to find jobs for 100,000 persons during its term in office. This would imply an increase in the employment rate to around 70 per cent. In order to achieve this goal the Government will need to persist with its economic policy of promoting stable growth, improving the functioning of the goods, capital and labour markets and securing an internationally competitive environment for business.

Sluggish economic development during the early years of the decade combined with tax cuts aimed at bolstering economic growth and employment have caused the general government surplus to decrease in recent years. The remaining surplus is wholly attributable to social security funds as both central government and local municipalities have slipped into deficit. The challenge for the immediate future is to restore a strong surplus in general government and to restore balance in local government finances. This will require a conservative expenditure profile in both central and local government finances and at the same time opportunities for new substantial tax cuts are limited.

With regard to the challenge of preparing for the expenditure pressures that are set to follow with population ageing, the baseline situation is less favourable than previously estimated. This underscores the need to curb public expenditure as well as the importance of both efficient markets and structural measures aimed at reinforcing general government. Sustainable central government finances are also essential to ensuring that the Government has sufficient fiscal policy leeway in all circumstances.

The pressure of increasing expenditure is greatest in pensions and health and social care services. It is estimated that by 2030, changes in the age structure will drive up the combined share of these expenditure items by 6 percentage points as a proportion of GDP. The labour reserves are dwindling, and if the pressures to increase public expenditure cause a corresponding shift to public services, then it will be increasingly difficult to find skilled and competent staff in the private sector.

Because of international tax competition, the growing expenditure pressures that lie ahead cannot be met by increasing taxes. An increased tax rate would undermine economic growth, which in the long-term will be slowing as it is because of population ageing. Given the dwindling supply of labour, economic growth and the revenue base for public services rely increasingly on improved productivity. There are several ways in which balance can in principle be maintained: raising the employment rate, adjusting the range and volume of public services to the resources available, charging the costs to end-users and increasing productivity.

1.2 Broad economic policy guidelines and integrated 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 that favours efficient resource allocation. According to the Commission's statement on the broad guidelines for economic policies in 2003-2005, the main challenges facing Finland are to reduce the high level of structural unemployment, to increase the employment rate of older workers, to enhance competition in certain sectors and to improve the efficiency of the public sector. To address these challenges, Finland should:

- continue to reform tax and benefit systems in order to make work pay;
- ensure that wages reflect productivity;
- step up efforts to enforce competition in network industries and non-tradable services;
- increase the efficiency of the public sector; and
- tighten controls on public sector spending.

While in the process of revising and updating the Lisbon Strategy, the European Council sent out a clear message that the biggest challenges facing the European Union in the years ahead are to accelerate economic growth and to boost employment.

The main emphasis in tackling these challenges should be on implementing the Lisbon Strategy objectives in line with the Broad Economic Policy Guidelines and the Employment Guidelines (Integrated Guidelines).

The Government's economic policy is in line with the Commission's recommendations on the BEPGs for 2003-2005 as well as with the requirements set out in the integrated guidelines document. 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 and in the Finnish National Reform Programme adopted by the Government in October 2005. The Stability Programme update and the Finnish National Reform Programme are consistent with each other.

1.3 Finland's 2005 Stability Programme update and administrative consideration of the programme

The 2005 Stability Programme update is based on the Government's decision on central government spending limits for 2006-2009, the Budget Proposal for 2006 that was issued in September, and the macroeconomic forecast underlying that proposal The update was drawn up after the submission of the 2006 Budget Proposal. The document will be delivered to the relevant EU bodies within the agreed time frame (15 October – 1 December 2005) 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.

The Stability Programme update complies with the Code of Conduct endorsed by the EU Council in October 2005. 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 2009 the surplus in general government is expected to stand at around 1½ 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.

2 ECONOMIC SITUATION AND OUTLOOK

2.1 Recent developments and short-term outlook

A marked slowdown in the growth of world trade and a surge in oil prices combined to undermine the confidence of industry and consumers in the euro area in the first half of 2005. Against a backdrop of weak domestic demand, economic growth was subdued, as measured against both the rest of the world and previous upswings in the area. Beginning in the early summer, however, business expectations began to strengthen, and a cautious revival is anticipated towards the end of the year as world trade picks up somewhat and the euro depreciates. High unemployment and the soaring price of oil are nonetheless still exerting a drag on household consumption in the euro area and also pose the greatest risk to an uptick in economic growth.

In Finland, economic growth was slim in the first half of 2005 owing to the exceptional timing of bulges in industrial output: the strong momentum of the metal and electronics industry came to a halt temporarily in the first quarter, and in the second quarter the labour disputes in forest industry led to a substantial drop in production. The growth in total output this year, 2 per cent, is based almost entirely on domestic demand, with labour disputes in forest industry and their related effects shaving one percentage point off growth. On the other hand, given the low level of comparison, figures for 2006 will show much stronger growth: GDP growth next year will exceed 3 per cent, even though the growth cycle is slowing in the wake of the boom in 2004. The growth in the provision of private services will continue to outstrip total output both this year and next, whereas growth in public services will remain sluggish.

Exports and imports increased significantly in the first half of 2005 despite the slowdown in world trade and labour disputes in forest industry. These shutdowns knocked a couple of percentage points off export growth, but the strong position of the Finnish electronics industry and other sectors in the face of international competition will nonetheless lift the growth in export volumes this year to nearly 4 per cent.

Because of the forest industry shutdowns and new working hours arrangements, the growth figure for exports will be higher in 2006, when exports will grow at twice the rate of GDP, reaching about 6 per cent.

After sustained decline over the past couple of years, employment showed a strong upward trend in the latter half of 2004, and in the first half of the current year, new jobs were created at a quickening rate, particularly within construction and in part-time retail sales jobs as well as in social and health care services. There were 39,000, or 1.6 per cent, more jobs in the first half of 2005 than a year earlier. Towards the end of the year, however, the trend will even out and the full-year increase in employment will be about 30,000 jobs, or just under 1½ per cent. This year the employment rate will rise to 68 per cent, from 67.2 per cent a year earlier. In 2006 employment will rise further, albeit more slowly, but as the labour supply gradually heads downward, the unemployment rate will fall to 7½ per cent, from 8.2 per cent this year. Long-term unemployment will remain a major problem. At the same time, the structural bottlenecks in the labour market will pose a mounting risk factor for sustained economic growth.

Inflation will remain well in check in the current year compared with other countries in the euro area. World market prices for crude oil have spiked sharply, but cheaper prices and charges for ICT and telecommunications goods and services in step with stiffening competition have contained the average rise in consumer prices. Labour costs will rise at nearly last year's rate and the temporary slowdown in productivity growth will mean higher unit labour costs. Nonetheless, it is estimated that price competitiveness will improve again next year owing to a pickup in productivity while labour costs have receded. Construction costs and housing prices have continued to escalate alarmingly. Last year, real house prices rose on average by 7 per cent on the previous year. This year, too, the rise in prices has clearly exceeded the overall rate of inflation.

The estimates of economic growth and associated factors in 2005-2006, as presented in Table 1, are based on Ministry of Finance forecasts (Economic survey) published in September. The estimates of international growth for 2005-2006 are in line with the initial assumptions of the scenario published by the Ministry of Finance in September 2005. For the most part there are only minor differences compared to the assumptions underlying the Commission's scenario this autumn. The impacts of these differences in underlying assumptions on economic trends are discussed under chapter 4.1 below.

1. Growth and associated factors

	2004	2004	2005	2006	2007	2008	2009
	mrd. eur			change			
Macroeconomic prospects							
1. Real GDP		3.6	2.1	3.2	2.6	2.3	2.1
2. Nominal GDP	**149.7**	4.1	2.2	4.2	3.6	3.4	3.2
				Components of real GDP			
3. Private consumption expenditure	**77.7**	3.2	2.4	2.6	2.2	2.0	1.8
4. Government consumption expenditure	**33.7**	1.6	1.7	1.4	1.2	0.9	0.7
5. Gross fixed capital formation	**28.2**	5.0	2.0	1.6	1.9	1.4	1.3
6. Changes in inventories (% of GDP)	**0.8**	0.5	0.5	0.5	0.5	0.5	0.5
7. Exports of goods and services	**56.6**	5.6	3.8	6.0	3.9	3.4	3.2
8. Imports of goods and services	**48.5**	6.0	4.4	3.5	2.4	2.2	2.0
				Contributions to real GDP growth, % points			
9. Final domestic demand	**139.6**	2.9	2.0	1.9	1.7	1.5	1.3
10. Changes in inventories	**0.8**	0.3	0.0	-0.1	0.0	0.0	0.0
11. External balance of goods and services	**8.1**	0.4	0.1	1.4	0.9	0.8	0.8
Price developments							
1. GDP deflator		0.5	0.1	1.0	1.0	1.1	1.1
2. Private consumption deflator		0.1	1.0	1.5	1.5	1.8	1.8
3. HICP		0.2	1.0	1.3	1.5	1.8	1.8
4. Public consumption deflator		3.7	2.9	2.4	2.8	2.8	2.8
5. Investment deflator		2.0	1.8	1.6	2.0	2.0	2.0
6. Export price deflator		1.0	0.3	-0.6	-0.8	-0.8	-0.8
7. Import price deflator		3.6	4.5	0.9	1.0	1.0	1.0
Labour market developments							
1. Employment, 1 000 persons	**2 365**	0.0	1.3	0.5	0.3	0.2	0.2
2. Employment, 1 000 hours worked	**4 068**	0.3	0.4	0.6	0.1	0.0	0.0
3. Unemployment rate (%)		8.8	8.2	7.5	7.0	6.6	6.2
4. Labour productivity, persons		3.6	0.8	2.7	2.3	2.1	1.9
5. Labour productivity, hours worked		3.3	1.7	2.7	2.5	2.3	2.1
6. Compensation of employees	**20.7**	4.5	3.8	3.4	3.4	3.4	3.4
Sectoral balances							
% of GDP							
1. Net lending/borrowing vis-á-vis the rest of the world		4.2	2.6	3.2	3.1	2.9	2.7
of which: - Balance on goods and services		5.4	4.0	4.3	4.2	3.9	3.7
- Balance of primary incomes and transfers		-1.3	-1.4	-1.2	-1.2	-1.1	-1.1
- Capital account		0.1	0.1	0.1	0.1	0.1	0.1
2. Net lending/borrowing of the private sector		3.1	1.9	2.6	2.6	2.4	2.2
3. Net lending/borrowing of general government		2.1	1.8	1.7	1.6	1.5	1.5
4. Statistical discrepancy		-1.1	-1.1	-1.1	-1.1	-1.1	-1.1
Basic assumptions							
Short-term interest rate (3 month money market)		2.1	2.2	2.4	-	-	-
Long-term interest rate (10 year government bonds)		4.1	3.5	3.7	-	-	-
USD/EUR exchange rate		1.2	1.3	1.3	-	-	-
Nominal effective exchange rate		1.5	0.1	0.1	-	-	-
World GDP growth, excluding EU		5.7	4.8	4.8	-	-	-
EU-25 GDP growth		2.4	1.6	1.9	-	-	-
Growth of relevant foreign markets		10.0	7.7	9.7	-	-	-
World trade growth		9.0	6.0	5.0	-	-	-
Oil prices (Brent, USD/barrel)		38.3	52.0	52.0	-	-	-

2.2 Medium-term macroeconomic scenario

The projections shown in the Stability Programme for economic development in 2005-2006 are based on the short-term economic scenario compiled by the Ministry of Finance in September 2005. The medium-term projections for 2007-2009 are based on calculations and surveys of longer term growth prospects in the economy. The GDP growth estimate is in line with the estimates of potential output growth based on the production function method as developed by the EU Commission together with Member States.

Mid-term economic growth will be constrained primarily by changes in the population age structure, the slow growth in production capacity in recent years and the relocation of international production. In these conditions, economic growth is set to slow in the medium term to just under 2½ per cent. Indeed over the next few years economic growth will come almost exclusively from productivity growth.

The international economy peaked in 2004, and it is expected that growth in 2005-2006 will be falling back in the United States, Japan and in the euro countries. The Chinese economy, however, is expected to remain on a strong growth path, and the same goes for Russia. In the euro area there are uncertainties with respect to the development raw material prices, crude oil in particular, and also with respect to the development of the external value of the euro. The continuing strength of the euro is having an adverse effect on the price competitiveness of European export companies, at the same time as record-high crude oil prices are undermining business profitability as well as household confidence. Furthermore, economic growth in Europe is constrained by structural rigidities and population ageing. The outlook for the international economy is also overshadowed by other structural problems and imbalances, such as the deficits in the current account balance and central government finances in the United States as well as uncertainties about the sustainability of economic growth in China.

The slowdown in world economic growth will also constrain the medium-term growth potential of Finnish exports. It is expected that exports will increase by more than 3 per cent a year. This is based on the expectation that the electronics industry and other branches of industry will step up production primarily outside of Finland, closer to the end-product market that are expanding more rapidly than the domestic market. The growth prospects for the Finnish export sector are also limited by the continuing strength of the euro. The electronics industry will continue to account for a growing proportion of Finnish exports, with growth in other export businesses remaining significantly slower. Electronics exports will not, however, have as prominent a role in economic growth as was the case in the 1990s. Profitability in the electronics industry is adversely affected by declining export prices, particularly for mobile phones. The decline in export prices coupled with the anticipated increase in import prices, signifies a continuous weakening in the exchange ratio and a slow downturn in the current account surplus ratio from its current high level.

Growth in private investment is expected to slacken after strong growth in 2004. In the medium term, it is estimated that growth in private investment will remain at about 1½ per cent, as expectations of economic growth in Finland are quite moderate. In addition, it is anticipated that in the future, Finnish companies will step up their investments abroad, close to large markets and in countries with lower production costs. In the baseline scenario, the rate of investment will remain at around 19 per cent in the medium term, which is significantly lower than in previous decades.

Private consumption has been boosted by tax cuts, the still-low interest rates and stronger employment. As bank loans are offered at very good rates and confidence remains solid, household indebtedness has increased sharply in recent years and is edging close to the peak level of the early 1990s – although household interest expenses in proportion to disposable income are still substantially lower today. EMU membership contributed to greater stability in the financial markets, making possible a cautious rise in indebtedness without upsetting the balance of the economy. In the medium term, however, consumer indebtedness and expectations of rising interest rates will begin to restrict growth in consumption. Accordingly, it is estimated that over the next few years private consumption will rise by about 2 per cent annually in real terms.

Projections for the development of expenditure and revenue in general government are set out in chapters 3 and 5 below.

Statistics Finland's population forecast indicates that the ranks of the working-age population will begin to dwindle at around the turn of the decade, but the labour supply can be expected to start waning even before then if the average age of retirement cannot be significantly raised. The first signs of a dwindling labour force supply will become evident in 2006. Coupled with high structural unemployment, the decrease in the labour force is one of the key factors limiting economic growth in the medium term. However, the pension reform that came into force at the beginning of 2005 is expected to help slow down the decline in the labour supply.

Population ageing is set to intensify competition for skilled labour in the years ahead, causing pressures for an acceleration of labour costs. This, in turn, might cause industrial price competitiveness to suffer. The dwindling supply of skilled labour threatens to lead to a slowdown in economic growth if productivity cannot be increased faster. Total productivity growth can be expected to begin slowing down gradually towards the end of the decade, as production continues to grow in the service sector where productivity is lower. The collective incomes policy agreement signed at the end of 2004 will also have the effect of supporting employment in the years ahead, especially in lower productivity sectors, which will contribute to restricting productivity growth throughout the term of the agreement. Productivity is expected to grow by about 2 per cent annually over the medium term, somewhat more slowly than the average historical long-term trend.

After a long muted period, employment has begun to gain strength. New jobs have been created especially in the service sector. Having said that, industry has continued to relocate production abroad and the number of industrial jobs in Finland has continued to decrease up to the present year. If the economy performs in line with the projection above, the numbers employed will increase over the programme period by almost 30,000, but unemployment will decrease even more as a result of the reduced labour supply. At the end of the programme period, the unemployment rate will stand at just over 6 per cent. At the same time, the employment rate is expected to remain at just over 68 per cent over the next few years.

The outlook on medium-term economic growth described in this chapter is based on projections of potential economic growth that are estimated using the European Commission's production function method. The calculations involve a number of uncertainty factors and the risk is that actual growth will fall short of the growth projections set out in the Stability Programme. This is discussed in closer detail in the sidebar under chapter 4.1. Apart from the baseline scenario, Chapter 4.1. also describes slower and faster growth scenarios.

3 GENERAL GOVERNMENT: BALANCE AND DEBT IN 2005-2009

3.1 Fiscal policy strategy

One of the Government's key objectives concerns the stability of central government finances and the long-term sustainability of fiscal policy, which are pursued by seeking to increase employment and by means of a conservative expenditure profile. The Government's declared aim is to secure balanced central government finances under normal conditions of economic growth at the end of the electoral period, as measured in terms of national accounting. 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-to-GDP ratio. Furthermore, the Government expects that even in conditions of adverse economic development, the deficit in central government finances, as measured in national accounting terms, shall not exceed 2¾ per cent of GDP. In the light of current forecasts it is unlikely that the economy will be as sluggish as this over the next few years.

Preparation of the central government spending limits has been based on the fiscal policy lines set out in the Government Programme. The spending limits procedure has been revised in line with the Government Programme so that most of total budget appropriations are allocated to spending limits that cover the whole electoral term. This increase in allocations is included in the statement on the central government spending limits for 2004-2007 that was submitted to Parliament on 23 May 2003. The Government is committed to these spending limits and the measures specified in the Government Programme will be implemented within these limits. The Finnish spending limits system is described in closer detain under chapter 7.

The motivating force behind the spending limits for 2006-2009 has similarly been to support the Government's economic policy objectives and to persist with a fiscal policy that secures stable growth. The starting-point is a cautious expenditure policy where strict economy is exercised in all administrative branches. This also helps to create economic leeway for political decision-making.

3.2 General government balance and debt

The overall surplus in general government will stand at around 1½ per cent of GDP over the next four years. It is predicted that public sector EMU debt relative to GDP will slowly edge down towards the 40 per cent mark. In 2005 central government final accounts surplus, mainly accumulated from the sale of shares, is available for paying down central government debt.[1] Finland will continue in the medium term to meet the Stability and Growth Pact objectives for EU countries in respect of the surplus in general government finances and indebtedness.

The Government has taken steps to improve conditions for employment and to strengthen competitiveness by means of tax cuts and by increasing central government expenditure. In the short term, however, these measures have had the effect of slowing the increase in central government tax revenue. The corporate and capital tax reform took effect at the beginning of 2005, and it is expected that over time it will have the effect of increasing tax revenue with improvements in the operating environment and profitability of business companies.

As a result of these measures and the fairly muted economic growth in early years of the decade, the financial position of general government and central government in particular has weakened. Central government finances were still marginally in surplus last year, but will slide into slight deficit during 2005. The outlook for central government finances is also muted in the medium term. In this environment of slowing economic growth, the threat is that the central government deficit will grow further in the years ahead, in which case the objective of balance in central government finances by the end of the Government's term in office may not be reached. Continued favourable economic growth and rising employment together with adherence to a tight expenditure policy will in turn support the achievement of the goal of balanced central government finances.

Over the past five years, municipal expenditures have shown an average nominal growth of over 5 per cent a year. This, coupled with the weak trends in tax revenue,

[1] The Government submitted its proposal for the second supplementary budget for 2005 on 14 October 2005. The proposal includes increases in tax revenue as well as in revenue from the sale of shares. Primarily on the strength of revenue from the sale of shares, the budget proposal also increases the amount set aside for the repayment of central government debt, and central government debt and general government gross debt as a proportion of GDP will drop in 2005 by about one percentage point more than was previously expected. To some extent the second supplementary budget also improves the balance of central and general government finances in 2005. As has been pointed out elsewhere in this Stability Programme update, the projections presented in this programme are based on a macroeconomic scenario issued in September. For reasons of forecast consistency no changes have been made on the basis of the second supplementary budget to other than debt projections. In any case the changes implied by the second supplementary budget would remain marginal.

has saddled local government finances with a one half per cent deficit-to-GDP ratio. At the same time, local government debt has doubled. However, the balance in local government finances will begin slowly to improve in the next few years as a result of the anticipated increase in tax revenues and central government subsidies to local government and the expected slowdown in expenditure growth. The obligation of maintaining financial balance in the medium term and the ongoing changes in the population structure coupled with the problems of labour availability will necessitate changes in the municipal and service structure.

Employment pension funds will keep overall general government finances clearly in surplus, despite the weakened financial balance in both central and local government. The financial surplus of employment pension funds will decrease somewhat during the period ahead as employment pension expenditure continues to increase but pension contributions are slightly lowered. The surplus of employment pension funds will drop to close to 2 per cent of GDP in 2009.

3.3 Structural balance in public finances

The output gap, as estimated on the basis of the production function method developed jointly by the European Commission and Member States, has been negative since 2002, i.e. production has fallen short of its potential. It is expected that because of the labour disputes in forest industry, the output gap will be at its greatest in 2005 and then gradually begin to narrow. Growth in the economy's potential output is expected to stand at 3 per cent in 2005, and it is estimated it will slow to just over 2 per cent at the end of the programme period (Table 4). Contributing factors include the expected decreases in labour input and capital input, as well as the slowdown in the growth of total factor productivity.

The impact of the output gap on the cyclical sensitivity of general government finances is gauged by applying OECD income and expenditure elasticity estimates. Fiscal policy has supported economic growth in 2002–2004, which is reflected in the reduced structural financial balance in general government. In recent years, fiscal policy support for economic growth has come primarily in the shape of tax cuts. In 2005 the imputed structural financial balance in general government is strengthening, though this is the result of labour disputes in the forest industry and the consequent slowdown in GDP growth well below its potential. In addition, the labour disputes will lead to an imputed growth carryover effect, as a result of which it is estimated that economic growth will outpace potential growth in 2006. This, in turn, will reduce the negative output gap and thereby its adverse effects on the financial position in general government. At the same time, discretionary fiscal policy will again assume a slightly stimulatory stance because the structural financial balance will diminish compared with 2005. The changes in the structural financial balance are so small, however, that the prevailing fiscal policy can in practice be characterised as relatively neutral.

2. General government budgetary prospects

	2004 milj. eur	2004	2005	2006 % of GDP	2007	2008	2009
				Net lending (EDP B.9) by sub-sector			
1. General government	3 194	2.1	1.8	1.6	1.6	1.5	1.5
2. Central government	724	0.5	-0.5	-0.5	-0.5	-0.7	-0.5
3. Local government	-997	-0.7	-0.5	-0.4	-0.2	-0.1	-0.1
4. Social security funds	3 467	2.3	2.8	2.5	2.4	2.3	2.2
				General government (S13)			
6. Total revenue	79 289	53.0	53.2	52.4	52.0	52.0	52.0
7. Total expenditure	76 095	50.8	51.4	50.8	50.5	50.5	50.5
8. Net lending/borrowing	3 194	2.1	1.8	1.6	1.6	1.5	1.5
9. Interest expenditure (incl. FISIM)	2 339	1.6	1.7	1.6	1.3	1.3	1.2
pm: 91. FISIM	59	0.0	-	-	-	-	-
10. Primary balance	5 533	3.7	3.4	3.1	2.9	2.8	2.8
				Selected components of revenue			
11. Total taxes	48 497	32.4	32.2	31.6	31.3	31.2	31.1
11a. Taxes on production and imports	21 359	14.3	14.2	14.0	13.9	13.9	13.8
11b. Current taxes on income, wealth, etc	26 666	17.8	17.7	17.3	17.0	17.0	17.0
11c. Capital taxes	472	0.3	0.3	0.3	0.3	0.3	0.3
12. Social contributions	18 073	12.1	12.6	12.5	12.5	12.6	12.7
13. Property income	5 085	3.4	3.3	3.2	3.1	3.1	3.1
14. Other	7 634	5.1	5.1	5.0	5.1	5.1	5.1
15. = 6. Total revenue	79 289	53.0	53.2	52.4	52.0	52.0	52.0
p.m.: Tax burden	66 236	44.2	44.6	43.9	43.6	43.5	43.6
				Selected components of exenditure			
16. Collective consumption	11 726	7.8	8.0	7.9	7.9	7.9	7.9
17. Total social transfers	47 393	31.7	32.1	31.9	31.9	32.0	32.2
17a.Social transfers in kind	21 932	14.6	15.0	15.0	15.1	15.2	15.3
17b. Social transfers other than in kind	25 461	17.0	17.1	16.9	16.8	16.9	17.0
18. = 9. Interest expenditure (incl. FISIM)	2 339	1.6	1.7	1.6	1.3	1.3	1.2
19. Subsidies	1 915	1.3	1.3	1.3	1.3	1.3	1.2
20. Gross fixed capital formation	4 506	3.0	2.9	2.7	2.7	2.7	2.7
21. Other	8 216	5.5	5.5	5.4	5.3	5.3	5.2
22. = 7. Total expenditure	76 095	50.8	51.4	50.8	50.5	50.5	50.5
Pm.: compensation of employees	20 667	13.8	14.0	13.9	13.9	13.9	13.9

3. General government debt developments

	2004	2005	2006	2007	2008	2009
1. Gross debt, % of GDP	44.9	42.7	41.7	41.1	40.6	40.1
2. Change in gross debt ratio, % points	-0.1	-2.2	-1.0	-0.6	-0.4	-0.5
Contributions to changes in goss debt, % points						
3. Primary balance	-3.7	-3.4	-3.1	-2.9	-2.8	-2.8
4. Interest expenditure (incl. FISIM)	1.6	1.7	1.6	1.3	1.3	1.2
5. Stock-flow adjustment	2.1	-0.4	0.6	0.9	1.1	1.0
of which:						
- Differences between cash and accruals	0.2	0.0	0.0	0.0	0.0	0.0
- Net accumulation of financial assets	4.4	0.7	2.6	2.6	2.5	2.4
- of which: privatisation proceeds	-1.5	-1.0	-0.3	-0.3	-0.2	-0.2
- Valuation effects (incl. impact of GDP growth)	-2.5	-1.2	-2.1	-1.6	-1.4	-1.4
Implicit interest rate on debt, %	4.5	3.9	3.7	3.4	3.4	3.2

4. Cyclical developments, % of GDP

	2004	2005	2006	2007	2008	2009
1. Real GDP growth (%)	3.6	2.1	3.2	2.6	2.3	2.1
2. Net lending of general government	2.1	1.8	1.6	1.6	1.5	1.5
3. Interest expenditure (incl. FISIM)	1.6	1.7	1.6	1.3	1.3	1.2
4. Potential GDP growth (%)	3.0	3.0	2.9	2.6	2.3	2.1
contributions:						
- labour	0.6	0.6	0.5	0.4	0.3	0.2
- capital	0.3	0.4	0.4	0.3	0.2	0.1
- total factor productivity	2.0	2.0	1.9	1.9	1.8	1.8
5. Output gap	-0.3	-1.2	-0.9	-0.6	-0.3	0.0
6. Cyclical budgetary component	-0.2	-0.6	-0.4	-0.3	-0.1	0.0
7. Cyclically adjusted balance	2.3	2.4	2.0	1.9	1.6	1.5
8. Cyclically adjusted primary balance	3.8	4.0	3.6	3.2	2.9	2.8

4 SENSITIVITY ANALYSIS AND COMPARISON WITH LAST YEAR'S PROGRAMME

4.1 Risks in economic developments and their impact on public finances

The 2005 Stability Programme update is based primarily on the Government's decision on central government spending limits in 2006-2009, the Budget Proposal for 2006 that was issued in September, and the macroeconomic scenario underlying that proposal. The Stability Programme is based on a realistic and cautious assessment of economic developments. Its underlying assumptions based on the situation in September with respect to the financial market, raw material prices and international growth are more or less in line with the Commission's scenario in autumn 2005. The most significant difference has to do with assumptions about price levels and trends for crude oil. This minor difference would not in itself change the economic scenario that underlies this Stability Programme.

The short-term risks to international economic development are related to high unemployment and high oil prices, which are continuing to deter household consumption in the euro area and at the same time present the main short-term risk to an acceleration of economic growth. Structural financial imbalances in the US economy are also adding to the prospects of a weaker development.

Domestically, structural bottlenecks in the labour market are adding to uncertainties about economic development. Coupled with a tightening housing market and increasing household debt, this constitutes a mounting threat to the stability of economic growth. Household indebtedness has been rising sharply and is now approaching the level of 90 per cent of disposable income that was seen in the early 1990s. The increase in household total loans has continued to roll ahead this summer at a rate of 14 per cent, with home mortgages rising even faster. The debt servicing burden after buying a home has eased thanks to the fall in interest rates and extended loan maturities, but the upward trend in indebtedness nevertheless gives cause for concern. A further factor adding to uncertainty about domestic economic development is the heavy dependence of Finnish exports on the intensely competitive ICT products market.

The medium-term risks to economic development are related to the development of employment and productivity. The population in Finland is ageing faster than in other EU countries. In Finland the challenges associated with the changing age structure will first of all be felt in the labour market. The supply of labour will begin to shrink in the very near future. If steps to improve the functioning of the labour market fail and the labour reserves of the unemployed remain untapped, access to labour will be hampered to such an extent that the prospects of economic growth will be adversely affected at the same time as structural unemployment will remain widespread. Ageing presents a major challenge for the sustainable funding of general government, with growing expenditure pressures in pension and welfare services, at the same time as the dwindling labour force is causing the growth of national income and the tax base to slow down.

The economy may show a more favourable development than the baseline scenario if the challenges outlined above can be successfully tackled by economic policy measures.

The figure below illustrates the impacts of slower-than-baseline and faster-than-baseline growth on 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.

In the slow growth scenario, output growth in 2006-2009 would drop to around 1 per cent at the end of this period and the unemployment rate would decrease more slowly than in the baseline scenario to just under 8 per cent. The impacts of economic growth on general government finances are gauged by using OECD income and expenditure elasticity estimates. Calculated on this basis, general government finances will fall into deficit in the case of the slower growth scenario at the end of the forecast period. The debt ratio would start rising. This would undermine the sustainability of general government finances as the population continues to age.

In the more favourable scenario, economic growth would remain at over 3 per cent and the unemployment rate would drop to less than 5 per cent. The general government surplus would increase to over 3 per cent of GDP.

A one percentage point rise in the interest rate compared to the baseline scenario line would have only a minor impact from 2006 on total output and on employment, which is a key factor with regard to the balance of general government finances. The balance of general government finances, in turn, would be only nominally weaker than in the baseline scenario. In the scenario where the interest rate is lower than assumed, the development of general government finances would again be only marginally better than in the baseline scenario. The impacts of a one percentage point rise in the interest rate upon the balance of general government are clearly lesser than a corresponding deviation in economic growth from the baseline scenario.

The medium-term economic outlook described in the Stability Programme is based on projections of potential economic growth that use the European Commission's production function method. The calculations involve a number of uncertainty factors. (see sidebar)

The medium-term economic outlook presented in the Stability Programme is based on projections of potential economic growth that use the European Commission's production function method. The calculations involve uncertainties, particularly with regard to the assessment of labour input. The risk is that actual growth falls short of the growth scenario presented in the Stability Programme.

In the medium term economic growth in Finland will be held back by population ageing and the dwindling supply of labour. The process of demographic change is sweeping across Finland at a particularly fast rate, and therefore it will have significant impacts on GDP even in the medium term.

OECD assessment of medium-term economic growth

		1995-2000	2000-2005	2005-2010	2010-2020
			change, %		
Contributions to GDP per capita growth					
Increase in labour productivity	(1)	2,5	1,7	1,8	1,8
Demographic change	(2)	0,0	0,0	-0,2	-0,9
Employment rate	(3)	1,8	0,3	-0,3	0,1
GDP per capita	(4)=(1)+(2)+(3)	4,4	2,1	1,3	1,0

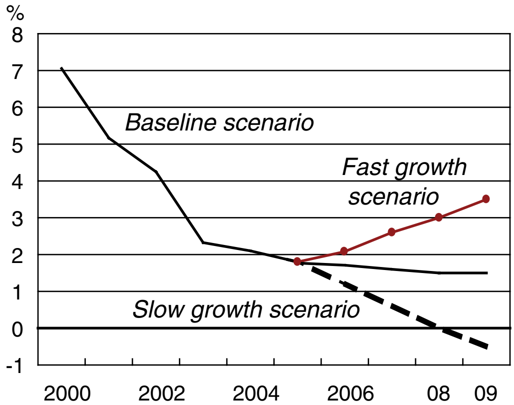
Source: OECD Economic survey of Finland.

The OECD has assessed the impacts of population ageing on economic growth in Finland in its 2004 country survey. Its assessments of the impacts of demographic change on economic growth in 2005-2010 are particularly noteworthy. Demographic change affects labour input via two routes. First, it reduces the number of people of working age. Second, it reduces the employment rate, since the employment rate in older age groups is markedly lower than the average employment rate, even if the positive cohort effect is taken into account. The OECD estimate also takes account of the pension reform that took effect at the beginning of 2005, which will drive up the employment rate.

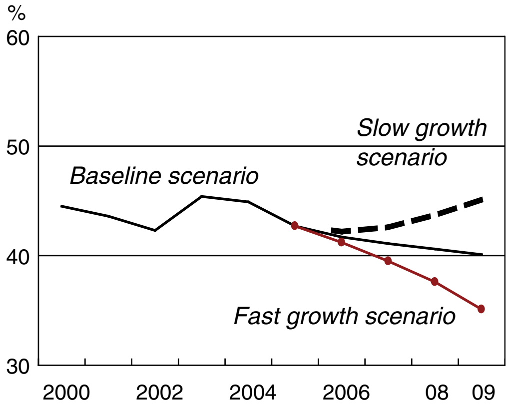
The European Commission uses a different method than the OECD to estimate future growth potential. According to the Commission's calculations, labour input will have a positive impact on GDP growth. These calculations of labour input are based on estimates of structural unemployment (NAIRU), which by 2009 will drop to close to 6 per cent. A trend-like increase is expected in the labour participation rate.

If economic growth were to fall short of projections by one percentage point, then the financial balance in general government, as calculated on the basis of the OECD estimate of general government GDP elasticity, would weaken by half a percentage point annually.

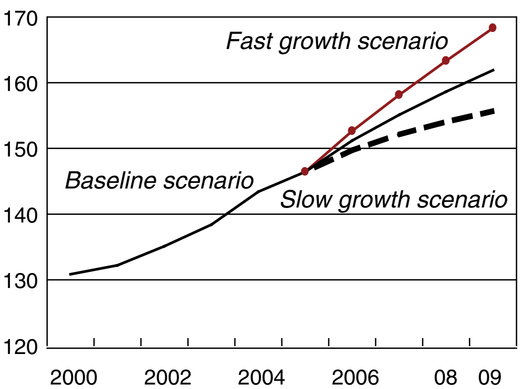
General government net lending
in ratio to GDP



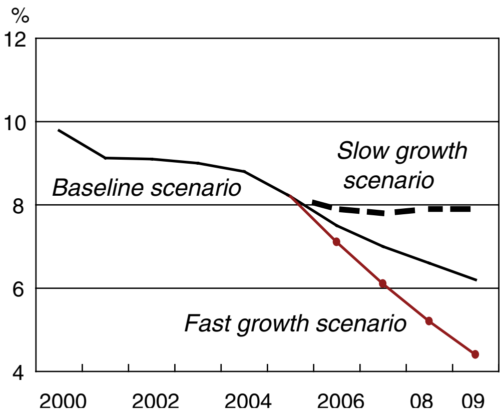
General government gross debt
in ratio to GDP



GDP
Eur bn



Unemployment rate



4.2 Comparison with last year's Stability Programme update

The previous Stability Programme update for 2004 predicted GDP growth at 3.2 per cent, whereas current preliminary data put the figure at 3.6 per cent. The surplus in general government finances, the labour market and inflation developed as projected.

Estimates of the growth of total output for 2005 are weaker than in the previous Stability Programme update, mainly because of the exceptional timing of bulges in industrial output during the current year. The estimate of the surplus in general government finances is unchanged.

Partly because of the low level of comparison, economic growth in 2006 will be more favourable. GDP growth next year will exceed 3 per cent, even though the growth cycle is slowing in the wake of the boom in 2004. The estimates presented in the 2005 update regarding the financial balance in general government in subsequent years are somewhat weaker than in the previous Stability Programme update. This is due to the somewhat weaker assessment of financial balance in central government and in social security funds. The 2004 Stability Programme update did not take full account of the cuts in taxes on earned income that the Government had announced for 2005-2007 on the basis of the collective bargaining agreement that was reached at the end of 2004. The financial surplus of employment pension funds will decrease during the period ahead as employment pension expenditure continues to increase but pension contributions are slightly lowered. The surplus of employment pension funds will drop to close to 2 per cent of GDP in 2009. Estimates of debt trends have been revised only marginally.

Unemployment has come down faster than was previously estimated. In spite of the sharp rise in the world market prices of crude oil, it is expected that inflation will be slower than previously anticipated. This is due primarily to cheaper telecommunications and ICT prices and services and to stiffening competition, which have contained the average rise in consumer prices. The wage settlement signed at the end of 2004 extends through to autumn 2007. There are no domestic inflationary threats on the horizon, provided that the current labour market bottlenecks do not get any worse.

The differences between the GDP growth estimates in the 2004 and 2005 Stability Programme updates are largely due to the adoption of a new calculation method. In the 2005 programme, economic growth projections are based on the European Commission's production function method, whereas in 2004 the estimates were based on other surveys on the growth prospects of the Finnish economy.

5. Divergence from previous update

	2004	2005	2006	2007	2008	2009
Real GDP growth (%)						
Previous update	3.2	2.8	2.4	2.2	2.0	-
Current update	3.6	2.1	3.2	2.6	2.3	2.1
Difference, % points	0.4	-0.7	0.8	0.4	0.3	-
General government net lending (% of GDP)						
Previous update	2.0	1.8	2.1	2.2	2.0	-
Current update	2.1	1.8	1.6	1.6	1.5	1.5
Difference, % points	0.1	0.0	-0.5	-0.6	-0.5	-
General government gross debt (% of GDP)						
Previous update	44.6	43.4	42.5	41.7	41.1	-
Current update	44.9	42.7	41.7	41.1	40.6	40.1
Difference, % points	0.3	-0.7	-0.8	-0.6	-0.5	-

Previous update: Stability programme update, November 2004.
Current update: Stability programme update, November 2005.

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 implications of population ageing over the next few decades without placing an unreasonable tax burden on future generations. Achieving these objectives calls for lowering central government debt as a ratio of GDP, excluding cyclical deviations. Stability and sustainability in general government finances require steps to curb and control public expenditure, to increase productivity and to strengthen the growth potential of the economy. The requirement of a cautious expenditure policy applies to both central government and the municipal sector. Improving the level of operational efficiency and productivity in the public sector is necessary not only for reasons of stability in general government finances, but also for the growth prospects of the Finnish economy. Improved productivity opens up significant opportunities to curb the growth of expenditures and to reallocate resources.

5.2 General government revenue and taxation

The update figures for central government revenue in 2005-2006 are in line with the economic survey issued in September 2005. Beyond 2006, tax revenues are estimated on the basis of the medium-term macroeconomic scenario.

Corporate and capital taxation have been reformed during the current Government's term in office, taxes on earned income have been cut and commodity taxes lowered. Aiming to increase employment and wage earners' purchasing power, the Government took the decision in connection with the 2004 comprehensive incomes policy agreement to continue to reduce taxes on labour in 2005-2007 by a gross amount of 1.7 billion euros. This is partly to compensate for the increase in the sickness insurance contribution that will be put in place in 2006 in connection with the financing reform of the sickness insurance system.

General government direct tax revenue will increase in 2006 by around 1½ per cent as changes made to taxation on earned income have the effect of reducing the amount of revenues. In personal taxation, the growth of the tax base will accelerate slightly in step with rising employment, which will have the effect of increasing revenue in the municipal sector and in social security funds.

In 2006, central government direct tax revenue will be reduced as a result of changes introduced to taxation on earned income. Income taxes will be cut by a total of 1 billion euros. This estimate includes a two per cent inflation adjustment, which corresponds to 150 million euros. The abolishment of the net wealth tax will lower central government direct tax revenue by 70 million euros.

The Government has committed itself to further reduce taxes on earned income in 2007 by 550 million euros. In addition, an inflation adjustment will be made to the tax scales. The Stability Programme works on the assumption that in 2008-2009, changes will be made to income tax scales so as to prevent a tightening of taxation.

The assumption is that there will be no significant changes in indirect tax bases in 2006-2009. Taxes on production and imports will rise by over 3 per cent next year. In the medium term the slowdown in the growth of the tax base will also slow the growth of indirect tax revenue.

General government in Finland consists of central government, local government (comprising municipalities and joint municipal authorities, 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 estimates by 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 changes. The tax rate is expected to drop by about one half a percentage point during the programme period.

It is expected that the pension contribution rate will fall slightly in 2006-2009. As part of the pension reform, the labour market organisations agreed to raise the prefunding rate of old age pensions until 2013, which will have the effect of increasing the old age pension component of the employment pension contribution. On the other hand, disability pension expenditures have increased much more slowly than anticipated, and consequently the disability component of the employment pension contribution will be reduced.

In spite of these tax cuts and changes in the tax structure, the tax wedge continues to remain too high from an employment standpoint, and therefore from this point of view it would be justified to further lower the taxation of labour.

5.3 General government expenditure

General government expenditure increased very rapidly in the early 1990s, primarily as a result of the economic recession that swept the country. At the same time total output actually slipped into negative territory, and consequently the expenditure-to-GDP ratio increased by double digits in the space of five years. Measures to restore general government finances and the onset of rapid economic growth turned things around in the mid-1990s. General government expenditure as a proportion of GDP peaked at 65 per cent in 1993, since when the figure has fallen back to 51 per cent in 2004. Most of this reduction has come in social security expenditure and general government interest expenses. The decrease in social security expenditure is mainly due to lowered unemployment security costs following the recovery of employment after the recession.

In 2005 the general government expenditure-to-GDP ratio will rise somewhat on the previous year to 51½ per cent because the value of GDP growth will remain modest. In 2006 it is projected that the ratio will return to 51 per cent. In 2007-2009, the ratio of general government expenditure to GDP is expected to remain stable. The Government Programme sets out in quite some detail the principles for key income transfers over the current electoral period, i.e. through to 2007. The central government spending limits procedure will also facilitate the management of public spending, with a ceiling imposed for around three-quarters of total on-budget entities through to the end of the electoral period.

Total central government expenditure will grow by an estimated 3½ per cent in 2005. The increase in expenditure will go mainly to various transfer expenditures, especially central government transfers to local government, and to financing social security funds. Central government debt will be paid down by using the cumulative surplus from previous years as well as the considerable revenue from the sale of shares. Interest expenses will decrease somewhat. According to the Budget Proposal the growth of central government expenditure will slow in 2006. Most of the increases in appropriations agreed upon in the Government Programme have by now been implemented, and the improving employment situation is also having the effect of curbing the growth of expenditure. Interest expenses will also continue to fall.

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

Active labour policy measures have been stepped up and an intersectoral employment programme launched in an attempt to tackle and prevent the problem of structural unemployment. The labour market support system has been reformed by increasing the remunerative nature of the subsidy, the ultimate aim being to strengthen its employment incentive effect. In line with the Government Programme steps are also being taken to increase the demand for low-paid work and the employment of older workers by reducing non-wage labour costs.

It is forecast that the growth in local government operating expenditure will slow to just over 4 per cent in nominal terms, primarily because of the slowdown in the growth of its biggest single expenditure item, i.e. wage and salary expenditure. Investment is expected to remain at the same level as in 2005. The 2006 Budget Proposal brings a slight improvement to the financial position of local municipalities, but the outlook for the municipal sector nonetheless remains bleak and debts will continue to accumulate. Seeking to curb the mounting pressures of rising expenditure, local authorities have set up projects aimed at improving the efficiency of service provision and reducing structural costs.

The biggest public expenditure categories are social security, health care and education, which in 2004 accounted for 21.9, 6.7 and 6.5 per cent of GDP, respectively. Although it is thought there will be no major changes in this general structure of tasks in 2005-2009, there are already some early indications of future structural changes, i.e. the growing share of social and health care expenditure and the decrease in general administrative costs

It is forecast that social security expenditure will increase somewhat, even though the pension reforms that are now in place are beginning to retard the growth in pension expenditure, inflation adjustments to pensions will be exceptionally small and unemployment will decline. However, population ageing and the ensuing growth of pension and social care expenses means that there is growing pressure towards an increased proportion of social security expenditure in the longer term as well.

It is expected that health care expenditure will continue to rise somewhat with the launch of the national health programme, and in the long term there will also be growing expenditure pressures in health care as a result of population ageing. Sickness insurance compensation, and the reimbursement of medical expenses in particular, will continue to rise apace. The share of the education expenditure is estimated to decrease slightly. The ongoing changes in the population structure will help to relieve pressures on education expenditure. It is projected that expenditure in general

6. General government expenditure by function, % of GDP

	2003	2009
1. General public services	6.1	5.6
2. Defence	1.6	1.5
3. Public order and safety	1.4	1.4
4. Economic affairs	5.0	4.4
5. Environmental protection	0.3	0.3
6. Housing and community amenities	0.4	0.4
7. Health	6.5	7.3
8. Recreation, culture and religion	1.2	1.2
9. Education	6.6	6.2
10. Social protection	21.6	22.3
11. Total expenditure	50.8	50.5

public services will decrease over the next few years among other things on account of the productivity action programme and the drive to cut back on personnel in central government.

5.4 The productivity of general government

Improving the level of operational efficiency and productivity in the public sector is necessary not only for reasons of stability in general government finances, but also for the growth prospects of the Finnish economy. The overall supply of labour is forecast to decline by several tens of thousands of people by the end of the next electoral period, and the same trend will continue beyond that point. In this situation the public sector workforce can no longer grow any more, but it is necessary to increase the efficiency of public administration and its services and to reallocate resources so that the growing service needs can be met, so that competition for the ever scarcer labour resources and the adverse effects of this competition on the economy can be avoided, and so that the availability of labour in other sectors can be safeguarded.

According to international comparisons and poll results among end-users, the standard of service provision in Finland is rated very highly, both in terms of quality, output and cost effectiveness. Productivity in public service provision, however, has declined or at best remained unchanged. Although the measurement of productivity in public services is somewhat problematic, both the statistics and research evidence point in much the same direction. What is more, local government expenditure has been growing much faster than expected, threatening the balance of general government finances.

Among the measures included in the action programme launched by the Government to increase public sector productivity are steps to improve and upgrade the structures and strategies of service provision; to take better advantage of economies of scale from specialisation and larger units; to make more efficient use of ICTs; and to improve the efficiency of purchasing.

According to Ministry of Finance estimates, some 35,000 people out of the total state sector workforce of around 124,000 will be retiring or moving to another employer by 2011. This provides a good opportunity to develop job tasks and skills and to carry out even major structural and strategic reforms aimed at increasing productivity in line with the principles of good human resources policy.

The Government's aim is to step up productivity and efficiency in central government so that by the end of the next electoral period, about half of the jobs vacated by natural turnover will be filled. This represents a reduction in personnel of just over 2 per cent per annum and a corresponding increase in productivity. Ministries have now drawn up revised productivity programmes and strategic personnel plans for the period 2007-2011 to ensure profitable and cost-effective running of central government. The revised productivity plans will be collated for summary and Government discussion in autumn 2005 and included in the spending limits proposal for 2007-2011.

Steps to increase the efficiency of finance and human resources administration in ministries, departments and agencies will include the general streamlining of operations and the coordination of services through service centres that are being created. The first service centres in central government finance and human resources administration have been set up or will be set up in 2006 within the administrative branches under the Ministry of Justice, the Ministry of the Interior and the Ministry of Finance. The target set for these functions is an average increase in productivity of 40 per cent by 2009. Resources thus saved will be reallocated to core tasks.

Productivity in state administration and services shall also be increased by streamlining supervision and decision-making in IT operations and by coordinating IT services. Steps will also be taken to improve service provision and the productivity of public administration by developing electronic and interactive services on the Internet and by launching a joint online service, which will be phased in from 2006. In addition, these efforts will be boosted by setting up a joint public administration platform for electronic identification and payment and by developing recommendations made by public administration.

These challenges also apply to local government. There are 432 municipalities and 231 joint municipal authorities in Finland that have responsibility for the provision of the bulk of welfare services in the country. An estimated 150,000 persons out of the total municipal sector workforce of around 450,000 will be retiring by 2016. The Government's decision on central government spending limits for 2006-2009 outlines a municipal and service structure reform aimed at securing the basic services that are the responsibility of local municipalities. The project to reform the municipal and service structure was set up by the Government on 11 May 2005. The aim of the project is to make sure that there is a strong enough structural and financial foundation for the production and provision of services that are currently the responsibility of local authorities. A ministerial groups preparing the basic services programme is charged with project management, while planning for practical implementation is in the hands of a municipal and service structure task force under the Ministry of the Interior.

The municipal and service structure task force will draft a proposal concerning the functions that shall be transferred from local to central government and outline the expected impacts of those transfers to the economic relationship between local and central government. Furthermore, the task force will submit its recommendations to the Government regarding the municipal structure, the allocation of responsibilities for service provision and methods of service production in spring 2006. In spring 2006, the Government will make its decision on future structures for the financing, organisation and production of services and outline any revisions that it feels are needed to the Act on Local Authority Boundaries. The Government's legislative proposals will be examined in Parliament during 2006 and they are due to take effect from the beginning of 2007.

The Government has also decided on other measures for increasing the productivity of municipal service production. The basic services programme for the balancing and development of municipal functions and funding includes a component that is concerned with improving the productivity of basic services. The Government has proposed changes to the system of central government transfers to municipalities that would help to boost the productivity of services funded through these transfers. These changes are due to take effect from the beginning of 2006. As regards central government subsidies for purposes of local government mergers in 2006-2009, conditions for eligibility have been so revised that these mergers are required to promote economy and efficiency. A new law has taken effect from the beginning of 2005 which states that central government grants can be made available for significant collaboration among local authorities.

The national health programme and social sector development programme (2004-2007) based on a Government decision-in-principle in 2002 also includes the aim of increased productivity, primarily through improved information management and more effective procedures. It is estimated that these programmes will yield benefits worth around 200 million euros a year from 2007. The first calculations and estimates suggest that this target will be met.

6 THE SUSTAINABILITY OF GENERAL GOVERNMENT FINANCES

6.1 Measures aimed at fostering sustainability

The longer term outlook for general government finances in Finland is 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. The effects of population ageing will begin to show up in the economic development rather soon as the growth of pension expenditure accelerates and the supply of labour continues to dwindle around the turn of the decade with the retirement of the babyboom generation. The costs of health and social care provision for the elderly population will rise most steeply during the 2020s.

Over the next two decades the population in Finland will be ageing faster than in any other EU country and the old-age dependency ratio in 2025 will be the highest in the EU. However, provision for coping with the financing and expenditure pressures that will be faced as a consequence of population ageing has been made among other things by

- pursuing a disciplined fiscal policy to reduce levels of public debt;
- prefunding for future pensions;
- reforming pension schemes for greater sustainability; and
- strengthening the funding base of general government by means of an economic policy that supports growth and employment.

The structural surplus in central government and the reduction in government debt and interest outlays have created room for manoeuvre to ensure that the growth in expenditure and the weakening of the revenue base caused by population ageing will not lead to a new rise in the central government debt ratio. The prefunding of earnings-related pensions has helped considerably to ease the pressures to raise pension contributions in the future. Thanks to prefunding, long-term increases in pension contributions will be no more than one-half of the rise in pension expenditure. At the end of September 2005, the (non-consolidated) market value of pension funds was 99.9 billion euros (65 per cent of GDP), significantly higher than the (non-consolidated) general government gross debt.

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.

Pension schemes have been reformed and updated on several occasions over the past ten years. The most recent comprehensive package of reforms took effect 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 by at least three years – and in this way ultimately to strengthen the sustainability of the pension system.

The most important elements of the 2005 pension 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.
- Accelerated pension accrual at ages 63-68 and the removal of the pension ceiling (at 60% of income) are intended to encourage people to stay on longer in employment.
- A mechanism whereby the level of 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.
- Pensions will be determined according to the individual's entire employment history instead of the former 10-year rule.
- The additional prefunding of pensions for a fixed period will have the effect of slowing the increase in pension contributions in the long term.

In the long term the pension reform is expected to ease the pressures of increasing pension contributions by one-half.

Employment and the sustainability of general government have been strengthened not only by the pension reform, but also by a reform of the unemployment insurance system. The minimum age for eligibility for the "unemployment pipeline", a relatively common pathway to early retirement in Finland, was raised from the beginning of 2005 by two years to age 57. People in the unemployment pipeline, i.e. older workers in receipt of an extended earnings-related unemployment allowance, can retire on old-age pension between ages 62-65.

A temporary low-pay subsidy scheme will start up as from the beginning of 2006; the experiment will run through to 2010. Under this scheme employers will be eligible to receive a subsidy for all employees aged 54 or over who are earning 900-2000 euros a month for a full-time job. It is estimated that some 5 per cent of all wage earners will fall within this category. The subsidy will have the effect of supporting the employment of older workers in low-paid jobs.

In a quest to strengthen the sustainability of the pension system, discussions are underway on the possibility of pension funds taking greater risks with a view to increasing their revenue from investment, which would further ease the pressures to increase pension contributions. Risk-carrying investments currently account for around one-third of the total market value of pension funds.

Long-term sustainability requires that the employment rate increases from the current level of around 68 per cent to close to 75 per cent. Indeed, employment is now showing clear growth. The trends are particularly favourable among older employees. The employment rate in the age group 55-64 has increased from 36.4 per cent in 1997 to 50.9 per cent in 2004, indicating that babyboomers are staying on in employment longer than the age groups before them. These favourable trends need to continue among ageing employees in order that the target of a 75 per cent employment rate can be achieved, because it is this age group that carries the greatest labour potential.

6.2 Sustainability scenario

The initial year for the sustainability scenario is 2004, and the scenario extends through to 2050. The scenario is based on Eurostat's population forecast for Finland (2004). The macro-economic assumptions used in the scenario (employment, unemployment, productivity and interest rate) are consistent with the baseline scenario jointly agreed upon in the working group dealing with the economic impacts of population ageing under the EU Economic Policy Committee.

The scenario expects the employment rate to rise to over 74 per cent by 2030 and the unemployment rate to settle at around 6.5 per cent by 2013. The employment rate will rise most sharply in older age groups, for instance in the age bracket 55-64 to 62 per cent over the next 15 years. Labour productivity is expected to increase on average by 2 per cent annually during the early part of the prognosis period and by an average of 1.7 per cent annually from 2030 onwards. The assumption underlying the scenario was that the structure of the labour force has no bearing on labour productivity and that the number of hours worked will remain constant. The average rate of GDP growth for the whole forecast period is 1.8 per cent per annum. The real interest rate was assumed at 3 per cent, both for public debt and for investments by employment pension funds. Inflation is 2 per cent per annum. The sustainability scenario differs somewhat from the national medium-term scenario because the EU Economic Policy Committee's assumptions concerning the Finnish economy are slightly different from the national assumptions.

With respect to both expenditure and taxes and social security contributions, the scenario is based on current legislation and decisions already made. In other words the scenario is based on assumptions of no policy change, which means that the tax rate, for example, rises in the scenario because of increases in pension contributions. In this respect the scenario differs from the sustainability scenarios of earlier stability programmes where the tax rate was anchored to the level at the initial year.

It is expected that by 2030, age-dependent expenditures (pensions, health care, long-term care and education) will increase by almost six percentage points as a proportion of GDP. Pension expenditure as well as health care and long-term care expenditure will both rise by around three percentage points as a proportion of GDP. Education expenditure relative to total output will decline because of the smaller size of younger age groups. Health care and long-term care expenditure were estimated in the same way as in the scenarios prepared for the EU in 2001.

Using these assumptions, it seems that the foundation for general government as a whole is not sustainable. The deficit of general government will exceed the three per cent mark after the mid-2030s. Upon closer examination of the different sectors of general government, the situation is rather divided and the sustainability problem will surface much earlier in the central and local government sectors. Pension funds will continue to remain in surplus throughout the forecast period, and their market value will rise to 81 per cent of GDP in 2050. According to the scenario other general government (central and local government) will remain in deficit throughout the period, and the amount of the deficit will continue to increase. The constant deficit will have the effect of increasing general government gross debt, which by the early 2030s will exceed 60 per cent of GDP.

7. Long-term sustainability of public finances, 5 of GDP

	2000	2005	2010	2020	2030	2050
Total expenditure	48.8	51.4	51.9	54.5	58.1	62.6
O which: age -related expenditures		23.6	24.2	26.7	29.6	30.6
Pension expenditure		10.4	11.2	12.9	14.0	13.7
Old-age and early pension		8.0	8.8	10.7	12.0	12.1
Other pensions		2.4	2.4	2.2	2.0	1.7
Health care		5.5	5.6	6.2	7.0	7.4
Long-term care		1.8	1.9	2.5	3.3	4.3
Education expenditure		5.9	5.4	5.2	5.2	5.1
Interest expenditure	2.8	2.3	2.3	2.3	3.1	6.6
Total revenue	55.9	53.4	53.5	55.4	56.5	57.6
Of which: property income	4.1	4.4	4.6	4.9	5.0	5.1
Of which: from pensions contribution	8.9	9.1	9.0	10.3	11.2	11.2
Pension reserve fund assets	49.4	59.6	65.6	73.0	77.4	80.6
Of which: consolidated public pension fund assets	29.2	46.4	51.0	56.8	60.2	62.7
Net lending	7.1	1.8	1.6	0.8	-1.6	-5.1
Assumptions						
Labour productivity growth		2.2	1.9	2.1	1.7	1.7
Real GDP growth		3.1	2.2	1.7	1.4	1.4
Participation rate, males (aged 20-64)		81.0	83.3	85.7	86.4	86.5
Participation rate, females (aged 20-64)		76.4	76.6	80.3	81.5	81.9
Total participation rates (aged 20-64)		79.3	79.8	82.9	84.0	84.2
Unemployment rate		8.0	6.8	6.5	6.5	6.5
Population aged 65+ over total populationä		15.8	16.9	22.6	26.1	27.0

6.3 Pension fund assets

Finland’s earnings-related pension system is a partially pre-funded, defined benefit system in which the benefits are determined according to the length of 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. Within the national accounts framework, the pension funds in the private and municipal sector are counted as social security funds. By contrast, the State Pension Fund is part of central administration. Tables 8-10 show the non-consolidated and consolidated market value of the pension funds in 2000-2004.

In 2004 the return from investments of consolidated liquid assets – interest and dividends – amounted to 2,467 million euros. Interest and dividends, however, represent only part of the returns generated by pensions funds; much of those returns come from the sale of shares and long-term bonds. When these items are added to the figure, returns from the investment of non-consolidated pension fund assets in 2004 amounted to 6.6 billion euros.

8. Financial assets of Employment pension institutions (sektor 13141) in Finland, million euros

	2000	2001	2002	2003	2004*
A. Non-consolidated liquid assets					
AF21 Currency	0	0	2	0	0
AF22 Transerable deposits	134	241	256	257	376
AF29 Other deposits	276	228	880	379	377
AF331 Short term bills	1 279	2 125	1 838	2 320	2 624
AF332 Long term bonds	29 559	30 202	32 312	32 821	36 355
AF34 Derivatives	105	20	80	111	201
AF511 Quoted shares	15 347	13 016	10 518	13 807	17 225
AF52 Manual fund shares	323	3 093	2 740	4 693	7 794
Total	47 023	48 925	48 626	54 388	64 952
% of GDP	36.1	36.0	34.8	38.2	43.4
B. Liabilities of general government (sektor 13) to pension funds (sector 13141)					
AF331 Short term bills	20	5	29	26	257
AF332 Long term bonds	10 322	6 887	4 786	4 666	3 512
Total	10 342	6 892	4 815	4 692	3 769
% of GDP	7.9	5.1	3.5	3.3	2.5
C. (=A-B) Consolidated liquid assets of pension funds (sector 13141)					
AF21 Currency	0	0	2	0	0
AF22 Transerable deposits	134	241	256	257	376
AF29 Other deposits	276	228	880	379	377
AF331 Short term bills	1 259	2 120	1 809	2 294	2 367
AF332 Long term bonds	19 237	23 315	27 526	28 155	32 843
AF34 Derivatives	105	20	80	111	201
AF511 Quoted shares	15 347	13 016	10 518	13 807	17 225
AF52 Manual fund shares	323	3 093	2 740	4 693	7 794
Total	36 681	42 033	43 811	49 696	61 183
% of GDP	28.2	31.0	31.3	34.9	40.9
D. Total assets of pension funds (sector 13141)					
Non-consolidated total assets	60 737	62 480	63 570	69 290	79 957
% of GDP	46.4	46.0	45.5	48.6	53.4
Consolidated total assets	49 179	54 687	57 781	63 737	75 434
% of GDP	37.6	40.3	41.3	44.7	50.4

Source: Statistics Finland: Financial statistics.

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

	2000	2001	2002	2003	2004
			milj. eur		
Non-consolidated assets	3843	4427	44841	5795	6867
Consolidated assets	1522	1686	3099	4549	6339
			% of GDP		
Non-consolidated assets	3.0	3.3	3.5	4.1	4.6
Consolidated assets	1.2	1.2	2.2	3.2	4.2

Source: State pension institute.

10. Market value of the investments made by employment pension institutions (tables 8 and 9)

	2000	2001	2002	2003	2004
			milj. eur		
Non-consolidated assets	64 580	66 907	68 411	75 085	86 824
Consolidated assets	50 701	56 353	60 880	68 286	81 773
Consolidated liquid assets	38 203	43 711	46 866	54 246	67 522
			% of GDP		
Non-consolidated assets	49,4	49,3	48,9	52,7	58,0
Consolidated assets	38,7	41,5	43,6	47,9	54,6
Consolidated liquid assets	29,2	32,2	33,5	38,1	45,1

Source: Statistics Finland: Financial statistics and State pension institute.

7 NATIONAL FISCAL PROCEDURES AND INSTITUTIONS

In order to promote a sustainable and credible fiscal policy, the Government has committed itself to a new spending limits procedure whereby approximately three-quarters of total budget appropriations are allocated to spending limits that cover the whole electoral term. This objective is included in the Government Programme. In May 2003, a separate Government statement was issued on the matter, and Parliament was notified. The spending limits for the electoral term are expressed at 2004 price and cost levels, and where necessary they are revised in line with technical changes in the budget structure. Expenditures affected by cyclical fluctuations, other variable costs not dependent on Government decisions, and also expenditure caused by administrative rearrangements or technical adjustments in the budget proposal, with the exception of changes in spending principles, are excluded from the scope of the spending rules. These include the following:

- unemployment security expenditure, housing allowances and transfers to the Social Insurance Institution; these expenditure items are, however, covered by the spending rules insofar as they are affected by changes made to their bases;
- debt interest payments;
- any compensation to other tax recipients deriving from tax changes decided by central government;
- changes in transfers payable to the Social Insurance Institution caused by changes in social security contributions;
- expenditure corresponding to revenues from the European Union;
- expenditure corresponding to national lottery receipts and profit entered as revenue from the Slot Machine Association;
- capital expenditure.

Supplementary budget proposals, on the other hand, are included in the spending limits. The Government's declared aim is to secure balanced central government finances under normal conditions of economic growth at the end of the electoral period, measured in terms of national accounting. Furthermore, the Government's guiding premise is that even in conditions of adverse economic development, the deficit in central government finances, as measured in national accounting terms, shall not exceed 2¾ per cent of GDP. In the light of current forecasts it is unlikely that the economy will be as sluggish as this over the next few years. In addition, the Government has agreed, as a supplement to the Government Programme, that if annual proceeds from the sale of shares exceed 500 million euros, a maximum of 10 per cent of the excess amount can be used on a discretionary basis for non-recurring supplementary expenditures, primarily for infrastructure investments as well as for promoting R&D activities, notwithstanding the expenditure rules and regulations or the spending limits for the electoral term.

The allocation of appropriations by administrative branch is revised annually on the basis of a decision on central government spending limits. In preparation of that decisions ministries submit their own four-year action and financial plans as well as their own spending limits proposal for the administrative branch. The spending limits established by the Government provide a framework within which each administrative branch works to prepare their proposals for the following year's budget. The Government Programme requires that more action strategies will be included in ministries' spending limit plans. Steps have been taken to promote the integration of the spending limits procedure into the ministries' opereting and financial plans. The aim has been to establish a system whereby resource priorities within and between ministries can be steered by joint Government decisions. Furthermore, the aim has been to strengthen the political control of the Government in the process of drawing up these plans.

The motivating force behind the spending limits for 2006-2009 has similarly been to support the Government's economic policy objectives and to persist with a fiscal policy that secures stable growth. The starting-point is a cautious expenditure policy where strict economy is exercised in all administrative branches. This also helped to create economic leeway for political decision-making.

Furthermore, the Government seeks by means of a separate Strategy Document to promote, coordinate and control implementation of the Government Programme. The Strategy Document includes the policy programmes agreed upon in the Government, i.e. the employment policy programme, entrepreneurship policy programme, information society policy programme and civil participation policy programme.

Other intersectoral policies under special Government supervision are also included. The document sets out specific impact and other targets for the policy programmes and the intersectoral policy programmes, and details the concrete measures by which they shall be pursued. The Strategy Document is implemented within the framework of central government spending limits and state budgets.

In May 2003, the Government set the spending limits for 2004 at 28,049 million euros, which was subsequently revised for technical reasons to 28,089 million euros. The sum total of the 2004 budget and supplementary budgets was around 80 million euros below the revised spending limits, so expenditure was well within the framework established. Spending is also on track to remain within the 2005 framework: when the spending limits for the second supplementary budget are taken into account, there still remains some 87 million euros of unallocated provision. The experiences of the new spending limits procedures are good.

In its Budget Proposal for 2006 the Government submits that the expenditure included in the spending limits remain 232 million euros below the limits set for 2006. The amount of this unallocated provision is almost the same as the corresponding expenditure needs in the current year and in 2004. Decisions already made are causing expenditure pressure for 2007 and beyond, and therefore the preparation of the next spending limits for 2007-2011[1] is a challenging task. However the Government is committed to the spending limits and managed to agree on cutbacks in the spending limits decision for 2006-2009 in order to remain on target.

The cautious expenditure policy also applies to the municipal sector. Local government finances will remain constrained over the coming years. In the longer term population ageing will cause escalating demand and funding pressures related to basic services. Differences in the financial situation between municipalities will remain marked, and a growing number of municipalities are now running a permanent deficit. In order to restore economic balance, local governments will need to take decisions on their service structure and productivity that will keep the increase in operating expenses within the confines of their increased tax revenue and central government transfers.

The Government Programme says the balance in financing municipal functions and obligations will be improved through a basic public services programme covering the Government's entire term in office and agreed upon jointly by central and local government, and through a related annual basic services budget drawn up jointly by central and local government and endorsed by the Government. The basic public services programme will assess income and expenditure on municipal functions and other obligations in municipality groupings and the measures needed to balance them. The

[1] The central government spending limits will exceptionally be drawn up for a five-year period because the personnel reduction targets included in the productivity action programme extend to 2011.

basic public services programme shall be attached to the decision on central government spending limits and it shall be revised annually in connection with the spending limits procedure.

The municipal and service structure project set up by the Government also has an important role in curbing public expenditure. The aim of this project is to make sure there is a sound enough structural and financial basis for the future production and provision of services that are currently the responsibility of the local government sector and at securing the cost-effective provision of those services. At the same time, the quality, impact, and availability of these services as well as needs for technological development are taken into account. This project as well as the basic public services programme are explained in more detail in the Finnish National Reform Programme 2005-2008.