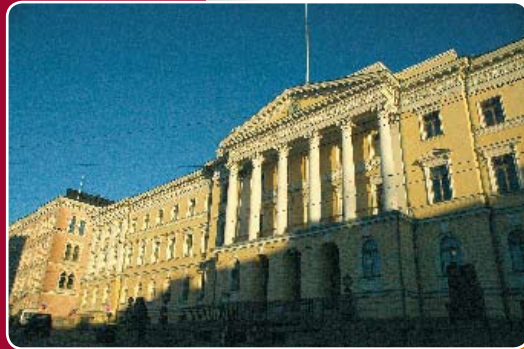




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Stability programme update for Finland 2007



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Economic and economic policy surveys



MINISTRY OF FINANCE

Stability programme update for Finland 2007

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Abstract	<p>This Stability Programme update draws on the central government spending limits for 2008 – 2011 and on the budget proposal for 2008 submitted in September, as well as related economic policy guidelines and assessments on economic developments.</p> <p>The main medium-term constraint to economic growth is the ageing of the population, which in Finland will be faster and more pronounced than in the rest of the EU. The combination of shrinking labour supply and high structural unemployment together with mounting household indebtedness, changing regional demography as well as globalisation and adjustments to rapid technological advances is a demanding mix in terms of economic growth.</p> <p>An ageing population coupled with high structural unemployment is a major challenge to sustainable public finances in particular. Expenditure pressure in pensions and welfare services will soon start mounting while labour supply will drop and growth in GDP and the tax base will slow down.</p>	

The surplus in general government will average at 3.1% of GDP over the next four years. The social security funds account for the bulk of the surplus in general government finances. The funds are being accumulated in response to the mounting expenditure pressure caused by the ageing population. The debt ratio in public finances (EMU debt) is anticipated to edge down below 28%. Finland will meet the objectives of the Stability and Growth Pact both in terms of the balance in public finances and with regard to the debt ratio in the medium term. However, a sustainability analysis that includes the forthcoming demographic changes indicates that overall general government finances are not sustainable in the long term. Based on Eurostat's 2004 population projection, a surplus of 4% of GDP would be required to secure sustainability in general government finances. Under the current Stability Programme, the surplus would amount to 2½ of GDP by the end of the government term, which means there would be a sustainability gap of about 1½% of GDP. If the latest national population forecast were to be used for the computations, the sustainability figure would be even bleaker than this.

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INTRODUCTION AND SUMMARY

The population of Finland is ageing faster than in the rest of the EU member states. The working age population will start to decrease in the near future, when the first baby boom cohort – those born in 1945 – turns 65 at the end of this decade. The most recent population projection by Statistics Finland (2007) indicates that the working age population (ages 15 – 64) will decline by roughly 265,000 people by 2050. The number of over 65-year-olds will swell by about 713,000 over the same period, which is 124,000 more senior citizens than forecast in the EU population projection for Finland made in 2004.

This demographic change will place public finances in a new situation and one that is more difficult than before. In Finland, the bulk of all pensions and health care and care sector services are financed through the public funds, in other words by central and local government and the social security funds. Public pension expenditure will start soaring already in the next decade, while the demand for care and nursing services for the elderly will be at its highest for some decades. Coupled with all this, the number of people of working age will drop, leading to slower growth in total output and tax revenue.

Government's key economic policy objective is to improve the wellbeing of the Finnish people by providing better conditions to create more jobs and to boost productivity growth. With the labour market experiencing challenges such as an ageing workforce and labour mismatches, the task of creating new jobs is more demanding than during the previous electoral period. However, providing the world economy remains buoyant and wage trends help perk employment, it is possible to create 80,000 to 100,000 new jobs over the current parliamentary term.

Spending limits that are set for the whole electoral period are an integral part of the Government's fiscal policy. In line with the Government Programme and the spending limits decision of May 2007, most tax cuts will be scheduled for the latter part of the period so as not to jeopardise stable economic performance. One essential means of curbing growth in public expenditure consists of ways to boost productivity, with key projects involving the restructuring of municipalities and services and the government productivity programme.

The cyclical upswing in Finland is likely to continue into 2008. Economic growth will average 2.7% over the programme period. To reach a growth path of this magnitude, productivity will have to be high. Indeed, the economic

performance projected in the baseline scenario involves certain risks which, if they were to materialise, would result in considerably slower economic growth.

Risks in the global economy are related to the uncertainty of the world market price of crude oil and imbalances in the international economy as well as more volatile financial markets. On the domestic side, structural bottlenecks in the labour market pose a risk to economic performance in the short term. The downside of prolonged robust economic growth is higher cost and price pressure. The pay agreements contracted in the autumn risk hampering price competitiveness because the settlement level was high. If medium-term economic expansion and growth in tax revenue proves to be slower than anticipated, the higher-than-expected pay rises in local government could pose a risk to stability in municipal finances.

The ageing of the population will lead to less labour supply and this will hamper economic growth opportunities in the medium term. To safeguard long-term sustainability in public finances, it is essential to make sure that economic growth is vigorous. This means productivity must improve and supply capacity in the economy, especially labour supply, needs to be boosted.

The financial position in general government is expected to stay in surplus but to weaken over the programme period. The social security funds account for the bulk of the surplus in general government finances. These funds are being accumulated in response to the mounting expenditure pressure caused by an ageing population. The surplus in general government is to average at 3.1% of GDP over the projection period. The debt ratio in public finances (EMU debt) is anticipated to edge down below 28%.

This Stability Programme update builds on the 2008-2011 spending limits for central government finances and the 2008 budget proposal submitted in September, as well as related economic policy guidelines and assessments on economic developments. The expenditure estimates include additional expenditure generated by the decisions made in the context of the 2008 budget proposal and the main foreseeable on-budget spending pressure.

Under the revised Stability and Growth Pact, every Member State must have a specific medium-term objective for general government. Finland's medium-term budgetary objective was set out in last year's Stability Programme update as a 2 per cent surplus-to-GDP ratio in general government finances. Finland will meet this objective over the current programme period too.

The Government's view is that the medium-term outlook in the Finnish economy must be assessed with a view to making provision for the impending demographic changes. The Government Programme aim is, perked by structural reforms to boost employment, to achieve a surplus in central government finances by 2011 equivalent to a structural surplus of 3½% at the level of general government, taking into account the projected developments in local government finances and in the social security funds. In line with this, the Government's

intention in the Stability Programme update is to reach a structural surplus of 3½% of GDP by the end of the programme period in 2011.

Neither the general government balance outlined in the baseline scenario in this Stability Programme nor the medium-term objective is sufficient to ensure sustainable public finances in the long term. Preliminary estimates drawn up using the population projection published by Statistics Finland in June 2007 indicate that to ensure long-term sustainability, a general government surplus of just over 4½% is required. Various combinations of economic policy instruments are available to bridge the sustainability gap. An evaluation will be made during this parliamentary term to assess whether sufficient provision has been made to meet the impending challenges brought about by the ageing of the population, so that any requisite action can be undertaken while the present Government is still in office.

The projections and medium-term forecasts indicate a general government-to-GDP ratio of 2½% by the end of the review period, which falls short of the targeted 3½% surplus for general government finances. In its Programme, the Government is aiming to achieve economic growth that is much faster than that presented in the forecasts. The Government plans to foster labour supply, improve the functioning of the labour market and reduce structural unemployment by means of targeted increases in appropriations, through tax cuts tuned to the economic cycle and by implementing structural reforms. The Government is prepared to take corrective action should the target be jeopardised.

1 ECONOMIC POLICY OBJECTIVES AND PREMISES

1.1 General

The Finnish economy has grown robustly over an exceptionally long period of time. Growing supply constraints, especially more labour force bottlenecks, can be said to pose the greatest risk to favourable economic outlook. The Government Programme predicts that it is possible to create 80,000 to 100,000 new jobs over the current parliamentary term. To improve employment and economic performance to this extent, resolute measures are necessary to boost labour supply and productivity as well as a buoyant world economy and moderate wage trends to help support labour demand.

Sustainability in central and local government relies heavily on continued favourable employment and economic performance. Economic performance has been much better in Finland in the past few years than in the rest of the euro area on average, and general prospects for 2008 are also bright.

Prospects in the latter years of the government term will be overshadowed by accelerated ageing of the population. Coupled with mounting public spending due to an ageing population, the fall in the population of working age risks curbing growth in total output and tax revenue. To ease the pressure on public finances caused by the ageing of the population, the Government will help improve the capacity of the economy and ensure sound spending and tax policies.

A higher employment rate is essential from the viewpoint of sustainable public finances. The labour market is becoming tighter, and unless new measures to boost labour supply are introduced, the threshold of structural unemployment will soon be reached. Greater occupational and regional labour mobility is necessary to ease the problem of labour market mismatches.

Growth in public spending is being curbed by means of multi-annual spending limits to contain expenditure extending during the current parliamentary term as specified in the spending limits decision made on 25 May 2007, which draws on the Government Programme, and by restructuring municipalities and services and through the Government productivity programme. This will

create a more efficient public sector and labour resources in the public sector will be allocated to better respond to the needs arising from the ageing of the population. Labour demand in the public sector should not be allowed to hamper growth potential in the private sector and the rest of the national economy. Without new measures to boost productivity growth and unless resources are reallocated, public sector labour demand will supersede labour needs in the private sector to an ever greater degree.

The Government aims to secure a structural surplus equivalent to 1% of GDP in central government by the end of the government term in 2011. This means mean that the debt-to-GDP ratio would continue to shrink over the government period. To achieve this, the line adopted in expenditure and tax policies has to be respected but action must also be taken to boost economic growth potential and to meet the Government's employment objectives. In its tax policy stance, the government is committed to ensuring that it does not jeopardise long-term sustainability in general government or the obligations set out in the Stability Programme for Finland.

1.2 Broad Economic Policy Guidelines

In line with the Integrated Guidelines for 2005-2008 (Broad Economic Policy Guidelines and the Employment Guidelines) and to achieve the Lisbon Strategy objectives, economic growth potential in the Community should be promoted hand in hand with robust public finances. The aim should be to promote knowledge work, to boost labour supply and to create new jobs.

In its March 2007 Presidency conclusions, the European Council observed that the renewed Lisbon Strategy for Growth and Jobs is beginning to deliver results and called on the Member States to pursue actions to build on the favourable overall economic upturn in implementing reforms. The Broad Economic Policy Guidelines of spring 2007 recommended the following economic policy guidelines to the euro area economies: to secure economic stability for public finances especially in an expansionary economy, the quality of public expenditure, competitiveness in the service sector and flexicurity in the labour market.

No formal country-specific recommendations were presented for Finland. However, there are a number of points to watch that Finland should focus on: to implement reforms to improve competition and productivity in certain service sectors, simplify recruitment procedures for businesses, encourage local wage bargaining systems, and address bottlenecks in the labour market to tackle high structural unemployment.

The Government's economic policy is in line with the Commission's recommendations on the BEPGs as well as with the requirements set out in the Integrated Guidelines for 2005-2008. The economic policy measures taken by the Government relating to the recommendations on general government finances and structural policy are described in more detail later on in this Stability Programme and in the Finnish National Reform Programme adopted by the Government in October 2007. The Stability Programme update and the Finnish National Reform Programme are consistent with each other.

1.3 Stability Programme update for 2007 and its handling in Finland

This year's Stability Programme update draws on the 2008-2011 spending limits for central government finances and on the 2008 budget proposal submitted in September including related economic forecasts. The expenditure estimates for 2008-2011 include additional expenditure generated by the decisions made in the context of the 2008 budget proposal and the main foreseeable on-budget spending pressure.

The document will be delivered to the relevant EU bodies within the agreed time frame (15 October – 1 December 2007) once it has been approved by the Government in plenary session. The contents of the Stability Programme update has been presented to Parliament during the drafting period. As in earlier years, the Commission's assessment and the Council's statement on Finland's Stability Programme will be submitted to Parliament in connection with Ecofin preparations. The Stability Programme update complies with the Code of Conduct endorsed by the EU Council in October 2005.

2 ECONOMIC SITUATION AND OUTLOOK

2.1 Recent developments and short-term outlook

Globally, the prolonged period of economic prosperity will continue, with the slow-down in the United States and Europe being offset by strong growth elsewhere. The outlook is still bright in a good number of emerging economies. Oil producers are stepping up their demand and imports. And although recent volatility experienced in the international financial market has led to greater uncertainty in worldwide growth prospects, it is reasonable to assume that the world economy will grow at a 5% rate this year, which is faster than in the 2000s on average, and will decelerate only marginally next.

In Finland, total output continued to grow fast in the first half of 2007. Annual production will exceed last year's volume by 4½%. The current period of robust economic performance has been further strengthened by strong international demand coupled with relatively low interest rates and tax cuts. As in 2006, net exports and domestic demand will foster growth, although the focus will shift more towards domestic demand. The construction industry has somewhat overheated, with output growth close to maximum relative to production potential.

The cyclical upswing will probably continue in 2008, with GDP growth reaching nearly 3½%, which has been the average rate of growth over this cycle. Export demand is expected to remain good, although prospects might be dampened if the existing uncertainty continues to escalate. Stock orders are still high in the metal industry and construction, for instance, but supply constraints are slowing down production growth. Export growth is in fact anticipated to slacken. The yield requirement on investment is already higher, but the financial turbulence has so far not spread to households. Private consumption will remain strong. Higher purchasing power together with better employment will foster consumption demand more strongly than indebtedness, focusing mainly on services. The fastest period of growth in house purchases is now over, as high debt levels coupled with growing debt service payments and soaring prices are curbing purchases in the housing sector. In spite of labour supply problems in some sectors, employment figures will continue to improve fast by about 2%.

The employment rate will climb to 70 per cent for the first time since 1991. With older employees remaining in the labour market for longer and more job vacancies attracting new workers, labour supply will also continue to increase. The unemployment rate will slide down to 6.7%, well below the euro area average. In 2008, the number of employed people is expected to still grow by an estimated ½%, even though economic growth will slow down and labour market mismatches will become more widespread. New jobs will continue to be created mainly in private services, while the number of employees in industry and construction activities, for instance, will stay more or less the same. The employment rate is predicted to rise to 70.5%. Labour supply is not likely to grow much more, as the number of people exiting the labour market will soon to exceed the number of those reaching working age, the number of foreign workers will grow only modestly and the use of resources outside the labour force are close to full capacity use now. The unemployment rate is expected to edge down to 6.3%, and is mostly long-term unemployment.

Job creation is now being hampered by greater labour shortages, as there are plenty of vacancies and recruitment periods have become longer. Structural unemployment will decrease thanks not only to the buoyant economy but also owing to enhanced public employment services and reforms implemented in the labour market subsidy system. Nonetheless, structural unemployment still accounts for over two thirds of overall unemployment.

Labour costs have risen only moderately by Finnish standards in recent years, contributing to economic growth and better job prospects. Although labour costs have risen faster than in competing countries in Europe, higher productivity has ensured cost competitiveness. In 2008, following the new incomes policy agreement, wages and salaries will increase at the fastest rate since 1991. Moreover, productivity growth will be slower. In private sectors where a collective agreement has already been reached, pay rises are expected to remain within the scope of productivity growth and profitability. However, should a higher pay level become a general trend, there is a threat that this will quickly weaken cost competitiveness in other sectors.

The rise in consumer prices has accelerated by nearly one percentage point this year, reaching 2½%, due to higher housing costs among other things. Average inflation will stay in the same range as in 2008, unless external factors give rise to higher cost pressure than this year. The relative significance of inflation factors will change slightly though. Besides pay rises, next year's increases in indirect taxes and health care fees will raise the price level temporarily whereas housing costs will grow slower.

The estimates on economic growth and associated factors for 2007-2008 presented in Table 1 are based on forecasts by the Ministry of Finance published in September this year. The assumptions in the forecasts are in line with the Commission's estimates. The impact of the risks related to economic developments on actual performance in general government is discussed in section 4.1 below.

Table 1a. Macroeconomic prospects

	2006	2006	2007	2008	2009	2010	2011
	EUR bn	change					
1. Real GDP		5.0	4.4	3.3	3.0	2.5	2.1
2. Nominal GDP	167.1	6.3	7.2	6.0	5.1	4.4	3.9
Components of real GDP							
3. Private consumption expenditure	85.9	4.3	4.0	3.8	2.3	1.6	1.3
4. Government consumption expenditure	36.3	1.0	0.8	1.8	1.5	1.7	1.5
5. Gross fixed capital formation	32.0	4.2	5.0	3.1	2.5	2.4	2.2
6. Changes in inventories (% of GDP)	2.4	1.4	2.0	2.1	2.5	2.8	3.1
7. Exports of goods and services	74.4	10.4	5.7	4.7	5.0	4.5	4.0
8. Imports of goods and services	65.7	8.3	4.4	3.8	3.0	2.8	2.6
Contributions to real GDP growth. % points							
9. Final domestic demand	154.2	3.2	3.2	2.9	2.0	1.6	1.4
10. Changes in inventories	2.4	0.4	0.4	-0.3	0.0	0.0	0.0
11. External balance of goods and services	8.7	1.3	0.8	0.6	1.0	0.9	0.7

Table 1b. Price developments

	2006	2007	2008	2009	2010	2011
	change					
1. GDP deflator	1.2	2.7	2.7	2.0	1.8	1.8
2. Private consumption deflator	1.4	2.4	2.8	2.2	2.0	2.0
3. HICP	1.6	2.4	2.4	2.2	2.0	2.0
4. Public consumption deflator	3.1	2.9	3.8	3.2	2.9	2.9
5. Investment deflator	3.2	3.1	2.0	2.0	2.0	2.0
6. Export price deflator	2.5	2.2	0.1	-0.5	-0.5	-0.5
7. Import price deflator	6.5	2.7	1.2	1.0	1.0	1.0

Table 1c. Labour market developments

	2006	2006	2007	2008	2009	2010	2011
	level	change					
1. Employment, 1 000 persons	2 446	1.8	1.8	0.6	0.4	0.1	-0.1
2. Employment, 1 000 hours worked	4 189	1.7	1.8	0.4	0.2	-0.1	-0.3
3. Unemployment rate (%)		7.7	6.7	6.3	5.8	5.6	5.6
4. Labour productivity, persons		3.1	2.5	2.7	2.6	2.4	2.2
5. Labour productivity, hours worked		3.2	2.5	2.6	2.8	2.6	2.4
6. Compensation of employees	64.7	5.0	5.7	6.0	5.4	4.1	3.9
7. Compensation per employee		2.8	3.7	5.1	5.0	4.0	4.0

Table 1d. Sectoral balances

	2006	2007	2008	2009	2010	2011
	% of GDP					
"1. Net lending/borrowing vis-à-vis the rest of the world"	4.8	4.9	4.6	5.0	5.0	4.8
of which:						
- Balance on goods and services	5.2	5.5	5.4	5.5	5.5	5.4
- Balance of primary incomes and transfers	-0.5	-0.7	-0.8	-0.6	-0.6	-0.6
- Capital account	0.1	0.1	0.1	0.1	0.1	0.1
2. Net lending/borrowing of the private sector	2.1	1.6	2.1	2.5	3.4	3.6
"3. Net lending/borrowing of general government"	3.8	4.5	3.7	3.6	2.8	2.4
4. Statistical discrepancy	-1.2	-	-	-	-	-

Table 1e. Basic assumptions

	2006	2007	2008	2009
Short-term interest rate (3 month money market)	3.1	4.3	4.4	4.3
Long-term interest rate (10 year government bonds)	3.8	4.3	4.4	4.5
USD/EUR exchange rate	1.3	1.4	1.4	1.4
Nominal effective exchange rate	0.5	2.2	1.0	0.0
World GDP growth	5.5	5.6	5.3	5.4
EU-25 GDP growth	2.7	2.9	2.4	2.4
Growth of relevant foreign markets	8.8	6.4	5.9	5.7
World trade growth	9.4	7.8	7.1	7.7
Oil prices (Brent, USD/barrel)	64.2	70.6	78.8	76.0

* No specific underlying assumptions were defined for the medium-term computations. Instead, they are based on general assessments on developments in the operating environment.

2.2 Medium-term macroeconomic scenario

Growing supply constraints, such as less labour supply due to the ageing of the population, will start hampering economic growth opportunities already during this government term. The population projections of Statistics Finland indicate that the working-age population will start declining at the end of the decade. The number of people in the labour force can be expected to start diminishing even before that, but the pension reform introduced in 2005 is expected to curtail the drop in labour supply to some extent. Unemployment is more clearly structural in nature. This, together with the forthcoming demographic changes, means that the existing labour resources will decrease in the next five years.

The medium-term 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. The method is used to illustrate growth in potential production. Assessments on economic production potential draw on forecasts for various supply factors, such as labour, capital stock and productivity projections. The estimates involve a number of uncertainties, and the risk is that actual growth will fall short of the growth projections presented in the Stability Programme. There are a number of risks related to total demand that could mean that actual growth is much slower than in the baseline scenario. On the other hand, economic performance could improve much better than forecast in the baseline scenario if economic policy succeeds in meeting the challenges in the economy. Chapter 4.1 describes not only the baseline scenario but also slower and faster growth scenarios.

While economic growth in Finland has been robust in recent years, medium-term growth prospects, projected until 2011, are nonetheless subdued. Annual growth is forecast to drop below 2 per cent by 2010. The ageing of the population and the ensuing decline in labour supply are likely to hamper growth, reflected in a weaker labour input component in potential production estimates. Household indebtedness and slower growth in employment, in turn, will begin to curb medium-term consumption potential in the household sector. Modest growth in production capacity will also curtail growth prospects.

The global economy has reached a cyclical peak but growth is nonetheless expected to remain strong in a number of countries important to the Finnish economy, such as Russia. Growth is still quite robust in the euro area too, but in international terms, medium-term growth will remain modest relative to other world economic areas. The new EU Member States will experience the fastest economic growth in the next few years too.

Annual growth in exports is estimated at just over 5 per cent, which is lower than what Finland has been used to since the mid-1990s. The underlying assumption is that Finnish export companies, chiefly the electronics industry, will increase production abroad, closer to the end-product markets. The growth

opportunities of Finnish export companies are also constrained by a consistently strong euro and price hikes in raw materials. With export prices still falling, especially in mobile phone exports, and import prices on the rise, the terms of trade are anticipated to continue deteriorating.

New jobs have been created especially in the service sector and construction industry in recent years. However, medium-term economic growth projections will not create opportunities for employment to improve at quite the same rate as in the recent past. The assumed economic growth and productivity forecasts suggest that around 23,000 new jobs in total will be created between 2007 and 2011. Unemployment is likely to be reduced slightly more if labour supply decreases as anticipated. The unemployment rate will edge down to 5½% at the turn of the decade and will be mainly structural in nature. Unless new economic policy measures are introduced, the employment rate cannot reach more than 71%.

3 GENERAL GOVERNMENT BALANCE AND DEBT

3.1 Fiscal policy strategy and medium-term budgetary objective

The Government aims to secure a structural surplus equivalent to 1% of GDP in central government finances by the end of the government term in 2011. To achieve this, restraint in expenditure and tax policies is necessary and strong action to boost economic growth potential and to foster employment are called for. To keep economic growth as stable as possible, all changes in expenditure and taxation will be scheduled with due regard to the economic cycle and so that the targeted surplus can be reached. Tax policy measures will be gauged so that neither the long-term sustainability of public finances nor the commitments included in Finland's Stability Programme are jeopardised. Moreover, the Government Programme declares that the central government finances must never show a deficit of more than 2½% of GDP even in a weak economy. This means, bearing in mind the surplus in the social security funds, keeping overall general government finances more or less in balance. The present outlook is that such weak economic performance is unlikely in the medium term.

Under the revised Stability and Growth Pact, every Member State must have a specific medium-term budgetary objective (MTO) for general government. In addition, a safety margin estimated by the Commission against breaching the 3% reference value, preventing economies from exceeding the value during normal macroeconomic fluctuations, must be taken into account when setting the MTO. The revised Pact also stipulates that euro area and ERM II Member States pursue an annual improvement of the cyclically-adjusted balance of 0.5% of GDP as a benchmark to meet its MTO. In good times the adjustment should be higher than the said benchmark.¹

¹ Good times are defined as periods when the output gap is positive, i.e. actual total output exceeds its potential.

Finland's medium-term budgetary objective was set out in last year's Stability Programme update as a 2% surplus-to-GDP ratio in general government finances. Finland will meet this objective over the current programme period too.

The Government's view is that the medium-term outlook in the Finnish economy must be assessed with a view to making provision for the impending demographic changes. The Government Programme aim is to achieve, fuelled by structural reforms to boost employment, a surplus in central government finances by 2011 equivalent to a structural surplus of 3½% at the level of general government finances, taking into account the projected developments in local government finances and in the social security funds. In line with this, the Government's intention in the Stability Programme update is to reach a structural surplus of 3½% of GDP by the end of the programme period in 2011.

Neither the financial balance outlined in the baseline scenario in this Stability Programme nor the target established for the medium-term is sufficient to ensure sustainable public finances in the long term. An estimated sustainable general government surplus ratio amounts a good 4½ of GDP in the medium term. Various economic policy options can be used and combined to bridge the sustainability gap. An evaluation will be made during this parliamentary term to assess whether sufficient provision has been made to meet the impending challenges brought about by the ageing of the population, so that any requisite action can be undertaken while the present Government is still in office. Sustainability scenarios, including computations on the preconditions for a sustainable general government, are presented in chapter 6 of this publication.

The baseline scenario in the Stability Programme include the additional expenditure stemming from the decisions made in the context of the 2008 budget proposal and the main foreseeable on-budget spending pressure and tax decisions.² The Government is committed to the spending limits decision of 25 May 2007, which aims for spending limits that curb growth in expenditure during this parliamentary term. Measures entered in the Government Programme will be implemented insofar as it is possible within the parameters of the spending limits decision. To boost productivity, the Government will carry on implementing both the project to restructure municipalities and services and the productivity programme. The purpose is to make public functions more efficient and to reallocate public sector labour resources to cater more effectively for the demands of the ageing population.

2 The figures for general government balance and debt in this paper deviate from those in the September Economic Survey. This Programme includes the Government's proposal of 25 October 2007 for a fourth supplementary budget for 2007 and the impact of collective agreements contracted to date. The earnings level in local government is assumed to be determined according to the local government agreement made on 1 October 2007.

The general government surplus for 2011 is estimated at 2½% of GDP, which falls short of the targeted 3½% surplus for general government finances. The Government is prepared to take corrective action should the target be jeopardised.

Under the Government Programme, the Government's economic policy strategy is to achieve economic growth that is faster than that presented in the economic forecasts. It is vital to raise the employment rate to safeguard sustainable public finances. The labour market is becoming tighter, and unless new measures to boost labour supply are introduced, the threshold of structural unemployment will soon be reached. Greater occupational and regional labour mobility is necessary to ease the problem of labour market mismatches.

To increase the supply of labour, the Government will endeavour to make student graduation periods shorter. Effort will be made to make work pay and reduce incentive traps by lowering taxes on labour within the parameters of the economic cycle and by revamping social protection. To promote occupational and regional labour mobility, the adult education system will be reformed and eligibility for tax relief on housing costs for a second place of residence will be improved. To reduce structural unemployment, the Government will improve training schemes for the unemployed, enhance subsidised jobs and make job brokerage more efficient.³

3.2 General government balance and debt

The surplus in general government is estimated to average 3.1% of GDP over the next four years. The EMU-debt ratio in public finances is anticipated to edge down below 30% by 2010. Finland meets the objectives of the Stability and Growth Pact both in terms of the balance in public finances and with regard to the debt ratio.

Economic expansion has been robust for several years now, which has strengthened general government finances. The rate of production growth is slowing down, however, which means growth in revenue bases will also slacken while the ageing population is creating mounting pressure on public spending. Thus the existing high surplus level in general government finances will drop towards the end of the projection period.

Spending will increase considerably in central government in 2008 as a result of expenditure decisions made by the previous and current governments, but there will still be a surplus thanks to the cyclical upswing. Central government finances are expected to show a slight surplus throughout this election period. The spending limits adopted by the Government will help curb spending in

³ The Finnish National Reform Programme offers a more comprehensive description of the Government's structural policy measures.

the next few years. Employment prospects have improved, which has lowered unemployment expenditure figures from previous estimates.

By boosting employment, among other things, the Government aims to achieve economic growth that is faster than that presented in the forecasts. This would strengthen central government finances and make the financial position of general government more sustainable.

The surplus in general government still mainly depends on employment pension funds. With growth in pension expenditure accelerating, however, the surplus in the employment pension funds will start shrinking already in the medium term. Altogether, the surplus in the social security funds will amount to 3% of GDP this year but is expected to drop to 2% by 2011. Aggregate central and local government finances will show a slight surplus in the next couple of years and will remain in balance at the end of this parliamentary term.

Strong economic expansion has fuelled growth in local government tax revenue and reinforced their financial position both this year and last. However, higher-than-expected pay raises will lead to faster growth in expenditure both this year and next. Local government finances are anticipated to show a slight deficit in 2007, but the debt stock will grow slower than in the past years. In 2008, in spite of higher spending, the financial stance in the municipalities will improve, as a general increase in the earnings level will boost municipal tax receipts. In addition, central government transfers to local government will also grow appreciably.

Local government is predicted to be close to balance between 2009 and 2011. Despite the overall improvement in local government, the differences in the financial position of individual municipalities will probably remain large. The economic forecasts for local government are based on projections by the financial working group of the Advisory Board for Municipal Administration and Economy (Kuthanek) and on the macroeconomic developments presented above.

Structural reforms are still necessary in order to prepare for the ageing of the population and mounting service demand even though local government finances are on the mend. Besides expenditure pressure, the shrinking labour supply threatens to narrow down the tax base, which could jeopardise the sustainability of municipalities. Municipalities should make provision not only for longer-term risk factors but also for cyclical fluctuation, when tax revenue might actually decrease instead of growing steadily. At the projected spending rate, local government will sink into a clear deficit and a number of municipalities would face dire financial difficulties.

3.3 Cyclically adjusted balance in general government finances

The production function method devised by the by the EU Commission together with the Member States shows that, thanks to exceptionally robust economic growth, Finland's total output will exceed its potential level in 2007. Moreover, the output gap will remain slightly positive relative to GDP in 2008 even though economic growth is slackening. The more production exceeds its potential level, the more supply factors and mechanisms in the economy tend to slow down growth.

Growth in potential output is estimated to shrink from a good 3% to 2% by 2011. In the medium term, the output gap is forecast to close. This means that at the end the programme period, total output would equal its potential level. The slowdown in potential output is mainly due to an anticipated drop in the growth contribution of labour input and capital input (Table 4). The change in the labour input will have a negative impact on production potential by the end of the review period, mainly because the population of working age is declining. Output growth potential will in fact rely almost entirely on growth in total factor productivity in the future.

Economic activity has a direct effect on general government tax revenue and on unemployment-related expenditure, for instance. The impact of the output gap on the balance in public finances is gauged by applying OECD income and expenditure elasticity estimates when computing the cyclically adjusted balance. On the basis of the above elasticities and output gap, it is possible to evaluate how strongly the positive gap impacts general government finances. The cyclically adjusted balance will narrow down slightly between 2008 and 2011, indicating expansionary fiscal policy. The cause for the decrease in the balance derives from not only growing pension expenditure but also tax cuts. The computation of potential output and cyclically adjusted balances involves substantial elements of uncertainty, mainly due to Finland's sharp cyclical fluctuations of the 1990s caused by the deep recession early in the decade and due to structural changes in the economy.

Table 2. General government budgetary prospects

	2000 EUR	2006	2007	2008	2009	2010	2011
	million	% of GDP					
Net lending (EDP B.9) by sub-sector							
1. General government	6 401	3.8	4.5	3.7	3.6	2.8	2.4
2. Central government	1 534	0.9	1.5	0.7	0.7	0.1	0.2
3. -							
4. Local government	-315	-0.2	-0.1	0.1	0.1	0.0	-0.1
5. Social security funds	5 182	3.1	3.1	2.9	2.8	2.6	2.3
General government (S13)							
6. Total revenue	87 797	52.6	51.9	51.0	50.6	49.8	49.6
7. Total expenditure	81 396	48.7	47.4	47.3	47.0	47.0	47.2
8. Net lending/borrowing	6 401	3.8	4.5	3.7	3.6	2.8	2.4
9. Interest expenditure	2 414	1.4	1.5	1.5	1.3	1.3	1.2
10. Primary surplus	8 815	5.3	6.0	5.2	5.0	4.1	3.6
Selected components of revenue							
12. Total taxes	52 391	31.1	30.8	30.4	30.1	29.3	29.1
12a. Taxes on production and imports	23 150	13.6	13.2	13.1	12.9	12.5	12.3
12b. Taxes on income	28 736	17.2	17.3	17.0	17.0	16.6	16.6
12c. Capital taxes	505	0.3	0.3	0.3	0.2	0.2	0.2
13. Social security contributions	20 431	12.2	12.0	11.8	11.8	11.9	11.9
14. Property income	6 095	3.6	3.7	3.6	3.6	3.6	3.6
15. Other income	8 880	5.6	5.4	5.2	5.1	5.0	5.0
16. = 6. Total revenue	87 797	52.6	51.9	51.0	50.6	49.8	49.6
p.m.: Tax burden	72 400	43.1	42.6	42.0	41.7	41.0	40.8
Selected components of expenditure							
17. Sum of compensation of employees and intermediate consumption	37 758	22.6	21.9	21.6	21.5	21.5	21.5
17a. Compensation of employees	22 320	13.4	13.0	12.9	12.7	12.6	12.6
17b. Intermediate consumption	15 438	9.2	8.9	8.8	8.8	8.9	8.9
18. Social payments	30 153	18.0	17.3	17.3	17.3	17.5	17.8
18a. Social transfers in kind supplied via market producers	3 557	2.1	2.1	2.1	2.2	2.2	2.3
18b. Social transfers other than in kind	26 596	15.9	15.2	15.2	15.1	15.3	15.5
19. = 9. Interest expenditure	2 414	1.4	1.5	1.5	1.3	1.3	1.2
20. Subsidies	2 144	1.3	1.3	1.3	1.3	1.2	1.2
21. Gross fixed capital formation	4 070	2.4	2.5	2.6	2.5	2.5	2.4
22. Other expenditure	4 857	2.9	2.9	3.1	3.1	3.1	3.1
23. = 7. Total expenditure	81 396	48.7	47.4	47.3	47.0	47.0	47.2
of which: Government consumption	36 266	21.7	21.1	20.9	20.9	20.9	21.0

Table 3. General government debt developments

	2006	2007	2008	2009	2010	2011
	% of GDP					
1. Gross debt, % of GDP	39.2	35.3	32.8	30.4	29.0	27.9
2. Change in gross debt, % points	-2.2	-3.9	-2.6	-2.4	-1.3	-1.1
Contributions to changes in gross debt, % points						
3. Primary balance	5.3	6.0	5.2	5.0	4.1	3.6
4. Interest expenditure	1.4	1.5	1.5	1.3	1.3	1.2
5. Stock-flow adjustment	1.7	0.6	1.1	1.2	1.4	1.3
of which:						
- Net acquisition of financial assets	3.4	3.8	3.0	3.0	2.9	2.7
- of which: privatisation proceeds	-0.7	-0.2	-0.2	-0.2	-0.2	-0.2
- Valuation effects (incl. impact of GDP growth)	-1.7	-3.2	-1.9	-1.7	-1.4	-1.4
Implicit interest rate on debt	3.9	4.2	4.3	4.2	4.3	4.3
Other variables						
6. Liquid financial assets (AF1, AF2, AF3, AF5)	97.6	-	-	-	-	-
7. Net financial liabilities (7=1-6)	-58.4	-	-	-	-	-

Table 4. Cyclical developments, % of GDP

	2006	2007	2008	2009	2010	2011
	% of GDP					
1. Real GDP growth (%)	5.0	4.4	3.3	3.0	2.5	2.1
2. Net lending of general government	3.8	4.5	3.7	3.6	2.8	2.4
3. Interest expenditure	1.4	1.5	1.5	1.3	1.3	1.2
4. Potential GDP growth (%)	3.3	3.7	3.3	3.1	2.6	2.2
contributions:						
- labour	0.4	0.6	0.3	0.1	-0.2	-0.4
- capital	0.7	0.8	0.8	0.7	0.6	0.4
- total factor productivity	2.2	2.2	2.2	2.2	2.2	2.2
5. Output gap	-0.2	0.4	0.3	0.2	0.1	0.0
6. Cyclical budgetary component	-0.1	0.2	0.2	0.1	0.1	0.0
7. Structural financial balance (2-6)	3.9	4.3	3.5	3.5	2.7	2.4
8. Structural primary balance (7+3)	5.4	5.8	5.0	4.8	4.0	3.6

4 SENSITIVITY ANALYSIS AND COMPARISON WITH PREVIOUS PROGRAMME

4.1 Risks in economic developments and risk impact on public finances

The short-term risks to international economic developments are related to not only uncertainty in the world market price of crude oil but also global imbalances and expanding current account surpluses and deficits. The fundamental view is still that global demand will continue to grow reasonably fast, but, should uncertainty in the financial markets prevail, it could impact growth prospects more than is currently assumed.

Domestically, the surge in the household debt ratio and structural bottlenecks in the labour market are adding to uncertainties in the short-term economic outlook.

The household debt ratio has already exceeded the record level of the early 1990s and is now around 100% of disposable income. At the same time, the household savings ratio has settled on a downward trend in recent years. By examining the situation through an average path of developments, however, the full picture remains obscure, as nearly half of all Finnish households have no debt whatsoever. In addition, financial assets net of debt correspond to the total annual average income of households. However, the distribution of assets and debts is not evenly spread, as some households have a large debt burden while others own a significant amount of assets. The heavily indebted households form a risk group, in which consumption is expected to decrease in the future, as rising interest rates will reduce their net income after debt servicing costs. There is a distinct risk that average household consumption might drop significantly if the conditions for credit deteriorate and asset volatility increases. The surge in asset prices, which has lasted for several years now, risks leading to a plummet in prices during a downturn.

The downside of prolonged robust economic growth is higher cost and price pressure. Labour costs have risen only moderately by Finnish standards in recent years, contributing to economic growth and better job prospects. Although labour costs have risen faster than in competing countries in Europe, higher productivity has ensured cost competitiveness. In 2008, wages and salaries will increase at the fastest rate since 1991, following the new collective agreements. Moreover, productivity growth will be slower. There is a risk that cost competitiveness might drop sharply especially in sectors where productivity is lower. The cuts in production capacity that took place in the forest industry this year and last will reduce output growth and threaten to hamper export performance even if global demand were to stay as robust as forecast. If medium-term economic expansion and growth in tax revenue proves to be slower than anticipated, the higher-than-expected pay rises in local government could pose a risk to the stability of municipal finances.

The level of earnings is expected to rise by an annual average of 4½% in the medium term. A faster rise in the earnings level partly reflects the mismatches in the labour market. If the markets become tighter, the pressure for even faster pay rises will mount, which would weaken cost competitiveness and would increase wage expenses in the public sector. Unless economic growth momentum can be boosted through higher productivity, the shortage in skilled labour will start curbing performance.

The main risks in the medium-term outlook are related to employment and productivity prospects. The challenges posed by the ageing population will impact the labour market first, as labour supply will start falling in the near future already. Unless improvements in the functioning of the labour market are made and the labour input of the unemployed is better exploited, the availability of labour will become so limited that it will narrow down economic growth potential while structural unemployment will remain widespread. The ageing population is a serious challenge to sustainable public finances, because the spending pressure in pensions and health care and welfare services will mount while growth in GDP and the tax bases will slow down because the labour force is diminishing.

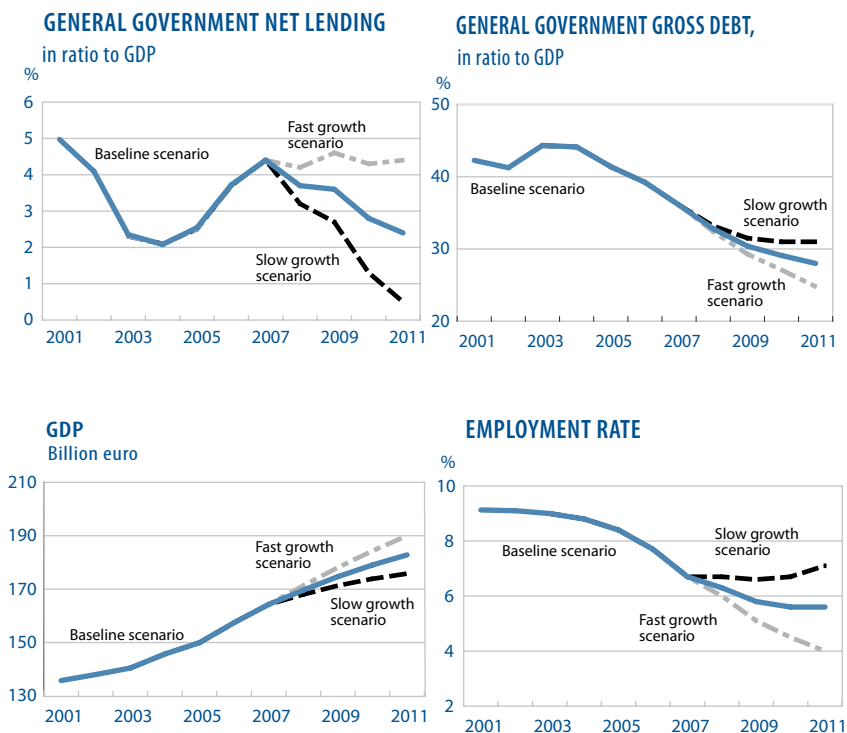
Climate change will weaken the long run growth potential and competitiveness of the economy. The commitments made to reduce greenhouse gases and to increase the use of renewable energy to help prevent climate change might also weaken economic growth potential and competitiveness. It is not possible to quantify the significance of these commitments yet.

The medium-term GDP growth estimate was computed using the production function method as developed by the EU Commission together with the Member States, with a view to evaluating potential output growth. The European Commission's production function method involves uncertainties, particularly with regard to the assessment of labour input. A trend-like increase is expected in Finland's labour participation rate, which is, however, not certain. Were

participation rates to remain at current levels in all age groups, the participation rate for the whole population would fall significantly in the future. Economic growth might thus prove to be weaker than in the baseline scenario if labour supply starts falling faster than assumed in this Programme.

The figures below illustrate the impacts of slower-than-baseline and faster-than-baseline economic 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 2008-2011 would drop to around 1% at the end of the review period and the unemployment rate would start rising. The impacts of economic growth on general government finances are gauged by using OECD elasticity estimates. In the slow growth scenario, the surplus in general government finances would disappear completely at the end of the forecast period and the debt ratio would barely decrease. This would seriously undermine the sustainability of general government finances as the



population continues to age.

Economic performance could prove to be more positive than that in the baseline scenario if the challenges described above are addressed through economic policy measures. In the faster growth scenario, the economy would grow at an average rate of nearly 4% and unemployment would drop to around 4%. This implies robust economic growth and further improvements in employment in a situation where there are mounting supply constraints. This means major structural reforms to boost output potential should be introduced, so that general government finances fuelled by fast economic expansion could remain sustainable. In the faster growth scenario, the surplus in public finances would rise to around 4½% of GDP and the debt ratio would drop to 25% by 2011.

4.2 Comparison with last year's Stability Programme update

Last year's Stability Programme update predicted GDP growth for 2006 at 4.5%, whereas current preliminary data put the figure at 5%. This is the fastest rate of growth since 2000 and much brisker than over the past decade on average. Economic growth was robust and broad-based, although it is partly explained by the low production level in the forest industry in 2005, when a month-long production stoppage occurred.

The economy has been buoyant for longer than anticipated, and the current forecast for total output in 2007 is much higher than previously estimated. The upswing has been further strengthened by rapid growth in the global economy, now in its fourth year, along with relatively low interest rates and tax cuts. As in 2006, growth is supported by net exports and domestic demand, although the focus is shifting towards domestic demand. Private consumption expenditure, in particular, is expected to grow faster than predicted a year ago.

In assessing Finland's potential output growth, stronger-than-expected economic expansion is reflected in the medium-term growth estimates. Total productivity will grow slightly more than previously anticipated, and capital stock has increased more than was expected a year ago. These are both mirrored in Finland's economic growth prospects in the medium term.

Employment has also profited by the prolonged economic upturn both in the Finnish economy and Finland's main export countries. The number of employed people will grow by roughly 50,000 this year and unemployment will decrease more than was predicted in the 2006 Stability Programme update.

Inflationary expectations have changed from last year's projection. Inflation accelerated in 2006. There was a sharp price hike in world market prices in crude oil but by the end of the year they had edged down to the same level as they were

at early in the year. The international market price of other raw materials rose substantially too. Inflation has continued to accelerate marginally this year. The world market price of oil peaked at nearly \$80 a barrel in mid-July, and has since then remained in the range of \$70 a barrel. With the euro having appreciated against the dollar, inflationary pressure from oil prices has eased considerably. The price estimates for 2008 include elements of considerable uncertainty in terms of international market price developments in oil and other raw materials, for instance. Cost pressure derived from labour costs will be much higher than previously forecast.

The estimated surpluses in general government would appear to be greater than expected a year ago, mainly because economic growth has been faster than anticipated. Fuelled by brisk economic expansion, general government finances will further strengthen in 2007. The surplus in central government will reach 1½% of GDP and the financial position in the municipalities will be close to balance. General government finances will stay well in surplus in 2008 but will nevertheless edge down, because total spending will grow faster while growth in tax revenue is assumed to slacken. In the 2006 Stability Programme update, central government finances were expected to slightly improve towards the end of the review period, but are now anticipated to weaken instead due to the scheduling of tax cuts for the latter part of the government term. Additionally, the output growth rate is decelerating, which means the revenue bases will also grow slower.

Local government finances and social security funds will see slightly better developments than previously predicted. With respect to the balance in general government finances, the estimated debt ratio has been brought down.

Table 5. Divergence from previous update

	2006	2007	2008	2009	2010	2011
Real GDP growth (%)						
SP-2006	4.5	3.0	2.9	2.6	2.1	-
SP-2007	5.0	4.4	3.3	3.0	2.5	2.1
Difference, % points	0.5	1.4	0.4	0.4	0.4	-
General government net lending (% of GDP)						
SP-2006	2.9	2.8	2.7	2.7	2.4	-
SP-2007	3.8	4.5	3.7	3.6	2.8	2.4
Difference, % points	0.9	1.7	1.0	0.9	0.4	-
General government gross debt (% of GDP)						
SP-2006	39.1	37.7	36.2	35	33.7	-
SP-2007	39.2	35.3	32.8	30.4	29.0	27.9
Difference, % points	0.1	-2.4	-3.4	-4.6	-4.7	-

Previous update: Stability Programme update, November 2006

Current update: Stability Programme update, November 2007

5 QUALITY OF PUBLIC FINANCES

5.1 Government policy

To ease the pressure on public finances caused by the ageing of the population, the Government aims to improve the capacity of the economy and ensure sound spending and tax policies. The Government plans to foster labour supply, improve the functioning of the labour market and reduce structural unemployment by means of targeted increases in appropriations, through tax cuts and by implementing structural reforms. Growth in public spending will be curbed by making public sector functions more efficient and by boosting productivity. The main instruments in this context are the restructuring of municipalities and services and the Government productivity programme. More efficient and productive public functions are vital not only to ensure stability in general government finances but also to secure growth prospects for the Finnish economy. Better productivity creates significant opportunities to curb expenditure growth and to reallocate resources.

This Stability Programme update is in line with National Reform Programme for Finland published in October 2007. The NRP only incorporates reforms included in the Government Programme or which the government has decided to implement during its term in office. All the reforms listed in the NRP are contained within the Government spending limits and were taken into account in the baseline scenario presented in the Stability Programme.

5.2 General government revenue and taxation

The Government Programme drawn up in spring 2007 aims to promote employment through tax cuts. In line with this, taxes will be reduced by a total of EUR 2.4 billion by the end of the government term. The main emphasis will be on easing taxes on labour. The Government will make a mid-term assessment of the magnitude of income tax cuts in the light of pay settlements. Pension income will also be reduced so that the maximum tax rate for pension

income is the same as that for earned income. To date, pension taxation has been higher in some income brackets than in the equivalent scales for earned income. This discrepancy will be addressed by raising the central government tax deduction on pension income. Inheritance taxes will be cut at the beginning of 2008 by raising the minimum threshold for taxable inheritance and by easing the position of spouses and under-age children. This will reduce tax revenue by EUR 165 million, but the full impact of the tax cuts will take place in 2009.

Under the Government Programme, the tax base for corporate taxation will remain contained and any changes that might jeopardise the competitiveness of Finnish businesses will be avoided. Business profitability has been good in recent years, creating a sound basis for corporate tax receipts. The corporate tax accrual is calculated to grow by an average of 4% between 2007 and 2011. This is based on the assumption that productivity will continue to improve, as labour costs will be growing faster than before.

To counterbalance the tax cuts some indirect taxes will be raised. To promote energy saving and efficiency, energy taxes will be raised by EUR 300 million in 2008. To curtail growth in the consumption of alcohol, excise duties on alcoholic beverages will go up by 10%.

Private consumption has been growing fast in the past few years. The surge in household indebtedness will curtail potential growth in consumption in the medium term, however. This means revenue in indirect taxes, such as VAT, will also grow slower in the medium term. The VAT rate on foodstuff is scheduled to be lowered by 5 percentage points in October 2009 and this will further reduce tax receipts by EUR 500 million. As a result, annual growth in central government tax revenue from production and imports will slow down more than GDP growth. With domestic demand growing slower and tax cuts being implemented, central government tax revenue will increase by an average of 3.3% between 2007 and 2011.

Local government tax receipts will grow by 7½% in 2007 and the total tax accrual will rise to EUR 16.4 billion. The income tax rate was raised in 106 municipalities, pushing up the average tax rate from 18.39% in 2006 to 18.46%. Growth in tax revenue will continue to swell in 2008, as economic expansion is anticipated to stay robust and a rising earnings level in the national economy will perk the municipal tax base. Local government tax revenue is expected to grow by an annual average of over 4% between 2009 and 2011.

Over a half of all basic services in municipalities are financed through local government tax receipts. Close to 90% of all tax revenue in the municipalities consisted of local government tax receipts in 2006. Corporate tax revenue accounted for 8% and real estate tax receipts for 5% of tax revenue. Tax projections for 2008 – 2011 suggest that the average tax rate will stay at the same level as in 2007, at 18.46%. Higher-than-expected pay rises in local government might mean that more municipalities than before will face financial difficulties, leading

to higher municipal taxation.

Central government transfers to local government will grow considerably in 2008. The revision in the distribution of costs between central and local government will increase central government spending by around EUR 250 million. Owing to a higher earnings level in local government and the rise in consumer prices, the index adjustment in central government transfers will climb to a record 5.2%, increasing transfers to local government by over EUR 350 million. Moreover, the Government will support the wage settlement in the municipalities by EUR 150 million.

The developments in the social security funds are determined by macroeconomic trends on the basis of current legislation and forthcoming changes. The tax rate is expected to drop by about 1.7 percentage point during the Stability Programme period. The employment pension contribution rate is assumed to rise slightly in 2008-2011. By contrast, with less unemployment, the unemployment contributions of both employers and employees will decrease.

5.3 General government expenditure

Finland's general government expenditure grew very fast in the early 1990s mainly due to the recession. Aggregate general government spending peaked at 65% of GDP in 1993, after which it edged down to 50% in 2005. Measures to restore general government finances and the onset of rapid economic growth changed the course of developments in the mid-1990s. Most of the reduction in spending has taken place in social security expenditure and general government interest expenses. The drop is mainly due to lower unemployment security costs, as employment improved after the recession.

The expenditure-to-GDP ratio will fall by 3 percentage points altogether in 2006 and 2007, as spending will grow quite moderately and the value of total output will increase by as much as 14% altogether in these two years. Growth in expenditure will accelerate in 2008 and the expenditure-to-GDP ratio will stay in the same range as in 2007 at around 47½%. The GDP ratio is expected to remain fairly stable beyond 2008. Spending will grow mainly in 2008, and is expected to ease down between 2009 and 2011.

Aggregate central government expenditure is expected to increase by about 2½% in 2007 and considerably more in 2008. With a large number of infrastructure route projects being launched this year and being recorded in expenditure to the full amount, investment expenditure in central government will increase by about one fifth next year. The revision in the distribution of costs between central and local government will increase central government spending by around EUR 250 million. Owing to raises in national pensions and student grants, central government transfers to the Social Insurance Institution will grow by EUR 100 million. Universities will receive more basic funding, and

the number of students admitted to basic vocational training and apprenticeships will increase. Appropriations for active labour market programmes will be retargeted.

Under the Government Programme, most of the increase in spending throughout this electoral period will be allocated in health care and welfare services, in current transfers and to promote competence. The funds are aimed at bolstering basic health care, increasing the number of personnel who provide home and institutional care for the elderly, broadening and developing the coverage and support available to family carers, and to foster R&D. Central government staff numbers will be cut over the review period as outlined in the Government productivity programme, which will reduce growth in consumption expenditure. All told, on-budget expenditure in this Government's first spending limits decision will be nearly EUR 6 billion higher in 2011 than in 2007. In real terms (at 2008 prices), on-budget spending will grow by about EUR 1.7 billion from 2007 to 2011 based on the spending limits decision made in May this year.

Consumption expenditure in municipalities and joint municipalities is expected to grow by a nominal 5½% and by 1½% in real terms both this year and next. The pay rises in local government will further fuel growth in spending. A higher level of earnings will also impact municipal finances due to costlier purchased services, as wage costs are one of the main elements in them. Investment projects in big cities and towns will keep the investment rate high.

Local government consumption expenditure is expected to grow by a nominal 5% between 2009 and 2011. Staff numbers in the municipalities are anticipated to grow by 4,000 employees a year, almost entirely due to a net increase in the health care and social welfare sectors.

The forthcoming decline in labour supply will make it more difficult than before for municipalities to recruit staff. This will be further exacerbated because large numbers of local government employees will be retiring at the same time as demand for municipal services is escalating. This might result in greater wage drift and more frequent enforcement action in the purchase of services, which threatens to increase local government expenditure more than anticipated.

The ratio of social security expenditure to GDP will drop considerably between 2005 and 2008 thanks to less spending in unemployment and owing to the pension reforms. The ratio is expected to start rising at the turn of the decade. The ageing of the population and the related increase in pension and care and nursing expenses means the ratio in health care and social welfare expenditure is likely to grow in the longer term too.

Table 6. General government expenditure by function, % of GDP

	COFOG- division	2005	2011
1. General public services	1	6,8	5,9
2. Defence	2	1,6	1,3
3. Public order and safety	3	1,5	1,3
4. Economic affairs	4	4,7	4,1
5. Environmental protection	5	0,3	0,3
6. Housing and community amenities	6	0,2	0,2
7. Health	7	6,8	6,9
8. Recreation, culture and religion	8	1,2	1,0
9. Education	9	6,1	5,6
10. Social protection	10	21,2	20,6
11. Total expenditure (=item 7=22 in Table 2)	TE	50,5	47,2

5.4 Productivity in general government

The standard of service provision in Finland is highly rated according to international comparisons and poll results among end-users, both in terms of quality and effectiveness. Although there are problems related to the gauging of productivity in public services, both statistical data and research results show that productivity in public sector service provision has in some cases fallen and in others remained unchanged in recent years.

The imminent demographic changes in Finland will result in declining labour supply in the next years. Unless labour productivity continues to increase consistently both in the public and private sector, it will be difficult to safeguard growth in the long run.

Productivity in central government

The Government will continue to implement the productivity programme for central government, as outlined in the Government Programme, and will decide on new measures to boost productivity in connection with the spring 2008 spending limits decision. The productivity-boosting measures introduced by the previous Government and which are now in their execution phase will help reduce staff requirements in government by 9,600 person-years from 2005 to 2011 and bring corresponding savings and opportunities for reallocation.

In tandem with the ongoing productivity measures, preparations are underway for new productivity plans, as outlined in the Government programme. The Government will examine all new proposals in late autumn 2007 and decide on additional action in connection with the spring 2008 spending limits decision. The Government aim is to improve productivity through new measures by reducing staff numbers by a further 4,800 person-years. The measures will be implemented so that the standard of service and development activities are not compromised.

With old-age retirement on the rise, natural attrition in central government staff numbers will start escalating especially from 2011 onwards and will stay high throughout the next decade. Roughly 2,100 public servants will retire on old-age pension in 2007, and from 2012 the annual figure will be over 3,700. Further action will be taken and decisions will be made to revamp services and administrative practices and to improve efficiency, because expenditure pressure is mounting and competition for labour is increasing. Natural attrition provides an excellent window of opportunity to carry out extensive reforms in service provision, efficiency and productivity without jeopardising existing employment contracts.

By centralising all core development functions in public administration in the Ministry of Finance on 1 January 2008, it will be possible to plan, implement and assess more efficiently all measures taken to enhance administrative practices. All administrative and human resources management functions in central government, including payroll and accounting, will be centralised in shared service centres. Together with the existing ones, altogether five service centres will be set up in central government, forming a network of shared service centres in administrative and human resources management with commonly agreed operating modes and uniform ICT resolutions. The aim is to have the system in full operation by the end of 2009.

Productivity demands have been taken into consideration in the Government's ICT strategy and related action plan. Productivity demands play a key role in the government facilities strategy. New work facilities and operating environments are often required when new operating modes are adopted. Significant productivity benefits can be gained by centralising public procurement and by reorganising procurement processes. Indeed, the joint public procurement unit has been much more actively used recently.

Reform in restructuring municipalities and services

Municipalities and services will be reformed as stipulated in the Act on Restructuring Municipalities and Services, which entered into force on 23

February 2007 and is effective until the end of 2012 and as specified in the decrees issued by virtue of the act.

The purpose of the new legislation is to bolster both municipal and service structures, enhance the ways in which services are produced and provided, revamp the municipal financial structures and the system of central government transfers to local government and review the division of duties between central and local government with a view to ensuring a solid structural foundation and a sound financial basis in the municipalities. The purpose is to boost productivity and curb growth in expenditure in the municipalities and to enhance the steering systems used in providing municipal services.

The structure of local government can be bolstered by regrouping and amalgamating municipalities. The aim is to create a municipal structure that is viable, robust and coherent. All mergers will be made on a voluntary basis. By autumn 2007, the Government had ratified decisions on 15 municipal mergers, which means that the total number of municipalities will be 415 at the beginning of 2008. In addition, another 100 or so municipal amalgamation projects are currently being assessed and 44 municipalities have presented a proposal for a merger. The provisions governing subsidies for municipal amalgamations were amended at the beginning of 2007 so that where a merger creates a municipality with a total population of over 20,000 inhabitants, the amalgamation subsidy is larger.

Service structures will be strengthened by consolidating individual services that require a population base of more than one municipality to be viable, and closer cooperation between municipalities will be promoted. This way, good quality services that are accessible to everyone can be ensured throughout the country. Municipalities and partnership areas responsible for providing basic health care services and related social services must have a minimum population base of around 20,000 inhabitants. Where municipalities and partnership areas offer basic vocational training, the minimum population base must be in the range of 50,000 inhabitants. To secure the provision of services requiring a large population base, the country is divided into municipal alliances as stipulated in the Act on Specialized Medical Care. Functions will be made more effective

by boosting efficiency in municipal service provision and production and by improving the operating conditions in the Helsinki metropolitan area and other urban areas suffering from problems in the community structure. Large urban areas are obligated to take part in joint implementation.

6 SUSTAINABILITY OF GENERAL GOVERNMENT FINANCES

6.1 Measures to enhance sustainability

The long-term outlook for general government finances in Finland is overshadowed by the impending rise in costs due to population ageing and by the shrinking of the revenue base resulting from less labour supply. With the baby boom generation retiring soon and causing a rise in pension expenditure and a fall in labour supply towards the end of this decade, the effects of the ageing population will actually become manifest in economic developments quite soon. The sharpest increase in the costs of health and long-term care provision for the elderly will take place in the 2020s. Finland's old-age dependency ratio in 2025 will be the highest in the EU.

The following measures have been taken to make provision for the financial and expenditure pressure created by the ageing of the population:

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

The structural surpluses in central government finances and reduction in government debt and interest outlays have created room for manoeuvre so that the impending growth in expenditure and fall in the revenue base caused by the ageing of the population will not lead to a new increase 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. The market value of the pension funds' assets is currently about 70% of GDP.

Finland's pension system has been reformed on several occasions since the early 1990s. The most recent comprehensive reform took effect at the beginning of 2005. The aim is to strengthen the sustainability of the pension system by adjusting pensions to changes in life expectancy and to encourage older workers (from the age of 63 onwards) to stay longer in employment by introducing an accelerated pension accrual. The aim is to postpone retirement by at least three years. Indeed, the employment rate among older workers has been rising considerably, indicating that the pension reforms have been able to serve their purpose. The employment rate in the age group 55-64 has risen from 36.4% in 1997 to 55% in 2006. The buoyant economy has also had its impact on the favourable employment trend among older workers.

To strengthen the sustainability of the pension system, the risk-carrying possibilities in the investments of the pension funds were revised as of 2007. The aim is to raise the long-term real return on investment in the pension funds from 3½% to 4% per annum by allowing for more investment in risk-carrying equity. Equity investment currently accounts for 48% of the total market value of pension funds. The revision is expected to release pressure to raise pension contribution rates by a good 1 percentage point relative to wages in the long term. The main purpose of the funding and returns in the Finnish defined benefit pension scheme is to ease pressure to raise pension contributions.

The 2005 pension reform and this year's revised investment arrangements together are anticipated to reduce the long-term pressure to raise contribution rates from 10 percentage points to about 4 percentage points of wages.

Besides the pension reform, the unemployment insurance system has also been revamped to better support employment and the sustainability of public finances. The minimum age for eligibility for the "unemployment pipeline", a relatively common pathway to early retirement in Finland, was raised at the beginning of 2005 by two years to age 57. People in the unemployment pipeline (extended earnings-related unemployment security for ageing workers) can retire on old-age pension flexibly between ages 62 and 65. Altogether 1½% of the labour force was in the pipeline in 2006.

A temporary low-pay subsidy scheme was launched at the beginning of 2006, which aims to promote the employment of older workers in low-paid jobs. Under this scheme, employers are entitled to a subsidy for all workers in their payroll aged 54 or older who earn between EUR 900 and 2,000 a month for a full-time job. The scheme was scheduled to terminate in 2010 but the Government decided in May 2007 to extend it beyond this date.

Young people at risk of marginalisation will be given help in seeking work through additional funds to be granted from the start of 2008 for employment,

education and training and other special measures. Henceforth labour market support may be granted as a form of wage subsidy to companies who recruit young unemployed people who have been unemployed for three months instead of six. To promote the recruitment of disabled people, the appropriations for wage subsidies for the disabled will be doubled from the beginning of 2008.

Low-wage older workers have more incentives to postpone retirement because they are entitled to accelerated pension accrual and because all work and earnings-related pension accrual from it after the age of 63 do not cut into their national pension.

To boost employment, a number of incentive traps have been removed by reforming the tax and social security schemes with a view to encouraging individual initiative and job creation. The Government has launched a social protection reform to be implemented in stages. The aim is to create more incentives for people to work, to reduce poverty and to ensure an adequate level of social protection in all life situations. To improve the functioning of the labour market, the social protection reform also involves an overall review of taxation, basic security and unemployment benefits. The taxation of social benefits and user charges for public services will be examined too. The reform will be implemented in stages, with the first proposals to be submitted to Parliament by the autumn session of 2008 at the latest. The Committee aims to complete its work by the end of 2009. The reform will be carried out so that general government finances remain sustainable in the long term.

Voluntary long-term pension saving schemes, designed to complement the statutory pension system, play a minor role in Finland. Both the statutory and voluntary schemes are taxed so that contributions and return on investment are tax-exempt while pensions are subject to tax (EET model). Contributions in the voluntary pension system are tax-exempt within given parameters only. The Government aims to revise the taxation of long-term pension saving to better promote competition in the supply of savings instruments.

6.2 Sustainability scenario

The sustainability scenario starts in 2011 and extends through to 2050. The scenario is based on Eurostat's population forecast for Finland (2004). The macro-economic assumptions used in the scenario, i.e. 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 (AWG) under the EU Economic Policy Committee.

In the scenario, the employment rate is expected to rise to over 74% by 2030 and the unemployment rate to settle at around 6.5% by 2013. Labour productivity is assumed to increase on average by 2% annually during the early

part of the forecast period and by an average of 1.8% a year from 2030 onwards. The assumption is that changes in the structure of the labour force have no bearing on labour productivity and that the number of hours worked is constant. The average rate of GDP growth for the whole forecast period is 1.9% per annum. The real interest rate is assumed at 3% in the baseline scenario, both for public debt and for investments by earnings-related pension funds.

In the sustainability scenario the total tax rate is kept constant at the level forecast for 2011. The increased pressure in pension expenditure is released into the pension contributions, assumed to rise by about 1½ percentage points of GDP by 2030. Keeping the total tax rate constant, taxation in other areas is allowed to ease.

Age-related expenditure (pensions, health care, long-term care, education and unemployment) is expected to increase by 5.1 percentage points of GDP by 2050. Pension expenditure will be up by 2.5 percentage points and spending on health care and long-term care together by 2.8 percentage points of GDP. With unemployment decreasing, unemployment expenses relative to GDP will drop slightly and the ratio of education expenditure to GDP will decrease because younger cohorts are smaller (cf. Table 7).

Calculated on the basis of these assumptions, overall public finances do not seem to be on a sustainable foundation. In terms of the national accounts (excluding changes in the valuation of assets), public finances would slip into deficit in 2025, with the deficit exacerbating so that by 2050 it will have reached 6% of GDP. Taking changes in the valuation of assets into account, the deficit-to-GDP ratio would be about one percentage point lower by the end of the review period.

On closer examination of the different sectors in general government, it can be seen that the situation is dualistic. The pension funds will stay in surplus throughout the projection period and the market value of their assets will amount to 63% of GDP in 2050. The rest of general government (central and local government) is calculated to stay in deficit throughout the period, and the deficit will climb to 6½% by 2050. The result is that the public debt-to-GDP ratio will exceed the 60% mark by 2040, escalating to over 80% of GDP by the end of the projection period.

In the baseline scenario, the sustainability gap in general government (S2) is about 1½% of GDP. This means that either spending must be reduced or revenue increased by the amount shown by the indicator if general government finances are to be kept sustainable in the long term.

The most recent population projection by Statistics Finland (2007) indicates that the number of over 65-year-olds will swell by about 713,000 by 2050. This is 124,000 more senior citizens than forecast in the EU population projection for Finland made in 2004, and which was used to compute the above sustainability scenarios. The number of over 85-year-olds will grow the most because life expectancy is longer, and it is estimated that they will number around 390,000

Table 7: Long-term sustainability of public finances, % of GDP

	2005	2010	2020	2030	2050	2050-2010 change
Total expenditure	50.1	47.0	48.9	51.7	55.1	8.1
Of which: age-related and unemployment expenditures	25.0	25.6	27.6	30.2	30.7	5.1
Pension expenditure	10.4	11.2	12.9	14.0	13.7	2.5
Old-age and early pensions	8.0	8.8	10.7	12.0	12.1	3.3
Other pensions (disability and family pensions)	2.4	2.4	2.2	2.0	1.7	-0.7
Health care	5.5	5.8	6.2	6.6	7.0	1.2
Long-term care	1.8	1.9	2.1	3.0	3.5	1.6
Education	5.9	5.5	5.3	5.4	5.3	-0.2
Unemployment	1.4	1.2	1.1	1.1	1.1	-0.1
Interest expenditure	1.7	1.3	0.9	1.2	4.1	2.8
Total revenue *)	52.6	49.8	51.5	51.1	50,0	0.2
Of which: property income *)	3.2	3.6	5.1	4.7	3.6	0.0
pension contributions	9.1	9.0	10.3	11.2	11.2	2.2
Cyclically adjusted balance * -)	2.5	2.8	2.7	-0.5	-5.0	-7.8
Gross debt	43.7	30.5	19.3	24.5	82.6	52.1
Of which: consolidated debt	41.3	29.1	17.9	23.1	81.2	52.1
Pension funds' financial assets	62.6	70,0	76.2	74.3	62.8	-7.2
Of which: consolidated liquid financial assets	51.7	59.6	64.9	63.3	53.5	-6.1

*) As of the year 2011, property income and balance include valuation changes and sales profits of equity investments

Assumptions	per cent			
Labour productivity growth	1.9	2.1	1.8	1.8
Real GDP growth	2.2	1.7	1.4	1.4
Participation rate				
males (20-64)	83.3	85.7	86.4	86.5
females (20-64)	76.6	80.3	81.5	81.9
total (20-64)	79.8	82.9	84.0	84.2
Unemployment rate	6.8	6.5	6.5	6.5
Population aged 65+ ovet total population	16.9	22.6	26.1	27
Inflation	1.8	2.0	2.0	2.0
Real interest rate	3.0	3.0	3.0	3.0

in 2050 where they now total about 100,000.

If the computations were to be made using the new national population projections, the outlook for general government sustainability would be even more pessimistic than in these scenarios. The surge in the number of people needing care and nursing compared to the earlier projections means that expenditure in health care and nursing services will increase. A provisional assessment based on the 2007 population projection suggests that a general government surplus ratio of over 4½% would in this case be necessary to secure sustainability in general government in the medium term.

Preconditions for sustainability in general government finances

Various combinations of economic policy instruments are available to bridge the sustainability gap. It can be narrowed down already during this government term by adopting a tight front-loaded fiscal policy or alternatively the adjustment can be spread over a longer period of time. An effective way would be to raise productivity in order to curb growth in spending. If service structures were to be reorganised, it would be possible to provide the existing welfare services with the current resources well into the future even when service demand starts to accelerate. In Finland's case, the long-term rate of return on the pension fund assets play a key role in the sustainability of public finances.

Two sensitivity analyses were made in addition to the baseline scenario to illustrate the impact of various policy measures on the sustainability of general government finances. In the first analysis, real rate of return on the assets was assumed to be 4% a year, which corresponds to the target set by the pension funds themselves and which is the same as the one used on the national computations. The real return on equity (dividends + appreciation) is assumed to be a good 5% a year. The assumed interest rate on public debt is kept unchanged at 3% in real terms. The purpose of the higher returns on investment in the sensitivity analysis is not to lower pension contribution rates but to accumulate more assets in the pension funds. A one percentage point increase in returns would reduce the deficit in public finances by 3 percentage points of GDP in 2050 and would keep the pension funds' asset value much higher than public debt throughout the projection period. Thus an increase of one percentage point in the rate of return in the pension funds would reduce the imputed sustainability gap by half.

If, in addition to revising in the rate of return as described above, productivity in health care and long-term care were to grow by 0.5% a year until 2050, the imputed sustainability gap would be eliminated altogether. The surplus in general government (incl. dividends + appreciation) would be close to 3% of GDP in 2050, pension assets a good 100% and gross public debt just over 30%

of GDP.

The purpose in restructuring municipalities and services is to boost productivity in local government service provision. If productivity can be boosted by ½% a year, this would mean that the target surplus of 3½% in general government by the end of the programme period would be sufficient from the viewpoint of long-term sustainability.

7a: Balance in general government, debt and pension assets in 2050, % of GDP ¹⁾

	Balance	Debt	Pension assets	Debt minus pension assets
(1) Baseline scenario	-5.0	83	63	20
(2) Real rate of return on pension assets 4%	-1.2	73	107	-34
(3) (2) + Productivity growth 0.5% a year in health care and long-term care	2.8	31	107	-76

¹⁾ The figures include changes in the valuation of the pension assets.

However, if we look at developments in the recent past, it is a highly demanding target to improve productivity in health care and long-term care by 0.5% a year. Data by Statistics Finland show that overall productivity in municipalities and joint municipalities has deteriorated considerably throughout the 2000s.

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 to 10 show the non-consolidated and consolidated market value of the pension funds in 2000-2006.

The revenue from the investment proceeds of consolidated liquid assets – interest and dividends – amounted to EUR 3.1 billion in 2006. Interest and dividends, however, represent only part of the revenue generated by the pensions

8. Financial assets (market value) of the earnings-related pension institutions (S13141), EUR million

	2000	2001	2002	2003	2004	2005*	2006*
A. Non-consolidated assets							
AF21 Currency	0	0	2	0	0	0	0
AF22 Transferable deposits	134	241	256	257	376	510	903
AF29 Other deposits	276	228	880	379	377	246	199
AF331 Short term bills	1 279	2 125	1 838	2 320	2 624	2 666	1 537
AF332 Long term bonds	29 559	30 202	32 312	32 821	36 355	38 965	37 507
AF34 Derivatives	105	20	80	111	201	156	969
AF511 Quoted shares	15 347	13 016	10 518	13 807	17 225	20 355	23 052
AF52 Mutual fund shares	323	3 093	3 399	5 209	7 794	14 20	21 886
Total	47 023	48 925	49 285	54 904	64 952	77 318	86 053
% of GDP	35.6	35.0	34.2	37.6	42.6	49.2	51.5
B. Liabilities of general government (sector 13) to pension funds:							
AF331 Short term bills	20	5	29	26	257	42	76
AF332 Long term bonds	10 322	6 887	4 786	4 666	3 512	3 606	2 817
Total	10 342	6 892	4 815	4 692	3 769	3 648	2 893
% of GDP	7.8	4.9	3.3	3.2	2.5	2.3	1.7
C. Consolidated liquid assets (=A-B)							
AF21 Currency	0	0	2	0	0	0	0
AF22 Transferable deposits	134	241	256	257	376	510	903
AF29 Other deposits	276	228	880	379	377	246	199
AF331 Short term bills	1 259	2 120	1 809	2 294	2 367	2 624	1 461
AF332 Long term bonds	19 237	23 315	27 526	28 155	32 843	35 359	34 690
AF34 Derivatives	105	20	80	111	201	156	969
AF511 Quoted shares	15 347	13 016	10 518	13 807	17 225	20 355	23 052
AF52 Mutual fund shares	323	3 093	3 399	5 209	77 94	14 420	21 886
Total	36 681	42 033	44 470	50 212	61 183	73 670	83 160
% of GDP	27.7	30.1	30.9	34.4	40.2	46.9	49.8
D. Total assets of pension funds							
Non-consolidated total assets	60 737	62 480	63 570	69 290	78 377	9 0617	99 312
% of GDP	45.9	44.7	44.2	47.5	51.4	57.7	59.4
Consolidated total assets	49 179	54 667	57 825	63 737	73 854	86 224	95 688
% of GDP	37.2	39.1	40.2	43.7	48.5	54.9	57.3

Source: Statistics Finland, Financial statistics

9. Financial assets (market value) of the State Pension Fund

	2000	2001	2002	2003	2004	2005	2006
	EUR million						
Non-consolidated assets	3 843	4 427	4 484	5 795	6 867	8 201	10 305
Consolidated assets	1 522	1 686	3 099	4 549	6 339	7 963	10 127
	% of GDP						
Non-consolidated assets	2.9	3.2	3.1	4.0	4.5	5.2	6.2
Consolidated assets	1.2	1.2	2.2	3.1	4.2	5.1	6.1

Source: State Pension Fund

10. Financial assets (market value) of the earnings-related pension institutions Tables 8 and 9)

	2000	2001	2002	2003	2004	2005	2006
	EUR million						
Non-consolidated assets	64 580	66 907	68 054	75 085	85 244	98 540	109 617
Consolidated assets	50 701	56 353	60 924	68 286	80 193	93 909	105 815
Consolidated liquid assets	38 203	43 19	47 569	54 61	67 522	81 355	93 287
	% of GDP						
Non-consolidated assets	48.8	47.8	47.3	51.4	56.0	62.7	65.6
Consolidated assets	38.3	40.3	42.3	46.8	52.6	59.8	63.3
Consolidated liquid assets	28.9	31.3	33.0	37.5	44.3	51.8	55.8

Sources: Statistics Finland and State Pension Fund

funds; much of the revenue derives from the sales profits and appreciation of shares and bonds. When these items are included, revenue from proceeds of non-consolidated pension fund assets amounted to EUR 6.9 billion in 2006.

7 NATIONAL FISCAL PROCEDURES AND INSTITUTIONS

The new Government, which took office in April 2007, is committed to following the spending rules it has set and the first spending limits decision of 25 May 2007 based on them. Measures entered in the Government Programme will be implemented insofar as it is possible within the framework of the spending limits decision. The Government will review annually the need for changing focus in expenditure, for example through structural reform or inter-administrative transfers, on the basis of submissions from the leaders of governmental party groups.

Roughly three-quarters of all central government budget appropriations are binding for the whole electoral period through the spending limits. Expenditures affected by cyclical fluctuations, costs not dependent on Government decisions and expenditure stemming from administrative arrangements or technical adjustments in the budget proposal, apart from changes in spending principles, are excluded from the scope of the spending rule. The spending limits for the government term are expressed in the price and cost level for 2008. The overall level of the spending limits will be adjusted annually only for price level changes or for changes in the structure of the budget.

Compared with the spending limits system used in the last electoral period, the following will be excluded from the spending limits: pay security expenditure, the central government contribution to social assistance expenditure, appropriations for VAT expenditure and expenditure corresponding to technically transmitted

payments and external funding contributions. The central government's contribution to the sickness insurance expenditure incurred by the Social Insurance Institution and the central government's contribution to switch-leave compensation are currently excluded from the spending limits but will now be included in them.

The following items are excluded from the spending limits:

- unemployment security, the central government contribution to expenditure incurred by the Social Insurance Institution under the National Pensions Act, the central government's contribution to social assistance, pay security, housing allowances and low-wage subsidies (however, expenditure caused by changes in the basis of these items will be included in the spending limits);
- debt interest payments;
- eventual compensation to other tax recipients for tax changes decided by central government;
- changes in the transfers paid to the Social Insurance Institution caused by changes in social security contributions;
- - expenditure corresponding to technically transmitted payments and external funding contributions;
- expenditure corresponding to the revenue from betting and lottery, totalisator betting and the transferred earnings of the Slot Machine Association;
- financial investment expenditure;
- appropriations for VAT expenditure.

Primary expenditure, in other words on-budget expenditure excluding interest expenses, will grow by an annual average of 1.6% in real terms over the spending limits period of 2008 – 2011. Growth will be fastest in 2008, when real growth in expenditure in the administrative branches will reach 5%. Real growth in expenditure will taper off to ½% per annum between 2009 and 2011.

A fixed annual provision of EUR 300 million is reserved for supplementary budget needs in the overall spending limits. In addition, it was agreed in the Government Programme that EUR 200 million at 2011 prices would be set aside to be allocated in the Government's first spending limits decision or at a later date. Following the spending limits decision of May 2007, altogether EUR 101 million of the additional provision remains unallocated. The following allocations have so far been made from the unallocated reserve: EUR 60 million

for 2008, EUR 75 million for 2009 and EUR 90 million for 2010.

The aim is to keep transport route construction and its funding stable every year. If costs for civil engineering works are anticipated to increase substantially because of a high capacity utilisation rate, project starts and other transport route construction will be postponed.

If the annual revenue from the sales of shares exceeds EUR 400 million, a maximum of 25% but no more than EUR 150 million of the excess can be used for one-off expenditure without reference to the spending limits to boost expertise, innovation and economic growth, unless specific reasons arise to do otherwise.

If total annual expenditure falls below that specified in the spending limits even after supplementary budgets, the surplus, to a maximum of EUR 100 million, may be used for one-off expenditure in the following year without reference to the spending limits.

The Government Programme allows for adjustments to the level of spending limits to adapt to rescheduling and re-budgeting expenditure. Where expenditure is rescheduled, it is possible to increase the overall spending limit in one budget year by the amount required, provided that in a later year in the same spending limits period a corresponding decrease is made. If the expenditure for a project or other equivalent entity needs to be re-budgeted and earlier appropriations have not been cancelled, the spending limit will be increased by the re-budgeted amount.

The Government Programme includes inter-administrative policy programmes designed to implement the policy objectives set out in the Government Programme across administrative boundaries. The policy programmes of the new Government are a policy programme for employment, entrepreneurship and worklife, one for health promotion and one for the well-being of children, youth and families.

Experiences of the system of spending limits

The previous government term (2003-2007) demonstrated that a multi-annual system of spending limits based on a spending rule is functional. The Government committed itself to adhere to the system of spending limits and expenditure was kept within the limits decided on throughout the electoral period. The economy developed much more briskly than expected over the past electoral period. Partly thanks to the spending rules, there was less scope

for pro-cyclical fiscal policy, and the surplus generated in central government finances was used to debt reduction and to augment the State Pension Fund. It can also be noted that excluding the automatic fiscal stabilizers from the spending rules was a good idea.

This Government made a commitment in its Government Programme to adhere to a spending rule covering the whole of the election period. The system of spending limits has been improved based on experience to date⁴. To increase the flexibility of the system, a fixed annual provision for supplementary budgets and an unallocated provision for recognition of new government expenditure were added. Additionally, there is now the option of allocating unbudgeted funds within the spending limits to the next budget year and re-budgeting has been made more flexible overall.

In practical terms, it is important to have the Government annually review the needs and potential for the re-allocation of expenditure within the set overall spending limits. What this means is that new items could be introduced by transferring funds from other items that are to be reduced or discontinued.

Generally, the problem with the spending rules is that in practice they dictate the level of expenditure, and the spending limits level chosen thus becomes a crucial factor. An error of judgment in scaling may lead to indispensable measures being left untaken because of the strict spending limits set. On the other hand, a ceiling on spending loses its fiscal policy meaning if it is set too high, and it will also not serve to curb the growth of expenditure. Another problem is that the spending limits system can be circumvented through tax subsidies and by using various funding schemes such as public-private-partnership for projects.

Systems like the Finnish spending limits system are also criticized because they are not statutory but are agreed on by coalition partners. However, experience from the past term of office and the present Government shows that this has not eroded the importance of the spending limits system or lessened the Government's commitment to observing it.

⁴ The Ministry of Finance set up a working group in 2006 to evaluate the need to develop the system of central government spending limits. The working group made a proposal for a revised system of spending limits to be applied over the new parliamentary term (cf. http://www.vm.fi/vm/en/04_publications_and_documents/01_publications/08_other_publications/20070213Fiscal/name.jsp). The new Government adopted most of the recommendations made by the working group.



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