# FINLAND’S
# STABILITY PROGRAMME
**September 1998**

## 1 Economic policy premises

The Finnish economy has not only seen rapid growth in recent years but also redressed a number of imbalances in the economy. Owing to these favourable developments, employment has improved substantially, aided by reductions in taxes and indirect labour costs as well as by structural reforms that have improved the functioning of the labour markets.

Finnish public finances have now been brought into balance and state debt into a decline, as targeted by the Government. Greater efficiency has been brought about in general government functions without loss to the comprehensive coverage and high quality of public services, while income transfers are also targeted more effectively.

Further consolidation of public finances is deemed essential by this Government. The long-term plans in public finances will be spelled out in the next government’s programmes following next year’s general elections.

Owing to the existing collective incomes policy agreement, greater competition and the lack of import price pressures, an inflation hazard that might weaken competitiveness is at present negligible, but as the utilisation rate of resources continues to rise, the risk of overheating increases. Continued reforms in the commodity and labour markets are therefore called for in order to offset eventual bottlenecks.

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With the onset of the third stage Economic and Monetary Union on 1 January 1999 Finland will, together with 10 other EU countries, adopt a single currency, the euro. In the same context, the surveillance of Member States’ public finances will be enhanced. The surveillance is based on the drawing up of Stability Programmes in the Member States participating in the euro area and of Convergence Programmes in the non-participating Member States, as laid down in Council Regulation No. 1466/97.

This first Finnish Stability Programme, ratified by Government, sets out the premises for economic policy and describes the decisions taken in public finances. Based both on this information and on macroeconomic projections for the years 1998 to 2002, medium-term developments in public finances, particularly general government deficit and indebtedness, are evaluated. This Programme has been prepared in conjunction with the State budget proposal and will be submitted to Parliament for information, adhering to the procedural practices adopted in the context of the Convergence Programmes.

The general elections in March 1999 will bring the term of office of the current Government to an end. Consequently, the central government expenditure guidelines for the years 2000 to 2002, comprising only expenditure decisions already taken, are not binding.

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The economic policy of this government has aimed, inter alia, at fulfilling the convergence criteria for Economic and Monetary Union, and at bringing central government indebtedness into a decline. These objectives have been met.

The Stability and Growth Pact, supplementing the EC Treaty, establishes that Member States shall ensure, in order to warrant sustainable convergence, that their public finances remain close to balance or in surplus in the medium term. Finland endorses the same objective. Should economic growth prove to be slower than forecast in this Programme, this objective would still be met, on condition that public spending evolves in accordance with the existing decisions and within the expenditure guidelines laid down for central government finances.

In accordance with the declaration by ECOFIN issued on 1 May 1998, any room for manoeuvring arising from better-than-expected economic developments will be allocated to the consolidation of central government finances. Should budgetary developments prove to be weaker than estimated in this Programme, Government will take the necessary consolidation measures.

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It was observed in the government statement on Finnish participation in the euro area, handed to Parliament in February 1998, that Finnish public finances have traditionally been in surplus. A major deficit in public finances arose when Finland went into an exceptionally deep recession in the early years of this decade. With financial balance having gradually been improved, it has been a question of recovering the situation that previously prevailed.

The said government statement advocates the securing of a sufficiently strong position in public finances well into the future, so that social security funding for the ageing population does not become an excessive burden for the economy. For this reason, Finnish budgetary objectives remain more demanding than those agreed upon in the European Union.

Despite the surplus in general government finances, central government finances remain in deficit. The expenditure guidelines for the years 1999 to 2002, approved in March 1998, are based on existing fiscal decisions and imply that even in conditions of strong economic growth central government deficit will remain in the range of FIM 6 billion (1 per cent of GDP).

Continued reduction of the deficit in central government finances is essential. The Government endorses the objective of reaching a surplus in central government finances during the period of rapid growth, in order to secure sufficient room for manoeuvring during periods of economic decline.

## 2. General government consolidation measures

### 2.1 Implemented savings programmes and policy guidelines

In order to reduce the state debt ratio to GDP, the Government resolved to keep effective the savings programmes outlined by the previous Government in 1991-1995, and in addition to carry out structural reductions in expenditure totalling no less than FIM 20 billion compared to estimated expenditure developments over 1996-1999 (1995 estimate). The purpose was to make the cuts as comprehensive as possible, which was seen as the best means of securing the basic structures of the economy, the functioning of public services and the livelihood of the general population. It was decided that the cuts in expenditure would be front-loaded and that the impact of the cuts on employment would be taken into account when targeting the measures.

Later decisions by the Government have also involved cuts in spending. During this Government’s term of office overall expenditure cuts, the 1999 budget proposal inclusive, are calculated to total FIM 22 billion (4 per cent of GDP in 1996).

The most substantial cuts in spending made by the Government relate to income transfers, with central government transfers to local governments falling by altogether FIM 7.6 billion between 1996-1999. And with reductions in unemployment benefits, child allowances, student aid and national pension appropriations, income transfers to households will fall by FIM 7.9 billion in all. Progress reports indicate that the Government austerity programme appears to be going according to plan.

With the budget proposal for 1999 this Government brings the central government consolidation programme included in the Government Programme to a conclusion. The sum total of permanent cuts in expenditure amounts to FIM 57 billion, which is about 10 per cent in relation to GDP in 1996.

## 2.2 Government expenditure guidelines for 1999-2002

The State Budget spending guidelines for 1999-2002 were outlined by Government in March 1998. The expenditure ceilings for 1999 are binding, while the guidelines for the latter years are target guidelines.
The overall expenditure ceiling for 1999 amounts to FIM 190.6 billion, and the Government's budget proposal will fall below this ceiling. The expenditure ceiling is sized so that the volume of expenditure will not increase between 1999 and 2002.
The expenditure ceilings have been allocated as a lump sum for each administrative sector. No decisions on the individual sizing of appropriations have been made; such decisions are made in conjunction with the drafting of the annual budget proposals.

## 2.3 Tax policy

The structure of taxation has been reformed to expand employment opportunities and make work pay. Between 1996 and 1999 tax concessions on earned income, excluding adjustment for inflation, are calculated to amount to approximately FIM 13.3 billion (2 per cent of GDP).
Tax concessions in income taxation for 1999 apply to various income brackets, the greatest weight being on low and middle income wage earners; all marginal tax percentages barring the highest one will be lowered by 0.5 percentage points and an inflation adjustment of 2 per cent will be made in the rates.
The maximum limit for the earned income tax concession in municipal taxation will be raised and reshaped. In the same context, a higher maximum limit on the standard deduction for work-related expenses will be set. The reforms are set to mitigate the detrimental effects on work incentives.

## 2.4 General government balance

The financial deficit in general government (net borrowing) peaked in 1993 at 8 per cent as a proportion of GDP, while the public debt ratio correspondingly grew rapidly. Owing to extensive cuts in public spending in the 1990's and thanks to an acceleration in economic growth, the financial deficit fell in 1997 below the 3 per cent criterion defined in the Treaty. In addition to a reduction in deficit, further government indebtedness has been curbed by increased acquisition of government bonds by the social security funds.

**1. General government net lending and debt (EMU definitions) as a percentage of GDP**

| | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|---|---|---|
| ***Net lending*** | | | | | | | |
| Central government | -4.5 | -7.7 | -11.2 | -11.3 | -9.6 | -7.3 | -4.0 |
| Local government | -0.9 | -0.8 | 0.4 | 1.3 | 0.6 | 0.4 | 0.0 |
| Social security funds | 3.9 | 2.6 | 2.8 | 3.9 | 3.9 | 3.4 | 2.9 |
| **General govt., total** | **-1.5** | **-5.9** | **-8.0** | **-6.1** | **-4.7** | **-3.5** | **-1.1** |
| ***Debt*** | | | | | | | |
| Central government | 18.0 | 35.6 | 52.5 | 54.8 | 53.9 | 54.3 | 51.8 |
| Local government | 5.1 | 5.9 | 5.5 | 4.8 | 4.1 | 3.4 | 3.3 |
| Social security funds | 0.6 | 0.5 | 0.8 | 0.4 | 0.1 | 0.0 | 0.0 |
| **General govt., total** | **23.1** | **41.5** | **58.0** | **59.6** | **58.1** | **57.8** | **55.1** |

## 3. Medium-term projection for 1998-2002

### 3.1 Economic outlook for 1998-2002

The outlook in European developments at the dawn of the euro area is good; developments in the international economy are estimated to be fairly auspicious in the medium term, with OECD economies anticipated to grow by an annual average of 2.5 per cent.
Although growth in total output in Finland has been brisk for a number of years, prospects for further growth are still promising. The comprehensive incomes policy agreement signed in autumn 1997 determines wage setting into the beginning of the year 2000, and wage settlements beyond that are also expected to remain within a framework that ensures price stability. Although some production bottlenecks have begun to form, cost developments are anticipated to remain supportive of economic growth in the next few years.
Other general assumptions in the base scenario:
- The terms of trade will remain unchanged in the medium term.
- Interest rates at forward rate levels of August 1998.
- Central government expenditure observes budgetary decisions reached.
- Central government revenue adheres to budgetary decisions reached, but owing to the impact of integration, revenue from indirect taxation is expected to gradually lag behind the business-as-usual scenario. The effect is estimated to be FIM 5 billion in 2002.

**2. Main economic indicators for 1997-2002**

| | 1997 | 1998* | 1999* | 2000** | 2001** | 2002** | 1998-2002 |
|---|---|---|---|---|---|---|---|
| | change, % | | | | | | |
| GDP | 6.0 | 5.5 | 4.0 | 2.7 | 2.6 | 2.6 | 3.5 |
| Imports | 10.5 | 9.4 | 6.1 | 5.5 | 5.3 | 5.3 | 6.3 |
| Exports | 12.9 | 8.7 | 4.7 | 4.5 | 4.5 | 4.5 | 5.4 |
| Private consumption | 3.3 | 4.0 | 4.1 | 3.2 | 2.9 | 2.7 | 3.4 |
| Public consumption | 0.7 | 0.7 | 0.5 | 1.0 | 1.0 | 1.0 | 0.8 |
| Private investment | 13.3 | 11.6 | 8.2 | 5.2 | 4.8 | 4.7 | 6.9 |
| Public investment | 6.7 | -3.4 | -6.7 | 1.0 | 1.0 | 1.0 | -1.4 |
| Price of private consum. | 1.5 | 1.5 | 1.7 | 2.0 | 2.0 | 2.0 | 1.8 |
| Price of GDP | 2.2 | 2.3 | 1.9 | 2.2 | 2.1 | 2.0 | 2.1 |
| Employment | 2.5 | 2.6 | 1.9 | 1.0 | 0.8 | 0.7 | 1.4 |
| Labour productivity | 3.6 | 2.8 | 2.0 | 1.7 | 1.8 | 1.9 | 2.0 |
| | level | | | | | | |
| Unemployment rate, % | 12.7 | 10.5 | 9.0 | 8.4 | 8.0 | 7.8 | |
| Employment rate (15-64 years), % | 62.9 | 64.4 | 65.5 | 66.0 | 66.3 | 66.6 | |
| Current account, % of GDP | 5½ | 6 | 6 | 6 | 6 | 6 | |

* forecast
** medium-term projection

Average medium-term economic growth in Finland is estimated at 3 ½ per cent annually between 1998-2002. Should this scenario be realised, the Finnish economy would grow between 1995-2002 as rapidly as in the 1980's, with the difference that the economic imbalances exacerbated in the 1980's, whereas now the imbalances are easing.
Labour productivity saw robust growth during the recession as companies adjusted costs to a lower level. Between 1987 and 1996 productivity in the Finnish economy rose by an annual average of 3.2 per cent. Over the period under review, productivity growth is expected to slacken to a 2 per cent range, as economic growth expands from the industrial sector to the service sector, where the productivity level is typically lower than the average.

With part of the labour force inactive during the recession returning to the markets as labour demand increases, labour supply is estimated to grow slightly faster than the population of working age.
The employment rate is estimated to be about 67 per cent in 2002. The slowdown in economic growth is reflected in labour demand, where growth is expected to fall to less than one per cent a year towards the end of the review period. This, together with increased labour supply, anticipates an unemployment rate of about 8 per cent.

### 3.2 Developments in general government balance between 1997-2002

The development path in general government finances presented in Table 3 is based on existing economic policies and on the macroeconomic projections presented in Table 2, including the general assumptions that were examined in detail in section 3.1.

**3. General government net lending and debt (EMU definitions) as a percentage of GDP**

| | 1997 | 1998* | 1999* | 2000** | 2001** | 2002** |
|---|---|---|---|---|---|---|
| ***Net lending*** | | | | | | |
| Central government | -4.0 | -2.3 | -0.9 | -1.1 | -1.2 | -1.0 |
| Local government | 0.0 | 0.0 | -0.2 | -0.2 | -0.2 | -0.2 |
| Social security funds | 2.9 | 3.4 | 3.5 | 3.5 | 3.5 | 3.5 |
| **General government total** | **-1.1** | **1.1** | **2.4** | **2.2** | **2.1** | **2.3** |
| ***Debt*** | | | | | | |
| Central government | 51.8 | 48.8 | 45.4 | 43.3 | 41.7 | 40.1 |
| Local government | 3.3 | 3.1 | 3.1 | 3.1 | 3.1 | 3.1 |
| Social security funds | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **General government total** | **55.1** | **51.9** | **48.5** | **46.4** | **44.8** | **43.2** |
| Central government (unconsolidated) | 67.2 | 63.8 | 60.2 | 58.0 | 56.2 | 54.3 |

* forecast
** medium-term projection

The policy assumptions behind the medium-term projection are based on the Government Programme of May 1995 and the two-year incomes policy agreement extending to early 2000, while central government projections are founded on the 1998 State Budget, the expenditure guidelines for 1999-2002 approved in February 1998 and the 1999 Budget Proposal. Fiscal policy deliberations are dealt with in greater detail in Chapter 2.
General government surplus in the projection amounts to over 2 per cent of GDP between 1999 and 2002. Central government deficit is estimated to fall from an anticipated 2.4 per cent in 1998 to approximately 1 per cent in 1999 and to remain at this level over the entire period under review. Local government finances are forecast to remain in slight deficit over the whole evaluation period, while social security funds are foreseen to record a steady surplus of about 3.5 per cent in relation to GDP.
The Council Regulation on Stability Programmes prescribes that public investment be examined. It is crucial from the point of view of sustainability in public finances that any potential government deficit not exceed investment expenditure, i.e. that consumption expenditure be not covered by borrowing. Likewise, it is important that general government consolidation be not implemented unsustainably by cuts in investment alone, as this would only defer expenditure into the future.
Prior to the 1990's recession it was possible without exception to finance public sector investment in Finland through revenue. In the 1990's, instead, deficit has exceeded investment in both the whole of general government and in central government finances. Along with the

balancing of the deficits, the situation is set to improve, but the position that prevailed in the 1970’s and 1980’s has not yet been reached.

### 3.3 Sensitivity analysis of public finances

The diagrams on the next page illustrate, in addition to the base scenario, a fast and slow growth alternative. In these alternative scenarios growth in total output is assumed to deviate by one percentage point from the base scenario in the years 1999 - 2002. In the slow growth alternative this would mean a slackening of growth to about 1 ½ per cent towards the end of the period examined, while in the more favourable scenario economic growth would remain at an annual level of 3 ½ per cent. In the slow growth scenario the unemployment rate would remain virtually unchanged. A rise in unemployment would be curbed on the assumption that growth in labour supply would decrease with the slowdown in economic growth. Public finances would in this alternative take another downward turn to a financial deficit towards the end of the review period. In the rapid growth scenario the unemployment rate would see a rapid decrease and the surplus in public finances would continue to grow along with a strengthening in central government finances.

The analysis of interest rate sensitivity in public finances is based on a projection where interest rates are assumed to deviate by one percentage point either up or down from the base scenario from the beginning of 1999. In the high interest rate scenario, total output as well as employment, vital from the viewpoint of balance in public finances, would deviate from the base scenario less than in the slow growth alternative, while developments in general government deficit and indebtedness would be more favourable than in the slow growth scenario despite the impact of interest rates. Conversely, in the low interest rate scenario, general government developments would not be quite as favourable as in the fast growth alternative, with growth in total output and employment also remaining weaker.