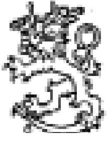


Ministry of Finance

UNOFFICIAL TRANSLATION

STABILITY PROGRAMME FOR FINLAND

November 2001 update

1 Economic policy objectives and premises

1.1 Government objectives

The primary economic policy goal of this Government, nominated in spring 1999, is to improve employment. To achieve this, the fundamentals for sound economic growth must be secured and the competitiveness of the operating environment for entrepreneurship be ensured. Strong public finances form an ever more significant basis for economic stability and growth in today's euro area conditions.

The Government is committed to enhancing the preconditions for economic growth by means of reforms in the product, capital and labour markets and to developing the tax and social benefit systems in order to boost employment and encourage independent initiative.

Preparation for the ageing of the population is a key feature in the Government's economic policy. By securing a surplus in central government finances and by reducing State debt, room for manoeuvre has been created to deal with cyclical fluctuations and future expenditure pressure caused by the ageing population. During the period of economic upswing, a surplus in general government finances was also motivated by the need to secure stability in the economy and to curb overheating.

The Government Programme sets the following objectives for securing a balance in central government finances:

- By means of tight budgetary policy, the Government aims to secure a structural financial surplus (as defined in national accounts terms) in central government to reduce the central government debt-to-GDP ratio below 50 per cent during the election period ending in 2003.

- Central government expenditures will be kept constant in real terms, at the 1999 Budget level or lower, over the whole term of office.

- State privatisation proceeds will be allocated primarily to the redemption of state debt, to safeguarding the existing level of R&D funding and to securing the operating conditions of the Finnish Industry Investment Ltd (Suomen Teollisuussijoitus Oy).

These principles outlined in the Government Programme have since been specified by the following decisions and positions:

- The Government's spring 2001 spending limits for the years 2002-2005 were adopted in line with the fiscal policy position. Based on this decision, central government expenditure excluding interest expenses will increase by just over ½ per cent a year in real terms in relation to the 2000 Budget.

- The Government has expressed in the General Strategy and Outlook section of the 2002 Budget Proposal that the central government surplus should amount to 1½ to 2 per cent of GDP on average during the current decade, in order to reduce State debt sufficiently to secure sustainable public finances in later years too. It has become increasingly more uncertain whether this target can be met in the next few years, which highlights the importance of structural measures to strengthen public finances.

- The Government furthermore observes in the General Strategy and Outlook section of the 2002 Budget Proposal that the pending weakening in central government finances would not jeopardise long-term sustainability in public finances if the implementation of structural reforms bolstering sustainability can be secured.

In its Programme, the Government stated that it would make provision for implementing a FIM 10-11 billion reduction (about 1½ per cent of GDP) in income taxes and social security contributions over the election period. The tax cuts were pointed out to be contingent on robust economic growth, moderate wage settlements and reforms in the tax structures.

In line with the Government Programme, the emphasis in taxation will shift towards capital and property taxes and environmental taxes. The timing of the tax cuts is influenced by the cyclical position of the economy, and the aim is to ensure that the changes in the tax rates in all tax brackets are equal in magnitude and that the overall effect of the cuts is job-conducive in particular for those in the lowest income brackets.

1.2 Broad Economic Policy Guidelines

The Broad Economic Policy Guidelines (BEPGs) document is the key instrument for coordinating economic policies in the European Union. It is proposed in the 2001 BEPGs that the following measures should be Finland's priorities in budgetary policy:

- adhere to the expenditure targets set in the budget for 2001;

- maintain high government surpluses in 2001 and the following years;

- ensure the long-term sustainability of public finances in view of the future effects of population ageing on pensions and health care costs, to which Finland is particularly exposed; this requires the continuation of the policy of debt reduction but needs to be complemented by measures, to be adopted during the programme period, raising the low effective retirement age.

The BEPGs advocate that concerning Finland's labour markets strong efforts should be made to reduce high marginal effective tax rates on low wage earners and to improve incentives in benefit, especially pension, schemes to take up a job offer and to stay in the labour force. Furthermore, Finland is encouraged to increase the efficiency of active labour market programmes and refocus them to the needs of those most prone to the risk of long-term unemployment.

The following measures should be Finland's priorities in structural policy: to enhance compliance with regulations in public procurement, especially at the local level, and increase transparency in the provision of public services in order to heighten private firms participation; boost competition in industries such as distribution, construction, and media sectors. The priority in the financial markets should be to develop further the risk capital market by adapting the fiscal framework to make it more conducive to investment and entrepreneurship.

The Government's economic policy is in line with the recommendations for economic policies of the BEPGs. Despite a weaker international and domestic economic outlook, the surplus in general government will be kept high, at over 2 per cent of GDP even in the weakest year. At the same time, the Government is stepping up structural reforms in the labour markets and in the pension system.

Government economic policy measures related to recommendations on public finances and structural policy are described in greater detail in later sections of this Stability Programme and in the report on structural reforms[1] drawn up in November 2001.

1.3 Finland's 2001 Stability Programme Update

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

1 Product and Capital Market Reforms in Finland, Ministry of Finance, November 2001.

In the 2000 Update to Finland's Stability Programme, the Government maintained an aim of keeping a general government surplus ratio of at least 4½ per cent over the election period. This goal was observed to be in line with the minimum surplus target of almost 1½ per cent in central government finances. At the time the 2000 Stability Programme was drawn up, the sustained period of economic upswing was still ongoing and there were clear signs of overheating in the economy.

The contagion of a weaker world economy affected the Finnish economy in the course of 2001, changing significantly short-term prospects in public finances. Tax receipts will be considerably lower than earlier anticipated not only in 2001 but also later over the period covered by the Stability Programme. Pressure for spending has mounted. The changes primarily involve developments in central government finances.

Based on the Stability Programme, the surplus-to-GDP ratio in general government is expected to still stay at the 4½ per cent level this year but to drop to somewhat above 2 per cent over the coming three years. The general government surplus is expected to be on average almost one percentage point lower annually over 2000-2004 than assumed in the previous Stability Programme.

The Government deems a smaller general government surplus than previously targeted to be acceptable in times of cyclical weakness because the Government is simultaneously pushing forward with new reforms that will bolster the structural fundamentals of longer term sustainability.

Reaching a structural surplus in central government as established in the Government Programme still remains a key goal for long-term sustainability in public finances. In next spring's negotiations on spending limits, the Government will examine ways of achieving a structural surplus in central government finances in 2003.

Should there be a significant risk of the goals set out in Stability Programme being jeopardised, the Government will take the corrective action it deems necessary, in line with the requirements established in the Stability and Growth Pact.

1.4 Processing the Stability Programme in Finland

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

The Programme is only indicative for 2004, as general elections will be held in Finland in spring 2003, followed by the appointment of a new government.

1 On 10 July 2001 the ECOFIN Council endorsed the Opinion of the Economic and Financial Committee and the Code of Conduct on the content and format of the Stability and Convergence Programmes.

2 Economic situation and outlook

2.1 Recent developments and short-term outlook

The Finnish economy experienced a sustained period of rapid economic growth from 1994 to 2000. Exports, notably exports of the electronics industry, was a key factor that sustained growth. With the global economy and exports weakening, total output also stagnated during the first half of 2001. Domestic demand remained robust, however. The terrorist attacks against the United States in September and accelerated global fight against terrorism have further weakened short-term growth prospects.

The growth in employment, surplus in public finances and reduction in State debt in recent years were all achieved during a period of exceptionally fast growth. The slowdown in economic growth is not a direct threat to these achievements, but making provision for the pressure caused by the ageing of the population has become a clearly more demanding task than it appeared to be in conditions of stronger growth.

The comprehensive incomes policy agreement contracted in late 2000 and effective until January 2003 and the sound financial balance bolster Finland's economic stability in an unstable world economy. The good competitive position of companies provides excellent preconditions for boosting production in the future.

The estimates presented in Table 1 on economic growth and on factors affecting growth are up to 2002 in line with the economic forecast published on 8 November 2001 by the Ministry of Finance. The forecasts on international developments are similar to those presented by the Commission in connection with its forecast round in the autumn (situation in mid-October 2001).

Total output is not expected to grow to any significant degree in 2001 from the high level reached in 2000. Annual growth is estimated to be about ½ per cent. Exports will fall slightly and growth in domestic demand is also anticipated to be lower than the year before. Employment will still increase in relation to the previous year and unemployment will clearly fall. The annual increase in consumer prices promises to slacken to below 3 per cent.

Global economic growth prospects for 2002 are bleak. The period of falling exports is expected to be over, however. Growth in domestic demand will range around 2 per cent and total output is anticipated to grow about 1½ per cent. Employment will cease to grow and unemployment is expected to slightly rise. The average employment rate is forecast at 67½ per cent of the working age population and the unemployment rate at 9½ of the labour force. The increase in consumer prices is projected to slow down to below 2 per cent.

1. Growth and associated factors

	2000	2001*	2002*	2003**	2004**
GDP growth at constant market prices, %	5.7	0.6	1.6	2.7	3.0
GDP level at current market prices, EUR bn	131.7	136.1	139.8	146.2	153.2
GDP deflator, % change	3.4	2.8	1.1	1.8	1.8
HICP, % change	3.4	2.7	1.7	1.6	1.6
Employment1), % change	1.7	1.2	-0.1	0.3	0.5
Labour productivity2), % change	2.8	2.7	2.4	2.2	2.1
Unemployment rate, %	9.8	9.2	9.4	9.3	9.1
Sources of growth: percentage changes at constant prices					
1. Private consumption expenditure	3.0	1.7	2.6	2.8	2.9
2. Government consumption expenditure	0.7	1.5	1.4	0.9	0.9
3. Gross fixed capital formation	4.8	3.0	0.5	2.2	3.1
4. Changes in inventories as a % of GDP	-0.1	-0.4	-0.4	-0.4	-0.4
5. Exports of goods and services	18.1	-2.2	0.4	5.5	6.0
6. Imports of goods and services	15.7	-1.0	0.9	5.5	6.0
Contribution to GDP growth, % points					
7. Final domestic demand	3.0	1.3	1.7	2.0	2.2
8. Changes in inventories	0.3	-0.4	0.0	0.0	0.0
9. Net exports	2.7	-0.7	-0.1	0.6	0.7
Assumptions (Commission)					
Short-term interest rate (3-month money market)	4.5	4.3	3.3	3.3	[3,3]
Long-term interest rate (10-year government bonds)	5.5	5.0	5.0	5.0	[5,0]
USD/EUR exchange rate	0.92	0.90	0.92	0.91	[0,91]
World GDP growth excl. EU, %	4.6	2.3	2.6	4.0	[4,0]
EU-15, GDP growth, %	3.3	1.8	1.8	2.8	[2,8]
Growth of relevant foreign markets, %	11.3	3.0	4.0	6.8	[6,8]
World import volumes, excluding EU, %	11.3	1.0	2.4	5.9	[5,9]
Oil prices, (Brent, USD/barrel)	29.0	26.0	24.0	25.0	[25]

1) National accounts
2) Growth of GDP at market prices per person employed at constant prices

2.2 Medium-term macroeconomic scenario

The macroeconomic scenario on which the Stability Programme builds follows for the years 2001-2002 the short-term forecast outlined above. The projection for 2003-2004 is based on an examination into the longer term growth prospects in the economy. The assumption in the projections is that the world economy will start recovering in the latter half of 2002 and that economic growth in the EU will return to a level of close to 3 per cent in 2003-2004 (Table 1).

Despite the current uncertainties in economic developments, Finland's medium-term growth prospects are still good. production resources will not constrain growth, economic stability and the financial balance remain good, information technology industries, which offer strong growth potential, are well represented in Finland, and service production promises growth prospects on a wide scale. If economic policy succeeds as planned, cost developments will not be a hindrance to economic growth either and the Finnish economy can grow at the same rate as the rest of the EU.

The projections beyond 2002 are based on the following assumptions:

- The global economy will in broad terms develop as envisaged in the Commission assumptions and forecasts as available in October 2001 (Table 1).

- Export demand will grow in line with world economic growth while domestic demand will grow slower.

- Real wages will evolve in line with average growth in productivity.

- Expenditure and revenue developments in central government will evolve as outlined in sections 3 and 5 of this Programme.

Economic growth would average around 2 per cent a year over 2001-2004 on the basis of this projection, in other words just under one percentage point slower than in the last quarter of the 1990s on average.

Productivity growth is anticipated to slacken from nearly 3 per cent a year to slightly over 2 per cent over the period of the Stability Programme, as growth in employment shifts more towards the service sector, where labour productivity developments are slower than average. Labour demand is expected to start growing slowly between 2003-2004. Nonetheless, the employment rate is envisaged to be more or less in the same range in the latter half of the projection period as at present, at 67½ per cent and the unemployment rate to be slightly over 9 per cent.

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

3 General government: balance and debt in 2001-2004

3.1 Fiscal policy strategy

A central fiscal policy objective of the Government Programme is to create a structural surplus for central government finances over the medium term (section 1.1). Carrying out the objective rests on four-year central government expenditure limits that are approved annually and on the annual budgets that are built on the basis of them.

The central government expenditure limits for the period 2002-2005 were confirmed on 8 March 2001. According to the decision on spending limits, the central government's total expenditure would contract in real terms during 2003-2005 compared with 2002.

Within the Stability Programme, the central government's expenditure for 2001 is in line with the budget and the three supplementary budgets for the current year. In respect of government expenditure, the Stability Programme in the years ahead is based on the Budget Proposal for 2002 and the central government expenditure limits, the level of which in the period 2003-2004 has nevertheless been revised in the light of new decisions taken after March 2001 and of economic developments. In particular, expenditure for defence, social and unemployment benefits as well as transport and communications has been reviewed.

In the Programme, central government revenue in the years 2001-2002 is stated according to the estimates that were drawn up when preparing the November short-term forecast. For the following programme years, tax revenue is estimated on the basis of the medium-term macroeconomic scenario, furthermore taking into account the decline in the receipts from certain indirect taxes (about ½ per cent of GDP in 2004).

The projections for the local government finances are based on the estimates of the Advisory Board for Municipal Economy and Administration and on the above-described macroeconomic scenario. The finances of social security funds have been estimated on the basis of the present legislation and known changes to it in accordance with the macroeconomic developments.

3.2 General government: balance and debt

It is estimated that in 2001 the general government surplus will decline as a ratio of GDP from the previous year's 6.9 per cent to 4.7 per cent (Table 2). In 2002-2004 the surplus is estimated to be at the level of 2-2½ per cent of GDP. The central government surplus will contract to an approximately balanced position in 2002-2004 and local government finances will be roughly in balance except for a slight deficit in 2002. In the programme period the surplus of the social security funds will correspond to a little more than 2½ per cent of total output.

Table 3 presents a calculation of the trend in general government debt. Public indebtedness will decrease less than one might expect on the basis of the general government surplus, the nominal growth in total output and privatisation proceeds because the employment pension funds belonging to the public sector are decreasing the proportion of central government paper in their investment portfolios. Gross public debt grows when the central government debt instruments in the possession of the employment pension funds are transferred to the domestic and foreign private sector. The acquisition of financial assets will also maintain the level of gross debt during the period of the Stability Programme.

The background to the change in the way employment pension funds behave is the recent more extensive diversification of investment portfolios, which has been made possible by the development of the financial markets. The calculations of this programme involve the technical assumption that the employment

2. General government budgetary developments, % of GDP

	2000	2001*	2002*	2003**	2004**
Financial balance					
General government	6.9	4.7	2.6	2.1	2.6
Central government	3.5	1.9	0.3	-0.3	0.0
Local government	0.1	-0.2	-0.3	-0.2	0.0
Social security funds	3.3	2.9	2.5	2.6	2.6
General government					
Total revenues	53.6	51.8	50.2	49.0	48.8
Total expenditures	46.7	47.1	47.6	47.0	46.2
Financial surplus	6.9	4.7	2.6	2.1	2.6
Net interest payments	1.0	0.7	0.3	0.3	0.1
Primary balance	7.9	5.4	2.9	2.3	2.8
Components of revenue					
Taxes	34.5	32.5	31.6	30.5	30.3
Social security contributions	12.2	12.2	11.8	11.8	11.8
Other revenues	6.9	7.1	6.8	6.7	6.7
Total revenues	53.6	51.8	50.2	49.0	48.8
Components of expenditures					
Collective consumption expenditure	7.6	7.7	7.8	7.7	7.6
Individual consumption expenditure	13.1	13.4	13.6	13.5	13.4
Social income transfers	16.5	16.6	16.9	16.6	16.3
Interest payments	2.8	2.8	2.6	2.5	2.4
Subsidies	1.5	1.6	1.6	1.5	1.5
Gross fixed capital formation	2.6	2.6	2.6	2.6	2.5
Other expenditures	2.5	2.5	2.6	2.5	2.4
Total expenditures	46.7	47.1	47.6	47.0	46.2

3. General government debt developments, % of GDP

	2000	2001*	2002*	2003**	2004**
Gross debt level, % of GDP	44.0	42.7	42.9	43.0	41.8
Change in gross debt, %	-3.2	-1.3	0.1	0.2	-1.2
Contributions to changes in gross debt, %					
Primary balance	-7.9	-5.4	-2.9	-2.3	-2.8
Net interest payments	1.0	0.7	0.3	0.3	0.1
Impact of nominal increase in GDP	-3.9	-1.5	-1.2	-1.9	-2.1
Stock flow adjustments	7.5	4.9	3.8	4.2	3.5
- Public sector consolidation 1)	4.3	1.9	1.2	0.6	0.5
- Privatisation receipts	2.0	0.3	0.3	0.3	0.3
- Net accumulation of financial assets 2)	1.2	2.7	2.3	3.3	2.6
Implicit interest rate on debt	6.6	6.2	6.2	5.9	5.6

1) The employment pension funds are assumed to reduce their investments in central government assets by EUR 2.5 billion, by EUR 1.7 billion in 2002 and by EUR 0.8 billion in 2003 and 2004
2) Including central government contribution of EUR 0.5 billion in Sonera share issue in 2001.

pension institutions will reduce their holdings of central government debt further in 2001-2004 by a total amount corresponding to about 4 per cent of annual GDP.

According to the Stability Programme, during the programme period gross general government debt will settle at a level of 41-42 per cent of GDP, compared with 44 per cent of GDP at the end of 2000.

3.3 Structural balance of public finances

An estimate of the structural balance of public finances (i.e. adjusting for the effects of the business cycle) first calls for an assessment of the prevailing business cycle situation compared with the average situation – which is neutral in terms of its business cycle effects – and thereafter an assessment of the business cycle impacts on the balance in public finances. Both phases involve a number of problems in principle and of a technical nature. For the Finnish economy, which has gone through an intense structural change, these problems are particularly serious. The calculation presented in the following is therefore only indicative.

According to the estimates presented in Table 4, Finland's total output will exceed its long-term trend path by 1½ per cent this year. On this basis, part of the general government surplus can still be attributed to a business cycle situation that is more favourable than average. The forecast production in 2002-2004 is set to correspond roughly to the trend level of production, which means that the business cycle situation will no longer have an essential impact on the state of public finances.

The estimate of the structural surplus in public finances up to 2004, which is presented in Table 4, is based on factoring out the business cycle effects by means of the deviation from the trend in total output.[1] According to the calculation, the structural surplus in public finances in per cent of GDP in 2001 will be just under one percentage point smaller than the forecast general government surplus. In 2002-2004, the surplus according to the programme and the structural one calculated in the manner mentioned will be, practically speaking, equal in size. During the five-year period from 2000 to 2004, the structural surplus in public finances is estimated to be on average about 3 per cent of GDP.

4. Cyclical developments, % of GDP

	2000	2001*	2002*	2003**	2004**
1. GDP growth at constant prices	5.7	0.6	1.6	2.7	3.0
2. General government financial balance, % of GDP	6.9	4.7	2.6	2.1	2.6
3. Interest payments, % of GDP	2.8	2.8	2.6	2.5	2.4
4. GDP trend, %-change	3.3	3.2	3.1	3.0	2.9
5. Deviation from GDP trend, % change	4.2	1.5	0.1	-0.2	-0.1
6. Cyclical budgetary component, % of GDP	2.5	0.9	0.1	-0.1	-0.1
7. Cyclically-adjusted balance, % of GDP (2 - 6)	4.3	3.8	2.5	2.2	2.7
8. Cyclically adjusted primary balance, % of GDP (2 - 6 + 3)	7.2	6.6	5.1	4.7	5.1

1 The calculations make use of the trend method presently employed by the Commission in calculating potential production.

3.4 Central government finances

In 2001 the central government's total revenue will decrease slightly because tax revenue is falling by about 4 per cent. The State's corporate tax receipts are forecast to decline by about a fifth. The non-recurring sales of shares, merger and acquisition arrangements and related capital gains which improved companies' results last year will no longer increase tax revenue to the same extent. Profits from ordinary business operations are also weakening, and this is reflected in tax revenue. The decrease in capital gains will gradually also lower the receipts from taxes on earnings and capital income. The effect of decisions lowering the tax burden on the central government's tax revenue corresponds to about 0.7 per cent of GDP.

State expenditure is estimated to rise in 2001 by a nominal rate of about 3 per cent and only slightly in real terms. The growth in expenditure is due primarily to income transfers. The real growth in the central government's consumption expenditure will be below one per cent. Central government investments will no longer decline. The interest expenditure on State debt will contract markedly as debt is paid down. Interest expenditure will nevertheless still be 12 per cent of the central government's total expenditure.

The surplus in central government finances in 2001 will correspond to 1.9 per cent of GDP. In 2000 the surplus was 3½ per cent of GDP.

In 2002 the central government's total revenue is estimated to hold steady at the current year's level. Total corporate tax revenue will fall further, but the increase in the central government's share of revenue compared with the municipalities will offset this from the standpoint of central government tax revenue. The budget proposal for 2002 includes tax cuts amounting to EUR 665 million (½% of total output), which was agreed in the collective bargaining negotiations in November 2000. The central government's share of the tax cuts is 70 per cent.

On the basis of the budget proposal, the central government's expenditure is estimated to grow in 2002 by more than 5 per cent at current prices, nearly half of which is attributable to the change in accounting practice, which will increase both revenue and expenditure within government finances (this is connected with the change in the financing relationships between the central government and the municipalities, details of which are given in section 7.2). Income transfers will show the biggest growth next year too. In fixed price terms, consumption expenditure will grow slightly, notably owing to an increase in maintenance works on roads and railways. The number of central government staff will not grow. The volume of investment expenditure will not grow mentionably either. The decrease in interest expenses will continue. In 2002 central government expenditure will exceed the expenditure ceiling set in the Government Programme (the level of the 1999 Budget) in real terms by just under 3 per cent.

It is estimated that the government's financial surplus next year will decrease to 0.3 per cent of GDP.

According to the Stability Programme, central government tax receipts will stagnate all the way into 2003, nevertheless picking up in step with the revival in the economy in 2004, when growth is expected to be about 3 per cent. Owing to the small growth in other revenue, the increase in the central government's total revenue in 2003-2004 will come in at an average of only about 1½ per cent.

According to the Stability Programme, in 2003-2004 central government expenditure net of interest expenses will rise at an annual rate of about 2½ per cent. Interest expenses will contract further by a substantial amount and the average growth in total expenditure will be less than 2 per cent. In real terms, total expenditure will not rise, based on the price assumptions that have been made.

According to estimates, central government finances in 2003 will be in slight deficit and in 2004 they will be in balance.

The changes in the surplus estimates compared with the previous programme are shown in Table 5 below.

In the Budget Proposal for 2002 it is estimated that sales of government assets will yield about

EUR 0.4 billion. For subsequent years, the assumption made is that revenue from the sale of assets will be of the same magnitude.

3.5 Finances of local government and social security funds

Finland's general government includes the central government administration, the local administration comprising primarily the municipalities and federations of municipalities, and the social security funds. Although Finland's employment pension system is for the most part handled by private insurance companies, it is classified – for reasons such as its statutory nature – within the social security funds belonging to the general government.

The municipalities' overall financial position swung to a slight surplus in 2000. The differences among individual municipalities' financial situations have nevertheless remained large. In 2001 the growth in municipal tax revenue will slow down substantially after the previous year's exceptionally fast growth. The increase in expenditure has continued at a rate of about 5 per cent. Municipal finances will remain nearly in balance. The state of municipal finances is estimated to weaken in 2002, when the aggregate financial deficit of the municipalities is assumed to be nearly ½ per cent of GDP. The decrease in tax revenue will be offset by the growth in income transfers from the central government.

During 2003-2004 the uncertainties in the revenue base and mounting expenditure pressures will keep municipal finances tight. The medium-term balance obligation nevertheless compels the municipalities to maintain their finances roughly in balance. Essential changes are not forecast to occur in the stock of total municipal debt by 2004.

Changes taking place in the financing relationships between the government and the municipalities are discussed in section 7.2 below.

In the years ahead, social security contributions will not be subject to any mentionable upward pressures. In 2001, the financial surplus of the social security funds will fall owing to the reductions that have been made in social security contributions to about 2.9 per cent of total output. Over the following three years the surplus will stabilise at a level of 2½ per cent of GDP. The surplus will be accumulated within the employment pension funds, which are taking steps to provide for the retirement of baby-boomers. The market value of the employment pension funds was 54 per cent of total output at the end of 2000. This figure does not include the Government Pension Fund, which is counted as part of the central government.

The buffer funds which were motivated by Finland's participation in Economic and Monetary Union and were to be set up within the framework of the social security funds have reached their full level ahead of schedule. The maximum amount of the buffer that is to be built up within the equalisation fund of the employment pension system corresponds to 2½ per cent of the annual amount of salaries, while the buffer which has been accumulated within the unemployment insurance fund corresponds to annual earnings-related unemployment benefits resulting from an unemployment rate of 3.6 per cent.

From the viewpoint of the funding of social security, the years 2002-2004 are a time for preparation because the situation will weaken rapidly after the period under review as a consequence of the ageing of the population. The challenges which public finances and the national economy will face over a longer period as a result of the ageing of the population are discussed in more detail in section 6 and the appendix.

4 Sensitivity analysis and comparison with the previous year's programme

4.1 Risks posed by the economic outlook and the sensitivity of public finances to them

The scenario of public finances, which is presented in this Programme, is based on a cautious estimate of growth. Compared with this baseline, both a faster and slower scenario are possible.

At the time of preparing the Stability Programme, the international economy faces great uncertainties. Brisker than forecast growth in the world economy is nevertheless a completely possible alternative if the uncertainties and particularly the doubts which spring from them are dispelled and this is reflected in the confidence of economic agents. In such conditions growth-supporting economic policies would be able to exert their full influence. In Finland the government is seeking to deploy structural policy measures to improve the fundamentals for sustainable growth. In favourable circumstances the effect of these long-term measures can support growth as early as during the Stability Programme period.

Likewise, there is cause to be prepared for a slow growth scenario. International developments, particularly over the next few years, constitute the biggest risk in this respect. From the standpoint of the latter years of the Stability Programme, we must also recognise the risk that domestic stability may be undermined.

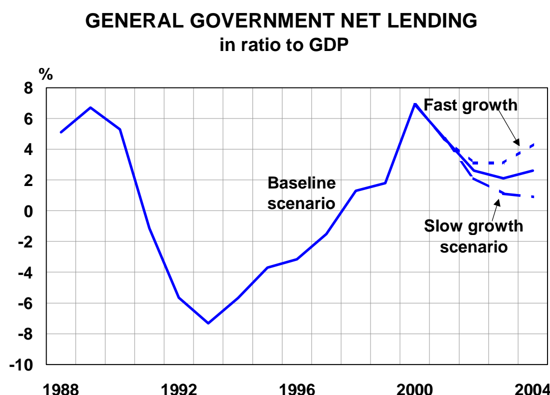
The accompanying charts present a baseline scenario as well as fast and slow growth alternatives. In these alternatives the growth in total output in 2002-2004 is assumed to diverge from the baseline scenario by an average of one percentage point.

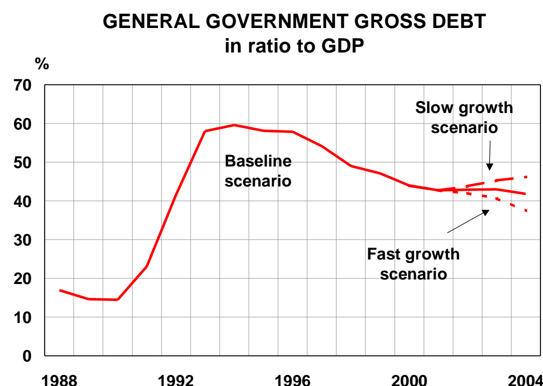
In the above presented basic scenario, the growth in total output in 2002-2004 will be at an average rate of 2½ per cent. In the slow growth scenario the growth in production over the same period would remain on average at 1½ per cent and the rate of unemployment would again rise to over 10 per cent. In this scenario, public finances would nevertheless remain in surplus throughout the entire period under review. Central government finances would fall into deficit, however.

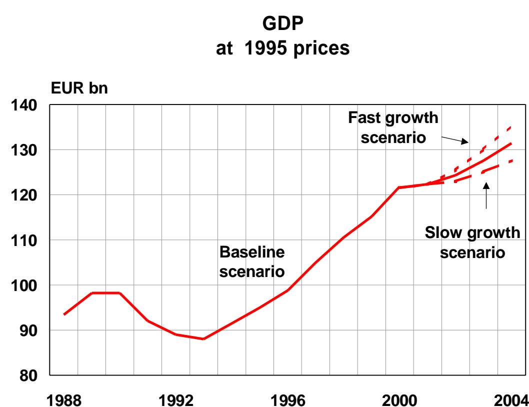
In the fast growth scenario, average growth would be about 3½ per cent and the rate of unemployment would decline to under 8 per cent. In this alternative the general government surplus would grow to more than 3 per cent of GDP, with central government finances again strengthening.

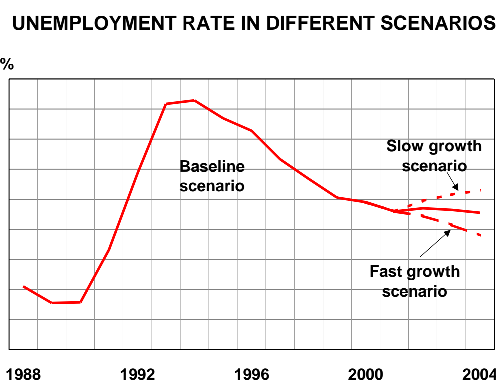
The sensitivity of the public finances outlook to fluctuations in interest rates has been estimated by calculations in which the level of interest rates is assumed to diverge, from the beginning of 2002, by one percentage point either upwards or downwards from the baseline. In the high interest rate alternative, total output and employment - which is important for the balance in public finances - diverge from the baseline less than in the slow growth alternative. Furthermore, developments in the balance in public finances would also be more positive than in the slow growth scenario despite the effects of interest rates. Similarly, in the low interest rate alternative, public finances would not evolve quite as positively as in the fast growth scenario, and developments in total output and employment would also be weaker.

The conclusion is that general government finances would remain clearly in surplus during the current business cycle even though economic growth were somewhat slower than has been estimated in this programme or if the level of interest rates turned out to be higher than forecast in the programme.









4.2 Comparison with the previous year's programme

Following the previous update of the Stability Programme that was published at the beginning of September 2000, economic growth in 2000 turned out to be about ½ percentage point stronger than had been forecast (Table 5). Similarly, in 2000 the surplus in public finances turned out to be more than 2 percentage points greater than was forecast in the previous update of the Stability Programme.

The strong growth in the surplus was attributable to the higher than estimated tax revenue, particularly from corporate tax, as well as to the growth in dividend income. Part of the increase in revenue came from one-off factors.

The growth estimate for 2001 has subsequently had to be adjusted downward by nearly 4 percentage points compared with the forecast calculations that were the basis of the previous Stability Programme. The overall surplus in public finances in the current year, measured as a ratio of total output, nevertheless appears to be of the same magnitude as in the previous update of the Stability Programme. The central government's financial surplus will be somewhat stronger than was forecast a year ago. On the other hand, the surplus of the social security funds will be smaller than forecast previously owing to the decreases in employment pension and unemployment insurance contributions which were agreed in autumn 2000, and municipal finances too will be slightly weaker than was forecast the previous time.

For the next three years of the Stability Programme, economic activity is believed to be clearly weaker than was estimated in the previous update of the Stability Programme. The level of total output in 2001-2004 will be on average 4 per cent lower than was estimated in autumn 2000. This will be reflected in the state of public finances. It is now estimated that the financial surplus in the general government in 2001-2004 will be on average about 1½

percentage points lower than was forecast in the update of the Stability Programme that was presented in early autumn 2000. Applying the same estimates of the effect of cyclical fluctuations on the financial balance in the general government as were used above in Table 4, it can be seen that the decline in the financial surplus is due in its entirety to the weakening in the business cycle.

According to the Stability Programme update, gross general government debt will not decline to the same extent as was estimated in the previous update. The reason for this is the lower general government surplus and the changed investment policy of the pension insurance companies.

5. Divergence from previous update, % of GDP

	2000	2001*	2002*	2003**	2004**
GDP growth					
Previous update (2000) %	5.2	4.2	3.2	2.7	2.7
Latest update (2001) %	5.7	0.6	1.6	2.7	3.0
Difference, % points	0.5	-3.6	-1.6	0.0	0.3
General government financial balance					
Previous update (2000) % of GDP	4.5	4.7	4.4	4.5	4.9
Latest update (2001) % of GDP	6.9	4.7	2.6	2.1	2.6
Difference, % points	2.4	0.0	-1.8	-2.4	-2.3
Gross debt levels					
Previous update (2000) % of GDP	42.4	39.2	37.1	34.9	32.2
Latest update (2001) % of GDP	44.0	42.7	42.9	43.0	41.8
Difference, % points	1.7	3.6	5.8	8.1	9.6

5 Revenue and expenditure structures of public finances

5.1 The Government's policy line

The Government Programme's main policy lines concerning the level and structure of revenue and expenditure within public finances are connected with reducing debt, developing taxation and directing expenditure towards boosting employment and human capital, on the one hand, and combating poverty and social exclusion, on the other. The general starting points based on the Government Programme are described briefly in Section 1 above.

The developments in public finances according to the Stability Programme were described above by means of the financial balance and debt of the general government. In addition, an overview was given of the outlook for the finances of the central government, the municipal sector and the social security funds. Next we examine the qualitative development of the public economy in the light of total revenue and expenditure as well as their internal structure (Table 2). At the same time, supplementary information will be added to the picture of the structural objectives of fiscal policy. Sections 6 and 7 deal with structural policy – which has a central influence on public finances – from the standpoint of the challenges connected with the ageing of the population, the smooth functioning of the markets, public services as well as the financial relationships between the central government and the municipalities.

5.2 General government revenue and taxation

The general government revenue ratio (revenue as a ratio of the value of total output) was exceptionally high in 2000 - nearly 54 per cent (Table 2). According to the Stability Programme, by 2004 the revenue ratio will decline by nearly 5 percentage.

The overall tax ratio peaked in Finland in 1994, when it hit (according to the concepts employed in Table 2) about 48 per cent of GDP. In each of the years 1999 and 2000, the effect of tax cuts corresponded to slightly less than ½ per cent of GDP. As a consequence of the changes in taxes and social security contributions which are to be carried out in 2001, the general government revenue ratio will decline by slightly less than a percentage point, and in 2002 by just over ½ percentage point. According to the Stability Programme, the overall tax ratio, which in 2000 had risen to nearly 47 per cent of GDP owing to non-recurring factors, will decline to about 43½ per cent of GDP by 2002.

In line with the Government Programme, the reductions in taxes and tax-like charges will be applied to the taxation of labour income and to indirect labour costs. This will support economic growth and employment.

In 2002 central government income tax will be lowered by dropping all marginal tax rates by one percentage point and by raising the level of lowest taxable income by 4½ per cent. In municipal taxation, the earned income tax allowance will be increased by an amount which is estimated to reduce total tax revenue by slightly less than EUR 0.2 billion. The combined effect of all the measures implemented in 2002 will lower the tax rate of middle income wage and salary earners by more than one per cent. The income tax cuts slightly favour low income earners.

Further, in 2002 it is proposed to lower private employers' old age pension contributions (in labour-intensive companies by 0.65 percentage points and in others by 0.45 percentage points) and the corresponding contributions of the municipalities and congregations (by 0.75 percentage points). Pension beneficiaries' extra health insurance contributions would be lowered by 0.8 percentage points. Both employers' and employees' unemployment insurance contri-

butions will be lowered by 0.3 percentage points.

The changes in taxes and payments proposed for 2002, which support employment and households' disposable income, are estimated to reduce general government revenue by a total of more than a billion euros annually (3/4 per cent of GDP).

After 2002 the reductions in indirect taxes will lower the general government revenue ratio somewhat. The revenue ratio is set to fall in 2003-2004 by a total of just over one percentage point.

The cyclical sensitivity of tax revenue has increased substantially in Finland in recent years. In particular, the revenue from tax items that are sensitive to developments in the equity markets has fluctuated strongly, with strong repercussions on overall tax revenue. In 2000 these factors sharply increased tax revenue and the surplus, whereas this year and next they will reduce tax revenue significantly and cut into the surplus.

The economic policy assessment of taxation, especially from the viewpoint of labour market repercussions, must be carried out in the context of the entire tax and benefit system. The Finnish welfare state, which is based on high taxation and a comprehensive social security system, ran up against problems as the recession took hold in the first half of the 1990s. In addition to the direct financing problems, attention began to be paid to the combined effect of taxes and social benefits as disincentives lowering the attractiveness of payroll work. To alleviate these problems, in 1997-98 a package of measures was launched which were estimated to have lowered the threshold for seeking employment and to have increased the number of full-time employees by more than 30,000 persons (1.5 per cent of the level of people in employment in 1996).

The tax on labour income was lowered during the previous government by FIM 13 billion within personal taxation, and the tax cuts of FIM 10-11 billion according to the present government's programme will be carried out by the end of 2002. The reductions in income taxes that will be put into effect in 1998-2002 correspond to a total of about 2 per cent of total output. From the beginning of 2000, the capital and corporate income tax base was raised by one percentage point to 29 per cent.

The future challenges of tax policy will undergo thorough study next year. In June 2001 the Ministry of Finance set up a working group that will have the task of assessing the development needs of income and wealth taxation, particularly in respect of corporate and capital income taxes, in the light of international developments and mounting tax competition. In September 2001, acting on a recommendation by the Economic Council, the Prime Minister's Office in turn set up a working group to find out how Finland's taxation structure stacks up on an international yardstick and the kind of pressures for change which Finland's tax system will be subjected to under the influence of the international tax system and international economy as well as domestic factors. Further subjects which the working group will look into are what a sustainable tax rate would be from the viewpoint of financing a welfare society and what the effects of various tax rate and tax structure alternatives would have on the growth of production, labour supply and demand as well as income distribution and regional development. Both working groups mentioned are scheduled to see their work to completion by the end of October 2002.

An aim of this Government's programme, as that of its predecessor, is to shift the focus of taxation from being a burden on labour towards environmental and energy taxation, taking into account international competitiveness. In 1996-99, environment-based taxation, primarily energy taxation, was tightened by a total of EUR 0.6 billion, which went towards offsetting the above described lowering of the tax burden on labour. The government is presently studying how energy taxes can be used to implement the commitments undertaken in the Kyoto Protocol. The objective is to achieve an optimal model from the standpoint of the national economy

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5.3 Level and structure of general government expenditure

In 2000, total general government expenditure reached just under 47 per cent of GDP (Table 2). General government expenditure has fallen by more than 15 percentage points as a ratio of GDP from its peak level in the early 1990s thanks to consistent budgetary discipline and the brisk growth in the economy. In the first part of the Stability Programme period, the lowering in the expenditure ratio will come to a halt and the growth in expenditure will slightly exceed the nominal increase in total output. The rise in the expenditure ratio from 2000 to 2002 will nevertheless remain under one percentage point. According to the Stability Programme, thereafter the expenditure ratio will turn downward, ending at 46 per cent of GDP in 2004.

All in all, the structure of general government expenditure will change relatively little during the Stability Programme. Interest expenses, which peaked in 1993 at 4.5 per cent of GDP, had declined to 2.8 per cent by 2000 (net interest expenses fell to 1 per cent of GDP). During the Stability Programme the ratio of interest expenses to the value of total output will decline further.

During the programme period, consumption and investment expenditure will track the trend in total output fairly closely. In the first part of the programme period the growth in social income transfers will exceed the growth in total output, but as economic growth picks up towards the end of the programme period, it will fall back again. During the programme period, state aid will remain at a level of about 1½ per cent of total output.

In allocating central government expenditure, particular attention will be paid to improving long-term growth prerequisites through developing human capital, on the one hand, and to combating poverty and social exclusion, on the other. During the previous Government, the main priority was the promotion of research and development activities. The present Government's emphasis has shifted to education. Over the latest three-year period an additional amount of about one billion euros has been spent on education, notably in the form of starting free pre-primary education, increasing central government transfers to local government for educational services and stepping up funding for universities.

Another important priority is the fight against poverty and social exclusion. The Government Programme states that broadly based growth in employment and lowering of unemployment constitute the best means for combatting poverty and social exclusion. Developments in employment will be taken into account when deciding on the scope of labour market measures. Measures to combat exclusion and poverty were already launched in 2001 and they are being continued. Rises in benefits have gone towards child allowances associated with labour market subsidies and national pensions, into subsistence compensation connected with labour policy, into adjusting the grounds for granting housing allowances and into certain sickness allowances. The government has furthermore proposed that the basic daily allowance of unemployed persons, and the income support of those receiving labour market subsidies should be improved. On the basis of the collective bargaining agreement, an increase will be made in the level of earnings-related unemployment benefits as from 1 March 2002. All in all, the measures aiming at combating poverty and social exclusion which are to be carried out in 2001-2002 are estimated to reach approximately EUR 300 million.

The amount earmarked for transport and communications investments in the 2002 budget is about EUR 0.5 billion. Additional funds will also go towards supporting municipal finances (section 7.2.)

6 Sustainability of public finances

6.1 Government policy line

The Finnish economy faces a number of significant challenges in the coming years. Owing to developments in the global economy, economic competition has considerably increased and spread to new areas, so that the traditional sheltered sector has become much narrower. The introduction of the euro and market integration play a key role. Due to the ageing of the population, labour supply will be decreasing in the next few decades and the financial basis for funding social security and pensions correspondingly weakening. The fall in labour supply will eventually hamper growth potential in the economy and add more pressure to the financing of public expenditure.

These challenges highlight the importance of strict fiscal restraint and the need for structural reforms. Provision must be made in public finances for the pressure arising from the ageing population by means of reducing the debt burden in central government finances. Furthermore, efforts must be made to raise the employment rate, to promote continued active participation in working life and to strengthen the structure of the pension schemes. Fostering economic growth by means of competence, entrepreneurship and innovation is also important. Moreover, enhancing and improving the quality of public services production constitutes another key target area (this is addressed in more detail in section 7.1).

The best way to secure long-term sustainability in public finances is to ensure that there is a sufficiently large surplus in central government finances over the next decade to be able to reduce the debt burden. This means that pressure to spend needs to be contained by means of structural reforms. In addition, it is important to curb future growth in pension expenditure. A vital factor in this context is to raise the average age of retirement, as outlined in the Government Programme.

The labour market organisations and employment pension institutions contracted an agreement in 1999 on some measures to raise the age of retirement. The Government implemented the reforms by means of legislative amendments that came into force at the beginning of 2000. In the same context, the Government decided to follow up in the implementation of agreed measures and to evaluate in collaboration with the labour market organisations whether the actions were sufficient.

Since then, in the course of 2001, the Government has accelerated tripartite preparations to reform the unemployment and employment pension schemes in such a way that working groups drafting proposals would hand them over in the course of autumn 2001 so that all pertinent legal provisions can be adopted in spring 2002.

The working groups preparing reforms on the unemployment benefit and employment pension systems completed their work in mid-November 2001. The agreement of the labour market organisations relating to private sector employment pensions reached on the basis of the working group's proposals is in line with Government targets to develop employment pensions to encourage continuing working, to maintain the ability to work and to foster employability and to strengthen the principle of earnings-related benefits. Also the orientations reached by the working group on unemployment benefits correspond to the Government's objectives to develop employment and to improve employability. The Government will begin to draft legislation on private sector employment pensions and unemployment benefits on the basis of the proposals and will step up efforts to start negotiating reforms in public sector pensions.

The reforms proposed for the earnings-related unemployment benefit scheme are as follows:

- the eligibility age limit for the 'additional daily allowance' after 500 days of unemployment will be raised from 57 years to 59 years and an eligibility condition of 5 years of work history in the past 15 years will be applied;

- daily unemployment allowances would be granted until the age of 65; changes related to the 'additional daily allowances' would replace the current system of unemployment pension;

- the level of the daily unemployment allowance granted for additional days would be higher under certain circumstances for those with a long work history;

- the conditions for renewing the right to a daily unemployment allowance would be eased by reducing the 're-entry condition' from 10 months to 8 months; the daily earnings-related unemployment allowance will be raised for the first 130 days of unemployment for those who have been made redundant for economic or production reasons and who have a work history of at least 20 years;

- the changes related to the additional daily allowances and the unemployment pensions would come into force after a transition period as of 2007, while the rest of the changes would become effective for the most part at the beginning of 2003.

The fixed old-age retirement age of 65 used in the pension scheme will be abolished, being replaced by a more flexible retirement age and a system of pension accrual that takes earlier earnings much better into account. The changes will come into force mainly at the beginning of 2005. The new system would include the following features:

- unemployment and individual early retirement pensions will be abolished in stages;

- it will become possible to retire on old-age pension flexibly between the ages of 63 and 68 and on early old-age pension between the ages of 62 and 63;

- pension rights accrue for work done between the ages of 18 and 68; the standard pension accrual is 1.5 per cent of earnings per working year; at the age of 63 the accrual rises to 4.5 per cent a year;

- unlike at present, pensions would accrue also during periods of sickness leave and parent's leave and during periods of child home care leave and on the basis of student grants for a maximum of 5 years;

- the 60 per cent pension ceiling in relation to earnings will be abolished;

- a single employment pension index will be adopted, where the weight of the consumer price index is 0.8 and that of the index of wage and salary earnings 0.2;

- the relevance of the accrual principle will be given greater emphasis in computing part-time pension and the age limit for part-time pension will be 58 years;

- the earnings base used to compute pensions will be agreed on later in such a way that the size of the pension is not contingent on how the work history is divided into different contract periods; the aim is to introduce a system which takes the whole work history into account when computing pensionable earnings;

- another significant matter for further preparation is the way in which the longer life expectancy is taken into account either in pensions or in the age of retirement.

In preparing the pension reform on the basis of the proposals presented, the Government will attempt to resolve the questions that are still open in a way which will improve the sustainability of public finances.

These reforms together are expected to considerably improve the economic incentives for remaining in work. The pensions of those with a long work history will be much higher than is the case in the present system. Staying in the active labour force and seeking and accepting a job would become more worthwhile in financial terms.

In line with the Government Programme, measures in labour policy will concentrate in particular on ways to reduce long-term unemployment and to enhance job brokering. Measures in employment policy aim to foster ways of improving labour competence in order to boost employment and the functioning of the labour markets and to secure labour supply. Particular emphasis will be placed on the demands caused by changes in the age structure

of the population. The National Action Plan adopted in April 2001 gives a more detailed description of the Government's employment policy measures.

By safeguarding the preconditions for economic growth it is possible to secure growth in the national economy, which then ensures that an adequate revenue base can be maintained in society for funding the costs incurred by the ageing of the population.

By boosting and enhancing education and research and by improving their quality it is possible to build a foundation for a growth strategy based on innovation, high technology advances and a higher value added in general.

The level of education is rising fast in newly industrialised countries and world trade concentrates on highly processed products and services. New demands for developing education are being placed on the domestic services markets too. This means that the educational system in Finland constantly faces new challenges and educational policy takes on a key economic role. The Government will present a report to Parliament in early 2002, which addresses issues related to educational policy.

6.2 Pressure caused by the ageing population

Long-term economic policy challenges are closely tied in with the ageing of the population, which in Finland will be faster than in the rest of Europe.

While in 2000 the elderly dependency ratio in Finland was still below the EU average, by 2020 it will have risen to well above the average, becoming the second highest in the EU after Italy. This is because the number of people of working age will fall and the population of pensioners will rise.

In the light of calculations made at the Ministry of Finance the ageing of the population gives rise to pressure not only in the funding of pensions but also in expenditure for health care and long-term care services (for more details on the computations, see the appendix). The expenditure ratio in the whole of general government (ratio of current expenditure to GDP) is estimated to grow by about 6½ percentage points of GDP over 2010-2030 as a result of an ageing population. Between 2030 and 2050, ageing would further increase pressure on outlays by another 2 percentage points. These developments would eventually increase the expenditure ratio to almost 50 per cent of GDP, that is 5 percentage points higher than the level in 2000.

There is the risk that the pressure caused by the ageing population might lead to a rising tax ratio again in 10 to 15 years' time. Although the calculations are based on very cautious growth estimates for expenditure not directly related to the ageing of the population, over the next 20 to 30 years the tax ratio threatens to rise above the level experienced in the early 1990s recession years.

Serious risks are involved in the threat of a heavier tax burden. Firstly, it is uncertain whether such a high tax rate would be viable in conditions of deeper integration as tax bases are increasingly mobile.

Secondly, it should be noted that the underlying assumption in the calculations is that the labour force participation rate will rise. However, it is possible that high taxes that continue to rise could reduce labour supply so that the growth path envisaged in the scenarios could prove too optimistic. Weaker growth would further exacerbate the pressure on taxation and public finances could end up on an unsustainable path.

Sustainability in public finances could also be jeopardised should economic developments in the next few years be weak. The long-term scenario described in the appendix is based on the assumption that unemployment and State debt will have become considerably lower by the end of this decade than they are at present and that the balance in central government is still strong. If this were not be the case, the sharp rise in health care and nursing expenditure would make it necessary to raise taxes and to increase social security contributions. This would add to the risks involved in economic developments.

7 Other factors with an impact on public finances

Section 6 above gives a short description of the type of necessary structural reforms and projects related to the ageing of the population which are of consequence to public finances.

This section first briefly examines the functioning of the markets and structural policy related to public services. Well-functioning markets play a key role in creating the prerequisites for general operating and growth conditions in the economy and accordingly are important for economic stability and the sustainability of public finances. By enhancing the market elements in public services, it is possible to foster the efficient use of resources and to improve the quality of service production.

Within the scope of the institutional structures in general government, there is a need to develop the financial relations of local government and central government. Section 7.2 describes the current system in broad terms, illustrates the existing problems and presents the most recent reforms.

7.1 Reforms in the product and capital markets and in public services

The Finnish economy has become increasingly open in recent years. Determined measures have been taken to expose the markets to competition. Further reforms in the financial markets have been pursued, particularly to secure more effective supervision and to enhance the stability of the markets.

By bolstering the functioning of the markets it is possible to create conditions for the reorientation of production in step with the rapidly changing demands of the global economy. Flexibility in production also protects public finances from the negative effects of sharp fluctuations in the level and structure of demand. By removing barriers to competition, it is possible to encourage new entrepreneurs and innovations to penetrate the markets.

A key economic policy goal of the Government is to safeguard the preconditions for sustainable economic growth by implementing structural reforms on the product, capital and labour markets. The measures in industrial policy focus on improving the functioning of the product and capital markets. Key areas of interest comprise measures to boost the competition environment and market access as well as the promotion of entrepreneurship. Efforts have been made to reduce the amount of sector-specific business subsidies and to replace them with the development of the operating environment of business and intangible investments. The system of business subsidies has been made simpler, supervision of aid has been boosted and measures have been taken to better evaluate the impact of the subsidies.

Product and capital market reforms adopted by the Government are presented in greater detail in Finland's product and capital market reforms report. The most recent issue was published in November 2001.

The ageing of the population will give rise to major challenges for public services in the next few decades. To secure the quality and availability of public services, especially in social welfare and health care, throughout the country in coming years too, the structure and systems of public service production must be reformed. Productivity and quality in public services can be developed by exploiting advanced technology, new operating modes and by enhancing collaboration between public service production and the private sector. Pilot projects and reforms for making more effective use of the markets and competition in service production are underway in local government.

A working group set up to examine Finland's competition policy has also looked into the ways of promoting competitiveness in public services. A study into ways of fostering the conditions for competition in the statutory employment pension schemes, in turn, aims to

enhance the functioning of the employment pension system and to boost the profitability of employment pension assets.

To correct the recognisable weaknesses in the health care system and to safeguard the future of the service system, the Government launched a national health care project in autumn 2001. Action plans will be drawn up in the project on the following:

- to reform the operating and administrative structures of the service system and to boost efficiency and productivity;

- labour demand and skills in health care;

- the level and structure of funding and improvements in the State steering system;

- to develop the division of labour and cooperation between public health care and private service production, which complements public services;

- to harmonise and enhance care practices.

7.2 Institutional changes in general government – financial relations between local and central government

In Finland, central and local government are jointly responsible for financing the statutory services. Local governments are in charge of providing the services and central government pays local authorities part of the cost incurred in the form of central government transfers. The system of central government transfers to local government is based on an imputed need for transfers for each municipality and on an equalisation of transfers on the basis of tax revenues in the municipalities.

At present, municipalities use the transfers to cover on average about one fifth of their expenditure. In addition to the central government transfers, revenue in the local governments consists of tax receipts (mainly municipal taxes levied on wages and salaries, property taxes and the local government apportionment of corporate income taxes) and of various charges.

There are 448 municipalities in Finland, of which almost a half have less than 5,000 inhabitants. Revenue and expenditure in the different municipalities vary considerably and there are major differences in the revenue structure. The aim of the system of central government transfers is to ensure that the basic rights of the citizens are adequately secured throughout the country.

In 2000, central government transfers to local governments totalled approximately EUR 4 billion. Central government disbursed about EUR 0.2 billion in general transfers, a good EUR 2 billion in transfers for social welfare and health care and nearly EUR 2 billion in transfers for education and culture. Moreover, central government transfers are granted to local authorities for building start-up costs.

The system of central government transfers to local government has been reformed in stages in the 1990s. The most significant change took place in 1993, when the expenditure principle used in the system was replaced by an imputation principle. Between 1993 and 1998 central government transfers had to be substantially reduced in order to balance central government finances. In 1993, central government transfers amounted to 8½ per cent of GDP and by 1998 they were down to 4 per cent. Owing to growth in tax revenue in local government, however, overall revenue in municipalities has remained unchanged in real terms. Although local government finances are in balance on an aggregate level, financial differences between the municipalities are substantial.

The 2002 Budget Proposal includes a number of reforms related to local government finances and to the financial relation between local and central government. Central government measures will boost local government finances by a net value of almost EUR 0.3 billion in 2002 compared to 2001.

To improve local government stability, no more tasks that would increase spending in local government will be introduced over the election period and the bases used in the central government transfer system will be revised at the beginning of 2002 through changes in the VAT system, in the local government apportionment

of corporate income taxes and in the tax equalisation system. The reforms will raise the municipalities' imputed central government transfers for social welfare and health care, reduce the financial differences between municipalities and improve the predictability of corporate tax apportionments for the municipalities. The EUR 0.6 billion cut in the corporate tax apportionment reduces the significance of the cyclically sensitive corporate taxes for local government finances.

By revising the provisions governing the imputed subsidies for integration efforts, the integration of municipalities is being promoted. Moreover, principles will be laid down to allow for investment and development support to municipalities intending to integrate.

Appendix

Public finances in the long term [1]

The expenditure pressure caused by the ageing of the population will mount over several decades to come. It is impossible to accurately forecast the exact impact this will have. Owing to the potential magnitude of the problems, it is nonetheless important to attempt to assess coming developments in quantitative terms too. To this end, a scenario describing the long-term expenditure pressure has been drawn up, which is based on the following assumptions:

- The population projections and forecasts on developments in the population of working age, and the young and old age groups are based on the Eurostat estimates compiled in 2000. The projection indicates that the population in Finland will begin to decrease in the mid-2020s. The population at that stage is forecast to be 5.3 million inhabitants, that is about 150,000 more than today. The number of people aged over 65 will grow fast, so that in 2030 their number will be 600,000 higher than at present. The number of people aged under 15, instead, will decrease. The number of people of working age (15 to 64 year-olds) will begin to fall from 2010 onwards by over ½ per cent a year. The population of working age is estimated in the projection to be about 350,000 lower in 2030 than today. Based on the population forecast, projected developments in the elderly dependency ratio in Finland and in other EU Member States over the next two decades are illustrated in Table 1.

- The increase in labour productivity is estimated to average around 1.75 per cent a year in the coming decades. Total output is envisaged to grow an annual rate of about 1½ per cent after the review period of the Stability Programme.

- The projection on employment pension contributions and employment pensions is based on estimates drawn up in autumn 2000 by the Central Pension Security Institute. It was assumed that the pre-funding rules governing employment pensions in the private sector remain unchanged. The effective retirement age is assumed to rise by slightly over a year in the coming decades.

On the basis of these assumptions, employment pension expenditure is forecast to rise by about 6 percentage points of GDP by 2035 and to then level off. Based on existing pre-funding rules, employment pension contributions would rise by 3½ per cent of GDP by 2050. The financial surplus in the employment pension institutions would fall from the figure of about 3 per cent of GDP in 2000 to just below 2 per cent in 2050.

Other age-related expenses in the public sector were assessed using the same demographic assumptions as in the pension estimates. All expenditure other that that affected by changes in the age structure of the population (also excluding interest expenses) is assumed to remain unchanged in relation to GDP. Interest expenses are derived from the financial balance assumption and the consequent debt developments presented below.

The assumption for the long-term scenario is that central government will be kept in surplus until the debt-to-GDP ratio in central government has been pushed down to around 10 per cent of GDP. Based on these assumptions, this can be achieved in the 2010s. By the same token, central and local government finances are assumed to be close to balance from this time onwards.

With all other items that affect the position of public sector finances being determined on the basis of the assumptions, the element of flexibility in the estimates lies in taxes. On the basis of the assumptions on expenditure and finan-

1 A detailed description of these scenarios is presented in the publication 'Economic Policy Challenges in Coming Years' by the Ministry of Finance, Economic and Economic Policy Surveys no. 3/2001. Changes in the short-term outlook that took place after the spring 2001 calculations had already been drawn up have not been taken into account in these scenarios.

cial balance, the level of taxation would become a residual so that the debt developments correspond to the above estimates. Based on the assumptions, public finances would remain in surplus throughout and the requirements set by the Stability and Growth Pact would be met.

The main results of the baseline scenario are presented in Table 2. The fall in interest expenses would first offset additional costs arising from the ageing population and the expenditure ratio in general government would decline. Beyond 2010 the ageing of the population would bring employment pension outlays and local government consumption expenditure to a rise in relation to GDP. The overall general government expenditure ratio (expenditure-to-GDP ratio) is estimated to rise by 6½ percentage points over 2010-2030 owing to the ageing of the population (Figure).

Between 2030 and 2050, ageing would further increase pressure on outlays by another 2 percentage points. The assumptions in the scenario imply an eventual increase in the expenditure ratio to almost 50 per cent of GDP, in other words clearly higher than the level in 2000. Even in fairly favourable conditions the tax ratio would tend to climb back to the peak 1990s figures of 46-47 per cent of GDP (Figure).

1. Elderly dependency ratio in EU Member States (people aged 65 or over, % of those aged 20 to 64)

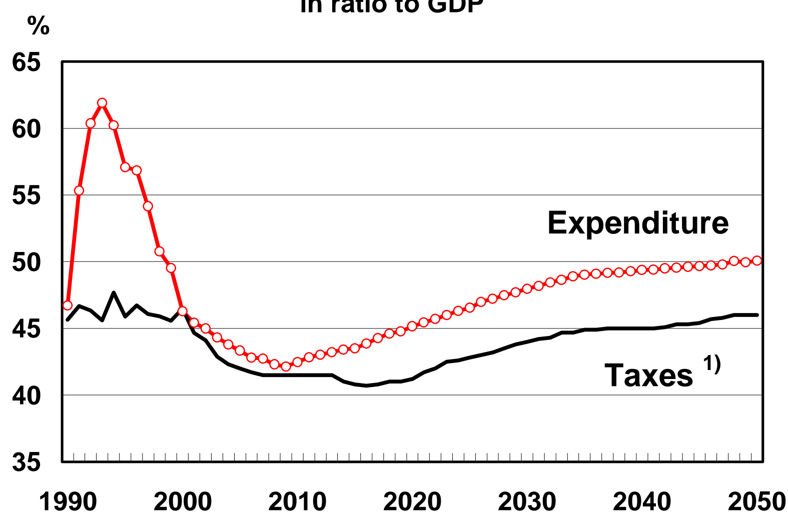
	2000	2010	2020	Change 2000-2020
Belgium	28	29	36	8
Denmark	24	27	34	10
Germany	26	33	36	10
Greece	28	32	36	8
Spain	27	29	33	6
France	27	28	36	9
Ireland	19	19	25	5
Italy	29	34	40	11
Luxembourg	23	26	31	8
Netherlands	22	25	33	11
Austria	25	29	32	7
Portugal	25	27	30	5
Finland	**25**	**28**	**39**	**14**
Sweden	30	31	38	8
United Kingdom	26	27	32	6
EU-15	27	30	35	8

Source: Eurostat

2. Public finances in the long run, % of GDP

	2000	2010	2020	2030	2040	2050
Total expenditures	46.7	42.5	45.1	48.0	49.4	50.1
Employment pensions 1)	6.7	8.6	10.7	11.9	12.4	12.5
Health care	4.2	3.9	4.6	5.5	5.9	6.2
Social services	3.9	3.6	4.2	4.9	5.4	5.7
Other expenditures	29.1	25.0	25.0	25.0	25.0	25.0
Interest payments	2.8	1.4	0.6	0.6	0.6	0.6
Total revenues	53.6	46.9	46.6	49.4	50.4	51.4
Employment pension contributions	7.2	8.0	9.1	10.1	10.4	10.8
Financial balance	6.9	4.4	1.5	1.4	1.0	1.3
Primary balance	7.9	2.4	-0.5	-0.3	-0.4	-0.3
Gross debt level	44.0	18.9	9.8	9.6	9.7	9.6
Assumptions						
Labour productivity, % change	2.8	1.8	1.8	1.8	1.8	1.8
Real GDP, % change	5.7	2.3	1.1	1.3	1.4	1.3
Participation rate (aged 15-64), %	74.3	75.1	78.2	79.5	79.9	80.8
Unemployment rate, %	9.8	7.0	7.0	7.0	7.0	7.0

1) The employment pensions do not include central government pensions, which amounted to 1.8% of GDP in 2000.



1) Taxes consist of tax revenue and social security contributions in general government as a percentage of GDP.