



**Ministry of Finance**

**UNOFFICIAL TRANSLATION**

**STABILITY  
PROGRAMME  
FOR FINLAND**

**November 2003 update**

## Index

|  |    |
|--|----|
| Introduction and summary .....   | 1  |
| 1 Economic policy objectives and premises .....                              | 3  |
| 1.1 Economic policy objectives .....   | 3  |
| 1.2 Broad economic policy guidelines .....                                   | 4  |
| 1.3 Finland's 2003 Stability Programme update .....                          | 6  |
| 1.4 Processing the Stability Programme in Finland .....                      | 7  |
| 2 Economic situation and outlook .....                                       | 9  |
| 2.1 Recent developments and short-term outlook .....                         | 9  |
| 2.2 Medium-term macroeconomic scenario .....                                 | 11 |
| 3 General Government: Balance and debt in 2003-2007 .....                    | 13 |
| 3.1 Fiscal policy strategy .....   | 13 |
| 3.2 General government balance and debt .....                                | 14 |
| 3.3 Structural balance in public finances .....                              | 15 |
| 4 Sensitivity analysis and comparison with last year's programme .....       | 19 |
| 4.1 Risks in economic developments and their impact on public finances ..... | 19 |
| 4.2 Comparison with last year's Stability Programme update .....             | 21 |
| 5 General government revenue and expenditure .....                           | 23 |
| 5.1 Government policy .....  | 23 |
| 5.2 General government revenue and taxation .....                            | 23 |
| 5.3 General government expenditure .....                                     | 25 |

|  |    |
|--|----|
| 6 Sustainability in public finances .....                                      | 29 |
| 6.1 Measures aimed at fostering sustainability .....                           | 29 |
| 6.2 Sustainability scenario .....  | 32 |
| 7 Other factors with an impact on public finances .....                        | 37 |
| 7.1 Developing product and capital markets and public service production ..... | 37 |
| 7.2 Reform of corporate and capital income taxation .....                      | 39 |

**Tables:**

|  |    |
|--|----|
| 1. Growth and associated factors .....                             | 10 |
| 2. General government budgetary developments .....                 | 16 |
| 3. General government debt developments .....                      | 16 |
| 4. Cyclical developments .....                                     | 17 |
| 5. Divergence from previous Stability programme update .....       | 22 |
| 6. Long-term public finances .....                                 | 33 |
| 7. Public finances according to baseline and target scenario ..... | 34 |

**Figures:**

|  |    |
|--|----|
| 1. GDP deviation from potential output and general government financial balance ...<br>from GDP .....                                      | 2  |
| 2. General government net lending, general government gross debt, GDP growth ...<br>and unemployment rate in the different scenarios ..... | 20 |
| 3. General government financial balance .....  | 35 |
| 4. General government net financial assets .....   | 35 |

---

## INTRODUCTION AND SUMMARY

Continued sluggishness in the international economy has been holding back economic growth in Finland as well. For this reason Government decision-making has been aimed not only at long-term sustainability, but also at boosting economic recovery in 2003-2004. This has been possible by virtue of a strong financial position in general government. The Government's commitment to medium-term stability is important, on the one hand, for assuring consumer and business confidence and bolstering general government finances in view of the ageing of the population; and on the other hand, for promoting economic growth.

As well as drawing on the Government Programme and the Government's decision on spending limits, this Stability Programme update is based upon the 2004 Budget Proposal that was submitted in September as well as related economic policy decisions and economic forecasts. The Government's main economic policy objective is to create jobs for 100,000 people by the end of its term in 2007. In order to achieve this objective, the Government will continue to pursue an economic policy that is geared to promoting stable economic growth, to improving the functioning of markets and to securing an internationally competitive environment for business and industry. The Government's fiscal policy objective is to maintain strong central government finances and to make sure they remain in balance (as measured in national accounts terms) through to the end of its term in office.

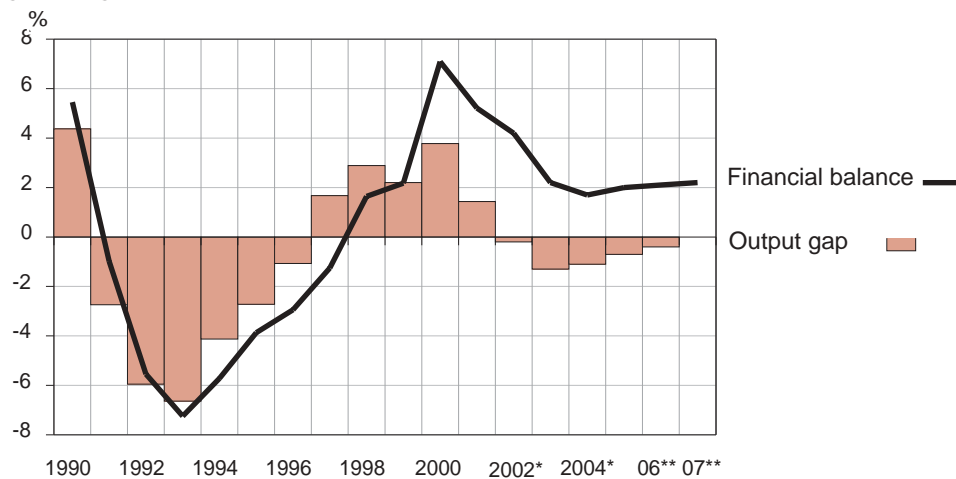
Exceeding the level decided upon earlier, tax cuts on labour in 2003 and further in 2004 will boost household purchasing power but at the same time create a stronger foundation for longer term economic growth by providing a greater incentive to work. The sustainability of central government finances will have been strengthened by new procedures adopted in 2003 on spending limits and the decisions taken in line with these procedures for the whole electoral period 2003-2007. Due to take effect in 2005, the structural reform of pension schemes will improve the long-term sustainability of public finances.

In 2004, the surplus in general government will be reduced to an estimated 1.7 per cent of GDP. It is forecast that by the end of the Stability Programme period, the surplus-to-GDP ratio will climb to over 2 per cent. This surplus falls slightly short of the economic policy objective of balanced central government finances since the baseline scenario for employment growth within this Stability Programme update also falls short of the targets set. This Programme offers no concrete measures on how to attain the Government's employment goals, mainly because work to finalise these measures is still underway. On the other hand, the baseline scenario of average GDP growth at 2.5 per cent, is a cautious estimate.

If the Government succeeds in its economic policy of supporting growth and reinforcing stability, and if the international economy throws up no surprises, it should be possible to raise the employment rate beyond the figures of the baseline scenario and thereby to strengthen the financial position of central government. If employment growth is on average around one-half a percentage point faster than in the baseline scenario, then central government finances will be in balance by the end of the programme period.

Calculations suggest that if the Government's employment goals are met, average production growth will exceed the baseline scenario by around 1½ percentage points. On such a growth track, central government would eventually show a clear surplus again.

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



---

# 1 ECONOMIC POLICY OBJECTIVES AND PREMISES

## *1.1 Economic policy objectives*

---

The main economic policy goal of the Government under Prime Minister Matti Vanhanen is to raise the employment rate. To achieve that goal, the Government will continue to pursue an economic policy that promotes stable economic growth, improves the functioning of markets and secures an internationally competitive environment for business and industry. The Government's fiscal policy objective is to maintain strong central government finances and to make sure they remain in balance (as measured in national accounts terms) through to the end of its term in office.

The main way to meet these objectives is to get the economy back on its earlier, faster growth track after three years of slow growth. The number of jobs has been shrinking since the spring, chiefly as a result of sluggish demand for export industry products. Strong public finances have helped Finland to avoid expenditure cuts during the period of slow economic growth, instead taxes have been cut. This also supports structural adjustment and increases growth potential over the longer term.

Tax cuts on labour in 2003 and further in 2004 will help to maintain and boost household purchasing power, strengthen confidence in domestic economic development, and lay a firmer foundation for longer term economic growth by providing a greater incentive to work. The tax cuts will mainly benefit small and medium income earners. The minimum target set for the whole electoral period – tax cuts on labour amounting to 1.12 billion euros – has already been reached in the 2004 Budget Proposal.

There has been a long-standing effort to prepare for the pressures of rising expenditure that are going to follow with the ageing of the population, primarily by means of raising the employment level and strengthening central government finances. In addition, steps

have been taken to increase the effectiveness of labour markets through reforms in the tax regime and social security systems with a view to encouraging employment and entrepreneurship. At the same time, pension and benefits schemes have been so revised that there is greater incentive to stay on at work for longer than before. The same economic policy line will be followed throughout the Stability Programme.

The sustainability of central government finances has been strengthened most particularly by new procedures adopted in 2003 for deciding on spending limits as well as by the very strict decisions taken within the framework of these procedures. The spending limits adopted impose an absolute ceiling for around three-quarters of State budget expenditure, including the supplementary budgets over the next four years. Expenditures that vary with cyclical fluctuations or automatic funding mechanisms, such as unemployment security costs and transfers to the Social Insurance Institutions, are not included in this. The impacts of changes in spending principles concerning these expenditures, are counted under the binding spending limits. Debt interest payments and EU budget expenditure flowing through the Finnish Budget are also excluded from the overall spending limits.

The Government Programme is aimed at maintaining balanced central government finances (as measured in national accounts terms) through to the end of the electoral period, at which point there should be an overall surplus in general government finances equivalent to around three per cent of GDP. Cyclical or other short-term deviations from the path of balanced central government finances are permitted in so far as they do not jeopardise the overall reduction of the central government debt ratio. However, the Government is committed to taking steps to cut expenditure and to taking other corrective action if the central government deficit threatens to rise above 2¾ per cent of total output.

### *1.2 Broad economic policy guidelines*

---

The Broad Economic Policy Guidelines (BEPGs) document is the key instrument for coordinating

economic policies in the European Union. Sharing as they do common interests with respect to economic policy, Member States need to streamline their economic policies in line with the principles of open market economy that is based on free competition and that favours efficient resource allocation. The recommendations for broad policy guidelines in 2003-2005 are divided into three main areas: macroeconomic policies oriented to growth and stability; economic reforms aimed at raising growth potential; and strengthening sustainability.

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

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

- 1) - Improve incentives in tax and benefit systems further to make work pay, in particular by addressing their combined effects on older workers, continue to reform the eligibility criteria, improve the administration of benefit systems and target the tax measures on low-paid labour.
  - Seek possibilities to ensure that wage bargaining systems allow wages to better reflect productivity differences across skills in order to improve the job prospects of low-skilled unemployed.
- 2) - Step up efforts to enforce competition in network industries and non-tradable services.
  - Make further efforts to increase the efficiency of the public sector, among other things by improving the framework conditions for increased competition, promoting the benchmarking of public sector efficiency and by increasing public tendering.
  - Improve mechanisms to help control spending and ensuring compliance with rules on expenditure.

The Government's economic policy is in line with the recommendations put forward in the BEPGs. The economic policy measures taken by the Government in respect of the recommendations concerning general government finances and structural policy are described in closer detail in the subsequent chapters of this Stability Programme as well as in the report on Product and Capital Market Reforms in Finland adopted by the Government in October 2003.



### *1.3 Finland's 2003 Stability Programme update*

---

As well as drawing on the Government Programme and the Government's decision on spending limits, the present Stability Programme update is based upon the 2004 Budget Proposal that was submitted in September as well as upon economic forecasts updated at the beginning of November. The Programme's projections of economic trends in 2003 are significantly weaker than in the previous Stability Programme update, mainly on account of weaker than expected development in the international economy. The estimate of total output volume in 2004 has been revised downwards somewhat, but forecasts of the growth rate are essentially unchanged, including the projection that economic growth will gather momentum during 2004.

When the 2002 Stability Programme was drawn up, the government in office at the time had no more than six months remaining of its term. Before its term ended, the government agreed in February 2003 on preliminary, technical spending limits for the period from 2004 through to 2007. The new Government that took office in April 2003, decided on incremental increases in expenditure rising to 1.12 billion euros beyond these limits during the electoral period. At the same time, the Government decided on overall tax cuts amounting to at least the same sum over the electoral period, with the emphasis on taxes on labour. Furthermore, the Government decided that cyclical or other short-term deviations from the path of balanced central government finances can be permitted in so far as they do not jeopardise the overall reduction of the central government debt-to-GDP ratio.

In spite of sluggish economic growth, the balance in general government finances in 2003 and 2004 is expected to remain only slightly weaker than in the previous Stability Programme update. The surplus-to-GDP ratio in general government is expected to be nearly one-half a percentage point lower both in 2003 and in 2004 than in the 2002 Stability Programme update. The lower-than-anticipated surplus in 2003 is due to central government's weakening financial position, which is mainly explained by cyclical factors and by increased spending items as set out in the Government Programme. In 2004, the financial position of central government will be affected not only by cuts in income taxes, but also by substantial cuts in tax rates on alcoholic beverages in an attempt to secure the tax base with EU enlargement.

According to the Stability and Growth Pact which complements the EU Treaty, Member States shall adhere to the medium-term objective of a budget position close to balance or in surplus. Although the financial position of general government looks set to weaken somewhat in 2003 and 2004, it will still remain clearly in surplus. In 2007 the surplus in general government is expected to stand at 2 per cent of GDP.

In line with the requirements set out in the Growth and Stability Pact, the Government will take corrective action if the central government deficit threatens to rise above 2¾ per cent of total output. In this situation general government finances would fall into deficit.

### *1.4 Processing the Stability Programme in Finland*

---

The Stability Programme update for 2003 was drawn up after the 2004 Budget Proposal was submitted. The Stability Programme complies with the Code of Conduct endorsed by the EU Council in July 2001. The document will be delivered to the relevant EU bodies within the agreed time frame (15 October – 1 December 2003) once it has been approved by the Government in plenary session. As in earlier years, the Stability Programme update will be submitted to Parliament for information.



---

## 2 ECONOMIC SITUATION AND OUTLOOK

### *2.1 Recent developments and short-term outlook*

---

The world economy has remained sluggish for longer than expected, and that has affected the Finnish economy, too. After a period of brisk growth in the latter half of the 1990s, GDP growth has slowed down to between 1-2 per cent; the figure for 2003 is estimated at 1.4 per cent. Output growth has been sustained mainly by household consumption and investment in housing, whereas exports and business sector investments have shown slow growth. Private consumption will remain the main foundation for growth in 2004 as well, but in addition it is expected that net exports will contribute to growth again.

The employment situation has not deteriorated in spite of subdued economic growth, but there are signs now of a turn for the worse, especially in industry. The growth of employment has tapered off and the numbers employed in 2003 will remain below the figure for 2002. The number of people in work as a proportion of the working age population (15-64 years) will decline somewhat in 2003, but is expected to rise to 67.5 per cent in 2004. The rise in consumer prices has slowed down during the current year, remaining well below the average for the euro area. Inflation will slow down in 2004 to just 0.7 per cent, mainly as a result of lowered alcohol prices. The current account will remain substantially in surplus.

The Government's fiscal policy is geared to supporting growth. In 2003 the structural surplus in general government finances will be reduced by around one GDP percentage point, in 2004 by somewhat less. If international demand recovers as expected, foreign trade will join domestic demand in supporting growth and total output will increase by 2.7 per cent. It is expected that growth will continue at more or less the same rate in 2005-2007 and that the unemployment rate will continue to come down.

## 2 ECONOMIC SITUATION AND OUTLOOK

Economic prospects for 2004 remain uncertain, but the risks of slower-than-forecast development have abated especially since the US economy has been gathering momentum. Domestic demand is supported by the substantial growth of household purchasing power in 2004 as a result of tax cuts and the slowdown of inflation, which will at once maintain strong growth of consumption.

The estimates of economic growth and associated factors in 2003-2004, as presented in Table 1, are based upon Ministry of Finance forecasts that were updated in November. The estimates for international developments in 2003-2005 are based on the same set of assumptions as the forecasts published by the Commission in October 2003.

### 1. Growth and associated factors

|   | 2002  | 2003* | 2004* | 2005** | 2006** | 2007** |
|---|-------|-------|-------|--------|--------|--------|
| GDP growth at constant market prices, %                         | 2.2   | 1.4   | 2.7   | 2.5    | 2.4    | 2.4    |
| GDP level at current market prices, EUR bn                      | 139.7 | 141.9 | 146.2 | 151.3  | 156.7  | 162.3  |
| GDP deflator, % change  | 1.1   | 0.1   | 0.3   | 1.0    | 1.2    | 1.2    |
| HICP, % change  | 1.6   | 1.0   | 0.7   | 1.3    | 1.8    | 1.8    |
| Employment <sup>1)</sup> , % change                             | 0.2   | -0.2  | 0.3   | 0.3    | 0.2    | 0.2    |
| Labour productivity <sup>2)</sup> , % change                    | 2.0   | 1.6   | 2.4   | 2.2    | 2.2    | 2.2    |
| Unemployment rate, %  | 9.1   | 9.1   | 8.8   | 8.4    | 8.0    | 7.7    |
| <b>Sources of growth: percentage changes at constant prices</b> |       |       |       |        |        |        |
| 1. Private consumption expenditure                              | 1.5   | 3.2   | 2.6   | 2.0    | 1.7    | 1.7    |
| 2. Government consumption expenditure                           | 4.0   | 2.1   | 1.5   | 1.4    | 1.3    | 1.1    |
| 3. Gross fixed capital formation                                | -4.0  | -4.0  | 1.1   | 0.7    | 1.1    | 1.1    |
| 4. Changes in inventories as a % of GDP                         | -0.2  | 0.0   | 0.0   | 0.0    | 0.0    | 0.0    |
| 5. Exports of goods and services                                | 4.9   | 1.6   | 5.1   | 5.1    | 5.0    | 5.0    |
| 6. Imports of goods and services                                | 1.3   | 1.5   | 4.0   | 3.7    | 3.6    | 3.6    |
| <b>Contribution to GDP growth, % points</b>                     |       |       |       |        |        |        |
| 7. Final domestic demand  | 0.8   | 1.3   | 1.8   | 1.4    | 1.3    | 1.3    |
| 8. Changes in inventories                                       | -0.2  | 0.0   | 0.0   | 0.0    | 0.0    | 0.0    |
| 9. Net exports  | 1.6   | 0.2   | 0.9   | 1.0    | 1.1    | 1.1    |
| <b>Assumptions (Commission)</b>                                 |       |       |       |        |        |        |
| Short-term interest rate (3-month money market)                 | 3.3   | 2.3   | 2.3   | 3.2    | -      | -      |
| Long-term interest rate (10-year government bonds)              | 4.9   | 4.1   | 4.4   | 4.8    | -      | -      |
| USD/EUR exchange rate   | 1.1   | 0.9   | 0.9   | 0.9    | -      | -      |
| EU-15, GDP growth, %  | 1.1   | 0.8   | 2.0   | 2.4    | -      | -      |
| World import volumes, excluding EU, %                           | 3.2   | 6.3   | 8.3   | 8.6    | -      | -      |
| Oil prices, (Brent, USD/barrel)                                 | 25.0  | 28.3  | 25.6  | 24.1   | -      | -      |

<sup>1)</sup> National accounts.

<sup>2)</sup> GDP growth at market prices per person employed at constant prices

## *2.2 Medium-term macroeconomic scenario*

---

The medium-term macroeconomic projections offered here are based on the assumption that both the global and the EU economy will develop in line with the Commission's short-term forecast published in October 2003 (Table 1). The medium-term estimates for 2005-2007 are based upon surveys of longer term growth prospects in the economy. One of the key factors impacting economic growth is that the population of working age will cease to grow by the end of the decade. Even before that, however, the population available for work will begin to dwindle, in spite of the rising age of exit from the labour market. Nonetheless the numbers employed will still continue to rise, with the unemployment rate expected to fall and the labour participation rate to increase somewhat.

It is anticipated that productivity growth will more or less follow the long-term historical trend, albeit at a markedly slower rate than in the 1990s, with service industries showing lower-than-average productivity growth accounting for much of the growth in employment. Real earnings are expected to increase in line with average growth in productivity. Projections for expenditure and revenue developments in general government are outlined under chapters 3 and 5.

The projection works from the assumption that the world economy will continue to recover and that economic growth in the EU area will accelerate to almost 2.5 per cent in 2005. This will also bolster demand for Finnish exports. It is estimated that the volume of exports will grow by around 5 per cent a year between 2005 and 2007, which is bound to increase business investment. With unemployment expected to fall and real earnings to increase, household income will rise. Rising incomes and positive economic momentum, in turn, will boost consumer demand.

Despite continuing uncertainties in the economic situation and longer term challenges, growth prospects in the Finnish economy are fairly good in the medium term. The current account is substantially in surplus, net foreign debt has turned into net foreign receivables and Finnish exports are in a strong competitive position, in spite of heavy pressures of globalisation. Finland's production structure is concentrated in areas of high technology know-how, where international competition is now stiffening. On the other hand, the substantial investments made in human capital are a major asset in this situation. As the global economy gathers pace, Finnish export industries will be well placed to take advantage.

In the domestic marketplace, too, the markets are expanding as the demand for health care and nursing services, for instance, is continuing to grow with the ageing of the population. Domestic production has not yet taken full advantage of the potential offered by new technology for improving productivity.

## 2 ECONOMIC SITUATION AND OUTLOOK

If the international economy develops favourably in the medium term and if domestic cost trends remain moderate, average economic growth between 2003 and 2007 will amount to around 2½ per cent a year. This would be a much slower rate than in the latter half of the 1990s. The employment rate is expected to remain more or less unchanged at around 67½ per cent, while the declining labour supply will bring down the unemployment rate to less than 8 per cent.

In addition to the baseline scenario, slower and faster growth scenarios have also been drawn up for this Programme. These are described under chapter 5.1.

---

## 3 GENERAL GOVERNMENT: BALANCE AND DEBT IN 2003-2007

### *3.1 Fiscal policy strategy*

---

The Government's main economic policy goal is to create jobs for at least 100,000 persons by the end of the electoral period. In line with this economic policy that is aimed at supporting employment and fostering stable economic growth, the Government will continue efforts to improve the functioning of product, capital and labour markets and secure an internationally competitive environment for business and industry.

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

For reasons of securing the sustainability of central government it is necessary to reduce the central government debt-to-GDP ratio. Indeed the aim is that central government finances shall be in balance at the end of the electoral period, as measured in national accounts terms. The spending limits for the period between 2004 and 2007 were approved in May 2003. Based on these limits, total expenditure in central government may increase by nearly one per cent a year in real terms on average during this period, with most of the increase coming in 2004.



In the estimates presented in this Programme, central government spending for 2003 is in line with the Budget and the two supplementary budgets. Central government spending in 2004 is based on the 2004 Budget Proposal, and in 2005-2007 it is expected to remain within the spending limits. Spending beyond those limits is estimated on the basis of assumptions concerning economic trends in development.

## *3.2 General government balance and debt*

---

The surplus in general government will fall in 2004 to an estimated 1.7 per cent of GDP. It is expected that the surplus-to-GDP ratio will rise to 2 per cent in 2005 and by the end of the Stability Programme period to over 2 per cent.

Having shown a surplus since 2000, central government finances are expected to fall into deficit again in national accounts terms during the period of this Stability Programme.

With tax revenues slowing down and spending continuing to rise, local government is in deficit in 2003 and expected to remain slightly in deficit from 2004 through to 2007. Uncertainties about the revenue base and growing expenditure pressures mean that the financial situation in local government will remain tight over the next few years, although the situation of individual municipalities will continue to vary widely. Nonetheless local governments are required to maintain their finances at least roughly in balance over a three-year planning period.

The financial surplus in social security funds is set to fall somewhat in 2003 and 2004 as a result of cuts implemented in social security contributions, but once they are raised again the surplus is expected to grow to around 3 per cent of GDP. The surplus in social security will be accumulated in statutory earnings-related pensions funds, while finances in the other social security funds – namely the Social Insurance Institution and the unemployment insurance fund – are mainly based on the pay-as-you-go system and are close to balance. With rising health insurance expenses and lowered health insurance contributions payable by pensioners, central government on-budget funds to the Social Insurance Institution will increase in 2003. The unemployment insurance fund will be in deficit in 2003 because of reductions in unemployment insurance contributions; the deficit will be covered by releasing reserves from the cyclical buffer included in the fund. All in all, with the exception of earnings-related pension institutions, social security funds will be more or less in balance over the review period.

The market value of the assets in statutory earnings-related pensions funds at year-end 2003 is around 53 per cent of GDP. The buffer funds that were motivated by Finland's participation in Economic and Monetary Union, reached their full level ahead of schedu-

le. The maximum in the buffer accumulated within the equalisation fund of the private sector earnings-related pension scheme corresponds to 2½ per cent of the annual payroll in the private sector, while the buffer that has been accrued in the unemployment insurance fund corresponds to annual earnings-related unemployment benefit expenses corresponding to an unemployment rate of 3.6 per cent.

As far as social security funding is concerned, the period from 2004 to 2007 remains one of preparation: with the continuing ageing of the population, the situation will rapidly deteriorate after the period under review. The longer term challenges presented by the ageing of the population to the national economy and public finances are discussed in closer detailed under chapter 6.

The central government debt-to-GDP ratio has dropped by 4½ percentage points from 2000 to 2003, and indebtedness will continue to show a marginally declining trend through to the end of the period under review. The stock of debt in local government is growing marginally, but no significant changes are anticipated in the debt-to-GDP ratio by 2007.

General government gross debt is expected to drop to around 44½ per cent of GDP in 2007, or by one-half of a percentage point from the level at year-end 2003. The surplus in general government will accumulate in the form of net growth in other financial assets, as illustrated in Table 3, since the surplus will be accrued almost entirely in earnings-related pension funds.

### *3.3 Structural balance in public finances*

---

Over the review period it is expected that the cyclically adjusted structural surplus in general government will be slightly higher than the projected surplus (Table 4). The cyclical factor in the surplus, which is assessed by factoring out business cycle effects by means of the deviation from calculated potential output, will be slightly negative over the first years of the projection period and approximate zero towards the end of this period.

Projections for potential output growth are based upon the EU Commission's econometric method, which is used in assessing the attainment of the fiscal policy objectives set out in stability and convergence programmes. Model calculations suggest that potential output growth in Finland has been slowing down in recent years and currently stands at just over two per cent. The growth rate looks set to continue to fall over the projection period as a result of slow business investment and weak employment trends.

### 3 GENERAL GOVERNMENT: BALANCE...

#### 2. General government budgetary developments, % of GDP

|                                    | 2002 | 2003* | 2004* | 2005** | 2006** | 2007** |
|------------------------------------|------|-------|-------|--------|--------|--------|
| <b>Financial balance</b>           |      |       |       |        |        |        |
| General government                 | 4.2  | 2.3   | 1.7   | 2.1    | 2.1    | 2.2    |
| Central government                 | 1.4  | -0.1  | -0.7  | -0.8   | -0.9   | -0.9   |
| Local government                   | -0.3 | -0.5  | -0.4  | -0.2   | -0.2   | -0.1   |
| Social security funds              | 3.0  | 2.8   | 2.8   | 3.0    | 3.2    | 3.2    |
| <b>General government</b>          |      |       |       |        |        |        |
| Total revenues                     | 51.9 | 51.0  | 50.4  | 50.8   | 50.8   | 51.0   |
| Total expenditures                 | 47.7 | 48.7  | 48.7  | 48.7   | 48.8   | 48.8   |
| Financial surplus                  | 4.2  | 2.3   | 1.7   | 2.1    | 2.1    | 2.2    |
| Net interest payments              | 0.2  | 0.1   | -0.1  | -0.3   | -0.3   | -0.4   |
| Primary balance                    | 4.4  | 2.4   | 1.6   | 1.8    | 1.8    | 1.8    |
| <b>Components of revenue</b>       |      |       |       |        |        |        |
| Taxes                              | 33.1 | 32.1  | 31.5  | 31.6   | 31.5   | 31.4   |
| Social security contributions      | 12.4 | 12.4  | 12.4  | 12.5   | 12.7   | 12.8   |
| Other revenues                     | 6.5  | 6.5   | 6.5   | 6.6    | 6.7    | 6.7    |
| Total revenues                     | 51.9 | 51.0  | 50.4  | 50.8   | 50.8   | 51.0   |
| <b>Components of expenditures</b>  |      |       |       |        |        |        |
| Collective consumption expenditure | 7.6  | 8.0   | 8.0   | 8.1    | 8.1    | 8.1    |
| Individual consumption expenditure | 14.0 | 14.5  | 14.8  | 14.9   | 15.1   | 15.2   |
| Social income transfers            | 16.8 | 17.2  | 17.3  | 17.3   | 17.3   | 17.3   |
| Interest payments                  | 2.2  | 2.1   | 2.0   | 1.9    | 2.0    | 2.1    |
| Subsidies                          | 1.4  | 1.4   | 1.4   | 1.4    | 1.3    | 1.3    |
| Gross fixed capital formation      | 2.9  | 2.7   | 2.5   | 2.4    | 2.4    | 2.3    |
| Other expenditures                 | 2.7  | 2.8   | 2.7   | 2.7    | 2.6    | 2.5    |
| Total expenditures                 | 47.7 | 48.7  | 48.7  | 48.7   | 48.8   | 48.8   |

#### 3. General government debt developments, % of GDP

|  | 2002 | 2003* | 2004* | 2005** | 2006** | 2007** |
|--|------|-------|-------|--------|--------|--------|
| Gross debt level, % of GDP                       | 42.7 | 45.1  | 44.7  | 44.9   | 45.0   | 44.6   |
| Change in gross debt, %                          | -1.3 | 2.4   | -0.3  | 0.1    | 0.1    | -0.3   |
| <b>Contributions to changes in gross debt, %</b> |      |       |       |        |        |        |
| Primary balance                                  | -4.4 | -2.4  | -1.6  | -1.8   | -1.8   | -1.8   |
| Net interest payments                            | 0.2  | 0.1   | -0.1  | -0.3   | -0.3   | -0.4   |
| Impact of nominal increase in GDP                | -1.4 | -0.7  | -1.4  | -1.5   | -1.6   | -1.6   |
| Stock flow adjustments                           | 4.3  | 5.4   | 2.7   | 3.7    | 3.8    | 3.5    |
| - Public sector consolidation                    | -2.3 | 2.2   | 0.0   | 0.0    | 0.0    | 0.0    |
| - Privatisation receipts                         | -0.9 | -0.3  | -0.3  | -0.3   | -0.3   | -0.3   |
| - Net accumulation of financial assets           | 7.6  | 3.5   | 3.0   | 4.0    | 4.1    | 3.7    |
| Implicit interest rate on debt                   | 5.2  | 4.7   | 4.4   | 4.3    | 4.5    | 4.7    |

**4. Cyclical developments, % of GDP**

|   | 2002 | 2003* | 2004* | 2005** | 2006** | 2007** |
|---|------|-------|-------|--------|--------|--------|
| 1. GDP growth at constant prices                  | 2.2  | 1.4   | 2.7   | 2.5    | 2.4    | 2.4    |
| 2. General government financial balance, % of GDP | 4.2  | 2.2   | 1.7   | 2.0    | 2.1    | 2.2    |
| 3. Interest payments, % of GDP                    | 2.2  | 2.1   | 2.0   | 1.9    | 2.0    | 2.1    |
| 4. Potential GDP, % change                        | 3.2  | 2.6   | 2.5   | 2.1    | 2.0    | 2.0    |
| 5. GDP output gap                                 | -0.2 | -1.3  | -1.1  | -0.7   | -0.4   | 0.0    |
| 6. Cyclical budgetary component, % of GDP         | -0.1 | -0.8  | -0.7  | -0.4   | -0.2   | 0.0    |
| 7. Cyclically-adjusted balance, % of GDP          | 4.3  | 3.0   | 2.4   | 2.4    | 2.3    | 2.2    |
| 8. Cyclically-adjusted primary balance, % of GDP  | 6.5  | 5.1   | 4.3   | 4.3    | 4.3    | 4.3    |

### 3 GENERAL GOVERNMENT: BALANCE...

---

## 4 SENSITIVITY ANALYSIS AND COMPARISON WITH LAST YEAR'S PROGRAMME

### *4.1 Risks in economic developments and their impact on public finances*

---

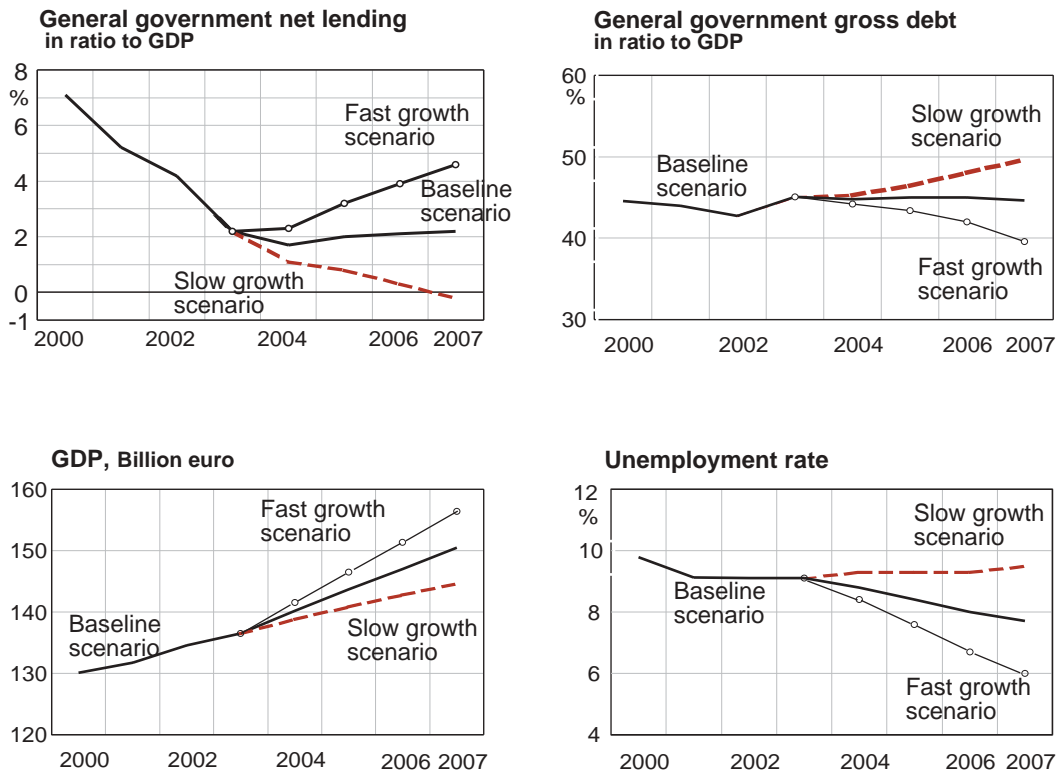
The economic developments projected in this Stability Programme involve certain risks, even in the short term. Growth in the global economy may be slower than forecast, as there is much uncertainty about the sustainability of economic recovery in the US and there are still no firm signs of recovery in the euro region. Domestically, the prominent role of technology industries in the Finnish economy is an additional source of uncertainty. It is notoriously difficult to predict future demand for products in these industries, which have moved and are continuing to move production to cheaper labour countries, particularly China. On the other hand, fiscal policy measures are expected to have a significant stimulative impact in 2004. Developments in the Finnish economy may therefore deviate in either direction from the projections of the Stability Programme

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

Growth may be faster than the projections of the baseline scenario if productivity and the employment rate can be raised in line with targets. Apart from sustained vigorous growth in overall productivity, this will require new business investment in a situation where structural adjustment in the IT industry, for instance, is leading to the relocation of production out of Finland. It is also important to improve productivity in the service sector, including public services. Employment, for its part, can be raised by further improving the effectiveness of labour markets, by improving incentives in tax and benefit systems to make work pay, and by making the education system more effective.

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

**Figure 2. General government net lending, general government gross debt, GDP growth and unemployment rate in the different scenarios**



In the slow growth alternative, production growth would average around 1.5 per cent between 2004 and 2007, and the unemployment rate would increase to around 10 per cent. General government finances would remain in surplus throughout the review period, but central government finances would show a deficit. The debt ratio in central government would start rising, undermining longer term prospects due to the ageing of the population.

In the more favourable scenario, economic growth would rise to almost 3.5 per cent and the unemployment rate would drop to 6 per cent. In this scenario the general government surplus would increase to around 4 ½ per cent of GDP and central government would also show a surplus.

In the light of these calculations, general government would remain in surplus even if economic growth turned out to be somewhat slower than anticipated in the baseline scenario.

## *4.2 Comparison with last year's Stability Programme update*

---

The previous Stability Programme update for 2002 predicted GDP growth at 1.6 per cent, whereas current preliminary data put the figure at 2.2 per cent. Developments in the labour markets were close to projections, inflation was somewhat slower than anticipated. The surplus in general government was 4.2 per cent of GDP, compared to the prediction of 3.8 per cent in the previous Stability Programme update.

Views on economic developments in 2003 have changed more profoundly. The slow-down in economic growth towards the end of 2002, its grinding to a halt at the beginning of 2003 and the delay in international economic recovery mean that GDP growth will remain at 1.4 per cent, well short of the 2.8 per cent forecast in the previous Stability Programme update. On the other hand, it would seem that because of strong growth in household consumption, the surplus in general government as a proportion of GDP will be no more than 0.5 percentage points smaller than predicted, standing at a strong 2.2 per cent of GDP. The central government surplus-to-GDP ratio will remain smaller than forecast in the 2002 update, largely because of certain increases in expenditures as well as cuts in income taxes that were brought forward for cyclical reasons.

Central government debt is set to increase in 2003 both in value terms and as a proportion of GDP: this is because the removal from the State Treasury's balance sheet of the repo portfolio or central government debt held by the Treasury itself that was no longer required for government debt servicing, has increased the amount of debt shown in the statistics. Accordingly the ratio of general government gross debt to total output increased by 3.2 percentage points from the previous Stability programme update.



#### 4 SENSITIVITY ANALYSIS AND COMPARI...

The growth forecast for 2004 has been raised only marginally since autumn 2002. Economic growth is slowly picking up from a somewhat lower level. This has its background in the slow recovery of the international economy.

It is predicted that the surplus in general government in 2004 will be somewhat lower than anticipated in last year's Stability Programme update. This is explained by slower growth and by a more stimulative fiscal policy. In 2005, general government surplus is still expected to remain smaller than previously forecast. The general government debt-to-GDP ratio is higher than envisaged in last year's update, but will continue to decline.

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

|   | 2002 | 2003* | 2004* | 2005** | 2006** | 2007** |
|---|------|-------|-------|--------|--------|--------|
| <b>GDP growth</b>                           |      |       |       |        |        |        |
| Previous update (2002) %                    | 1.6  | 2.8   | 2.6   | 2.5    | 2.4    | -      |
| Latest update (2003) %                      | 2.2  | 1.4   | 2.7   | 2.5    | 2.4    | 2.4    |
| Difference, % points                        | 0.6  | -1.4  | 0.1   | 0.0    | 0.0    | -      |
| <b>General government financial balance</b> |      |       |       |        |        |        |
| Previous update (2002) % of GDP             | 3.8  | 2.7   | 2.1   | 2.6    | 2.8    | -      |
| Latest update (2003) % of GDP               | 4.2  | 2.2   | 1.7   | 2.0    | 2.1    | 2.2    |
| Difference, % points                        | 0.4  | -0.5  | -0.4  | -0.6   | -0.7   | -      |
| <b>Gross debt levels</b>                    |      |       |       |        |        |        |
| Previous update (2002) % of GDP             | 42.5 | 41.9  | 41.9  | 41.4   | 40.7   | -      |
| Latest update (2003) % of GDP               | 42.7 | 45.1  | 44.8  | 44.9   | 45.0   | 44.6   |
| Difference, % points                        | 0.2  | 3.2   | 2.9   | 3.5    | 4.3    | -      |

Stability programme update, november 2002

Stability programme update, november 2003

---

## 5 GENERAL GOVERNMENT REVENUE AND EXPENDITURE

---

### *5.1 Government policy*

---

The government's fiscal policy objective is to maintain strong central government finances. This is essential if public finances are to cope with the financial implications of population ageing over the next few decades without placing an unreasonable tax burden on future generations. Sustainable central government finances are also essential if the Government is to have adequate fiscal leeway to ensure economic growth under all circumstances. To achieve these goals, the central government debt-to-GDP ratio must be reduced (excluding cyclical deviations).

---

### *5.2 General government revenue and taxation*

---

Central government revenue in 2003-2004 is in line with the 2003 forecast and the November update. Beyond 2004, tax revenues are estimated on the basis of the medium-term macroeconomic scenario. It is anticipated that tax scales for wage and salary income shall be revised annually in order to keep taxes from rising. The revenue estimates make provision for the reduction in revenues that is set to follow with the reform of corporate taxation in 2005. The content of the reform is described in chapter 7.2.

With economic integration expanding and deepening and with international tax competition stiffening during the programme period, there is also mounting pressure in wage and capital income taxation. However, it is extremely difficult to assess to exact extent and timing of this pressure. The medium-term scenario has the assumption that tax competition will slow down the growth of corporate income tax revenue.

Administratively, general government in Finland consists of central government administration, local government administration (comprising municipalities and federations of municipalities) and social security funds. Although the employment pension system is mainly run by private insurance companies, it is classified (among other reasons because of its statutory nature) under social security funds belonging to general government.

The projections for local government finances are based on the estimates of the Advisory Board for Municipal Economy and Administration and on the macroeconomic scenario described above. The development of the financial position of social security funds is determined by macroeconomic trends on the basis of current legislation and forthcoming amendments.

General government revenue as a proportion of GDP will decline during the first years of the projection period, primarily because of the timing of tax cuts. In addition to the cuts in income taxes, revenue from corporate income tax and alcoholic beverages will decrease.

Revenue from income and property taxes will decrease in 2003 by almost 4 per cent; both central and local government will see a slight decrease in tax receipts on the previous year. Revenue from corporate income tax is returning to normal after peak years. The tax base for personal taxation is set to grow, but tax revenues will initially decline with the introduction of tax cuts worth 0.75 billion euros (½% of GDP). Revenue in social security contributions will increase in 2003 by no more than a couple of per cent, partly as a result of the lowered basis for charging contributions.

Tax revenue is expected to show only marginal growth in 2004. Income and property tax receipts will be up by 1½ per cent, while taxes on production and imports will remain more or less unchanged. The immediate effect of lower tax scales and higher tax deductions will reduce tax revenues by 0.8 billion euros (½% of GDP).

As a result of changes in tax bases, the tax rate for earned income will be reduced on average by 1½ percentage points in the low and medium income brackets and by just over one percentage point in the high income bracket. Overall it is expected that tax revenues will increase by one per cent in 2004.

In step with EU enlargement, the Government is going to have to reduce the taxation of alcoholic beverages in 2004 in order to secure the tax base. The duty rates in new Member States are significantly lower than the current rates in Finland, and duty free quotas for the importation of alcoholic beverages will be lifted. It is anticipated that increased imports by travellers and tax cuts will together reduce tax receipts by 0.5 billion euros (0.4% of GDP). Tougher international tax competition related to the broadening and deepening of economic integration will hamper growth in tax revenue in general, which in turn will gradually erode the tax base.

During the period from 2000 through to 2004, taxes levied on wages have been reduced by a sum equivalent to around 3 per cent of GDP. Wage earners' average tax wedge (i.e. the ratio of income taxes, social security contributions payable by employees and employers and VAT to labour costs) has decreased with the easing of the bases for levying taxes and contributions. In 2004 the overall tax wedge will be reduced by around one percentage point to 54.7 per cent. Since 2000, the tax wedge has decreased by 4 percentage points and since 1995 by 5½ percentage points. In the low income brackets the tax wedge has been reduced since 2000 by an estimated 4.4 percentage points to 50.4 per cent, in the high income brackets by 3.7 percentage points to 59.6 per cent.

In spite of these tax cuts and changes in the tax structure, overall taxation remains very high when considered from the point of view of job creation. Indeed, steps are needed to further lower taxes on labour. Apart from general employment considerations, international tax competition is creating pressure to ease the taxation of highly qualified professionals. The Stability Programme works from the assumption that income tax scales will be adjusted in 2005-2007 in such a way as to hold stable the tax rate for income earners.

Earnings-related pension contributions are expected to rise somewhat in 2004-2007 so that provision can be made for the impending rise in pension expenditure. As part of the pension reform, the labour market organisation agreed to raise the prefunding rate of earnings-related pensions until 2013.

### *5.3 General government expenditure*

---

The ratio of general government expenditure to GDP has fallen by around 10 percentage points since 1995. In 2003 the figure stands at about 48 per cent, where it is expected to stay through to the end of the programme period.

Public spending will grow faster than GDP in 2003: increases will be recorded among others in social benefits and allowances as well as in local government consumption expenditure.

It is expected that central government spending will grow faster than in earlier years, in part because of increasing social transfers and local government financing. Central government subsidies to local authorities shall be increased with a view to raising service standards. In addition, all losses in municipal revenue resulting from tax cuts will be compensated to municipalities in full. In the 2004 Budget Proposal central government expenditure is up by almost 4 per cent on the appropriations in the 2003 Budget Proposal. However, spending in the ministries (excluding debt interest payments) is set to increase by 6 per cent in value terms and 4 per cent in real terms; around half of this is attributable to increases in appropriations required by current

legislation and decisions made during the previous electoral period, while the other half is due to increases in spending decided upon in connection with the new Government Programme and to compensations payable to other public sector tax recipients on account of cuts made in earned income taxation.

The Government has adopted a programme for the development of welfare services and income transfers in which the additional resources made available will be allocated as effectively as possible with a view to supporting job creation and the growth potential of the economy.

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

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

In autumn 2003 the Government will be deciding upon measures to bring forward the commencement of higher education. At the same time the student financial aid system will be developed with a view to providing stronger incentive for graduation. Working in close consultation with labour market organisations, the Government will also be looking into ways in which to postpone retirement by encouraging older employees to stay on at work and reducing incentives for employers to get rid of older employees. Decisions concerning the taxation of low-wage jobs will be drafted during 2004 so that they can be implemented in the 2005 Budget Proposal. The tax wedge for low-wage jobs will be reduced on both the employee and employer side, i.e. by cutting the taxes of low-income wage earners and by lowering employer contributions.

As far as local government finances are concerned, the 2004 state budget is more or less neutral. It is expected that the growth of local government consumption expenditure will slow down to five per cent in nominal terms and one-and-a-half per cent in real terms. Investment is expected to decline.

Expenditure in social security funds is expected to grow faster than total output. The pension reforms implemented are already beginning to slow down the growth of pension expenditure. Sickness insurance benefit payments continue to grow rapidly, alt-

though the introduction of generic substitution in April 2003 has significantly curbed the rise of drug costs.

The ratio of general government expenditure to GDP will remain more or less unchanged during the period from 2004 to 2007. The Government Programme sets out in some detail the principles for the most important income transfers over the current electoral period, i.e. through to 2007. The new spending limits procedure also supports the management of public spending.

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



---

## 6 SUSTAINABILITY IN PUBLIC FINANCES

---

### *6.1 Measures aimed at fostering sustainability*

---

Finland's longer term public finances are overshadowed by the impending rise in costs due to population ageing and by the decline of the revenue base resulting from the dwindling labour supply. The impacts of population ageing will soon begin to affect economic developments: the increase in pension expenditures will begin to gather pace and the numbers in the labour force will begin to decline by around the turn of the decade, once the babyboom generations who were born after the war reach retirement age.

Provision for the financial and expenditure pressure caused by the ageing population has been made by

- bolstering central government finances by means of a strict spending policy and reducing indebtedness;
- prefunding for future pensions and reforming pension schemes; and by
- fostering growth potential in the economy.

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



Pension schemes have been reformed and updated on several occasions over the past ten years. The most recent comprehensive package of reforms will be phased in primarily from the beginning of 2005. The aim of these reforms is to provide incentives for older people to stay on longer at work and to postpone retirement in the longer term by at least three years. The reform of the earnings-related pension scheme was based upon the guidelines drafted by labour market organisations and central government. The bills concerning the reform of private-sector earnings-related pensions were passed by Parliament during winter 2003. Corresponding changes will also be made to pensions in the public sector: the aim is to have the relevant legislation endorsed by the end of 2003.

The pension reforms that will be phased in from 2005 onwards are aimed at encouraging longer employment, supporting workplace health promotion and creating job opportunities. However some of the reforms have already been put into place during 2003, when for instance the minimum age of eligibility for part-time pension increased by two years. The most important elements of the reform are as follows:

- Early retirement schemes will be discontinued and replaced by a flexible old-age pension: persons aged between 62 and 68 are eligible.
- The so-called super pension accrual rate (at 4.5% a year) in the age range 63-68 is aimed at encouraging people to stay on at work longer.
- The removal of the pension ceiling (at 60% of income) has the same objective.
- A mechanism where pension security is adjusted to changes in life expectancy will be introduced to eliminate the increase in earnings-related pensions expenses arising from longer life expectancy.
- To offset the rise in employment pension contributions, the prefunding of pensions will be stepped up as from 2003 for a fixed period.
- In the future pensions will be determined according to the individual's entire employment history instead of the present 10-year rule.

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

These reforms of pension and unemployment security have clearly increased the financial incentive to stay on at work for longer than before, and they significantly strengthen the sustainability of public finances among other things by reducing long-term pressure to charge higher earnings-related pension contributions (see chapter 6.2 for more details).

In spite of these reforms, long-term sustainability in public finances requires that deficits in central government are avoided. Reducing central government indebtedness and interest outlays will help to make provision for financing the growing expenditure resulting from population ageing.

Long-term sustainability in public finances will also require a higher employment rate. It is forecast that the average rate of employment in 2004 will be 67.5 per cent. Despite several years of sustained economic growth and reforms to improve the functioning of labour markets, the employment rate is still lower than before the recession in the early 1990s. The fact that the employment rate stopped rising in 2002 was due to the slowdown of economic growth. The pension reforms and other structural changes will only begin to take full effect on the employment rate after a certain delay. Changes in the population's age structure will make the challenge of raising the employment rate even greater. The aim is to lengthen the amount of time that people spend in employment at both ends, i.e. to lower the age at entry into the labour market and to raise the age at exit.

It has proved harder than expected to resolve the problem of structural unemployment that was created in the early 1990s: the unemployment rate is still high. Lowering the level of structural unemployment is important not only for reasons of creating economic opportunities and for the functioning of the labour markets, but also for reasons of preventing marginalisation. At the same time it is necessary to take steps to increase the labour supply, and the skills and competencies of the workforce must be brought more closely in line with the changing needs of the workplace. In an attempt to improve the employment prospects of persons with reduced employment capacity, steps are being taken to set up labour service centres in cooperation with different authorities. Existing and new services for people with the weakest employment capacity and the relevant resources will be provided centrally at these centres. The labour policy programme is described in greater detail in the national action plan for employment that was drawn up in October 2003.

## 6.2 Sustainability scenario

---

Finland's major economic policy challenges in the longer term relate to the ageing of the population and to the resulting loss of labour force and growth in public expenditure. By 2020, the population structure in Finland will have changed faster than in any other EU Member State. However, Finland has made provision for these challenges by pre-funding a substantial amount of future pension expenditure, by reducing public indebtedness and by reforming tax and social security systems in such a way as to make work pay.

The steps taken to prefund earnings-related pensions and to strengthen central government finances mean that the financial assets of the public sector already exceed public debt. At year-end 2002, the market value of the assets in statutory earnings-related pension funds amounted to almost 51 per cent of GDP. Around half of these assets were invested in bonds and one-quarter in stocks. With current funding principles, the annual financial surplus in earnings-related pension institutions will remain between 3½ and 2½ per cent, and the value of their investments will increase to around 75 per cent of total output by 2030.

With most of its components phased in from the beginning of 2005, it is estimated that the forthcoming pension reform will postpone retirement by almost two years; together with earlier reforms, the combined effect will be more than three years. By 2050, the reform is expected to lower the ratio of pension expenditure to GDP by 1½ percentage points.

Long-term sustainability in public finances is expected to improve largely through the positive incentive effects of the pension reform: it is forecast that they will push up the employment rate from the current figure of 67½ per cent to around 73 per cent in 2050, or 4 percentage points higher than assumed in the EU ageing project, for example. As well as creating a stronger financial base, the pension reform will enhance the sustainability of the pension system and public finances at large by adjusting the level of pension security according to changes in life expectancy.

The Ministry of Finance drew up new sustainability scenarios for general government in October 2003. The base year for these scenarios is 2007, i.e. the year in which the current medium-term projection ends. The scenarios extend to 2050 and are based on Eurostat's population projection from 2000. Unlike the EU scenarios, the new projection for pension expenditure took into account the impacts of the pension reform. On the other hand it was assumed that spending on acute and long-term health care would develop in the same way as in the EU's ageing scenario. The Ministry of Finance

---

<sup>1</sup> Estimates drawn up in the Economic Policy Committee's working party addressing the question of the ageing of the population.

scenario expects the unemployment rate to drop to 7 per cent, with a corresponding decrease in unemployment expenditure. All in all it was estimated that expenditure related to ageing and unemployment would increase from 2000 to 2050 by 6½ percentage points in relation to total output. These estimates are based on an assumption of a fixed tax rate at 43.5 per cent throughout the period under review.

### 6. Long-term public finances, % of GDP

|  | 2000 | 2010 | 2020 | 2030 | 2040 | 2050  |
|--|------|------|------|------|------|-------|
| Overall expenditure                        | 46.7 | 48.1 | 50.3 | 53.4 | 55.5 | 57.7  |
| Pensions                                   | 10.7 | 11.8 | 13.3 | 14.7 | 14.6 | 14.5  |
| Acute health care                          | 4.6  | 4.9  | 5.2  | 5.6  | 5.7  | 5.8   |
| Long-term care                             | 1.6  | 1.9  | 2.2  | 2.7  | 3.3  | 3.3   |
| Unemployment                               | 1.7  | 1.6  | 1.4  | 1.4  | 1.4  | 1.4   |
| Interest expenses                          | 2.8  | 2.2  | 2.5  | 3.3  | 4.8  | 7.0   |
| Other expenditure                          | 25.3 | 25.7 | 25.7 | 25.7 | 25.7 | 25.7  |
| Overall revenue                            | 53.7 | 50.6 | 51.7 | 51.9 | 51.9 | 51.9  |
| Taxes and statutory                        |      |      |      |      |      |       |
| Social security contributions              | 46.9 | 43.9 | 43.9 | 43.9 | 43.9 | 43.9  |
| Other revenue (mainly investment proceeds) | 6.8  | 6.7  | 7.8  | 8.0  | 8.0  | 8.0   |
| Financial surplus                          | 7.0  | 2.5  | 1.4  | -1.5 | -3.6 | -5.8  |
| Primary balance                            | 8.1  | 1.4  | -0.5 | -2.9 | -3.4 | -3.4  |
| Net financial assets <sup>1)</sup>         | 4.0  | 23.8 | 33.5 | 21.3 | -8.6 | -47.5 |
| Gross debt                                 | 52.5 | 43.5 | 44.0 | 58.7 | 87.0 | 125.9 |
| <i>Assumptions</i>                         |      |      |      |      |      |       |
| Labour productivity, % change              | 2.8  | 2.2  | 1.8  | 1.8  | 1.8  | 1.8   |
| Employment rate, %                         | 66.9 | 68.7 | 71.2 | 72.5 | 72.8 | 73.2  |
| Unemployment rate, %                       | 9.8  | 7.0  | 7.0  | 7.0  | 7.0  | 7.0   |
| Real interest rate, %                      | 2.0  | 4.0  | 4.0  | 4.0  | 4.0  | 4.0   |
| Inflation, %                               | 3.4  | 2.0  | 2.0  | 2.0  | 2.0  | 2.0   |

<sup>1)</sup> Financial assets minus gross debt.

According to the baseline scenario, general government will fall into deficit in 2025. From that point on, the deficit will continue to grow so that in 2038 it will rise past the three per cent mark and by 2050 stand at almost 6 per cent of total output. Without adaptive measures then, it seems that the foundations of general government finances are not sustainable. The final results of the calculations are presented in Table 6 and Figure 3.

A target scenario was drawn up to assess the extent of the adaptive measures required. In this scenario it was assumed that general government finances will be consoli-

## 6 SUSTAINABILITY IN PUBLIC FINANCES

dated (expenditures cut and revenues increased) in 2008-2010 in such a way that by 2010, the financial balance in general government in relation to total output is one percentage point better than in the baseline scenario (Table 7 and Figure 3). This should suffice to secure the sustainability of public finances and keep them in surplus until 2040. In 2050 the deficit would stand at 0.9 per cent and gross debt at 57 per cent of total output. The EMU criteria for public finances would be met in each year. However even in this scenario the deficit and indebtedness in both central and local government finances would begin to grow as from 2025.

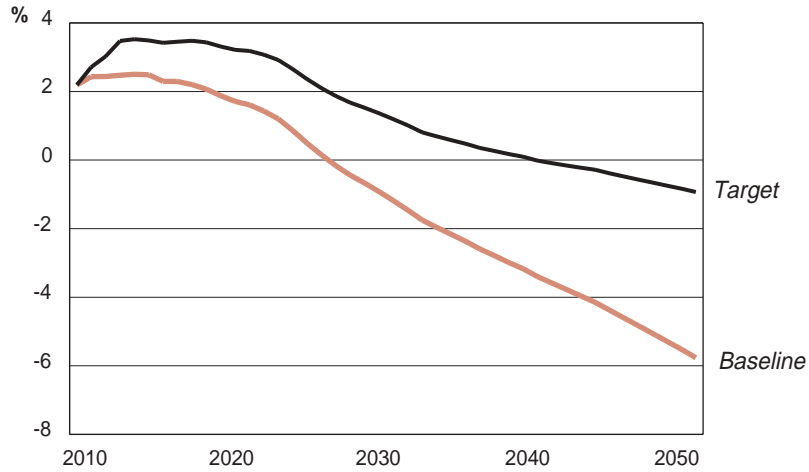
Finland's strategy is largely built on increasing the net financial assets in general government over the next 10-20 years in order to create room for the expenditure increases that are set to follow after this period as a result of population ageing. This will allow part of the growth in public spending to be financed from growing investment proceeds, without having to increase taxation (Figure 4).

There is a risk of a substantially weaker-than-expected development should general government finances decline considerably over the next few years for cyclical reasons, or should the real return on pension fund investments fall well short of the 4 per cent used in the scenario. A further risk is whether the tax rate of 43.9 per cent used in the calculations is internationally competitive in the longer term.

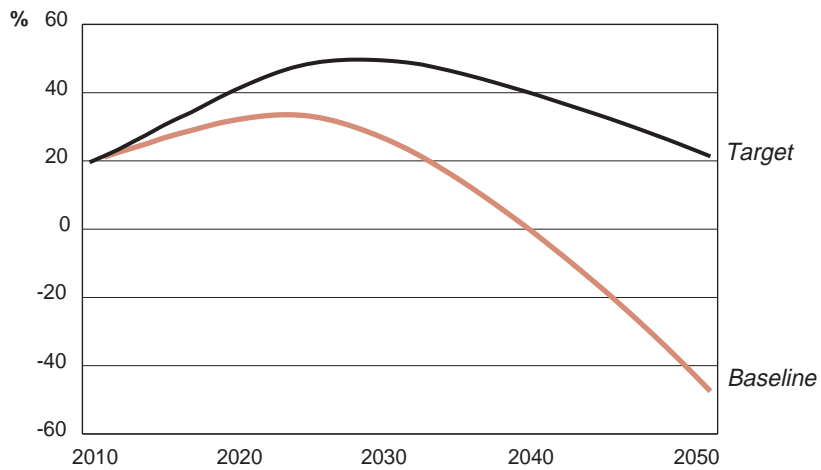
### 7. Public finances according to baseline and target scenario, % of GDP

|                      | 2010              |                 | 2030              |                 | 2050              |                 |
|----------------------|-------------------|-----------------|-------------------|-----------------|-------------------|-----------------|
|                      | Baseline scenario | Target scenario | Baseline scenario | Target scenario | Baseline scenario | Target scenario |
| Financial surplus    | 2.5               | 3.5             | -1.5              | 1.1             | -5.8              | -0.9            |
| Primary balance      | 1.4               | 2.4             | -0.5              | 0.5             | -3.4              | -2.4            |
| Net financial assets | 23.8              | 25.6            | 21.3              | 48.3            | -47.5             | 21.3            |
| Gross debt           | 43.5              | 41.7            | 58.7              | 31.7            | 125.9             | 57.1            |

**Figur 3. General government financial balance in ratio to GDP**



**Figure 4. General government net financial assets 1) in ratio to GDP**



1) Financial assets minus gross debt.



---

## 7 OTHER FACTORS WITH AN IMPACT ON PUBLIC FINANCES

### *7.1 Developing product and capital markets and public service production*

---

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

Competition shall be enforced most particularly in network industries as well as in non-tradable services. The efficiency of the public sector should be improved by facilitating competition, by promoting the benchmarking of public sector efficiency and by increasing public tendering. Furthermore, it is recommended that mechanisms be improved that will help control public spending and that compliance with rules on expenditure be ensured.

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

The objective of the Government's competition policy is to improve market functioning. Unimpeded and equitable access to the markets is the central requirement of competitive business activity. Well functioning markets encourage companies to innovate, invest in new business areas and develop flexible ways of working.

Work to reform the Competition Restrictions Act is currently underway. The aim of this project is to create a uniform operating environment for business companies by harmonising Finland's national competition regulations with EC competition rules. A furt-



## 7 OTHER FACTORS WITH AN IMPACT ON..

her objective is to step up national monitoring of competition restrictions and to facilitate cooperation between national and international competition authorities.

The Government is seeking to achieve planned and verifiable growth in the productivity of public administration and services and to make good use of the productivity benefits. General productivity development objectives will be set within the spending limits and budget procedure, within the basic services programme and performance target agreements. Productivity will be improved by means of structural and operational reform, by using information technology and by making more efficient use of the private sector in the provision of public services.

To improve productivity, the Ministry of Finance has launched a productivity action programme in which each administrative domain draws up a productivity development programme. Implementation of these development programmes will be included in the spending limits and budget proposals beginning in 2005-2007. Working closely with the ministries in charge of central government transfers to local government and the Association of Finnish Local and Regional Authorities, the Ministry of Finance will carry out an assessment of the development of productivity within public service provision. Furthermore, one of the aims of the ongoing reform of municipalities' financing and central government transfer system is to provide incentives to local authorities for improving service efficiency. The reform is due to take effect from the beginning of 2005.

Work to reform the national Public Procurement Act is continuing. The new procurement directives that are under preparation within the EC will probably be ratified by late 2003/early 2004: after that the drafting of a national procurement act can be stepped up. Although the EC procurement directives concern procurements exceeding certain threshold values, the work on preparing national legislation will also involve an examination, in particular, of the competitive tendering principles for procurements that are below the threshold value as well as for the so-called secondary services. Public procurements in Finland are for the most part so small that they fall below the threshold values set out in the directives. From the standpoint of efficient competition it is also necessary to regulate the competitive tendering for procurements that fall below the threshold value.

Efforts will be made to increase public tendering, among other things by increasing advisory services related to public procurements. Working closely with the Association of Finnish Local and Regional Authorities, the Government will be setting up, at the beginning of 2004, an advisory and service point that will have the task of promoting, within the framework of existing legislation, the capabilities of the public sector to utilise the private service sector in the provision of public services. In addition, the role of private service companies in providing public services will be examined.

## 7.2 Reform of corporate and capital income taxation

---

Following a Government decision on 14 November 2003, corporate and capital income taxation will be reformed in Finland as from the beginning of 2005. In view of the objective of sustaining the international competitiveness of the Finnish tax system, the corporate tax rate will be lowered by 3 percentage points to 26 per cent; and the capital income tax rate will be lowered by one percentage point to 28 per cent.

Part of the reform will involve abandoning the *avoir fiscal* tax credit system, which will be replaced by partly double taxation of dividends. In the future, 70 per cent of dividends from listed companies will be treated as taxable capital income for the recipient. Dividends paid out by other limited companies will be free of tax in so far as the proceeds do not exceed 9 per cent of the recipient's net assets. However, the maximum amount that anyone may receive free of tax is 90,000 euros. Beyond that limit, 70 per cent of dividends are treated as taxable capital income. In so far as dividends exceed the 9 per cent limit of net assets, 70 per cent of dividends will be taxable income.

Furthermore, voluntary pension plans which complement the statutory pension scheme, will no longer be taxed as earned income but capital income. At the same time the minimum retirement age under these plans will be raised from 60 to 62 years. The reform changes the tax incidence of pension saving, increasing the level of taxation while saving and reducing taxes when the pension is paid out.

To facilitate the transfer of businesses between generations, the corporate assets transferred will for purposes of inheritance and gift taxation be valued at 40 per cent of their taxable value. At the same time the property tax rate will be lowered, the lower limit for taxable assets raised to 250,000 euros and capital gains taxes levied on private persons increased.

It is difficult to assess the revenue impacts of the reform. According to static calculations tax revenue will decline by more than 300 million euros (0.2% of total output). The changes in tax revenue will affect central government only; their impacts upon local government will be compensated in full. However it is estimated that over time, the reform will also increase tax revenue as it makes business more profitable – but it has not been possible to take account of this dynamic effect in these programme projections.