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DECEMBER 2004 UPDATE OF THE STABILITY PROGRAMME OF FINLAND (2004-2008)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS[1]

On 2 December 2004 the government of Finland approved the updated stability programme and, as with previous updates, submitted it to parliament for information. The update of the stability programme covers the period from 2004 to 2008. The programme broadly complies with the code of conduct, as some of the basic assumptions variables are missing.

The macroeconomic scenario presented in the programme sees the economy growing above 3% in 2004 on the back of robust domestic demand, easing somewhat to a growth rate of 2.8% in 2005. Projected average growth of about 2.5% throughout the programme period seems to be on the cautious side. The short-term forecast is somewhat below the Commission services Autumn 2004 forecast; and also the medium-term projection based on potential output presented in the programme is below the growth potential as estimated by the Commission services.

The government's key budgetary policy objective is to keep central and local government finances close to balance. With social security funds regularly in surplus, the general government balance is to show an annual surplus close to 2% of GDP. According to this policy, balance in central government finances, in national account terms, should be restored at the end of the electoral period in 2007. To help to achieve this target the government in May 2003 approved annual spending limits for the period 2004-2007. Based on these limits, total expenditure of the central government is allowed to increase by nearly 1 per cent a year in real terms on average over that period. As most of the expenditure increase has been frontloaded to 2004, there is less room for manoeuvre within the ceilings in the latter part of the electoral period. Compared with the previous update, the projections for the general government surplus from 2004 to 2007 are virtually unchanged.

Although Finland is set to maintain a favourable public sector surplus, the budgetary outcome could be worse than projected as the baseline budgetary trend presented in the update only partially includes the tax cuts of € 1.7 billion i.e. 1.2% of GDP that supplement the two-and-half-year comprehensive wage agreement concluded at the end of November 2004. As there are no announced plans to decrease spending in 2005-2007, the central government deficit would be higher between 2005 and 2007 than cited in the programme, unless revenue-raising measures are introduced, thereby also lowering the surplus in general government finances. The government estimates that the wage-agreement-cum-tax-cuts will lower the general government surplus by 0.3 percentage points to about 1.9% of GDP in 2007. However, the government expects that the package will strengthen dynamism in the economy by improving the growth potential and job creation and in this way raise the revenue-raising capacity. In view of this risk assessment, the budgetary stance in the programme is sufficient to maintain the Stability and Growth Pact's medium-term objective of a position of close-to-balance for 2004-2008. It also provides a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations for 2004-2008.

[1] This technical analysis, which is based on information available up to 26 January 2005, accompanies the recommendation by the Commission for a Council opinion on the update of the stability programme, which the College adopted on 2 February 2005. It has been carried out by the staff of and under the responsibility of the Directorate-General for Economic and Financial Affairs of the European Commission. Comments should be sent to Timo Hirvonen (timo.hirvonen@cec.eu.int).

The general government gross debt ratio is forecast to remain well below 60% of GDP and be on a downward path throughout the programme period. The current programme projects the debt ratio to fall from an estimated 44.6% of GDP in 2004 to about 41% by 2008. Compared with the previous programme update, the current programme projects the debt-to-GDP ratio to be markedly lower from 2005 onwards due to higher nominal GDP growth, a lower level of central government borrowing, lower interest payments and higher tax receipts. The previous programme projected the debt-to-GDP ratio to remain virtually stable at below 45% of GDP in 2004-2007, compared with the current estimated decline of almost three percentage points.

The programme reviews the government's structural reform programme, which focuses on improving public sector sustainability by the pension reform taking effect in 2005. The reform, following up on earlier measures, is projected to raise the exit age from the labour force by three years to 62-63 years. It also outlines further measures to lower the persistently high structural unemployment. The collective wage contract agreed in late November 2004 supplemented with tax cuts is expected to foster dynamism in the economy and strengthen job creation. The measures taken and put forward by the government can indeed be expected to raise potential growth and strengthen further the sustainability of public finances.

Finland appears to be in a favourable position with regard to long-term sustainability of the public finances, in spite of important projected budgetary costs of an ageing population. The strategy outlined in the programme is broad-based and consists of further debt consolidation and structural reforms e.g. further steps of the pension reform and measures aimed at raising the exit age. The structural reforms enacted and planned should have beneficial effects on the public finances.

Overall, the economic policies outlined in the update are broadly consistent with the country-specific broad economic policy guidelines in the area of public finances. In particular, the multi-annual spending limits introduced in 2003 seem to have worked well in the first year of operation, namely 2004, when the final budgetary spending was below the ceiling and also expenditure in the 2005 budget is within the ceilings. The adherence to the expenditure framework is set to be maintained as it is politically binding.

Table: Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008
Real GDP (% change)	**SP Dec 2004**	**3.2**	**2.8**	**2.4**	**2.2**	**2.0**
	COM Oct 2004	3.0	3.1	2.7	n.a.	n.a.
	SP Nov 2003	*2.7*	*2.5*	*2.4*	*2.4*	*n.a.*
HICP inflation (%)	**SP Dec 2004**	**0.2**	**1.4**	**1.8**	**1.8**	**1.8**
	COM Oct 2004	0.2	1.5	1.7	n.a.	n.a.
	SP Nov 2003	*0.7*	*1.3*	*1.8*	*1.8*	*n.a.*
General government balance (% of GDP)	**SP Dec 2004**	**2.0**	**1.8**	**2.1**	**2.2**	**2.0**
	COM Oct 2004	2.3	2.1	2.2	n.a.	n.a.
	SP Nov 2003	*1.7*	*2.1*	*2.1*	*2.2*	*n.a.*
Primary balance (% of GDP)	**SP Dec 2004**[2]	**3.7**	**3.4**	**3.8**	**3.9**	**3.7**
	COM Oct 2004	4.1	3.9	3.8	n.a.	n.a.
	SP Nov 2003[2]	*3.7*	*4.0*	*4.1*	*4.3*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**SP Dec 2004**[1]	**2.1**	**1.7**	**2.0**	**2.1**	**1.9**
	COM Oct 2004	**2.8**	**2.3**	**2.3**	n.a.	n.a.
	SP Nov 2003[1]	*2.4*	*2.4*	*2.3*	*2.2*	*n.a.*
Government gross debt (% of GDP)	**SP Dec 2004**	**44.6**	**43.4**	**42.5**	**41.7**	**41.1**
	COM Oct 2004	44.8	43.4	42.2	n.a.	n.a.
	SP Nov 2003	*44.7*	*44.9*	*45.0*	*44.6*	*n.a.*

Note:
[1]Commission services calculations on the basis of the information in the programme

[2]The Finnish authorities provide primary balances on the basis of net interest payments rather than gross interest payments. The Commission services have recalculated the figures based on the data given in the programme and those have been used throughout the assessment. The figures provided by the Ministry of Finance can be found from Annex 1 Table 2

Sources:
Stability programme (SP); Commission services autumn 2004 economic forecasts (COM); Commission services calculations

1 INTRODUCTION

On 2 December 2004 the government of Finland approved the updated stability programme and, as with previous updates, submitted it to parliament for information. This is the sixth annual update of the programme presented originally in September 1998. The update covers the period from 2004 to 2008. The programme broadly complies with the code of conduct, as some of the basic assumptions variables are missing[2]. In addition, it includes a detailed breakdown of pension funds assets in Finland.

2 MACROECONOMIC DEVELOPMENTS

The current update sees GDP growth peaking at 3.2% in 2004, abating gradually thereafter to 2% by 2008. For 2004 and 2005, the macro-economic scenario is based on the November 2004 update by the Ministry of Finance, which is slightly more positive than the forecast underlying the government's 2005 budget proposal presented on September 14th 2004. The GDP growth profile has been revised upwards by 0.3 percentage points for 2004 and 0.1 percentage point for 2005. As a consequence, also the public finance projections of the programme for 2004-2005 differ somewhat from those included in the budget proposal.

In comparison with the Commission services autumn 2004 forecast (see Table 1), the programme is somewhat more cautious on growth prospects than the Commission services, which expect economic activity to peak in 2005 and then to ease in 2006 to 2.7% GDP growth. The Commission services expect a relatively larger growth contribution from final domestic demand than the update. On the labour market, both forecasts expect that the solid short-term growth will stimulate job creation and consequently reduce unemployment. The outlook for inflation is similar in both forecasts. Based on the available hard data up to Q3 and survey indicators, the programme assumptions for 2004 seem realistic, for 2005, the projection appears cautious, although the external outlook underlying the programme's macro-economic scenario is in line with the Commission services autumn 2004 forecast.

[2] [2]The Finnish authorities provide primary balances on the basis of net interest payments rather than gross interest payments. The Commission services have recalculated the figures based on the data given in the programme and those have been used throughout the assessment. The figures provided by the Ministry of Finance can be found from Annex 1 Table 2.

Table 1: Comparison of macroeconomic developments and forecasts

	2004		2005		2006		2007	2008
	COM	**SP**	**COM**	**SP**	**COM**	**SP**	**SP**	**SP**
Real GDP (% change)	3.0	3.2	3.1	2.8	2.7	2.4	2.2	2.0
Contributions:								
- Final domestic demand	2.5	2.5	2.2	1.9	2.0	1.8	1.6	1.5
- Change in inventories	-0.1	0.0	-0.2	0.0	0.0	0.0	0.0	0.0
- External balance on g&s	0.6	0.8	1.0	0.9	0.7	0.6	0.6	0.6
Employment (% change)	-0.4	-0.3	0.4	0.5	0.7	0.4	0.1	0.1
Unemployment rate (%)	8.8	8.8	8.6	8.5	8.3	7.9	7.6	7.3
HICP inflation (%)	0.2	0.2	1.5	1.4	1.7	1.8	1.8	1.8
GDP deflator (% change)	0.4	0.2	1.1	1.0	1.5	1.3	1.3	1.3
Current account (% of GDP)	7.5	n.a.	7.5	n.a.	7.4	n.a.	n.a.	n.a.

<u>Sources</u>:
Commission services autumn 2004 economic forecasts (COM); stability programme update (SP)

On 29 November 2004, the social partners settled on a two-and-half-year comprehensive wage agreement, which will give wage increases totalling 2.5% as of March 2005 for 15 months, and another 2.1% as of June 2006 for 16 months. The agreement will allow wages to better reflect productivity differences across sectors in line with a BEPG recommendation for Finland. As part of a political deal related to the incomes contract, the government proposed significant cuts by € 1.7 billion i.e. 1.2% of GDP in the taxation of earned income for 2005-2007. For 2005, the government proposes tax cuts of € 350 million or 0.2% of GDP compared with the programme. For 2006, the government is proposing to cut income taxes by € 810 million i.e. 0.6% of GDP and € 550 million in 2007 i.e. 0.4% of GDP. This more than doubles the government's initial objective of reducing income taxation of at least € 1.12 billion or 0.8% of GDP during the electoral period 2003-2007. The update takes only partially into account the wage development effects and tax cuts proposed in conjunction with the collective wage agreement.

For the latter part of the programme, namely years 2006-08, the projections are based on the economy's long-term growth potential. The programme assumes a gradual deceleration, from 2.6% in 2004 to 2% in 2008 (see Annex 1 Table 4). The estimates for potential GDP growth in the Commission services autumn 2004 forecast (Table 2) and Commission services calculations according to the commonly agreed methodology derived from the information in the stability programme update seem to be similar; both expect the economy's potential to weaken in the coming years. However, in the Commission services projections the level of potential growth is slightly higher than in the update, based on a somewhat higher contribution from labour. However, in both projections the contribution from labour is seen to be on a declining trend, despite rising labour force participation and a declining NAIRU, as the growth in working age population continues to be modest. Capital accumulation and total factor productivity are estimated to contribute in a similar fashion in both calculations. In the estimates based on the data from the update, the output gap is foreseen to widen from 2005 onwards. All in all, the update's projections for 2006-08 seem to be cautious, reflecting the fact that the working age population is assumed to start shrinking before the end of the decade.

Table 2: Sources of potential output growth

	2004		2005		2006		2007	2008
	COM	SP[3]	COM	SP[3]	COM	SP[3]	SP[3]	SP[3]
Potential GDP growth[1]	2.8	2.7	2.7	2.6	2.6	2.5	2.4	2.3
Contributions:								
- Labour	0.6	0.4	0.5	0.3	0.4	0.2	0.2	0.1
- Capital accumulation	0.3	0.3	0.3	0.4	0.4	0.4	0.4	0.4
- TFP	1.9	2.0	1.9	1.9	1.8	1.8	1.8	1.7
Output gap[1,2]	-0.6	-0.3	-0.3	-0.1	-0.1	-0.2	-0.4	-0.6

Notes:
[1]based on the production function method for calculating potential output growth
[2]in percent of potential GDP
[3]Commission services calculations on the basis of the information in the stability programme update (SP)

Sources:
Commission services autumn 2004 economic forecasts (COM); Commission services calculations

3 BUDGETARY IMPLEMENTATION IN 2004

In the November 2003 update of the stability programme, the budgetary target for 2004 was a surplus of 1.7% of GDP. In the current update, the projection for 2004 is 0.3 percentage points higher, at 2.0% of GDP, following mainly from the budgetary impact of GDP growth for 2004 now estimated higher by 0.5 percentage points than in the previous update. Looking at the financial balances within the public sector, local government finances remain in deficit of 0.4% of GDP and the social security funds surplus is 0.4 percentage points lower at 2.4% of GDP than envisaged in the 2003 update, but there is a marked uptick in the estimate for the 2004 central government balance. The 2003 update foresaw that the state finances would post a deficit of 0.7% of GDP in 2004, whereas the current projection is for a zero balance. This results from a higher overall tax intake, even though taxes on alcohol were cut on average by 33%, which was expected to cause a tax revenue loss of € 500 million or 0.4% of GDP. Also the fact that expenditures have been kept under control has contributed to the good result in public finances. As per cent of GDP, the latest programme estimates general government revenues at 50.5%, 0.1 percentage point higher than in 2003 update, while expenditure is 0.2 percentage points lower at 48.5% of GDP. The budgetary results seem to fall slightly short of the Commission services autumn 2004 forecast, which projected the public sector surplus at 2.3% of GDP in 2004.

Looking at the state budget implementation on a cash basis up to November 2004, it seems that the targets set in the 2004 budget can be reached. Despite direct (income taxation) and indirect (alcohol) tax cuts, the central government seems to be collecting more tax receipts than originally estimated in the 2004 budget. The better-than-expected revenue evolution is partly due to higher privatisation proceeds and dividend receipts. Following from stronger growth also the overall tax accrual has been higher than anticipated. Moreover, expenditure up to November is below the budgeted targets. This is confirmed by the fact that in the original 2004 budget net state borrowing was estimated at € 1.3 billion i.e. 0.9% of GDP after three supplementary budgets the latest estimate for net borrowing is € 26 million.

4 BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES

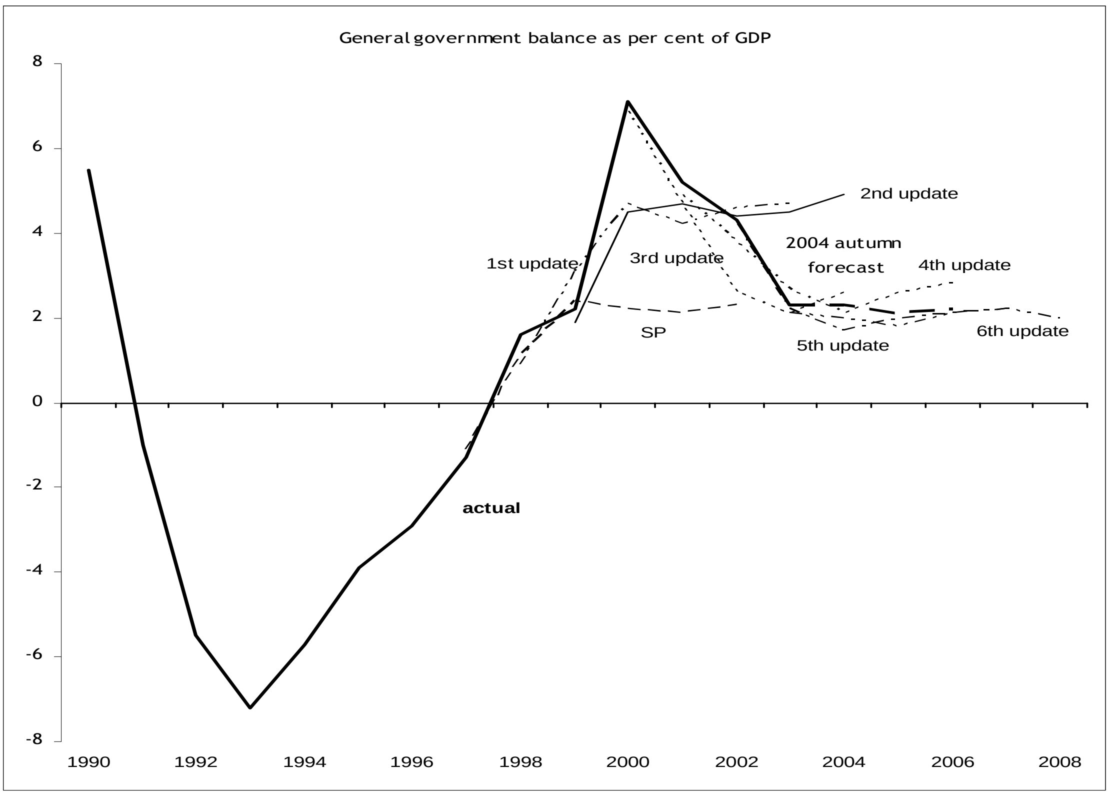
4.1 Evolution of budgetary targets in successive programmes

As presented in Table3, the general government surplus is projected to remain around 2% of GDP over the programme horizon. Apart from some marginal changes due to technical revisions, the envisaged adjustment path for revenues and expenditure on general government level are broadly in line with previous stability programme updates. Also the budgetary target presented in the latest programme seems to be in line with the previous targets, as illustrated in Graph 1.

Table 3: Evolution of budgetary targets in successive programmes

		2003	2004	2005	2006	2007	2008
General government balance (% of GDP)	**SP December 2004**	**2.1**	**2.0**	**1.8**	**2.1**	**2.2**	**2.0**
	SP November 2003	2.2	1.7	2.0	2.1	2.2	
	SP November 2002	*2.7*	*2.1*	*2.6*	*2.8*		
General government expenditure (% of GDP)	**SP December 2004**	**48.6**	**48.5**	**48.4**	**48.5**	**48.4**	**48.5**
	SP November 2003	48.7	48.7	48.7	48.8	48.8	
	SP November 2002	*47.1*	*46.9*	*46.4*	*46.1*		
General government revenues (% of GDP)	**SP December 2004**	**50.7**	**50.5**	**50.3**	**50.6**	**50.5**	**50.5**
	SP November 2003	51.0	50.4	50.8	50.8	51.0	
	SP November 2002	*49.9*	*49.1*	*49.0*	*48.9*		
Real GDP (% change)	**SP December 2004**	**2.0**	**3.2**	**2.8**	**2.4**	**2.2**	**2.0**
	SP November 2003	1.4	2.7	2.5	2.4	2.4	
	SP November 2002	*2.8*	*2.6*	*2.5*			
Sources: *Stability programmes (SP)*							

Graph 1: Budgetary targets in the Finnish stability programme updates



Source: Commission services, Statistics Finland, Stability programme and SP updates

4.2 Budgetary targets in the updated programme

The government's key budgetary policy objective is to reduce central government indebtedness and to secure sustainability of central government finances. This coincides with the long-term budgetary policy strategy of maintaining a sizeable surplus in general government finances. Also local governments are obliged to maintain a close to balance financial position within a three-year period. According to the budgetary strategy, the central government finances should be in balance, in national account terms, at the end of the electoral period in 2007. To help to achieve this target the government in May 2003 adopted multi-annual spending limits for 2004-2007. The spending limits are the primary instrument of the Finnish government to maintain budgetary discipline (see Box 2). Based on these limits, total expenditure by the central government is allowed increase by nearly 1 per cent a year in real terms on average in 2004-2007. As most of the expenditure increase was frontloaded to 2004, there is less room for manoeuvre within the ceilings between 2005 and 2007. Expenditure control is deemed necessary, as tax revenues will fall due to cuts in income taxation, reform of corporate and capital taxation and increased tax competition. As no spending cuts have been planned to finance tax cuts, the government seem to place its trust on the increased dynamism effects channelled through the economy via increased potential in the economy and higher job creation.

With a projected surplus on average of 2% of GDP the update is set to maintain a budgetary position of close-to-balance-or-in-surplus throughout the programme period (see Table 4)[3]. The latest programme update estimates the general government surplus to be at 2.0% GDP in 2004 and stay close to that ratio over the entire programme period. Compared with the previous update, the surplus estimates for 2004-2007 are virtually unchanged. Also the time profile of the primary surplus is similar, with some variations between 2005 and 2007 and then reaching 3.7% in 2008, the same as in 2004. This derives from the fact interest payments remain virtually constant at 1.7% of GDP during the programme period. With regard to the breakdown of general government revenues and expenditure, there does not seem to be any one-off or unspecified measures in the budgetary adjustment. The budget's expenditure and revenue components appear to follow smooth adjustment paths.

[3] The minimal benchmark for Finland is a surplus of 0.8% of GDP. The difference between the 3% of GDP reference value for the deficit and the estimated cyclical safety margin is the country's minimal benchmark. See the Commission services Public Finance Report 2002.

Table 4: Composition of the budgetary adjustment

(% of GDP)	2003	2004	2005	2006	2007	2008	Change: 2008-2004
Revenues	50.7	50.5	50.3	50.6	50.5	50.5	**0.0**
of which:							
- Taxes & social security contributions	44.5	44.1	44.1	44.3	44.3	44.2	**0.1**
- Other (residual)	6.2	6.4	6.2	6.2	6.2	6.2	**0.0**
Expenditure	48.6	48.5	48.4	48.5	48.4	48.5	**0.0**
of which:							
- Primary expenditure	46.8	46.8	46.9	46.9	46.6	46.8	**0.0**
of which:							
Gross fixed capital formation	2.9	2.8	2.7	2.7	2.6	2.6	**-0.2**
Collective consumption	22.4	22.5	22.7	22.8	22.9	23.1	**0.6**
Transfers and subsidies	18.6	18.6	18.5	18.5	18.3	18.3	**-0.3**
Other (residual)	2.9	2.9	3.0	2.9	2.8	2.8	**-0.1**
- Interest payments	2.0	1.7	1.6	1.7	1.7	1.7	**0.0**
Budget balance	**2.1**	**2.0**	**1.8**	**2.1**	**2.2**	**2.0**	**0.0**
Primary balance	**4.1**	**3.7**	**3.4**	**3.8**	**3.9**	**3.7**	**0.0**

Sources:
Stability programme update; Commission services calculations

Box 1: The Budget for 2005

The government presented its 2005 budget proposal on 14 September 2004 and the parliament adopted it on 23 December. In line with the government programme, increases in expenditure will be distributed in a way that will support economic growth and ensure the sustainability of public finances. The amount of appropriations in the budget totals to € 37.9 billion, of which €2.4 billion is interest expenses on central government debt. The budget proposal shows a deficit of € 940 million as revenues are projected to be € 36.9 billion.

The main measures in the 2005 budget are the following

- A 2% inflation adjustment in the central government income tax scale and a taxation reduction of € 350 million i.e. 0.2 % of GDP through an increase in earned income deductions in municipal taxation and lowering the state income tax scale.
- Reducing corporate income tax rate from 29% to 26% and capital income tax rate by 1 percentage point to 28%.
- Extending the domestic help credit in order to improve employment possibilities in domestic services.
- Increasing development cooperation spending by € 54.5 million, 0.03% of GDP.
- Providing grants and subsidies for municipality mergers.
- Increasing funding for research and technology by € 32 million, 0.02% of GDP.

As the baseline budgetary trend in the update, only partially includes the tax cuts of € 1.7 billion i.e. 1.2% of GDP that supplement the two-and-half-year comprehensive wage agreement concluded at the end of November, the budgetary outcome could be worse than projected. As there are no announced plans to decrease spending in 2005-07, the government would ceteris paribus have to incur higher debt to finance these tax cuts. Consequently, the central government deficit would be in a higher level between 2005 and 2007 than mentioned in the programme, thereby also lowering the surplus in general government finances. The government estimates that this package will lower the general government surplus by 0.3 percentage points to about 1.9% of GDP in 2007. The government expects that the collective wage agreement and the tax cuts will strengthen dynamism in the economy by improving the growth potential and job creation. According to government estimates employment is projected to increase by 1.5% (i.e. 35000 new jobs between 2005 and 2007) compared with the baseline calculations in the update.

However, Finland being a country with a high tax burden, continued high structural unemployment, and some room for fiscal manoeuvring and future strain on fiscal sustainability due to ageing population, these tax cuts combined with the new wage agreement are more than welcome. Even if the budgetary outcome would be somewhat weaker than the baseline scenario in the update, the public sector balance would still post a clear surplus. The drawback of the tax cuts is that the government's objective of having the central government finances in balance in national accounts terms in 2007 will be more difficult to meet, unless there are spending cuts or the economy continues to grow strongly and this way will increase the overall tax intake and lessen the need of borrowing. Already in the baseline projection, the central government deficit is seen to be at 0.3% of GDP in 2007, excluding the additional tax cuts.

A special factor that might cause downside risk to the domestic economic trend and also to public finances is the pivotal position of information and communications technology (ICT) products in Finland. Although in the early part of 2004 the ICT sector, primarily Nokia, was losing market shares in the face of tougher international competition, this sector has been able to win back markets during the year. Despite the increasing competition, the prospects for this sector appear favourable also for the future.

The cyclically-adjusted balance, is set to fall somewhat in 2005 from 2004, but rebound to a surplus of 2.4% of GDP in 2008. The cyclically-adjusted primary balance will follow the same adjustment as the cyclically-adjusted balance. This evolution is witnessed by both calculations in Table 5. The output gap is set to narrow in 2005-06, but widen again thereafter. In assessing the policy stance for the coming years, the data suggests that Finland will have a fiscal easing in 2004-05, while output gap narrows and beyond that the stance changes towards contractionary policy as the cyclically-adjusted balance primary increases. This combined with a widening output gap would suggest of a pro-cyclical fiscal tightening policy stance. However, if the income tax cuts announced in relation to the collective wage agreement were incorporated to the calculations, this would lessen the impact of tightening fiscal policy stance.

Table 5: Output gaps and cyclically-adjusted (primary) balances (CA(P)B)

	2003		2004		2005		2006		2007	2008	Change: 2008-2004
	COM	SP	COM	SP	COM	SP	COM	SP	SP	SP	SP
Budget balance[2]	2.3	2.1	2.3	2.0	2.1	1.8	2.2	2.1	2.2	2.0	0.0
Output gap[1,3]	-0.8	-0.8	-0.6	-0.3	-0.3	-0.1	-0.1	-0.2	-0.4	-0.6	-0.3
CAB[1,2]	2.8	2.6	2.8	2.2	2.3	1.9	2.3	2.2	2.4	2.4	0.2
CAPB[1,2]	4.7	4.6	4.5	3.9	4.0	3.5	3.9	3.9	4.1	4.1	0.2

Notes:
[1] SP (stability programme): Commission services calculations on the basis of the information in the programme
[2]in percent of GDP
[3]in percent of potential GDP
Sources:
Commission services autumn 2004 economic forecasts (COM); Commission services calculations

4.3 Sensitivity analysis

The programme includes two sensitivity scenarios for developments of public finances: low and high GDP growth scenarios (+/- 1 percentage point annual deviation from the baseline growth of about 2.5%). In the low growth scenario, general government finances are expected to be in surplus until 2007, but fall into a deficit in 2008, whereas general government gross debt would remain significantly below the 60% threshold. The Commission services estimate that an annual slower trend GDP growth by one percentage point leads to a decrease in general government net lending by almost 0.7 percentage points.

In order to assess the plausibility of these calculations, the Commission services have carried out additional simulations of the cyclically-adjusted balances under the assumptions of (i) a sustained 1.0 percentage point deviation from the growth targets in the programme over the 2004-2008 period; (ii) trend output based on the HP-filter[4] and (iii) no policy response (notably, the expenditure level is as in the central scenario[5]). The calculations reveal that, by 2008, in the low growth scenario the cyclically-adjusted balance is 1.5 percentage points below the central scenario[6]. Hence, in the case of persistently lower growth, additional measures would be necessary to keep the public finances on the path targeted in the central scenario. The results confirm the picture given by the sensitivity analysis of the programme. To conclude, the general government financial position appears to provide a sufficient safety margin against breaching the 3% reference value in the event of normal cyclical fluctuations[7].

5 EVOLUTION OF THE DEBT RATIO

The programme regards it essential that the general government gross debt will be reduced in view of the future expenditure pressures stemming from ageing population and globalisation of the economy. By the same token, the objective over the coming decades is to avoid an unreasonable financial burden for future generations. The general government gross debt ratio is forecast to remain well below 60% of GDP and be on a downward path throughout the programme horizon. The current estimate of 44.6% of GDP is in line with gross debt ratio for 2004 as expected in the 2003 update. The current programme projects the debt ratio to fall to about 41% of GDP by 2008. Compared with the previous programme update, the current programme projects the debt-to-GDP ratio to be markedly lower from 2005 onwards due to higher nominal GDP growth, a lower level of central government borrowing, lower interest payments and higher tax receipts. The previous programme projected a virtually stable debt ratio

[4]In the absence of a fully-specified macro-economic scenario that would underlie such deviations, it is obviously impossible to derive new estimates of potential growth from the agreed production function method.

[5]The effect of lower/higher growth on revenues is captured by using the conventional sensitivity parameters adopted in cyclical adjustment procedures.

[6] In the worse-case scenario, the cyclically-adjusted budgetary surplus would go down to some 0.8% of GDP in 2005, from where it would rise to about 1% by 2008.

[7] See footnote 2 on minimal benchmark.

over the period of 2004-2007, compared with the current estimated decline of almost 3 percentage points. The path of gross debt cited in the programme is largely in line with that in the Commission services autumn 2004 forecast. In addition, it appears that the financial assets in the public sector exceed gross debt, owing to the partial pre-funding of pensions.

Table 6: Debt dynamics

	average 2000-2003	2004		2005		2006		2007	2008
	COM	COM	SP	COM	SP	COM	SP	SP	SP
Government gross debt ratio	**44.1**	**44.8**	**44.6**	**43.4**	**43.4**	**42.2**	**42.5**	**41.7**	**41.1**
Change in debt ratio (1 = 2+3+4)	-0.2	-0.8	-1.0	-1.4	-1.2	-1.3	-0.9	-0.8	-0.6
Contributions:									
- **Primary balance** (2)	**-7.1**	**-4.1**	**-3.7**	**-3.9**	**-3.4**	**-3.8**	**-3.7**	**-3.9**	**-3.7**
- **“Snow-ball” effect** (3)	**0.5**	**0.3**	**0.2**	**0.1**	**-0.1**	**-0.1**	**0.0**	**0.3**	**0.4**
- Interest expenditure	2.4	1.8	1.7	1.7	1.6	1.6	1.6	1.7	1.7
- Real GDP growth	-1.1	-1.3	-1.4	-1.3	-1.2	-1.1	-1.0	-0.9	-0.8
- Inflation (GDP deflator)	-0.8	-0.2	-0.1	-0.5	-0.5	-0.6	-0.6	-0.5	-0.5
- **Stock-flow adjustment** (4)	**6.4**	**3.1**	**2.6**	**2.6**	**2.3**	**2.7**	**2.8**	**2.8**	**2.7**
- Cash/accruals	0.6								
- Accumulation of financial assets	5.6		1.7		2.0		2.6	2.5	2.5
of which: Privatisation proceeds	-0.4	0.0	0.6	0.0	0.3	0.0	0.3	0.3	0.2
- Valuation effects & residual adj.	0.1		0.3		0.0		0.0	0.0	0.0

Note:
The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the “snow-ball” effect.

Sources:
Stability programme update (SP); Commission services autumn 2004 economic forecasts (COM); Commission services calculations

6 STRUCTURAL REFORM AND THE QUALITY OF PUBLIC FINANCES

In terms of quality, Finland’s public finances appear to be sound. The previous governments have aimed at creating surpluses in central government finances[8] and to reduce the central government debt-to-GDP ratio. The new government appointed in June 2003 is continuing in the same direction and has introduced new measures to improve the quality of public finances as well as enhanced the role of spending ceilings (see Box 2). The challenges in the 2003-05 BEPGs for Finland also relate to these issues[9]. The government has responded to these challenges by implementing and

[8] The central government budget has shown a surplus between 2000 and 2003.

[9] In the BEPGs Finland was recommended, to reduce high level of structural unemployment, raise the employment rate of older workers, enhance competition in certain sectors and improve efficiency in the public sector.

putting forward measures to improve the functioning of product, capital and labour markets. A productivity action programme, in which each administrative domain draws up a productivity development plan, has been launched to improve productivity in the central government. The implementation of these programmes has to be accommodated within the agreed spending limits starting in 2005-07. The government introduced multi-annual spending limits in the beginning of its term to avoid expenditure overruns and to improve the predictability of the central government finances. The 2005 pension reform, that covers the private and the public sector, will be gradually implemented in the beginning of 2005, although some measures were introduced already in 2003 (see Box 3). As some of the measures are implemented as late as 2009, the financial benefits of the reform will largely accrue only after 2010. Combined with the overhaul of the unemployment compensation scheme, the pension reform should help to keep control over expenditure in coming years.

As for the more medium-term challenges, the government's key economic objective is to create 100 000 new jobs by the end of the electoral period in 2007 and to raise the employment rate to 75% of the working age population by 2011, currently at 67.8%. In addition, the government continues to encourage the employment of older workers, where the Lisbon target of a 50% employment rate was achieved in 2004. In order to attain these objectives, the government has put forward measures targeted to support entrepreneurship and employment[10]. To tackle the added pressure on local government finances deriving from the accelerating pace of retirement and the coincident increase in the need of service provision, the local governments have set up projects to improve efficiency in service provision and reducing structural costs. There are also projects under way to encourage mergers between municipalities.

The structural reform measures presented in the programme are clearly a step in the right direction, in particular with respect to improving the longer-term sustainability and quality of public finances overall.

[10] E.g. taxes on labour have been reduced, the quality of ALMPs have been improved, labour service centres have been established and efforts to prevent exclusion from the labour market have been intensified.

Box 2: Spending ceilings

Overview

Multi-annual spending ceilings were first introduced to the Finnish budgetary process in 1991, but after identified malfunction and recurrent overruns during the previous government in 1999-2003, the current government, which took office in June 2003, redesigned the spending ceilings and made them politically more binding. Under these new expenditure frames, the government at the beginning of its term agreed on the budget expenditures ceilings over the entire four-year electoral period. The government's overall guiding premise is that the deficit in central government finances, as measured in national accounting terms, must not exceed 2 ¾ % of GDP even during weak economic growth. The multiannual spending limits will provide a framework for the ministries in preparing their annual appropriation proposals for the following year's budget. Although all additional spending items have to be accommodated within the ceilings, in conjunction with the annual decision of central government spending limits, the government carries out a technical review so that ceilings are in line with the budget proposal’s cost and price level and also to include changes that have been made to the structure of the budget. In 2004, these adjustments revised upwards the spending ceilings by about € 500 million per year between 2005 and 2007 compared with the level decided in 2003.

About ¾ of the budget appropriations, namely the discretionary spending items, are under the binding spending limits. Supplementary budgets are also included in the spending limits. Spending items that are excluded from the ceilings are mainly cyclically fluctuating expenditure (housing subsidies and unemployment security payments), interest expenses on central government debt and certain items which are not fiscally sensible to tie to spending limits.

Experience so far

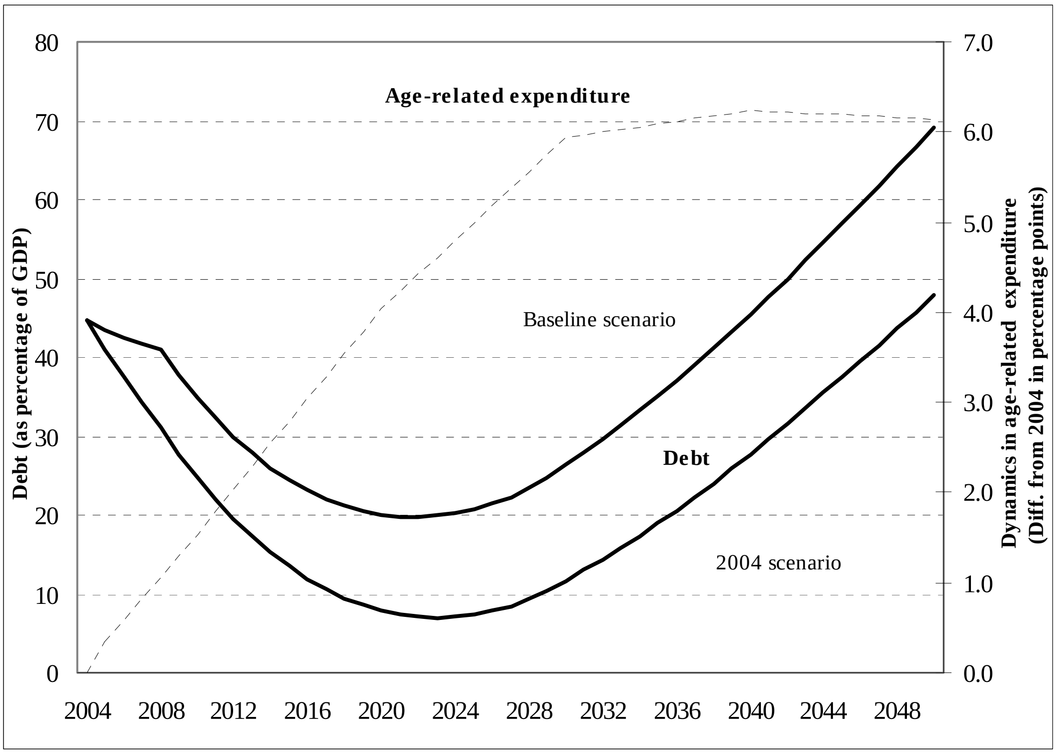
The spending ceilings worked well in its first year in operation, namely 2004, when final expenditure remained below the spending limit by € 84 million or 0.1% of GDP. Also, the 2005 budget is within the ceilings, with expenditures of € 307 million or 0.2% of GDP below the ceiling. This leeway will be used to cover any supplementary budgets and pay rises following from the new centralised wage agreement. For the coming years, there will testing times for the ceilings as the bulk of the overall spending for the electoral period of 2003-2007, was frontloaded to 2004. As a result, there will be less room to manoeuvre within the ceilings in 2005-2007.

7 THE SUSTAINABILITY OF THE PUBLIC FINANCES

The assessment of the sustainability of Finnish public finances is based on an overall judgement of the results of quantitative indicators and qualitative features. The quantitative indicators project debt development according to two different scenarios, to take into account different budgetary developments over the medium term. The “programme” scenario (baseline) assumes that the medium-term objective set up in the programme is actually achieved, while the “2004” scenario assumes that the underlying primary balance remains at the 2004 level throughout the programme period.

The graph below presents the gross debt development according to the two different scenarios. On the basis of the programme, age-related expenditure is foreseen to increase by 4.8% of GDP between 2008 and 2050 (see Annex 2 for a breakdown of different age-related expenditures). Gross debt is projected to decrease significantly over the next 20 years, falling to around 20% of GDP, as a consequence of continued budgetary surpluses. The impact of ageing on expenditures gradually increases up to around 2030, and thereafter stabilises at close to 6 percentage points of GDP above the current level. As a result of the rise in age-related expenditures, the primary surpluses turn into deficits and lead to a rise in the gross debt ratio[11].

Long-term sustainability: summary results



Sustainability indicators

	S1*	S2**	RPB***
Baseline scenario	0.3	1.3	4.2
2004 scenario	-0.2	1.1	4.2

Notes:
* It indicates the required change in tax revenues as a share of GDP over the projection period that guarantees to reach debt to GDP ratio of 60% of GDP in 2050.
** It indicates the change in tax revenues as a share of GDP that guarantees the respect of the intertemporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon to the debt as existing at the outset of the projection period; p.m. debt to GDP ratio in 2050: -5.7%
*** Based on S2, the Required Primary Balance (RPB) indicates the average minimum required cyclically adjusted primary balance as a share of GDP *over the first five years* of the projection period that guarantees the respect of the intertemporal budget constraint of the government for this period.

On the basis of the debt projections, it is possible to calculate a set of sustainability indicators to measure the gap between the current policies and a sustainable one. The S1 indicator shows the permanent change in the primary balance in order to have a

[11] It should be recalled that, being a mechanical, partial equilibrium analysis, projections are in some cases bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels is not a forecast of likely outcomes and should not be taken at face value. The more favourable 2004 scenario reflects a higher cyclically adjusted primary balance in 2004 kept constant up to 2008, which contributes to faster gross debt reduction than in the baseline scenario.

debt to GDP ratio in line with the Maastricht Treaty reference value in the very long run (year 2050)[12]. S2 shows the gap between the current tax policies and those that would ensure respect of the intertemporal budget constraint given the future impact of ageing on public expenditure, namely the change in the tax ratio that would equate the present discounted value of future primary balances to the current stock of gross debt. According to the latter, in order to tackle the cost of ageing entirely through a budgetary strategy Finland should increase its tax ratio permanently by around 1 percentage point. This would lead to a sustainable debt ratio of around -6% of GDP by the middle of the century [13]. The budgetary effort over the first five years of projections i.e. after the end of the programme to respect the intertemporal budget constraint requires a primary surplus of 4.2% of GDP on average, 0.5 percentage point higher than the one projected for the last year of the programme period (measured in underlying terms).

These results are broadly in line with the ones presented in the programme, where the surplus turns into a deficit of more than 3% of GDP around 2030 and debt in central and local government rises continuously in the absence of corrective measures. In interpreting these results, several factors must be taken into account.

- First, filling the sustainability gap on the revenue side may prove difficult given the relatively high level of taxation in Finland. The expected level of taxation will appear high relative to other industrialised countries and future pressures to reduce it cannot be excluded.
- Second, public pension funds in general government hold liquid assets of almost 40% of GDP. This leads to a current adjusted gross debt ratio of close to 2.5% that helps in coping with the future cost of ageing (see Annex 2)[14].
- Third, with regard to the update's envisaged rise in pension expenditure and social and health care expenditure, including for sickness insurance, certain provisions for addressing these expenditure pressures have already been made. The recent package of pension reforms will be implemented gradually starting from 2005. The package of reforms, which covers both the private and public sector workers, include incentives to stay longer in working life and therefore is expected to increase the exit age from labour market by two years. In addition to this, the overhaul of the unemployment insurance system is projected to raise the exit age by one more year to about 62-63 years. Despite these reform measures, an increase in the employment rate and productivity growth should contribute towards future generations not facing an overly large financial burden to finance health care costs. The underlying assumptions in the calculations i.e. longer life expectancy and constant productivity in providing social health services seem at least on the first part plausible as a life

[12] The respect of the underlying debt path does not ensure sustainability over an infinite horizon, but only that debt remains below 60% up to 2050. In most cases, this would imply an increasing trend and possible unbalances after the end of the projection period.

[13] The debt ratio of around -6% in 2050 according to the S2 indicator illustrates that the tax gap is higher in order to ensure a sustainable evolution of gross debt beyond 2050, compared with the S1 tax gap, which illustrates that a lower tax increase is compatible with the 60% reference value in 2050.

[14] The S2 indicator is calculated on a gross debt basis. In the case of Finland, for illustrative purposes, should it be calculated on the basis of adjusted gross debt, the S2 tax gap (baseline scenario) would be somewhat smaller at about 0.4. In addition, the Employment pension institutions (ESA S.13141) in Finland hold other assets than liquid ones (e.g. commercial real estate) of around 10% of GDP in 2003, which further contributes to a sustainable position in the long term.

expectancy coefficient will also be introduced as part of the pension reform in 2009. The life expectancy coefficient is set to cancel out the rise in earnings-related expenses due to longer life expectancy. However, the latter assumption appears to be on the cautious side as the government is looking into ways to improve public sector productivity.

- Fourth, the structural improvement of halving the unemployment rate by 2030 seems to be a rather cautious estimate when taking into account that the 2005 pension reform combined with other reforms should raise the exit age by three years and that the labour force will begin to shrink in the next decade. These calculations imply that Finland will continue to have a fairly high unemployment rate of 7.6% and 5.3% between 2010 and 2020, even in times of shortage of employees. On the other, the average GDP growth rate of 1.5% between 2010 and 2050 do not provide much contribution to job creation.

Finland appears to be in a favourable position with regard to long-term sustainability of the public finances, in spite of important projected budgetary costs of an ageing population. The strategy outlined in the programme is broad-based and consists of further debt consolidation and structural reforms e.g. further steps of the pension reform and measures aimed at raising the exit age. The structural reforms enacted and planned should have beneficial effects on the public finances. However, further action to stem the projected increase in age-related expenditure would be required in order to secure full sustainability in the long term.

Box 3: The 2005 pension reform

Overview

The 2005 pension reform consists of private sector, local government and central government employees, the respective pension reforms were approved by the parliament in 2003-2004. The reforms in these sectors are broadly similar. The major elements of the reform are:

* A flexible retirement age between 62 and 68 is introduced, with a sharp rise in the accrual rate after 62. From the age of 63 pensions will be calculated according to the accrued rights. Between 62 and 63 the pension will be reduced by 0.6% for each month of early retirement prior to 63. The accumulation rate will remain at 1.5% a year between ages of 18 and 52, increase to 1.9% between 53 and 62 and then rise to 4.5% between 63 and 68 (this compares with the previous rates of 1.5% between ages 53 and 59 and 2.5% for those aged over 60). The ceiling on the maximum pension will be abolished.
* The pension base will be determined by earnings over the entire career rather than over the last ten years of each employment relationship as in the previous system. Pensions will start to accumulate from the age of 18 until the age of 68. They will also accrue during some non-working periods, e.g. during studies and childcare leave, the accumulation is based on an income of € 500 a month.
* The system will adjust to future increases in life expectancy from 2009 by applying a “life expectancy coefficient” to the calculation of pensions. This coefficient will take into account that people will tend to live longer in the future than today and hence provide a mechanism for keeping total pension costs in check.
* The method of indexation will change. There are two indices in the pension system. The first adjusts past earnings to the present level when computing the pension at the time of retirement. This “wage multiplier” puts a weight of 80% on wages and 20% on the consumer price index. The other index aims at keeping the purchasing power of pensions intact. This index will have a weight of 80% on consumer prices and 20% on wage and salary earnings.
* The structure of employees' pension contributions will change. Employees aged 53 or over have to pay a 27% higher employees' pension contribution than those aged under 53. Currently, the contribution is 4.4% of earnings irrespective of age.
* Pension funding was strengthened from 2003 onwards so that additional funding of 7.5% of the insured wage sum will be available by 2013.
* Options for early retirement will be further curtailed. The most important changes are to the unemployment and disability pension, which accounted for 4% and 20% of all pensioners in 2003, respectively. In addition the minimum age for a part-time pension, which accounts for 3% of all pensioners, is to be raised from 56 to 58, while the amount of old-age pension accumulated during part-time retirement will be halved.

Conclusion

Even though the pension reform has many good measures, which will improve in the long-run the sustainability of public finances in Finland and provide incentives for employees to work longer, the medium term effects of the reform are less evident due to the relatively long phasing in period of the reform, as some measures will be implemented in 2009. It would have been highly recommended to have a shorter phasing in period as Finland will be facing the effects of ageing population already in the near future. Moreover, areas that should be addressed in the future include shortening of the unemployment pipeline to retirement and tackling the still generous part-time pension system. In the long run, the reform is foreseen to improve the contribution base and combined with earlier measures to increase the effective retirement age by three years to 62-63 years.

* * *

Annex 1: Summary tables from the stability programme update

Table 1. Growth and associated factors

	ESA Code	2003	2004[15]	2005	2006[16]	2007	2008
GDP *growth* at *constant* market prices (7+8+9)	B1g	2.0	3.2	2.8	2.4	2.2	2.0
GDP *level* at *current* market prices	B1g	142.5	147.5	153.2	159.0	164.5	170.0
GDP deflator		-0.1	0.2	1.0	1.3	1.3	1.3
HICP change		1.3	0.2	1.4	1.8	1.8	1.8
Employment growth[17]		-0.3	-0.3	0.5	0.4	0.1	0.1
Labour productivity growth [18]		2.3	3.5	2.3	2.0	2.0	2.2
Sources of growth: percentage changes at constant prices							
1. Private consumption expenditure	P3	4.3	3.0	2.1	2.1	2.0	1.9
2. Government consumption expenditure	P3	1.6	1.4	1.5	1.5	1.2	1.1
3. Gross fixed capital formation	P51	-2.1	3.5	3.0	2.1	1.7	1.3
4. Changes in inventories and net acquisition of valuables as a % of GDP	P52+ P53	0.4	0.0	0.0	0.0	0.0	0.0
5. Exports of goods and services	P6	1.1	3.3	4.1	3.5	3.0	3.0
6. Imports of goods and services	P7	2.6	2.0	2.7	2.7	2.3	2.3
Contribution to GDP growth							
7. Final domestic demand (1+2+3)		2.1	2.5	1.9	1.8	1.6	1.5
8. Change in inventories and net acquisition of valuables	P52+ P53	0.4	0.0	0.0	0.0	0.0	0.0
9. External balance of goods and services (5-6)	B11	-0.4	0.8	0.9	0.6	0.6	0.6

[15] Forecasts
[16] Trend values or period averages
[17] National accounts definition
[18] Growth of GDP at market prices per person employed at constant prices

Table 2. General government budgetary developments

% of GDP	ESA code	2003	2004	2005	2006	2007	2008
Net lending (B9) by sub-sectors							
1. General government	S13	2.1	200	1.8	2.1	2.2	2.0
2. Central government	S1311	0.2	0.0	-0.5	-0.4	-0.3	-0.6
3. State government	S1312						
4. Local government	S1313	-0.5	-0.4	-0.3	-0.2	-0.1	0.0
5. Social security funds	S1314	2.4	2.4	2.7	2.7	2.6	2.6
General government (S13)							
6. Total receipts	ESA	50.7	50.5	50.3	50.6	50.5	50.5
7. Total expenditures	ESA	48.6	48.5	48.4	48.5	48.4	48.5
8. Budget balance	B9	2.1	2.0	1.8	2.1	2.2	2.0
9. Net interest payments		0.2	-0.2	-0.3	-0.2	-0.2	-0.2
10. Primary balance		2.3	1.8	1.6	1.9	1.9	1.7
Components of revenues							
11. Taxes	D2+D5	32.3	31.8	31.5	31.4	31.4	31.3
12. Social contributions	D61	12.2	12.3	12.6	12.9	12.9	12.9
13. Other		6.2	6.4	6.2	6.2	6.2	6.2
14. Total receipts	ESA	50.7	50.5	50.3	50.6	50.5	50.5
Components of expenditures							
15. Collective consumption	P32	7.9	7.9	8.0	8.0	8.0	8.1
16. Individual consumption	D63	14.5	14.6	14.7	14.8	14.9	15.0
17. Social income transfers	D62	17.2	17.3	17.2	17.2	17.1	17.1
18. Interest payments	D41	2.0	1.7	1.6	1.7	1.7	1.7
19. Subsidies	D3	1.4	1.3	1.3	1.3	1.2	1.2
20. Gross fixed capital formation	P51	2.9	2.8	2.7	2.7	2.6	2.6
21. Other		2.9	2.9	3.0	2.9	2.8	2.8
22. Total expenditures	ESA	48.6	48.5	48.4	48.5	48.4	48.5

Table 3. General government debt developments

% of GDP	ESA code	2003	2004	2005	2006	2007	2008
Gross debt level		45.6	44.6	43.4	45.5	41.7	41.1
Change in gross debt		3.0	-0.9	-1.3	-0.8	-0.8	-0.6
Contributions to change in gross debt							
Primary balance		-2.3	-1.8	-1.6	-1.9	-1.9	-1.7
Interest payments	D41	0.2	-0.2	-0.3	-0.2	-0.2	-0.2
Nominal GDP growth	B1g	-0.9	-1.6	-1.7	-1.6	-1.5	-1.4
Stock-flow adjustment		6.0	2.6	2.3	2.9	2.8	2.7
Of which: Public sector consolidation		2.3	0.3	0.0	0.0	0.0	0.0
Privatisation receipts		0.1	0.6	0.3	0.3	0.3	0.2
Net accumulation of financial assets		3.5	1.7	2.0	2.6	2.5	2.5
p.m. implicit interest rate on debt		4.4	3.8	3.6	3.9	4.0	4.2

Table 4. Cyclical developments[19]

% of GDP	ESA Code	2003	2004	2005	2006	2007	2008
1. GDP growth at constant prices	B1g	2.0	3.2	2.8	2.4	2.2	2.0
2. Actual balance	B9	2.1	2.0	1.8	2.1	2.2	2.0
3. Interest payments	D41	2.0	1.7	1.6	1.7	1.7	1.7
4. Potential GDP growth[20]		2.6	2.6	2.4	2.4	2.3	2.0
5. Output gap[21]		-0.8	-0.2	0.2	0.2	0.0	0.0
6. Cyclical budgetary component		-0.5	-0.1	0.1	0.1	0.0	0.0
7. Cyclically-adjusted balance (2-6)		2.6	2.1	1.7	2.0	2.1	1.9
8. Cyclically-adjusted primary balance (7+3)		4.6	3.8	3.3	3.6	3.8	3.7

Table 5. Divergence from previous update

% of GDP	ESA Code	2003	2004	2005	2006	2007	2008
GDP growth	B1g						
previous update		1.4	2.7	2.5	2.4	2.4	
latest update		2.2	3.2	2.8	2.4	2.2	2.0
Difference		0.6	0.5	0.3	0.0	-0.2	
Actual budget balance	B9						
previous update		2.2	1.7	2.0	2.1	2.2	
latest update		2.1	2.0	1.8	2.1	2.2	2.0
Difference		-0.1	0.3	-0.2	0.0	0.0	
Gross debt levels							
previous update		45.1	44.8	44.9	45.0	44.6	
latest update		45.6	44.6	43.4	42.5	41.7	41.1
Difference		0.5	-0.2	-1.5	-2.5	-2.9	

[19] Member States can fill in lines 4-8 using either own figures or Commission services figures.
[20] Trend GDP, % change.
[21] Deviation from GDP trend, % change.

Table 6. Long-term sustainability of public finances [22]

% of GDP	2000	2005	2010	2020	2030	2040	2050
Total expenditure	46.7	48.4	49.0	51.5	54.6	36.9	59.3
Pensions	10.7	11.6	12.5	14.3	15.5	15.4	15.2
Old age pensions	7.2	8.0	8.9	11.2	12.4	12.3	12.2
Social and health care services	6.7	7.4	7.7	8.4	9.4	10.0	10.1
Sickness insurance	53.7	50.6	51.7	51.9	51.9	51.9	51.9
Education	6.1	5.8	5.6	5.6	5.6	5.5	5.4
Unemployment	1.7	1.7	1.7	1.4	1.0	0.8	0.8
Interest payments	2.8	1.7	2.1	2.1	3.3	5.3	7.8
Other expenses	16.6	17.7	16.7	16.7	16.7	16.7	16.7
Total revenues	53.7	50.2	50.9	51.6	51.7	51.8	52.0
Taxes and social security contributions	46.9	44.1	44.3	44.3	44.3	44.3	44.3
Other revenue	6.8	6.1	6.6	7.3	7.4	7.5	7.7
Financial surplus	7.1	1.8	1.9	0.1	-2.9	-5.1	-7.3
Financial assets and debt							
Pensions funds' consolidated assets	39.0	49.0	52.0	58.9	61.8	63.8	66.2
Other financial assets[23]	12.2	10.1	9.4	6.6	4.7	3.3	2.4
Financial assets, total	51.2	59.1	61.4	65.5	66.5	67.1	68.6
Gross debt (consolidated)	44.6	43.5	39.6	41.5	62.8	101.2	147.6
Net financial assets[24]	6.6	15.6	21.8	24.0	3.7	-34.1	-79.0
Assumptions							
Labour productivity growth	2.8	2.0	1.8	1.8	1.8	1.8	1.8
Real GDP growth	5.1	2.9	1.6	1.4	1.4	1.5	1.6
Participation rate (male aged 20-64)	81.4	80.6	80.6	81.2	81.3	81.3	81.3
Participation rate (female aged 20-64)	75.7	76.0	76.0	76.6	76.7	76.7	76.7
Total participation rates (aged 20-64)	78.6	78.5	78.5	79.1	79.2	79.2	79.2
Unemployment rate	9.8	8.5	7.6	5.3	4.0	4.0	4.0
Real interest rate	2.0	2.5	3.5	3.5	3.5	3.5	3.5
Inflation	3.4	1.8	2.0	2.0	2.0	2.0	2.0

[22] Information in this table, if provided, should be updated at least every 3 years.
[23] Mainly cash reserves of central and local government; this item has been kept constant during the whole period.
[24] Financial assets minus debt.

Table 7. Basic assumptions

	2003	2004	2005	2006	2007	2008
Short-term interest rate (annual average)	2.3	2.1	--	--	--	--
Long-term interest rate (annual average)	4.1	4.2	--	--	--	--
United States: short-term (three-month money market)	--	--	--	--	--	--
United States: long term (10-year government bonds)	--	--	--	--	--	--
USD/€ exchange rate (annual average)	1.13	1.23	1.24	1.24	--	--
Nominal effective exchange rate (euro area)	--	--	--	--	--	--
Nominal effective exchange rate (EU)	--	--	--	--	--	--
World GDP growth, excluding EU	--	--	--	--	--	--
United States, GDP growth	--	--	--	--	--	--
Japan, GDP growth	--	--	--	--	--	--
EU-25 GDP growth	1.0	2.5	2.3	2.4	--	--
Growth of relevant foreign markets	--	--	--	--	--	--
World import volumes, excluding EU	10.3	11.6	8.8	8.3	--	--
World import prices (goods, in USD)	--	--	--	--	--	--
Oil prices (Brent, USD/barrel)	28.5	39.3	45.1	40.1	--	--
Non-oil commodity prices (in USD)	--	--	--	--	--	--

Annex 2: Indicators of long-term sustainability

Main assumptions - baseline scenario (as % GDP)	**2009**	**2010**	**2020**	**2030**	**2040**	**2050**	**changes**
Total age-related spending	30.0	30.2	32.7	34.6	34.9	34.8	4.8
Pensions	12.3	12.5	14.3	15.5	15.4	15.2	2.9
Health care*	10.3	10.4	11.4	12.5	13.2	13.4	3.1
Education	5.6	5.6	5.6	5.6	5.5	5.4	-0.2
Unemployment benefits	1.7	1.7	1.4	1.0	0.8	0.8	-0.9
*Total primary non age-related spending***	17.1						
*Total revenues***	50.6						

* including sickness insurance payments

** constant

Results (as % GDP)	**2009**	**2010**	**2020**	**2030**	**2040**	**2050**	**changes**
Baseline scenario							
Gross debt	37.8	34.9	20.1	26.4	45.5	69.2	31.4
i + 0.5*	38.0	35.3	22.0	29.9	51.8	80.2	42.2
Adjusted gross debt**	-1.2	-4.5	-27.0	-30.5	-23.4	-13.7	-12.5
2004 scenario							
Gross debt	27.8	24.7	7.9	11.7	27.7	47.8	20.0
i + 0.5*	27.9	25.0	9.1	13.6	31.2	54.1	26.2
Adjusted gross debt**	-11.2	-14.7	-39.2	-45.1	-41.1	-35.1	-23.9

* i + 0.5 represents the evolution of debt under the assumption of the nominal interest rate being 50 basis points higher throughout the projection period.

** Adjusted gross debt equals Gross debt (Maastricht) net of consolidated public pension fund assets in the general government sector accumulated for the strict purpose of covering pension-related expenditure.