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**NOVEMBER 2005 UPDATE**  
**OF THE STABILITY PROGRAMME OF FINLAND**  
**(2005-2009)**  
**AN ASSESSMENT**

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## SUMMARY AND CONCLUSIONS<sup>1</sup>

The Finnish stability programme update was submitted on 24 November 2005. The programme covers the period from 2005 to 2009.

After recovering from an exceptionally deep recession in the beginning of the 1990s, the Finnish economy expanded strongly over the period 1995–2004, reaching an average growth rate of 3½ percent p.a., which is about 1½ percentage points above the euro area average. Strong growth has helped to raise the employment rate from its post-recession level of 60 % to 68% in 2004. With an average annual rate of 1½ percent, the inflation for the period 1995-2004 was ½ percentage point below the euro area level. The macroeconomic scenario underlying the programme envisages real GDP growth to ease from an annual average of 2.7% in 2005-2006 to 2.3% on average over the rest of the programme period. GDP growth rates for 2005 and 2006 are significantly influenced by production stoppages in the paper and pulp industry caused by a labour dispute, explaining the sharp decline in 2005 and a consequent hike in 2006. Both the short-term and medium-term forecasts presented in the programme are more cautious than the Commission services' forecasts. The programme's projections for inflation appear realistic and are in line with those by Commission services.

In its opinion of 17 February 2005 on the previous update of the Stability Programme, covering the period 2004-2008, the Council endorsed the budgetary strategy presented in the programme. The general government surplus for 2005 is estimated, based on the Commission services' forecast, at 1.9% of GDP, which corresponds closely to the targeted surplus in the previous update of the programme.

The updated programme broadly follows the model structure of the stability and convergence programmes specified in the new code of conduct<sup>2</sup>.

The government's key objectives in this update are achieving balanced central government finances under normal conditions of economic growth and securing the long-term sustainability of public finances in the light of the adverse effects of population ageing. Measures are also proposed to improve the financial accounts of local governments, which should enable them to record a balanced position by the end of the programme period. The general government surplus will be on a slightly declining trend to reach 1.5 % of GDP by the end of the programme period. Both revenues and expenditures as a ratio to GDP will decline from 2005 to 2007 (both by around 1 percentage point of GDP), after which both ratios, and therefore also net lending, are projected to remain stable. The profile of the primary surplus shows a somewhat steeper

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1 This technical analysis, which is based on information available up to 23 December 2005, accompanies the recommendation by the Commission for a Council opinion on the update of the stability programme, which the College adopted on 11 January 2006. 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 Mart Maiväli (mart.maivali@cec.eu.int). The analysis takes into account (i) the Commission services' autumn 2005 forecast, (ii) the code of conduct (Opinion of the Economic and Financial Committee on the "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005), (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances and (iv) the broad economic policy guidelines for the period 2005-2008.

2 The update has gaps in the compulsory and optional data prescribed by the new code of conduct (especially data on external assumptions for the years 2007-2009 are missing).

fall due to the projected drop in the GDP share of interest expenditure. The decline in the surplus reflects the phased introduction of tax cuts. Expenditure is to be kept in check by the government's budgetary spending ceilings and by a reduction in interest expenditure. Compared with the previous update, the surplus estimates for 2006-2009 have been revised downwards by around 0.5% of GDP, due to the tax cuts and a more cautious outlook on the financial position of social security funds and local governments.

In structural terms, the surplus is projected to decline slightly in the next three years from around 2 % of GDP in 2005 to 1¾ in the period 2006-2008, but to rebound in 2009. However, this rebound is entirely due to the assumed widening of the output gap to about -1% of GDP at the end of the programme period. The programme projects the structural surplus to decline to around 1½ % of GDP by the end of the programme period (2009)<sup>3</sup>, which is the programme's MTO. As the programme's MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. As regards appropriateness, the programme's MTO lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and is significantly more demanding than implied by the debt ratio and average potential output growth in the long term. Having an MTO well above the minimum required level is motivated in the programme by the goal of ensuring the long-term sustainability of public finances and the fact that in Finland the impact of ageing population kicks in at an early stage.

The risks attached to the budgetary targets in the update appear to be broadly balanced. The targets until 2007 are in line with the Commission services' autumn 2005 economic forecast, with the latter being slightly more optimistic. The multi-annual spending ceilings for central government have worked well so far to contain spending, while tax projections seem to be based on a cautious assessment. As regards economic growth, the stability programme draws attention to the risk that the adverse effects from population ageing and dwindling labour supply might be underestimated; however, taking into account that the growth assumptions seem cautious when compared with the Commission services' forecasts, the risks arising from the growth outlook appear to be balanced.

Taking into account the risk assessment above, the budgetary strategy outlined in the programme seems sufficient to ensure that the programme's MTO is maintained throughout the programme period. In addition, it also provides a sufficient safety margin against breaching the 3% of GDP deficit ceiling with normal macroeconomic fluctuations for the entire period. The general government gross debt level is forecast to remain well below the 60% of GDP reference value throughout the programme period. The update projects the debt ratio to fall from an estimated 42.7% of GDP in 2005 to 40.1% by 2009. The decline in the debt ratio that would result from the significant primary surpluses is tempered by a debt-increasing stock-flow adjustment reflecting the accumulation of assets in the social security funds.

With regard to the sustainability of public finances, Finland appears to be at low risk on grounds of the projected budgetary costs of ageing populations. The gross debt ratio is currently below the 60% of GDP reference value, and is projected to remain below this value throughout most of the projection period which extends until 2050. The significant

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<sup>3</sup> As calculated in the programme. Commission services' recalculations on the basis of the information in the programme according to the commonly agreed methodology give a structural surplus of 2% of GDP in 2009.

assets of social security and the currently favourable budgetary position contribute to limit the budgetary impact of ageing populations. However, in the long run, a risk to public finance sustainability could emerge, reflecting rising pension expenditure. Containing age-related expenditure over the long term, including the successful implementation of recent reform measures aimed at rising the effective retirement age, while maintaining sound budgetary positions would be key components in reducing risks to public finance sustainability.

The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. In particular, the measures are geared towards ensuring economic and fiscal sustainability and towards promoting growth and job creation, such as a major pension reform that is currently being phased in.

The National Reform Programme of Finland, submitted on 14 October 2005 in the context of the renewed Lisbon strategy for growth and jobs, identifies the following challenges with significant implications for public finances: (i) the sustainability of public finances and (ii) the functioning of the labour market. The budgetary implications of the actions outlined in the National reform Programme are fully reflected in the budgetary projections of the stability programme. The measures in the area of public finances envisaged in the stability programme are in line with the actions foreseen in the National Reform Programme. In particular, the stability programme outlines measures to improve the efficiency of both central and local governments, and confirms the intention to continue with applying central government budgetary spending limits beyond the current legislation period.

Overall, the budgetary position is sound and the budgetary strategy provides a good example of fiscal policies conducted in compliance with the Pact.

### Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008	2009
Real GDP (% change)	<b>SP Nov 2005</b>	<b>3.6</b>	<b>2.1</b>	<b>3.2</b>	<b>2.6</b>	<b>2.3</b>	<b>2.1</b>
	COM Nov 2005	3.6	1.9	3.5	3.1	n.a.	n.a.
	<i>SP Nov 2004</i>	3.2	2.8	2.4	2.2	2.0	<i>n.a.</i>
HICP inflation (%)	<b>SP Nov 2005</b>	<b>0.2</b>	<b>1.0</b>	<b>1.3</b>	<b>1.5</b>	<b>1.8</b>	<b>1.8</b>
	COM Nov 2005	0.1	1.0	1.4	1.3	n.a.	n.a.
	<i>SP Nov 2004</i>	0.2	1.4	1.8	1.8	1.8	<i>n.a.</i>
Output gap (% of potential GDP)	<b>SP Nov 2005<sup>1</sup></b>	<b>0.0</b>	<b>-0.7</b>	<b>-0.2</b>	<b>-0.2</b>	<b>-0.5</b>	<b>-0.9</b>
	COM Nov 2005 <sup>5</sup>	-0.2	-1.2	-0.7	-0.5	n.a.	n.a.
	<i>SP Nov 2004<sup>1</sup></i>	-0.3	-0.1	-0.2	-0.4	-0.6	<i>n.a.</i>
General government balance (% of GDP)	<b>SP Nov 2005</b>	<b>2.1</b>	<b>1.8</b>	<b>1.6</b>	<b>1.6</b>	<b>1.5</b>	<b>1.5</b>
	COM Nov 2005	2.1	1.9	1.9	1.8	n.a.	n.a.
	<i>SP Nov 2004</i>	2.0	1.8	2.1	2.2	2.0	<i>n.a.</i>
Primary balance (% of GDP)	<b>SP Nov 2005</b>	<b>3.7</b>	<b>3.4</b>	<b>3.1</b>	<b>2.9</b>	<b>2.8</b>	<b>2.8</b>
	COM Nov 2005	3.8	3.8	3.7	3.6	n.a.	n.a.
	<i>SP Nov 2004</i>	3.7	3.4	3.8	3.9	3.7	<i>n.a.</i>
Cyclically-adjusted balance = structural balance <sup>2,3</sup> (% of GDP)	<b>SP Nov 2005<sup>1</sup></b>	<b>2.1</b>	<b>2.1</b>	<b>1.7</b>	<b>1.7</b>	<b>1.7</b>	<b>2.0</b>
	COM Nov 2005 <sup>4</sup>	2.3	2.7	2.3	2.1	n.a.	n.a.
	<i>SP Nov 2004<sup>1</sup></i>	2.2	1.9	2.2	2.4	2.4	<i>n.a.</i>
Government gross debt (% of GDP)	<b>SP Nov 2005</b>	<b>44.9</b>	<b>42.7</b>	<b>41.7</b>	<b>41.1</b>	<b>40.6</b>	<b>40.1</b>
	COM Nov 2005	45.1	42.8	41.5	40.6	n.a.	n.a.
	<i>SP Nov 2004</i>	44.6	43.4	42.5	41.7	41.1	<i>n.a.</i>

**Notes:**

<sup>1</sup> Commission services calculations on the basis of the information in the programme

<sup>2</sup> Cyclically-adjusted balance excluding one-off and other temporary measures

<sup>3</sup> There are no one-off and other temporary measures in the programme

<sup>4</sup> There are no one-off and other temporary measures in the Commission services' forecast

<sup>5</sup> Based on estimated potential growth of 2.9%, 2.9%, 2.8% and 2.7% respectively in the period 2004-2007.

**Source:**

*Stability programme (SP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations*

## 1. INTRODUCTION

The Finnish stability programme update was submitted on 24 November 2005. The programme covers the period from 2005 to 2009. As with previous updates, it was presented to the Finnish parliament for information. The programme broadly follows the model structure for stability and convergence programmes specified in the new code of conduct<sup>4</sup>. Beyond the requirements of the code of conduct, the stability programme includes a breakdown of pension fund assets in Finland. Annex 2 provides a detailed overview of all aspects of compliance with the new code of conduct.

## 2. ECONOMIC OUTLOOK

After recovering from an exceptionally deep recession in the beginning of the 1990s, the Finnish economy expanded strongly over the period 1995–2000, reaching an average growth rate of 4½ % p.a., which is about 2 percentage points above the euro-area average. Finland's economic activity slowed with the global downturn in 2001, but recovered again thereafter to rates well above the euro-area average. The effects of the deep recession are still reflected in some structural indicators even though the strong pace of activity has helped to improve the situation. Employment has grown from its post-recession level of 60 % of the working age population in 1994 to 68% in 2004, while the unemployment rate has dropped from 17 % to 8.8% over the same period. The improvements were especially strong in the initial years of recovery during the period 1995-2000. While from 1998-2001 the inflation rate was slightly above the euro area average, peaking at 3 % in 2000, average inflation for the period 1995-2004 was ½ percentage point below the euro area level.

The current update sees GDP growth declining gradually to 2.1 % by 2009 from its peak of 3.6 % in 2004. GDP growth rates for 2005 and 2006 are significantly influenced by production stoppages in the paper and pulp industry caused by labour disputes, explaining the sharp decline in 2005 and a consequent hike in 2006 due to the base effect (see Table 1). The output gap implied by the programme (recalculated by Commission services) is moderately negative throughout the programme period, widening towards the final years of the programme.

In comparison with the Commission services' forecast extending to 2007, the programme is somewhat more cautious on economic growth prospects (by ¼ and ½ percentage point respectively in 2006 and 2007). The programme is also cautious on GDP growth prospects beyond 2007 when compared with Commission services' potential growth calculations<sup>5</sup>. The Commission services expect a relatively larger growth contribution from domestic demand. More specifically, the Commission services foresee markedly stronger growth in investment for 2006 and 2007, while growth in private consumption expenditure is only marginally lower in the update. The programme's projection for the growth in compensation of employees is similar between the forecasts. The external outlook underlying the programme's macro-economic scenario is broadly in line with the

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<sup>4</sup> The programme has gaps in the compulsory and optional data prescribed by the new code of conduct (especially data on external assumptions for the years 2007-2009 are missing).

<sup>5</sup> The macroeconomic scenario in the stability programme for 2005 and 2006 is based on the September 2005 short-term economic forecast of the Finnish Ministry of Finance. GDP growth estimates beyond 2006 are assumed in the programme to be the same as the estimated potential growth rate.

Commission services autumn 2005 forecast, only the forecast for oil price shows a major deviation<sup>6</sup>.

Growth of output will be accompanied by the creation of new jobs, albeit at a decelerating pace, in line with the growth profile. Expected productivity gains are closely in line with the Commission services' autumn 2005 forecast. Figures for 2005 and 2006 are distorted by the effect of the labour conflict on output. The unemployment rate looks set to fall significantly, by nearly 2 percentage points over the whole programme period, helped by broadly stagnating labour supply.

The outlook for inflation is similar in both forecasts. From a low 1% increase in 2005, largely brought about by special factors, inflation will rise gradually, still remaining well below the euro area average. Increasing competition, especially in telecommunications, is seen to keep price increases in check compared with other countries in the euro area. Also, the Commission services estimates suggest that the Finnish economy is less sensitive to oil price hikes than others. The centralised wage agreement, settled in 2004, and an assumed usual positive wage drift of about 1 percentage point, provides for moderate wage increases of about 3% p.a. in 2006-2007, which will be largely accommodated by the gains in productivity.

**Table 1: Sources of macroeconomic developments and forecasts**

	2005		2006		2007		2008	2009
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	1.9	2.1	3.5	3.2	3.1	2.6	2.3	2.1
<i>Contributions:</i>								
- Final domestic demand	2.1	2.0	2.3	1.9	2.1	1.7	1.5	1.3
- Change in inventories	-0.3	0.0	0.1	-0.1	0.0	0.0	0.0	0.0
- External balance on g&s	0.1	0.1	1.1	1.4	0.9	0.9	0.8	0.8
Output gap <sup>1</sup>	-1.2	-0.7	-0.7	-0.2	-0.5	-0.2	-0.4	-0.9
Employment (% change)	1.3	1.3	0.7	0.5	0.7	0.3	0.2	0.2
Unemployment rate (%)	8.4	8.2	7.8	7.5	7.2	7.0	6.6	6.2
Labour productivity growth (%)	0.5	0.8	2.8	2.7	2.4	2.3	2.1	1.9
HICP inflation (%)	1.0	1.0	1.4	1.3	1.3	1.5	1.8	1.8
GDP deflator (% change)	0.5	0.1	0.5	1.0	0.9	1.0	1.1	1.1
Compensation of employees (% change) <sup>2</sup>	4.5	3.8	3.6	3.4	3.5	3.4	3.4	3.4
External balance (% of GDP)	2.3	2.6	2.0	3.2	2.2	3.1	2.9	2.7
<b>Note:</b>								
<sup>1</sup> In percent of potential GDP, with potential GDP growth as reported in Table 2 below.								
<sup>2</sup> Total compensation								
<b>Source:</b>								
Commission services' autumn 2005 economic forecasts (COM); stability programme update (SP)								

Table 2 presents the potential growth estimates according to the commonly agreed methodology on the basis of the information provided in the programme<sup>7</sup>. The results are more cautious than those of the Commission services' autumn 2005 forecast, showing potential growth decelerating in the coming years. The main driver of growth is projected to be TFP, as contributions from capital accumulation and labour remain limited. The

<sup>6</sup> The oil price assumption of 52 USD/barrel for 2006 is markedly lower than the Commission services' forecast of 61 USD/barrel. However, it is not expected to impact the projections significantly.

<sup>7</sup> There are significant differences in the output gap estimates between the stability programme (not shown) and Commission services' calculations on the basis of the information provided in programme according to the commonly agreed methodology (Table 5). The calculations in the stability programme are based on the technical assumption of a closing output gap in the medium



contribution from labour is seen to be on a declining trend, reflecting only modest growth in working age population.

**Table 2: Sources of potential output growth**

	2005		2006		2007		2008	2009
	COM	SP <sup>1</sup>	COM	SP <sup>2</sup>	COM	SP <sup>2</sup>	SP <sup>2</sup>	SP <sup>2</sup>
Potential GDP growth	2.9	2.8	2.9	2.7	2.9	2.6	2.6	2.6
<i>Contributions:</i>								
- Labour	0.5	0.5	0.4	0.4	0.4	0.3	0.3	0.3
- Capital accumulation	0.4	0.4	0.4	0.4	0.5	0.4	0.4	0.4
- TFP	2.0	1.9	2.0	1.9	2.0	1.9	1.8	1.8
<i>Notes:</i>								
<sup>1</sup> Commission services' calculations on the basis of the information in the programme								
<i>Source:</i>								
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations								

### 3. GENERAL GOVERNMENT BALANCE

This section is in four parts. The first briefly compares the targets for the general government balance in the new update with those presented in previous stability programmes. It also discusses budgetary implementation in the year 2005. The second part describes the budgetary strategy in the new update, including the programme's medium-term objective. The third provides the analysis of the risks attached to the budgetary targets and assesses the country's position in relation to the budgetary objectives of the Treaty and the Stability and Growth Pact. The final part discusses the results of a sensitivity analysis.

#### 3.1. Targets in successive programmes and implementation in 2005

In the course of 2005, the time series for revenue and expenditure ratios have been revised, implying an upward level shift by around 3 % of GDP. Therefore, expenditure and revenue ratios in the most recent update of the stability programme and in previous vintages are not directly comparable<sup>8</sup>. However, this methodological change has no effect on the overall balance.

Compared with the previous update, the surplus estimates for 2006-2009 have been revised downwards by around 0.5% of GDP, as evident in Table 3 and Figure 1. The weaker position is explained by the fact that the present stability programme update takes full account of the cuts in income taxes, which the previous update did not. Also, a more cautious outlook is presented on the financial position of social security funds and local governments. The general government surplus is projected to decrease to around 1.5 % of GDP over the medium term.

Looking at the State budget implementation on a cash basis up to November 2005, it seems that the targets set in the 2005 budget, including the three supplementary budgets adopted in the course of 2005, can be reached. In line with past budgetary practices, the supplementary budgets for 2005 make adjustments to expenditure and revenue items, and show a distribution for the higher-than-expected revenues. The production stoppages in

<sup>8</sup> Total expenditure and revenue (ESA95 codes: TE and TR, respectively) shown in the programme are now compiled according to the harmonised definitions in Commission Regulation (EC) N° 1500/2000. The change concerns the way government consumption (and its components) and sales are considered in totals.

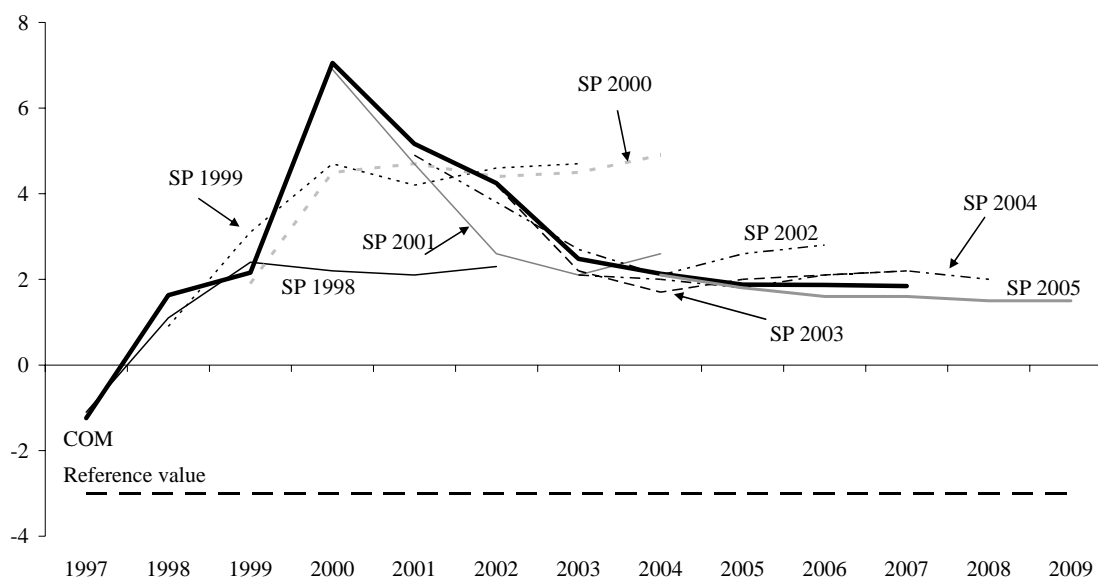
the paper and pulp industry have not had a major impact on the central government budget balance. According to the estimates of the Finnish Ministry of Finance, the negative effect on state budget revenue is about EUR 100 million i.e. 0.06 % of GDP. However, this is more than offset by increases in tax revenues provided for by the three supplementary budgets<sup>9</sup>. Corporate profits have grown faster than expected, despite the disruptions in the paper and pulp industry. Also, private consumption has grown faster than initially estimated. Since expenditure has remained bound by the rules of the budgetary ceilings, the latest estimates project that the central government budget might reach a close-to-balance position in 2005, instead of the deficit of 0.5% of GDP cited in the programme.

**Table 3: Evolution of budgetary targets in successive programmes**

		2004	2005	2006	2007	2008	2009
General government balance (% of GDP)	<b>SP Nov 2005</b>	<b>2.1</b>	<b>1.8</b>	<b>1.6</b>	<b>1.6</b>	<b>1.5</b>	<b>1.5</b>
	SP Dec 2004	2.0	1.8	2.1	2.2	2.0	2.0
	<i>SP Nov 2003</i>	<i>1.7</i>	<i>2.0</i>	<i>2.1</i>	<i>2.2</i>	<i>n.a.</i>	<i>n.a.</i>
	COM Nov 2005	2.1	1.9	1.9	1.8	n.a.	n.a.
General government expenditure (% of GDP)	<b>SP Nov 2005</b>	<b>50.8</b>	<b>51.4</b>	<b>50.8</b>	<b>50.5</b>	<b>50.5</b>	<b>50.5</b>
	SP Dec 2004	48.5	48.4	48.5	48.4	48.5	48.5
	<i>SP Nov 2003</i>	<i>48.7</i>	<i>48.7</i>	<i>48.8</i>	<i>48.8</i>	<i>n.a.</i>	<i>n.a.</i>
	COM Nov 2005	51.5	51.8	51.2	50.7	n.a.	n.a.
General government revenues (% of GDP)	<b>SP Nov 2005</b>	<b>53.0</b>	<b>53.2</b>	<b>52.4</b>	<b>52.0</b>	<b>52.0</b>	<b>52.0</b>
	SP Dec 2004	50.5	50.3	50.6	50.5	50.5	50.5
	<i>SP Nov 2003</i>	<i>50.4</i>	<i>50.8</i>	<i>50.8</i>	<i>51.0</i>	<i>n.a.</i>	<i>n.a.</i>
	COM Nov 2005	53.2	53.7	53.0	52.6	n.a.	n.a.
Real GDP (% change)	<b>SP Nov 2005</b>	<b>3.6</b>	<b>2.1</b>	<b>3.2</b>	<b>2.6</b>	<b>2.3</b>	<b>2.1</b>
	SP Dec 2004	3.2	2.8	2.4	2.2	2.0	<i>n.a.</i>
	<i>SP Nov 2003</i>	<i>2.7</i>	<i>2.5</i>	<i>2.4</i>	<i>2.4</i>	<i>n.a.</i>	<i>n.a.</i>
	COM Nov 2005	3.6	1.9	3.5	3.1	n.a.	n.a.
<i>Source:</i> Stability programmes (SP) and Commission services' autumn 2005 economic forecasts (COM)							

<sup>9</sup> The programme explains that for reasons of forecast consistency only debt projections are updated on the basis of the second supplementary budget of 14 October 2005 (but not the general government balance figures). As the programme states, the changes from the second supplementary budget that are not taken into account in the programme are marginal. The third supplementary budget of 11 November 2005, not included in the programme, indicates further marginal improvements in the central government balance.

**Figure 1: General government balance projections in successive stability programmes (% of GDP)**



Source: Commission services' autumn 2005 forecast (COM) and successive stability programmes

### 3.2. The programme's medium-term budgetary strategy

This section covers in turn the following aspects of the medium-term budgetary strategy outlined in the programme: (i) the main goal of the budgetary strategy; (ii) the composition of the budgetary adjustment, including the broad measures envisaged; and (iii) the programme's medium-term objective and the adjustment path towards it in structural terms.

#### 3.2.1. The main goal of the programme's budgetary strategy

The government's key objectives are achieving balanced central government finances under normal conditions of economic growth and securing long-term sustainability of the public finances in the light of the adverse effects of population ageing. Measures are also proposed to improve the public finance situation of local governments, with the aim of enabling them to record a balanced position by the end of the programme period (from an estimated deficit of around -0.5% of GDP in 2005).

According to the budgetary strategy, the central government finances should be in balance under normal conditions of economic growth at the end of the legislation period (2007). The Finnish Government is also committed to ensuring that, even in adverse economic conditions, the central government deficit, measured in national accounting terms, does not exceed 2¾ per cent of GDP. To help achieve the central government targets, the government has adopted multi-annual spending limits covering the 3 years following the budget year. The spending limits framework, in place since 2003, is the primary instrument of the Finnish government to maintain budgetary discipline. An agreement on central government spending limits extending to 2009 was reached in spring 2005. Expenditure control is deemed necessary, as tax revenues are constrained by cuts in personal income taxation, reform of corporate and capital taxation and increased tax competition.

**Table 4: Composition of the budgetary adjustment**

(% of GDP)	2004	2005	2006	2007	2008	2009	Change: 2009-2005
<b>Revenues</b>	53.0	53.2	52.4	52.0	52.0	52.0	<b>-1.2</b>
<i>of which:</i>							
- Taxes & social contributions	44.5	44.8	44.1	43.8	43.8	43.8	<b>-1.0</b>
- Other (residual)	8.5	8.4	8.2	8.2	8.2	8.2	<b>-0.2</b>
<b>Expenditure</b>	50.8	51.4	50.8	50.5	50.5	50.5	<b>-0.9</b>
<i>of which:</i>							
- Primary expenditure <sup>10</sup>	49.2	49.7	49.2	49.2	49.2	49.2	<b>-0.5</b>
<i>of which:</i>							
Consumption	22.4	23.0	22.9	23.0	23.1	23.2	<b>0.2</b>
Transfers other than in kind & subsidies	18.3	18.4	18.2	18.1	18.2	18.2	<b>-0.2</b>
Gross fixed capital formation	3.0	2.9	2.7	2.7	2.7	2.7	<b>-0.2</b>
Other (residual)	5.5	5.5	5.4	5.3	5.3	5.2	<b>-0.3</b>
- Interest expenditure	1.6	1.7	1.6	1.3	1.3	1.2	<b>-0.5</b>
<b>General government balance (GGB)</b>	<b>2.1</b>	<b>1.8</b>	<b>1.6</b>	<b>1.6</b>	<b>1.5</b>	<b>1.5</b>	<b>-0.3</b>
<b>Primary balance</b>	<b>3.7</b>	<b>3.4</b>	<b>3.1</b>	<b>2.9</b>	<b>2.8</b>	<b>2.8</b>	<b>-0.6</b>
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>GGB excl. one-off &amp; other temporary measures</b>	<b>2.1</b>	<b>1.8</b>	<b>1.6</b>	<b>1.6</b>	<b>1.5</b>	<b>1.5</b>	<b>-0.3</b>
<i>Source:</i>							
<i>Stability programme update; Commission services' calculations</i>							

### 3.2.2. The composition of the budgetary adjustment in the programme

According to the baseline scenario, central government finances are envisaged to show a deficit of around 0.5% of GDP throughout the programme period. As local governments are also foreseen to post a small, albeit declining deficit overall, the general government surplus of about 1½ percent of GDP rests solely on the surplus in social security funds.

According to the programme, the general government surplus is on a slightly declining trend to reach 1.5 % of GDP by the end of the programme period (see Table 4). Revenues and expenditures as a ratio to GDP will decline from 2005 to 2007, after which both ratios, and therefore also net lending, are projected to remain stable. The profile of the primary surplus shows a somewhat steeper fall due to the projected drop in the GDP share of interest expenditure. These projections are in line with the government's spending limits covering the programme period.

The decline in the surplus reflects the phased introduction of tax cuts. Expenditure is to be kept in check by tight budgetary spending limits across all administrative branches and by a reduction in interest expenditure. Interest expenditure is projected to decline markedly until 2007 and stabilise thereafter at around 1.3% of GDP. The fall in the interest component makes a strong contribution to the reduction in the overall expenditure ratio. The data presented in the programme suggest that interest savings are not channelled into additional primary expenditure. The programme provides no information on one-off measures.

As part of a political deal related to the 2004 comprehensive incomes policy agreement, the government proposed significant cuts to the amount of € 1.7 billion, i.e. 1.1% of GDP, in the taxation of earned income for 2005-2007. This is in addition to the government's initial objective of reducing income taxation by at least € 1.1 billion or

<sup>10</sup> Primary expenditure as a ratio to GDP shows a ½ percentage point jump in 2005, mainly due to the effect of lower nominal GDP resulting from the before mentioned paper industry stoppage.

0.8% of GDP during the period 2003-2007. In total the income tax cuts amount to €2.8 billion over the legislative period. To date €1.4 billion worth of tax cuts have been implemented by means of tax rate reductions focused on people with low and medium incomes and raising the ceilings of tax brackets. Cuts of €0.85 billion (corresponding to about 0.5% of GDP) will take effect in 2006. In addition, the usual inflation adjustments across the income tax scale will be implemented (see Box 1). In its revenue projections, the government assumes that part of the revenues foregone from the tax cuts will be offset by positive incentives to growth and employment that would strengthen the tax base.

#### **Box 1 : The budget for 2006**

The draft central government budget for 2006 was presented on 16 September 2005. Significant amendments to the budget proposal were added on 17 November 2005. The budget was approved by the parliament in December 2005. The budget targets a general government surplus of 1.8% of GDP in 2006. The amount of expenditure in the central government budget totals €39.5 billion i.e. 24.8% of GDP, of which €2.2 billion (1.4% of GDP) is interest on central government debt. The budget proposal shows a deficit of €395 million (0.2% of GDP) as revenues are projected to be €39.1 billion (24.5% of GDP).

The main measures in the 2006 budget are the following:

- A tax reduction of €840 million i.e. 0.5 % of GDP on earned income.
- A 2% inflation adjustment across the central government income tax scale, reducing tax revenues by €150 million (0.09 % of GDP).
- The wealth tax is discontinued, reducing central government tax revenues by €70 million (0.04 % of GDP).
- The new daily health contribution levied on wage and corporate income will be deductible from the taxation of earned income. This will reduce tax revenues by €100 million (0.06 % of GDP).
- New transport infrastructure projects with a total cost of €1 292 million (0.8% of GDP) were decided by the Government. The appropriation requirements will be EUR 211 million during the present legislation period (up to year 2007) and €1 081 million in following periods.
- An increase of €304 million (0.2 % of GDP) for central government transfers to local government.
- Increasing development cooperation spending by €70.7 million (0.04% of GDP).

#### *3.2.3. The programme's medium-term objective (MTO) and the adjustment path in structural terms*

According to the Stability and Growth Pact, stability and convergence programmes should present a medium-term objective (MTO) for the budgetary position. The MTO should be differentiated for individual Member States, to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances. The country-specific MTO is defined in structural terms (i.e. cyclically-adjusted, net of one-off and other temporary measures) and should fulfil a triple aim, namely (i) provide a safety margin with respect to the 3% of GDP deficit limit; (ii) ensure rapid progress towards sustainability; and (iii), taking (i) and (ii) into account, allow room for budgetary manoeuvre, considering in particular the needs for public investment. The code of conduct (Section I thereof) further specifies that, as long as the methodology for incorporating implicit liabilities is not fully developed and agreed by the Council, the country-specific MTOs are set taking into account the current government debt ratio and potential growth (in a long-term perspective), while

preserving a sufficient margin against breaching the deficit reference value of 3% of GDP. Member States are free to set an MTO that is more demanding than strictly required to achieve the triple aim of MTOs.

The programme projects the structural balance to reach a surplus of around 1½ % of GDP by the end of the programme period<sup>11</sup>, which is the programme's MTO.

Based on Commission services' calculations on the basis of the programme according to the commonly agreed methodology, the structural balance is set to weaken slightly in the next three years from a surplus of around 2 % of GDP in 2005 to 1¾ in the period 2006-2008, but to rebound in 2009. However, the rebound in the structural surplus is entirely due to the estimated widening of the output gap as the headline balance is projected to remain unchanged from its 2008 level (surplus of 1½ % of GDP). The structural primary balance is projected to follow a somewhat different adjustment path, explained by the decline in interest expenditure.

**Table 5: Output gaps, cyclically-adjusted and structural balances**

	2004		2005		2006		2007		2008	2009	Change: 2009-2005
	COM	SP <sup>1</sup>	COM	SP <sup>1</sup>	COM	SP <sup>1</sup>	COM	SP <sup>1</sup>	SP <sup>1</sup>	SP <sup>1</sup>	SP <sup>1</sup>
Gen. gov't balance	2.1	2.1	1.9	1.8	1.9	1.7	1.8	1.6	1.5	1.5	-0.4
One-offs <sup>2</sup>	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-
Output gap <sup>3</sup>	-0.2	0.0	-1.2	-0.7	-0.7	-0.2	-0.5	-0.2	-0.4	-0.9	-
CAB <sup>4</sup>	2.3	2.1	2.7	2.1	2.3	1.7	2.1	1.7	1.8	2.0	-0.1
change in CAB	-0.7	-0.7	0.4	0.0	-0.4	-0.4	-0.2	0.0	0.1	0.2	-
CAPB <sup>4</sup>	3.9	3.8	4.5	3.8	4.1	3.3	3.8	3.0	3.1	3.2	-0.6
Structural balance <sup>5</sup>	2.3	2.1	2.7	2.1	2.3	1.7	2.1	1.7	1.8	2.0	-0.1
change in struct. bal.	-0.7	-0.7	0.4	0.0	-0.4	-0.4	-0.2	0.0	0.1	0.2	-
Struct. prim. bal. <sup>6</sup>	3.9	3.8	4.5	3.8	4.1	3.3	3.8	3.0	3.1	3.2	-0.6

Notes:  
<sup>1</sup>Output gaps and cyclical adjustment according to the stability programme (SP) as recalculated by Commission services on the basis of the information in the programme  
<sup>2</sup>One-off and other temporary measures  
<sup>3</sup>In percent of potential GDP  
<sup>4</sup>CAB = cyclically-adjusted balance; CAPB = cyclically-adjusted primary balance.  
<sup>5</sup>CAB excluding one-off and other temporary measures  
<sup>6</sup>Structural primary balance = CAPB excluding one-off and other temporary measures

Source:  
*Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations*

### 3.3. Assessment

This assessment is in three parts. The first assesses the appropriateness of the programme's medium-term objective. The second analyses risks attached to the budgetary targets and the third examines whether the budgetary strategy laid down in the programme is consistent with the budgetary objectives of the Treaty and the Stability and Growth Pact.

<sup>11</sup> As calculated in the programme. Commission services' recalculations on the basis of the information in the programme according to the commonly agreed methodology give a structural surplus of 2% of GDP in 2009.

### 3.3.1. Appropriateness of the programme's medium-term objective

As the programme's MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. As regards appropriateness, the programme's MTO lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and is significantly more demanding than implied by the debt ratio and average potential output growth in the long term. Having an MTO well above the minimum required level is motivated in the programme by the objective, mentioned above, of securing the long-term sustainability of public finances and the fact that in Finland the impact of ageing population kicks in at an early stage.

### 3.3.2. Risks attached to the budgetary targets

The risks attached to the budgetary targets appear to be balanced. The update's targets for the general government balance are in line with the Commission services' autumn 2005 economic forecast (which is on a no-policy change basis for 2007), with the latter being slightly more optimistic. Based on data in Table 6 it appears that the programme is conservative in its assumptions on the tax intensity of economic activity for 2006-2007, but less so for the rest of the period. There appear to be only limited risks to the budgetary targets from the central government expenditure side. The multi-annual spending ceilings have worked well under the current government to contain expenditure within the agreed limits. As mentioned above, an agreement on central government spending limits extending to 2009 has already been reached under the present government. The risk of significant expenditure overruns from the announced targets appears to be relatively limited, at least for the present legislation period.

A special factor that might imply downside risk to the domestic economic performance and also to public finances is the heavy reliance on information and communications technology (ICT) production in Finland. However, despite the increasing competition, the prospects for this sector appear favourable also for the future.

The stability programme draws attention to the risk that the adverse effects on economic growth from population ageing and dwindling labour supply might be underestimated. The present calculations rest on the assumptions of a markedly declining NAIRU and a trend increase in the labour force participation rate. However, taking into account the slightly cautious growth projections when compared with the Commission services forecasts, the risks arising from the macroeconomic assumptions appear to be balanced.

**Table 6: Assessment of tax projections**

	2006		2007		2008	2009	p.m.: OECD <sup>1</sup>
	COM	SP	COM <sup>2</sup>	SP	SP	SP	
<b>Total taxes</b>							
Change in tax-to-GDP ratio	-0.3	-0.7	-0.3	-0.4	0.0	0.0	/
<i>Difference</i>	-0.4		-0.1		/	/	/
<i>of which<sup>3</sup>: - elasticity component</i>	-0.3		-0.3		/	/	/
<i>- composition component</i>	-0.1		0.1		/	/	/
p.m.: Observed elasticity to GDP	0.8	0.6	0.8	0.7	1.1	1.0	0.92
<b>Notes:</b>							
<sup>1</sup> OECD ex-ante elasticity relative to GDP							
<sup>2</sup> On a no-policy change basis							

<sup>3</sup>The decomposition is explained in Annex 4

Source:

Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

### 3.3.3. Compliance with the budgetary requirements of the Treaty and the Stability and Growth Pact

Taking into account the risk assessment above, the budgetary strategy outlined in the programme seems sufficient to ensure that the programme's MTO is maintained throughout the programme period. In addition, it also provides a sufficient safety margin against breaching the 3% of GDP deficit ceiling with normal macroeconomic fluctuations for 2005-2009.

For countries that have already achieved the programme's MTO, such as Finland, the only requirement for the "adjustment path" is that pro-cyclical fiscal policies are avoided in "good times". In assessing the policy stance for the coming years, the data suggest that it will be broadly neutral (much of the output gap fluctuation in 2005 and 2006 is explained by the forest industry production stoppage in 2005, which shows up in a closing output gap in 2006 and hence a deterioration in the structural balance, but actually had only a negligible effect on the budget, as explained above). Changes in the structural balance over the programme period are not of a significant magnitude. In the short term, fiscal policy will support economic growth primarily through tax cuts. All in all, the fiscal policies pursued by the government are not pro-cyclical in good times.

**Table 7: Assessment of tax elasticities**

	2006		2007	
	COM (observed)	ex-ante <sup>1</sup>	COM <sup>2</sup> (observed)	ex-ante <sup>1</sup>
<b>Total taxes</b>				
Change in tax-to-GDP ratio	-0.3	-0.1	-0.3	-0.1
<i>Difference</i>		-0.2		-0.2
<i>of which<sup>3</sup>: - elasticity component<sup>4</sup></i>		-0.4		-0.3
<i>- composition component</i>		0.3		0.2
p.m.: Elasticity to GDP	0.8	0.9	0.8	0.9

Notes:

<sup>1</sup>Tax projections obtained by applying ex-ante standard tax elasticities estimated by the OECD

<sup>2</sup>On a no-policy change basis

<sup>3</sup>The decomposition is explained in Annex 4

<sup>4</sup>The "elasticity component" includes discretionary measures, which are notably the income tax cuts of about 0.5 % of GDP in 2006 and 0.3 % of GDP in 2007. If the effects of the discretionary measures were netted out, the observed change in the tax-to-GDP ratio would be higher than the one implied by the standard OECD elasticities.

Source:

Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

The strategy for the general government balance outlined in the programme is consistent with the broad economic policy guidelines in the area of public finances (for a more detailed overview see Annex 3).



### 3.4. Sensitivity analysis

The programme includes scenarios for lower and higher GDP growth and interest rates (+/- 1 percentage point annual deviation from the baseline) in order to assess how changes in the assumptions would affect public finances. Revenue and expenditure elasticities as estimated by the OECD are used to measure the impact of economic growth deviations on general government finances. The results show that in the case of the slower-growth scenario general government finances would slip into deficit at the end of the forecast period and the debt ratio would start rising. In the fast-growth scenario, the general government surplus would increase to over 3 per cent of GDP. A deviation in interest rates is found to impact on public finances only marginally.

Commission services' simulations of the cyclically-adjusted balance under the assumptions of (i) a sustained 1.0 percentage point deviation from the real GDP growth projections in the programme over the 2005-2009 period; (ii) trend output based on the HP-filter<sup>12</sup> and (iii) no policy response (notably, the expenditure level is as in the central scenario<sup>13</sup>), reveal that, by 2009, the cyclically-adjusted balance is about 1.5 percentage point of GDP above/below the central scenario. Hence, in the case of persistently lower real growth, additional measures would be necessary to keep the public finances on the path targeted in the central scenario.<sup>14</sup> The results confirm the picture given by the sensitivity analysis of the stability programme.

## 4. GENERAL GOVERNMENT GROSS DEBT

This section is in two parts: the first describes the debt path envisaged in the programme and the second contains the assessment.

### 4.1. Debt developments in the programme

The programme regards it as essential that the general government gross debt will be reduced in view of the future expenditure pressures stemming from the rapidly ageing population. The general government gross debt ratio is forecast to remain well below 60% of GDP and to be on a downward path throughout the programme period, as illustrated in Figure 2 and Table 8. The decline in the debt ratio that would result from the significant primary surpluses is tempered by a debt-increasing stock-flow adjustment reflecting accumulation of assets in the pension funds.

The current stability programme update estimates general government gross debt at 42.7% of GDP in 2005, which is 0.7 percentage points lower than cited in the previous update. The source of the improvement is mainly receipts from the sale of shares. As a result, the debt ratio over the programme period has also slightly improved compared with previous updates' projections.

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<sup>12</sup> In the absence of a fully-specified macroeconomic scenario that would underlie such deviations, it is obviously impossible to derive new estimates of potential growth from the agreed production function method.

<sup>13</sup> The effect of lower/higher growth on revenues is captured by using the conventional sensitivity parameters adopted in cyclical adjustment procedures.

<sup>14</sup> Unexpected changes in inflation are not assumed to affect the expenditure-to-GDP ratio as nominal expenditure should broadly move in lockstep with the price level.

**Table 8: Debt dynamics**

	average 2000-2004	2005		2006		2007		2008	2009
	COM	COM	SP	COM	SP	COM	SP	SP	SP
<b>Government gross debt ratio</b>	<b>44.2</b>	<b>42.8</b>	<b>42.7</b>	<b>41.5</b>	<b>41.7</b>	<b>40.6</b>	<b>41.1</b>	<b>40.6</b>	<b>40.1</b>
Change in debt ratio (1 = 2+3+4)	-0.3	-2.3	-2.4	-1.3	-1.0	-0.9	-0.6	-0.5	-0.5
<i>Contributions:</i>									
- <b>Primary balance</b> (2)	<b>-6.5</b>	<b>-3.8</b>	<b>-3.5</b>	<b>-3.7</b>	<b>-3.2</b>	<b>-3.6</b>	<b>-2.9</b>	<b>-2.8</b>	<b>-2.7</b>
- <b>“Snow-ball” effect</b> (3)	<b>0.4</b>	<b>0.8</b>	<b>0.5</b>	<b>0.1</b>	<b>-0.1</b>	<b>0.2</b>	<b>-0.1</b>	<b>-0.1</b>	<b>-0.1</b>
- Interest expenditure	2.3	1.9	1.7	1.8	1.6	1.7	1.3	1.3	1.2
- Real GDP growth	-1.2	-0.8	-0.9	-1.4	-1.3	-1.2	-1.0	-0.9	-0.8
- Inflation (GDP deflator)	-0.7	-0.3	-0.3	-0.3	-0.4	-0.3	-0.4	-0.4	-0.4
- <b>Stock-flow adjustment</b> (4)	<b>5.9</b>	<b>0.6</b>	<b>0.5</b>	<b>2.3</b>	<b>2.3</b>	<b>2.5</b>	<b>2.4</b>	<b>2.4</b>	<b>2.3</b>
- Cash/accruals	0.4								
- Accumulation of financial assets	5.4								
<i>of which: Privatisation proceeds</i>	-0.5	0.0	-1.0	0.0	-0.3	0.0	-0.3	-0.2	-0.2
- Valuation effects & residual adj.	0.1								
<b>Note:</b>									
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.									
<i>Sources:</i>									
<i>Stability programme update (SP); Commission services’ autumn 2005 economic forecasts (COM); Commission services’ calculations</i>									

## 4.2. Assessment

The path of gross debt projected in the programme is broadly in line with the Commission services’ autumn 2005 forecasts. It is expected that gross debt will decline to about 40% of GDP by the end of the programme period. As mentioned before, the Commission services’ forecasts are more optimistic on the developments of the general government surplus and GDP growth prospects. Thus, the attainment of the reduction in the debt ratio targeted in the stability programme seems plausible. Also, the financial assets controlled by general government exceed gross debt, owing notably to the accumulation of assets by social security.

## 5. STRUCTURAL REFORM, THE QUALITY OF PUBLIC FINANCES AND INSTITUTIONAL FEATURES

In terms of quality, Finland’s public finances appear to be sound. The multi-annual spending limits have worked well under the present government to avoid expenditure overruns and to improve the predictability of the central government finances. The programme update contains an overview of a number of measures, which, among other objectives, improve the quality and sustainability of public finances already in the medium term. A government “productivity action programme” has been launched to improve productivity in the central government sector (see Box 2). The finances of municipalities are strengthened by the “basic services programme”, incorporating measures to balance local governments’ revenue and expenditure, and by a project to

reform municipal and social services structures. The latter reform was announced in May 2005, the other measures are ongoing and are in various stages of implementation.

The recent pension reform package is gradually being implemented from the beginning of 2005, although some measures were introduced already in 2003. As some of the measures will not be implemented before 2009, part of the financial benefits of the reform will accrue only after 2010. Combined with the changes introduced to the unemployment compensation scheme, the pension reform should help to keep control over expenditure in coming years.

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

#### **Box 2: The central government productivity programme**

The central government productivity programme is part of a wider effort to improve productivity in the public sector. Separate measures relate to the local governments. The main motivating force behind the programme is the desire to prepare already now for the adverse effects of population ageing on economic growth and public finances. In an environment of declining labour supply the public sector will be increasingly competing with the private sector for the ever scarcer workforce, which threatens to crowd out private sector growth. At the same time, to meet the increasing service needs with relatively fewer resources, the productivity in the provision of public services needs to be raised.

It is planned to fill on average about half of the posts in the state sector vacated by natural turnover (for example retirement), which translates to a reduction in state employment of about 17 500 people or around 14 percent of the workforce by 2011. Individual productivity programmes are drawn up by each ministry for their administrative areas, detailing the specific measures, their impacts on personnel numbers, spending limits and the budget. Ministries have to date drawn up revised productivity programmes and strategic personnel plans for the period 2007-2011. In general the measures are mostly concerned with improving the structures and strategies of service provision, utilizing economies of scale and making more efficient use of possibilities offered by ICT. Clearly, the personnel reduction target is the most challenging one for ministries to meet in practice.

The ministries are relatively independent in identifying their own measures, which highlights the crucial importance of prudent coordination and implementation mechanisms, as well as creating a general environment of consensus behind the efforts. For this end a central steering group has been set up to coordinate all aspects of the programme. Implementation of the plans is secured by including them in the central government budget spending limits procedure. The revised productivity plans will be included in the spending limit proposal for 2007-2011. Consequently, the next spending limits will be exceptionally agreed upon for 5 years to correspond with the productivity programme timeline.

The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. In particular, the measures are geared towards ensuring economic and fiscal sustainability and towards promoting growth and job creation, such as a major pension reform that is currently being phased in.

The National Reform Programme of Finland, submitted on 14 October 2005 in the context of the renewed Lisbon strategy for growth and jobs, identifies the following challenges with significant implications for public finances: (i) the sustainability of public finances and (ii) the functioning of the labour market. The budgetary implications of the actions outlined in the National reform Programme are fully reflected in the budgetary projections of the stability programme. The measures in the area of public finances envisaged in the stability programme are in line with the actions foreseen in the National Reform Programme. In particular, the stability programme outlines measures to improve the efficiency of both central and local governments, and confirms the intention to continue with applying central government budgetary spending limits beyond the current legislation period.

## **6. THE SUSTAINABILITY OF THE PUBLIC FINANCES**

The assessment of the sustainability of Finland's public finances is based on an overall judgement of the results of quantitative indicators and qualitative features. The debt projections and sustainability indicators are calculated according to two different scenarios, to take into account different budgetary developments over the medium term. The "programme" scenario assumes that the medium-term budgetary plans set up in the programme are actually achieved. The "2005" scenario assumes that the structural primary balance remains unchanged at the 2005 level throughout the programme period.

The long-term projections in the programme have been made using the agreed assumptions in the current Economic Policy Committee (EPC) projections (see Table A1 in Annex 5). On the basis of this information, age-related expenditure is foreseen to increase by 6.4% of GDP between 2009 and 2050, to which pension expenditures contribute 2.7% of GDP (see Table A2 in Annex 5). The Commission services' analysis is based on the set of government expenditure items covered by the common projections carried out by the Economic Policy Committee<sup>15</sup>. In addition to these expenditure items, the Finnish programme includes a projected rise in the revenue ratio.

The gross debt ratio is projected to remain below 60% of GDP in the "2005" scenario throughout the projection period, though in the "programme" scenario it rises above the reference value in the 2030s. However, when considering the adjusted gross debt/GDP ratio, taking into account the considerable assets accumulated by the social security sector in public pension schemes, it is projected to remain below the 60% of GDP reference value up to 2050 (see Table A4 in the Annex)<sup>16</sup>.

According to the S1 indicator, there is no sustainability gap for Finland regardless of whether the '2005' or the 'programme' scenario is considered. The projected future budgetary impact of ageing populations up to 2050 is more than offset by the positive initial budgetary position, the low current level of gross debt and the assets held by social security. However, S1 only takes into account changes in the primary balance up to 2050, which underestimates the cost of ageing.

According to the government's inter-temporal budget constraint, captured by the S2 indicator, a sustainability gap of almost 2% of GDP emerges in the '2005' scenario. The

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<sup>15</sup> Namely, government expenditure on pension, health-care, long-term care, education and unemployment benefits. Other expenditure items and revenues are assumed to remain constant as a share of GDP over the projection period.

<sup>16</sup> Liquid consolidated assets in public pension schemes are classified in general government in Finland. In 2004, they amounted to 45.1% of GDP, which is deducted from gross debt (at 44.9% of GDP in 2004) so that an adjusted gross debt measure can be calculated.

initial budgetary position is not sufficiently high to fully offset the future budgetary impact of ageing. In the ‘programme’ scenario, the sustainability gap is somewhat larger, due to a deterioration of the budgetary position, indicating the importance of maintaining the currently strong budgetary position in dealing with the challenge posed by ageing populations. This sustainability gap translates into a required primary balance (RPB) of about 4½% of GDP, higher than the structural primary balance of 3¼% of GDP of the last year of the programme period.

Moreover, the sustainability gap, as measured by the S2 indicator, would increase further by around 0.1% of GDP if the (budgetary or structural) adjustment was to be postponed by 5 years.

**Table 9: Sustainability indicators and the required primary balance**

	Sustainability indicators and RPB						
	2005 Scenario				Programme scenario		
	S1	S2		RPB	S1	S2	RPB
<b>Value (of which)</b>	<b>-1.5</b>	<b>1.2</b>		<b>4.4</b>	<b>-0.5</b>	<b>2.0</b>	<b>4.6</b>
<i>initial budgetary position</i>	-4.1	-4.1			-3.3	-3.3	
<i>debt requirement in 2050</i>	-1.5	:			-1.2	:	
<i>future changes in budgetary position</i>	4.0	5.3			4.0	5.3	

Note: The S1 indicator shows the difference, the sustainability gap, between the constant revenue ratio as a share of GDP required to reach a debt ratio in 2050 of 60% of GDP and the current revenue ratio. The S2 indicator, which shows the difference, the sustainability gap, between the constant revenue ratio as a share of GDP that guarantees the respect of the inter-temporal budget constraint of the government, i.e. that equates the actualized flow of revenues and expenses over an infinite horizon, and the current revenue ratio<sup>17</sup>. The Required Primary Balance (RPB) measures the average primary balance over the first five years of the projection period that results from a permanent budgetary adjustment carried out to comply fully with the inter-temporal budget constraint. See European Commission ((2005), European Economy, ‘Public finances in EMU – 2005’, Section II.3 for a further description.

In interpreting these results, several factors need to be taken into account.

The additional national long-term projections provided in the Finnish programme include a projected significant rise in the revenue ratio of 5.1% of GDP between 2009 and 2050. The impact on the S2 indicator of incorporating this projection would reduce the sustainability gap by 3.3 percentage points<sup>18</sup>. This rise in the revenue ratio reflects increases in pension contributions. Considering the already relatively high revenue ratio in Finland, a further increase may prove difficult, suggesting that budgetary consolidation should preferably take place on the expenditure side. The scenario highlights in this respect the need for further sustainability enhancing reforms and strengthening of the tax base. On the assumption that this additional national revenue projection will materialise, it would imply lower sustainability risks for Finland.

No new reform measures are announced although discussions are under way to allow pension schemes to take greater risks with the aim to increase returns from their financial investments. The most recent 2005 package of pension reforms covers both private and public sector workers and is expected to increase the exit age from the labour market by two years. In addition, the overhaul of the unemployment insurance system raises the age limit for the elderly unemployed to become eligible for extended benefits until they are entitled to pensions, which is projected to elevate the exit age by one more year. At this

<sup>17</sup> The sustainability gap indicators (S1, S2) do not necessarily suggest that taxes should be increased; strengthening the fiscal position by permanently reducing the level of non-age related primary spending could be preferable and has the same impact.

<sup>18</sup> The impact of these additional national long-term projections over the period 2010-2050 were calculated.

stage it is too early to assess the impacts of the reforms. On an encouraging note, the general trend over the past years shows an increase in the retirement age and a distinct improvement in employment opportunities for older workers, which can be partly linked to the enacted reforms. Successfully implementing the sustainability-enhancing reforms would make an important contribution to improving public finance sustainability.

**Overall assessment.**

With regard to the sustainability of public finances, Finland appears to be at low risk on grounds of the projected budgetary costs of ageing populations. The gross debt ratio is currently below the 60% reference value, and is projected to remain below this value throughout most of the projection period which extends until 2050. The significant assets of social security and the currently favourable budgetary position contribute to limit the budgetary impact of ageing populations. However, in the long run, a risk to public finance sustainability could emerge, reflecting rising pension expenditure. Containing age-related expenditure over the long term, including the successful implementation of recent reform measures aimed at rising the effective retirement age, while maintaining sound budgetary positions would be key components in reducing risks to public finance sustainability.

## Annex 1: Summary tables from the stability programme update

Table 1a. Macroeconomic prospects

	ESA Code	2004	2004	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. Real GDP</b>	B1*g		3.6	2.1	3.2	2.6	2.3	2.1
<b>2. Nominal GDP</b>	B1*g	149.7	4.1	2.2	4.2	3.6	3.4	3.2
<b>Components of real GDP</b>								
<b>3. Private consumption expenditure</b>	P.3	77.7	3.2	2.4	2.6	2.2	2.0	1.8
<b>4. Government consumption expenditure</b>	P.3	33.7	1.6	1.7	1.4	1.2	0.9	0.7
<b>5. Gross fixed capital formation</b>	P.51	28.2	5.0	2.0	1.6	1.9	1.4	1.3
<b>6. Changes in inventories and net acquisition of valuables (% of GDP)</b>	P.52 + P.53	0.8	0.5	0.5	0.5	0.5	0.5	0.5
<b>7. Exports of goods and services</b>	P.6	56.6	5.6	3.8	6.0	3.9	3.4	3.2
<b>8. Imports of goods and services</b>	P.7	48.5	6.0	4.4	3.5	2.4	2.2	2.0
<b>Contributions to real GDP growth</b>								
<b>9. Final domestic demand</b>		139.6	2.9	2.0	1.9	1.7	1.5	1.3
<b>10. Changes in inventories and net acquisition of valuables</b>	P.52 + P.53	0.8	0.3	0.0	-0.1	0.0	0.0	0.0
<b>11. External balance of goods and services</b>	B.11	8.1	0.4	0.1	1.4	0.9	0.8	0.8

Table 1b. Price developments

	ESA Code	2004	2004	2005	2006	2007	2008	2009
		level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. GDP deflator</b>			0.5	0.1	1.0	1.0	1.1	1.1
2. Private consumption deflator			0.1	1.0	1.5	1.5	1.8	1.8
<b>3. HICP<sup>19</sup></b>			0.2	1.0	1.3	1.5	1.8	1.8
4. Public consumption deflator			3.7	2.9	2.4	2.8	2.8	2.8
5. Investment deflator			2.0	1.8	1.6	2.0	2.0	2.0
<b>6. Export price deflator (goods and services)</b>			1.0	0.3	-0.6	-0.8	-0.8	-0.8
<b>7. Import price deflator (goods and services)</b>			3.6	4.5	0.9	1.0	1.0	1.0

**Table 1c. Labour market developments**

	ESA Code	2004	2004	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. Employment, persons<sup>20</sup></b>		2365	0.0	1.3	0.5	0.3	0.2	0.2
2. Employment, hours worked <sup>21</sup>		4068	0.3	0.4	0.6	0.1	0.0	0.0
<b>3. Unemployment rate (%)<sup>22</sup></b>			8.8	8.2	7.5	7.0	6.6	6.2
<b>4. Labour productivity, persons<sup>23</sup></b>			3.6	0.8	2.7	2.3	2.1	1.9
5. Labour productivity, hours worked <sup>24</sup>			3.3	1.7	2.7	2.5	2.3	2.1
<b>6. Compensation of employees</b>	D.1		4.5	3.8	3.4	3.4	3.4	3.4

**Table 1d. Sectoral balances**

% of GDP	ESA Code	2004	2005	2006	2007	2008	2009
<b>1. Net lending/borrowing vis-à-vis the rest of the world</b>	B.9	4.2	2.6	3.2	3.1	2.9	2.7
of which:							
- Balance on goods and services		5.4	4.0	4.3	4.2	3.9	3.7
- Balance of primary incomes and transfers		-1.3	-1.4	-1.2	-1.2	-1.1	-1.1
- Capital account		0.1	0.1	0.1	0.1	0.1	0.1
2. Net lending/borrowing of the private sector	B.9/ EDP B.9	3.1	1.9	2.7	2.6	2.4	2.2
3. Net lending/borrowing of general government	B.9	2.1	1.8	1.6	1.6	1.5	1.5
<b>4. Statistical discrepancy</b>		-1.1	-1.1	-1.1	-1.1	-1.1	-1.1

<sup>20</sup> Occupied population, domestic concept national accounts definition.

<sup>21</sup> National accounts definition.

<sup>22</sup> Harmonised definition, Eurostat; levels.

<sup>23</sup> Real GDP per person employed.

<sup>24</sup> Real GDP per hour worked.



**Table 2. General government budgetary prospects**

	ESA code	2004	2004	2005	2006	2007	2008	2009
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
<b>Net lending (EDP B.9) by sub-sector</b>								
<b>1. General government</b>	S.13	3,194	2.1	1.8	1.6	1.6	1.5	1.5
<b>2. Central government</b>	S.131 1	724	0.5	-0.5	-0.5	-0.5	-0.7	-0.5
<b>3. State government</b>	S.131 2							
<b>4. Local government</b>	S.131 3	-997	-0.7	-0.5	-0.4	-0.2	-0.1	-0.1
<b>5. Social security funds</b>	S.131 4	3467	2.3	2.8	2.5	2.4	2.3	2.2
<b>General government (S13)</b>								
<b>6. Total revenue</b>	TR	79289	53.0	53.2	52.4	52.0	52.0	52.0
<b>7. Total expenditure</b>	TE <sup>25</sup>	76095	50.8	51.4	50.8	50.5	50.5	50.5
<b>8. Net lending/borrowing</b>	EDP B.9	3194	2.1	1.8	1.6	1.6	1.5	1.5
<b>9. Interest expenditure (incl. FISIM)</b>	EDP D.41 incl. FISIM	2339	1.6	1.7	1.6	1.3	1.3	1.2
<b>pm: 9a. FISIM</b>		59	0.0	-	-	-	-	-
<b>10. Primary balance</b>	<sup>26</sup>	5533	3.7	3.4	3.1	2.9	2.8	2.8
<b>Selected components of revenue</b>								
<b>11. Total taxes (11=11a+11b+11c)</b>		48,497	32.4	32.2	31.6	31.3	31.2	31.1
<b>11a. Taxes on production and imports</b>	D.2	21,359	14.3	14.2	14.0	13.9	13.9	13.8
<b>11b. Current taxes on income, wealth, etc</b>	D.5	26,666	17.8	17.7	17.3	17.0	17.0	17.0
<b>11c. Capital taxes</b>	D.91	472	0.3	0.3	0.3	0.3	0.3	0.3
<b>12. Social contributions</b>	D.61	18073	12.1	12.6	12.5	12.5	12.6	12.7
<b>13. Property income</b>	D.4	5,085	3.4	3.3	3.2	3.1	3.1	3.1
<b>14. Other (14=15-(11+12+13))</b>		7,634	5.1	5.1	5.0	5.1	5.1	5.1
<b>15=6. Total revenue</b>	TR	79289	53.0	53.2	52.4	52.0	52.0	52.0
<b>p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)<sup>27</sup></b>		66,236	44.2	44.6	43.9	43.6	43.5	43.6
<b>Selected components of expenditure</b>								
<b>16. Collective consumption</b>	P.32	11726	7.8	8.0	7.9	7.9	7.9	7.9
<b>17. Total social transfers</b>	D.62 + D.63	47,393	31.7	32.1	31.9	31.9	32.0	32.2
17a. Social transfers in kind	P.31 =D.63	21,932	14.6	15.0	15.0	15.1	15.2	15.3
17b. Social transfers other than in kind	D.62	25,461	17.0	17.1	16.9	16.8	16.9	17.0
<b>18.=9. Interest expenditure (incl. FISIM)</b>	EDP D.41 incl. FISIM	2339	1.6	1.7	1.6	1.3	1.3	1.2

<sup>25</sup> Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

<sup>26</sup> The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41 + FISIM recorded as intermediate consumption, item 9).

<sup>27</sup> Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

<b>19. Subsidies</b>	D.3	1,915	1.3	1.3	1.3	1.3	1.3	1.2
<b>20. Gross fixed capital formation</b>	P.51	4,506	3.0	2.9	2.7	2.7	2.7	2.7
<b>21. Other</b> (21=22-(16+17+18+19+20))		8216	5.5	5.5	5.4	5.3	5.3	5.2
<b>22=7. Total expenditure</b>	TE <sup>28</sup>	76095	50.8	51.4	50.8	50.5	50.5	50.5
Pm: compensation of employees	D.1	20667	13.8	14.0	13.9	13.9	13.9	13.9

**Table 3. General government expenditure by function**

% of GDP	COFOG Code	2003	2009
1. General public services	1	6.1	5.6
2. Defence	2	1.6	1.5
3. Public order and safety	3	1.4	1.4
4. Economic affairs	4	5.0	4.4
5. Environmental protection	5	0.3	0.3
6. Housing and community amenities	6	0.4	0.4
7. Health	7	6.5	7.3
8. Recreation, culture and religion	8	1.2	1.2
9. Education	9	6.6	6.2
10. Social protection	10	21.6	22.3
11. Total expenditure (= item 7=26 in Table 2)	TE <sup>29</sup>	50.8	50.5

**Table 4. General government debt developments**

% of GDP		2004	2005	2006	2007	2008	2009
<b>1. Gross debt<sup>30</sup></b>		44.9	42.7	41.7	41.1	40.6	40.1
<b>2. Change in gross debt ratio</b>		-0.1	-2.2	-1.0	-0.6	-0.4	-0.5
<b>Contributions to changes in gross debt</b>							
<b>3. Primary balance<sup>31</sup></b>		-3.7	-3.4	-3.1	-2.9	-2.8	-2.8
<b>4. Interest expenditure (incl. FISIM)<sup>32</sup></b>		1.6	1.7	1.6	1.3	1.3	1.2
<b>5. Stock-flow adjustment</b>		2.1	-0.4	0.6	0.9	1.1	1.0
of which:							
- Differences between cash and accruals <sup>33</sup>		0.2	0.0	0.0	0.0	0.0	0.0
- Net accumulation of financial assets <sup>34</sup> <i>of which:</i> <i>privatisation proceeds</i>		4.4	0.7	2.6	2.6	2.5	2.4
- Valuation effects and other <sup>35</sup>		-1.5	-1.0	-0.3	-0.3	-0.2	-0.2
<b>p.m. implicit interest rate on debt<sup>36</sup></b>		-2.5	-1.2	-2.1	-1.6	-1.4	-1.4
<b>Other relevant variables</b>							
6. Liquid financial assets <sup>37</sup>							
7. Net financial debt (7=1-6)							

<sup>28</sup> Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

<sup>29</sup> Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

<sup>30</sup> As defined in Regulation 3605/93 (not an ESA concept).

<sup>31</sup> Cf. item 10 in Table 2.

<sup>32</sup> Cf. item 9 in Table 2.

<sup>33</sup> The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

<sup>34</sup> Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

<sup>35</sup> Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

<sup>36</sup> Proxied by interest expenditure (incl. FISIM recorded as consumption) divided by the debt level of the previous year.

<sup>37</sup> AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

**Table 5. Cyclical developments**

% of GDP	ESA Code	2004	2005	2006	2007	2008	2009
<b>1. Real GDP growth (%)</b>		3.6	2.1	3.2	2.6	2.3	2.1
<b>2. Net lending of general government</b>	EDP B.9	2.1	1.8	1.6	1.6	1.5	1.5
<b>3. Interest expenditure (incl. FISIM recorded as consumption)</b>	EDPD.41+FISIM	1.6	1.7	1.6	1.3	1.3	1.2
4. Potential GDP growth (%) (1)		3.0	3.0	2.9	2.6	2.3	2.1
contributions:							
- labour		0.6	0.6	0.5	0.4	0.3	0.2
- capital		0.3	0.4	0.4	0.3	0.2	0.1
- total factor productivity		2.0	2.0	1.9	1.9	1.8	1.8
5. Output gap		-0.3	-1.2	-0.9	-0.6	-0.3	0.0
6. Cyclical budgetary component		-0.2	-0.6	-0.4	-0.3	-0.1	0.0
7. Cyclically-adjusted balance (2-6)		2.3	2.4	2.0	1.9	1.6	1.5
8. Cyclically-adjusted primary balance (7-3)		3.8	4.0	3.6	3.2	2.9	2.8

(1) Until an agreement on the Production Function Method is reached, Member States can use their own figures (*SP*)

**Table 6. Divergence from previous update**

	ESA Code	2004	2005	2006	2007	2008	2009
<b>Real GDP growth (%)</b>							
<b>Previous update</b>		3.2	2.8	2.4	2.2	2.0	-
<b>Current update</b>		3.6	2.1	3.2	2.6	2.3	2.1
<b>Difference</b>		0.4	-0.7	0.8	0.4	0.3	-
<b>General government net lending (% of GDP)</b>	EDP B.9						
<b>Previous update</b>		2.0	1.8	2.1	2.2	2.0	-
<b>Current update</b>		2.1	1.8	1.6	1.6	1.5	1.5
<b>Difference</b>		0.1	0.0	-0.5	-0.6	-0.5	-
<b>General government gross debt (% of GDP)</b>							
<b>Previous update</b>		44.6	43.4	42.5	41.7	41.1	-
<b>Current update</b>		44.9	42.7	41.7	41.1	40.6	40.1
<b>Difference</b>		0.3	-0.7	-0.8	-0.6	-0.5	-

**Table 7. Long-term sustainability of public finances**

% of GDP	2000	2005	2010	2020	2030	2050
Total expenditure	48.8	51.4	51.9	54.5	58.1	62.6
Of which: age-related expenditures		23.6	24.2	26.7	29.6	30.6
Pension expenditure		10.4	11.2	12.9	14.0	13.7
Social security pension						
Old-age and early pensions		8.0	8.8	10.7	12.0	12.1
Other pensions (disability, survivors)		2.4	2.4	2.2	2.0	1.7
Occupational pensions (if in general government)						
Health care		5.5	5.6	6.2	7.0	7.4
Long-term care ( <i>this was earlier included in the health care</i> )		1.8	1.9	2.5	3.3	4.3
Education expenditure		5.9	5.4	5.2	5.2	5.1
Other age-related expenditures						
Interest expenditure	2.8	2.3	2.3	2.3	3.1	6.6
Total revenue	55.9	53.4	53.5	55.4	56.5	57.6
Of which: property income	4.1	4.4	4.6	4.9	5.0	5.1
<i>of which: from pensions contributions (or social contributions if appropriate)</i>	8.9	9.1	9.0	10.3	11.2	11.2
Pension reserve fund assets	49.4	59.6	65.6	73.0	77.4	80.6
Of which: consolidated public pension fund assets (assets other than government liabilities)	29.2	46.4	51.0	56.8	60.2	62.7
Net lending	7.1	1.8	1.6	0.8	-1.6	-5.1
<b>Assumptions</b>						
Labour productivity growth		2.2	1.9	2.1	1.7	1.7
Real GDP growth		3.1	2.2	1.7	1.4	1.4
Participation rate males (aged 20-64)		81.0	83.3	85.7	86.4	86.5
Participation rates females (aged 20-64)		76.4	76.6	80.3	81.5	81.9
Total participation rates (aged 20-64)		79.3	79.8	82.9	84.0	84.2
Unemployment rate		8.0	6.8	6.5	6.5	6.5
Population aged 65+ over total population		15.8	16.9	22.6	26.1	27.0

**Table 8. Basic assumptions**

**This table should preferably be included in the programme itself; if not, these assumptions should be transmitted to the Council and the Commission together with the programme.**

	2004	2005	2006	2007	2008
Short-term interest rate <sup>38</sup> (annual average)	2.1	2.2	2.4	-	-
Long-term interest rate (annual average)	4.1	3.5	3.7	-	-
USD/€ exchange rate (annual average) (euro area and ERM II countries)	1.2	1.3	1.3	-	-
Nominal effective exchange rate (for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)	1.5	0.1	0.1	-	-
World excluding EU, GDP growth	5.7	4.8	4.8	-	-
EU GDP growth	2.4	1.6	1.9	-	-
World excluding EU, GDP growth	10.0	7.7	9.7	-	-
Growth of relevant foreign markets	9.0	6.0	5.0	-	-
World import volumes, excluding EU	38.3	52.0	52.0	-	-
Oil prices, (Brent, USD/barrel)	2.1	2.2	2.4	-	-

<sup>38</sup>

If necessary, purely technical assumptions.

## Annex 2: Compliance with the code of conduct

The table below provides a detailed assessment of whether the programme respects the requirements of Section II of the new code of conduct. It is in four parts, covering compliance with (i) the window for the date of submission of the programme; (ii) the model structure (table of contents) in Annex 1 of the code; (iii) the data requirements (model tables) in Annex 2 of the code; and (iv) other information requirements. In the main text, points (ii) and (iii) are grouped into the “format” requirements of the code, whereas point (iv) refers to its “content” requirements.

Guidelines in the new code of conduct	Yes	No	Comments
<b>1. Submission of the programme</b>			
Programme was submitted not earlier than mid-October and not later than 1 December <sup>1</sup> .	x		
<b>2. Model structure</b>			
The model structure for the programmes in Annex 1 of the code of conduct has been followed.	x		
<b>3. Model tables (so-called data requirements)</b>			
The quantitative information is presented following the standardised set of tables (Annex 2 of the code of conduct).	x		
The programme provides all compulsory information in these tables.		x	
The programme provides all optional information in these tables.		x	
The concepts used are in line with the European system of accounts (ESA).	x		
<b>4. Other information requirements</b>			
<b>a. Involvement of parliament</b>			
The programme mentions its status vis-à-vis the national parliament.	x		
The programme indicates whether the Council opinion on the previous programme has been presented to the national parliament.		x	
<b>b. Economic outlook</b>			
Euro area and ERM II Member States uses the “common external assumptions” on the main extra-EU variables.		x	
Significant divergences between the national and the Commission services’ economic forecasts are explained <sup>2</sup> .	x		
The possible upside and downside risks to the economic outlook are brought out.	x		
The outlook for sectoral balances and, especially for countries with a high external deficit, the external balance is analysed.	x		
<b>c. Monetary/exchange rate policy</b>			
The <u>convergence</u> programme presents the medium-term monetary policy objectives and their relationship to price and exchange rate stability.			Not applicable
<b>d. Budgetary strategy</b>			
The programme presents budgetary targets for the general government balance in relation to the MTO, and the projected	x		

<b>Guidelines in the new code of conduct</b>	<b>Yes</b>	<b>No</b>	<b>Comments</b>
path for the debt ratio.			
In case a new government has taken office, the programme shows continuity with respect to the budgetary targets endorsed by the Council.			Not applicable
When applicable, the programme explains the reasons for possible deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify the situation, and provide information on them.	x		
The budgetary targets are backed by an indication of the broad measures necessary to achieve them and an assessment of their quantitative effects on the general government balance is analysed.	x		
Information is provided on one-off and other temporary measures.	x		
The state of implementation of the measures (enacted versus planned) presented in the programme is specified.	x		
If for a country that uses the transition period for the classification of second-pillar funded pension schemes, the programme presents information on the impact on the public finances.			Not applicable
<b><i>e. “Major structural reforms”</i></b>			
If the MTO is not yet reached or a temporary deviation is planned from the achieved MTO, the programme includes comprehensive information on the economic and budgetary effects of possible ‘major structural reforms’ over time.			Not applicable
The programme includes a quantitative cost-benefit analysis of the short-term costs and long-term benefits of such reforms.			Not applicable
<b><i>f. Sensitivity analysis</i></b>			
The programme includes comprehensive sensitivity analyses and/or develops alternative scenarios showing the effect on the budgetary and debt position of: a) changes in the main economic assumptions b) different interest rate assumptions c) for non-participating Member States, different exchange rate assumptions d) if the common external assumptions are not used, changes in assumptions for the main extra-EU variables.	x		
In case of such “major structural reforms”, the programme provides an analysis of how changes in the assumptions would affect the effects on the budget and potential growth.			Not applicable
<b><i>g. Broad economic policy guidelines</i></b>			
The programme provides information on the consistency with the broad economic policy guidelines of the budgetary objectives and the measures to achieve them.	x		
<b><i>h. Quality of public finances</i></b>			
The programme describes measures aimed at improving the quality of public finances on both the revenue and expenditure side (e.g. tax reform, value-for-money initiatives, measures to improve tax collection efficiency and expenditure control).	x		
<b><i>i. Long-term sustainability</i></b>			
The programme outlines the country’s strategies to ensure the sustainability of public finances, especially in light of the economic and budgetary impact of ageing populations.	x		
Common budgetary projections by the AWG are included in the programme. The programme includes all the necessary	x		

<b>Guidelines in the new code of conduct</b>	<b>Yes</b>	<b>No</b>	<b>Comments</b>
additional information. (...) To this end, information included in programmes should focus on new relevant information that is not fully reflected in the latest common EPC projections.			
<b><i>j. Other information (optional)</i></b>			
The programme includes information on the implementation of existing national budgetary rules (expenditure rules, etc.), as well as on other institutional features of the public finances, in particular budgetary procedures and public finance statistical governance.	x		
<b>Notes:</b> <sup>1</sup> The code of conduct allows for the following exceptions: (i) Ireland should be regarded as complying with the deadline in case of submission on “budget day”, i.e. traditionally the first Wednesday of December, (ii) the UK should submit as close as possible to its autumn pre-budget report; and (iii) Austria and Portugal cannot comply with the deadline but will submit no later than 15 December. <sup>2</sup> To the extent possible, bearing in mind the typically short time period between the publication of the Commission services’ autumn forecast and the submission of the programme.			

### Annex 3: Consistency with the broad economic policy guidelines

The table below provides an overview of whether the strategy and policy measures in the programme are consistent with the broad economic policy guidelines in the area of public finances included in the integrated guidelines for the period 2005-2008.

<b>Integrated guidelines</b>	<b>Yes</b>	<b>No</b>	<b>Not applicable</b>
<b><i>1. To secure economic stability</i></b>			
– Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it <sup>1</sup> .	x		
– Member States should avoid pro-cyclical fiscal policies <sup>2</sup> .	x		
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits <sup>3</sup> .			x
– Member States posting current account deficits that risk being unsustainable should work towards (...), where appropriate, contributing to their correction via fiscal policies.			x
<b><i>2. To safeguard economic and fiscal sustainability</i></b>			
In view of the projected costs of ageing populations,			
– Member States should undertake a satisfactory pace of government debt reduction to strengthen public finances.			x
– Member States should reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible (...)	x		
<b><i>3. To promote a growth- and employment-orientated and efficient allocation of resources</i></b>			
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages.	x		
<b>Notes:</b>			
<sup>1</sup> As further specified in the Stability and Growth Pact and the new code of conduct, i.e. with an annual 0.5% of GDP minimum adjustment in structural terms for euro area and ERM II Member States.			
<sup>2</sup> As further specified in the Stability and Growth Pact and the new code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in “good times”.			
<sup>3</sup> As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure.			



#### Annex 4: Assessment of tax projections

Table 6 compares the tax projections of the programme with those of the Commission services' autumn 2005 forecast and Table 7 those of the Commission services' autumn forecast with tax projections obtained by using standard *ex-ante* elasticities, as estimated by the OECD. The tables summarise the results for the total tax-to-GDP ratio. The underlying analysis is carried out exploiting information for the four major tax categories, i.e. indirect taxes, corporate and private income taxes and social contributions (see tables below)<sup>39</sup>.

Conceptually, the analysis draws on the definition of a semi-elasticity, which measures the change in a ratio vis-à-vis the relative change in the denominator. The semi-elasticity of the tax-to-GDP ratio of the *i*-th tax  $\frac{T_i}{Y}$  can be written as:

$$\eta_i = \frac{d\left(\frac{T_i}{Y}\right)}{dY} Y = \left(\frac{dT_i}{dY} \frac{Y}{T_i} - 1\right) \frac{T_i}{Y} = \left(\frac{dT_i}{dB_i} \frac{B_i}{T_i} \frac{dB_i}{dY} \frac{Y}{B_i} - 1\right) \frac{T_i}{Y} = (\varepsilon_{T_i, B_i} \varepsilon_{B_i, Y} - 1) \frac{T_i}{Y}$$

where  $\varepsilon_{T_i, B_i}$  and  $\varepsilon_{B_i, Y}$  denote the elasticity of the *i*-th tax  $T_i$  relative to its tax base  $B_i$  and the elasticity of the tax base  $B_i$  relative to aggregate GDP  $Y$  respectively.

To the extent that  $\varepsilon_{T_i, B_i}$  is derived from observed or projected data, it will typically reflect (i) the effect of discretionary measures (including one-offs) and (ii) the tax elasticity<sup>40</sup>. By contrast, if  $\varepsilon_{T_i, B_i}$  is the standard *ex-ante* elasticity, as estimated by the OECD, it will be net of discretionary measures.

The second elasticity  $\varepsilon_{B_i, Y}$  can be used as an indicator of the tax intensity of GDP growth; for instance, a higher elasticity of consumption relative to GDP means that for the same GDP growth indirect taxes will be higher.

The definition of a semi-elasticity has two practical implications. First, any change in the tax-to-GDP ratio of the *i*-th tax can be written as the product of the semi-elasticity and GDP growth:

$$d\left(\frac{T_i}{Y}\right) = \eta_i \cdot \frac{dY}{Y}$$

and the change in the total tax-to-GDP ratio is the sum:

$$\sum_i d\left(\frac{T_i}{Y}\right) = \sum_i \eta_i \frac{dY}{Y}$$

<sup>39</sup>

Private and corporate income taxes are generally not provided, neither in the programme nor in the Commission services' autumn 2005 forecast. Only the aggregate, direct income taxes, is given. For the purpose of this exercise the breakdown is obtained using the average shares over the past ten years, i.e. the composition of direct taxes is assumed to stay constant.

<sup>40</sup>

The observed or projected elasticity (*ex-post* elasticity) of the *i*-th tax also includes the effect of other factors (OF) such as discretionary measures:

$$\frac{\Delta T_i}{T_i} = \varepsilon_{T_i, B_i, ex\,ante} \frac{dB_i}{B_i} + \frac{OF_i}{T_i} = \varepsilon_{T_i, B_i, ex\,post} \frac{dB_i}{B_i}$$

Second, differences between two tax projections can be decomposed into an elasticity component and a composition component:

$$d\left(\frac{T_i}{Y}\right)' - d\left(\frac{T_i}{Y}\right) = \left[ (\varepsilon_{T_i, B_i}' \varepsilon_{B_i, Y}' - 1) \frac{T_i}{Y} - (\varepsilon_{T_i, B_i} \varepsilon_{B_i, Y} - 1) \frac{T_i}{Y} \right] \frac{dY}{Y} .$$

If  $(\varepsilon_{T_i, B_i}' - \varepsilon_{T_i, B_i}) = \alpha_i$ ;  $(\varepsilon_{B_i, Y}' - \varepsilon_{B_i, Y}) = \beta_i$ ,

$$\text{then } d\left(\frac{T_i}{Y}\right)' - d\left(\frac{T_i}{Y}\right) = \left[ (\alpha_i \varepsilon_{B_i, Y} + \beta_i \varepsilon_{T_i, B_i} + \alpha_i \beta_i) \frac{T_i}{Y} \right] \frac{dY}{Y}$$

where  $\alpha_i \varepsilon_{B_i, Y} \frac{T_i}{Y} \frac{dY}{Y}$  determines the elasticity component and  $\beta_i \varepsilon_{T_i, B_i} \frac{T_i}{Y} \frac{dY}{Y}$  the

composition component. The third component in the equation  $\alpha_i \beta_i \frac{T_i}{Y} \frac{dY}{Y}$  measures the interaction of the elasticity and the composition components. It is generally small but can become important in some cases. The tax elasticity relative to GDP of total taxes is obtained as  $\varepsilon = \sum_i w_i \varepsilon_{T_i, B_i} \varepsilon_{B_i, Y}$  with  $w_i$  the share of the *i*-th tax in the overall tax burden.

The tables below report the results of the assessment of the tax projections presented in the programme by major tax category, which, as mentioned above, are the basis for the aggregated results reported in Tables 6 and 7.

#### Assessment of tax projections by major tax category

	2006		2007		2008	2009	p.m.: OECD <sup>1</sup>
	COM	SP	COM <sup>2</sup>	SP	SP	SP	
<b>Taxes on production and imports:</b>							
Change in tax-to-GDP ratio	-0.2	-0.2	-0.2	-0.1	0.0	-0.1	/
<i>Difference</i>	-0.1		0.1		/	/	
<i>of which</i> <sup>3</sup> : - elasticity component	-0.1		0.0		/	/	
- composition	0.0		0.1		/	/	
p.m. Observed elasticity to tax	0.8	0.7	0.8	0.8	0.9	0.7	1.0
<b>Social contributions:</b>							
Change in tax-to-GDP ratio	0.2	-0.1	0.3	0.0	0.1	0.1	/
<i>Difference</i>	-0.3		-0.3		/	/	/
<i>of which</i> <sup>3</sup> : - elasticity component	-0.3		-0.3		/	/	/
- composition	-0.1		-0.1		/	/	/
p.m. Observed elasticity to tax	1.6	1.0	1.7	1.1	1.2	1.2	1.0
<b>Personal income tax<sup>6</sup>:</b>							
Change in tax-to-GDP ratio	-0.3	-0.3	-0.3	-0.2	0.0	0.0	/
<i>Difference</i>	0.0		0.1		/	/	
<i>of which</i> <sup>3</sup> : - elasticity component	0.0		0.0		/	/	
- composition	0.0		0.0		/	/	
p.m. Observed elasticity to tax	0.6	0.5	0.5	0.5	1.0	0.9	1.5
<b>Corporate income tax<sup>6</sup>:</b>							
Change in tax-to-GDP ratio	-0.1	-0.1	-0.1	-0.1	0.0	0.0	/
<i>Difference</i>	0.0		0.0		/	/	
<i>of which</i> <sup>3</sup> : - elasticity component	0.0		0.0		/	/	
- composition	0.0		0.0		/	/	
p.m. Observed elasticity to tax	0.5	0.4	0.4	0.5	1.0	1.1	1.0
<b>Notes:</b>							
<sup>1</sup> OECD ex-ante elasticities							

<sup>2</sup>On a no-policy change basis

<sup>3</sup>The decomposition is explained in Annex 4

<sup>4</sup>Elasticity relative to private consumption expenditure

<sup>5</sup>Elasticity relative to compensation of employees

<sup>6</sup>Taxes on income and wealth are split into private and corporate income tax using the average tax share over the past ten years, i.e. the share is assumed to be constant over the programme period

<sup>7</sup>Elasticity relative to gross operating surplus

*Source:*

*Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)*

### Assessment of tax elasticities by major tax category

	2006		2007	
	COM (observed)	ex-ante <sup>1</sup>	COM <sup>2</sup> (observed)	ex-ante <sup>1</sup>
<b>Taxes on production and imports:</b>				
Change in tax-to-GDP ratio	-0.2	0.0	-0.2	0.0
<i>Difference</i>	-0.2		-0.2	
<i>of which<sup>3</sup>: - elasticity component</i>	-0.1		-0.1	
<i>- composition component</i>	0.0		-0.1	
p.m.: Observed elasticity:				
- of taxes to tax base <sup>4</sup>	0.8	1.0	0.8	1.0
- of tax base <sup>4</sup> to GDP	0.9	1.0	0.8	1.0
<b>Social contributions:</b>				
Change in tax-to-GDP ratio	0.2	-0.2	0.3	-0.2
<i>Difference</i>	0.4		0.4	
<i>of which<sup>3</sup>: - elasticity component</i>	0.2		0.2	
<i>- composition component</i>	0.2		0.2	
p.m.: Observed elasticity:				
- of taxes to tax base <sup>5</sup>	1.6	1.0	1.7	1.0
- of tax base <sup>5</sup> to GDP	0.9	0.6	0.9	0.6
<b>Personal income tax<sup>6</sup>:</b>				
Change in tax-to-GDP ratio	-0.3	-0.1	-0.3	0.0
<i>Difference</i>	-0.2		-0.3	
<i>of which<sup>3</sup>: - elasticity component</i>	-0.3		-0.3	
<i>- composition component</i>	0.3		0.2	
p.m.: Observed elasticity:				
- of taxes to tax base <sup>5</sup>	0.6	1.5	0.5	1.5
- of tax base <sup>5</sup> to GDP	0.9	0.6	0.9	0.6
<b>Corporate income tax<sup>6</sup>:</b>				
Change in tax-to-GDP ratio	-0.1	0.1	-0.1	0.1
<i>Difference</i>	-0.2		-0.2	
<i>of which<sup>3</sup>: - elasticity component</i>	-0.1		-0.2	
<i>- composition component</i>	-0.1		-0.1	
p.m.: Observed elasticity:				
- of taxes to tax base <sup>7</sup>	0.5	1.0	0.4	1.0
- of tax base <sup>7</sup> to GDP	1.1	1.6	1.1	1.6

Notes:

<sup>1</sup>Tax projections obtained by applying ex-ante standard tax elasticities estimated by the OECD

<sup>2</sup>On a no-policy change basis

<sup>3</sup>The decomposition is explained in the text above

<sup>4</sup>Tax base = private consumption expenditure

<sup>5</sup>Tax base = compensation of employees

<sup>6</sup>Taxes on income and wealth are split into private and corporate income tax using the average tax share over the past ten years, i.e. the share is assumed to be constant over the programme period

<sup>7</sup>Tax base = gross operating surplus

*Source:*

*Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and*

## Annex 5: Indicators of long-term sustainability

**Table A1: Underlying assumptions compared**

% of GDP	2010		2020		2030		2050	
	EPC	SCP	EPC	SCP	EPC	SCP	EPC	SCP
Labour productivity growth	1.9	1.9	2.1	2.1	1.7	1.7	1.7	1.7
Real GDP growth	2.2	2.2	1.7	1.7	1.4	1.4	1.4	1.4
Participation rate males (aged 20-64)	82.8	83.3	85.6	85.7	86.5	86.4	86.5	86.5
Participation rates females (aged 20-64)	76.6	76.6	80.3	80.3	81.5	81.5	81.9	81.9
Total participation rates (aged 20-64)	79.8	79.8	82.9	82.9	84.0	84.0	84.2	84.2
Unemployment rate	6.8	6.8	6.5	6.5	6.5	6.5	6.5	6.5
Population aged 65+ over total population	16.9	16.9	22.6	22.6	26.1	26.1	27.0	27.0

**Table A2: Long-term projections**

Main assumptions - programme scenario (as % GDP)	2009	2010	2020	2030	2040	2050	changes	Impact on S2
<i>Total age-related spending</i>	25.2	25.3	27.9	30.6	31.1	31.6	6.4	5.3
Pensions	11.0	11.2	12.9	14.0	13.9	13.7	2.7	2.4
Health care	5.6	5.6	6.2	7.0	7.2	7.4	1.8	1.5
Care of the elderly	1.9	1.9	2.5	3.3	3.8	4.3	2.4	1.8
Education	5.5	5.4	5.2	5.2	5.2	5.1	-0.4	-0.3
Unemployment benefits	1.2	1.2	1.1	1.1	1.1	1.1	-0.1	-0.1
Others	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<i>Total primary non age-related spending</i>	24.1	24.1	24.1	24.1	24.1	24.1	0.0	0.0
<i>Total revenues</i>	52.5	52.5	52.5	52.5	52.5	52.5	0.0	0.0

**Table A3: The cost of a five-year delay in adjusting the budgetary position according to the S1 and S2**

	S1	S2
<b>2005 scenario</b>	<b>-0.3</b>	<b>0.1</b>
<b>Programme scenario</b>	<b>-0.1</b>	<b>0.1</b>

Note: the cost of a delay shows the increase of the S1 and S2 indicators if they were calculated five years later.

**Table A4: Debt development**

Results (as % GDP)	2009	2010	2020	2030	2040	2050	changes
<i>Programme scenario</i>							
Gross debt	40.1	37.3	23.4	37.5	70.5	114.2	74.1
<i>Gross debt, i + 1*</i>	40.1	37.7	27.0	44.9	85.4	142.9	102.8
<i>Gross debt, i - 1*</i>	40.1	36.9	20.3	31.5	59.1	93.3	53.2
Adjusted gross debt	-8.7	-11.9	-30.9	-24.8	-2.0	29.9	38.7
<i>2005 Scenario</i>							
Gross debt	27.2	23.7	2.1	6.6	28.2	58.5	31.4
<i>Gross debt, i + 1*</i>	27.2	23.9	3.7	8.9	32.7	68.7	41.5
<i>Gross debt, i - 1*</i>	27.2	23.4	0.7	5.0	24.9	51.0	23.8
Adjusted gross debt	-21.7	-25.5	-52.2	-55.7	-44.3	-25.7	31.4

\*  $i + 1$  and  $i - 1$  represents the evolution of debt under the assumption of the nominal interest rate being 100 basis points higher or lower throughout the projection period.

