UNOFFICIAL TRANSLATION

Ministry of Finance

STABILITY PROGRAMME FOR FINLAND

November 2006 update

Contents

INTRODUCTION AND SUMMARY

The population in Finland is ageing faster and earlier than in the rest of the EU member states. The population of working age will decline by over 300,000 people by 2030, as indicated by the population projections of Statistics Finland. An ageing population coupled with high structural unemployment seriously challenge the sustainability of public finances in particular. While the pressure to spend in pension and welfare services will start mounting, the labour force will be dwindling and growth in total output and the tax base will diminish.

The Finnish economy has reached its current cyclical peak and production growth is expected to gradually start slowing down in the next few years in the wake of the upswing and with the structural factors in the economy starting to erode growth potential. Together with declining labour force and high structural unemployment, economic growth is confronted with challenges such as a high household debt ratio, changes in regional demographics, and the demands created by globalisation and rapid technological advances. The significance of productivity as a growth factor will thus gain in weight. The obstacles to achieving higher productivity are not only an ageing population but also weak productivity in some industries, especially in the service sector where there is little competition.

Employment has improved considerably in recent years, and the Government's ambitious goal of creating 100,000 new jobs over the election period of 2003-2007 will probably be reached almost completely. Growth in employment is expected to start slowing down starting next year. High structural unemployment in the form of more skills mismatches in the labour market is a growing threat to stable economic growth. To boost labour supply, ageing workers need to be encouraged to stay in the labour force longer and young people should be able to enter the working life sooner. Demand for foreign labour has also become more significant.

The Government of Finland aims to meet these economic policy challenges by fostering sustainable growth in the employment rate and robust growth in productivity and by creating a stable and predictable operating environment for businesses and households. This Government created a more predictable economic policy environment and a more sustainable fiscal policy framework by making a commitment at the beginning of the election period in 2003 to adhere to a new system of spending rules, where the majority of Budget appropriations are gauged to spending limits that cover the whole of the election period. Furthermore, the Government has boosted competitiveness and improved job prospects by means of tax cuts and structural reforms. Tax reforms have also helped to secure long and moderate collective wage agreements and steady labour market developments. To ensure balanced public finances in the longer term, both public sector productivity should be boosted and the service structures revamped. The Government responded to this in September 2006 by presenting a bill to restructure the municipalities and services. It is important that there is the flexibility to reallocate resources from one task area to another according to changes in the demographic and regional structure and according to the new priorities of service needs.

Although local government is still clearly in deficit, the financial position in general government finances has remained strong overall. The surplus in general government is mainly accounted for by the social security funds, which are being accumulated in response to the mounting expenditure pressure caused by an ageing population. The surplus in general government is estimated at 2.7 per cent of GDP on average over the next four years. The EMU-debt ratio in public finances is anticipated to slowly edge down below 34 per cent. The projected public sector surplus in this Stability Programme is based on the assumption that economic growth will prove to be fairly good and that the pace of spending growth in central and local government will slow down. If medium-term economic growth were to slacken to the rate estimated by the OECD, for instance, and public spending continue to grow at the rate seen between 1996 and 2005, by the end of the projection period aggregate central and local government would go into deficit and the overall ratio of general government finances to GDP would be 3 percentage points weaker than in the baseline scenario. This Programme also includes a sustainability scenario where the demographic changes are taken into account. The calculations indicate that public finances on the whole are not built on a sufficiently sustainable basis in the long term.

This Stability Programme update draws on the 2007-2011 spending limits for central government finances and the 2007 budget proposal submitted in September, as well as related economic policy guidelines and assessments on economic developments. The expenditure estimates for 2008-2010 include additional expenditure generated by the decisions made in the context of the 2007 budget proposal and the main foreseeable on-budget spending pressure. Finland will continue to meet the Stability and Growth Pact objectives related to the surplus and debt ratio in general government finances also in the medium term. Finland’s medium-term budgetary objective as defined in the new Stability and Growth Pact is a 2 per cent surplus-to-GDP ratio in general government finances. The balance in general government finances presented in this Programme is stronger throughout the review period than the medium-term objective would require. However, neither the financial balance outlined in the baseline scenario nor the objective established for the medium-term is sufficient to ensure sustainable public finances in the long term.

1 ECONOMIC POLICY OBJECTIVES AND PREMISES

1.1 General

The main goal of the Government's economic policy is to boost employment so that the pressure on spending caused by the ageing of the population can be met. The Government's employment target of creating 100,000 new jobs over the election period will probably be nearly fully achieved. Employment is estimated to have improved by 80,000 new jobs by the end of this government's term in office at the end of March 2007. The employment rate will climb to nearly 69 per cent in 2006 and the unemployment rate will drop to a little over 7½ per cent. To reach an employment rate of 75 per cent by the end of the next government period, besides faster economic growth than the one presented in the baseline scenario, further improvements will be required in the functioning of the product, capital and labour markets.

The overall positive outlook in the national economy has been to a large degree influenced by the economic policy line adopted by this government, in which central government expenditure has remained within the boundaries of the new spending limits and the competitiveness of the tax system has been improved. In connection with the collective wage settlement contracted at the end of 2004, agreement was reached on income tax cuts for the rest of the government's term in office and on abolishing tax on wealth. By securing moderation in wage agreements, prospects for job creation have been enhanced and the cost competitiveness of the Finnish economy has been improved. Moreover, the functioning of the labour and product markets has been enhanced through structural reforms.

The Finnish economy faces major challenges in the longer term. The ageing of the population means expenditure pressure in public finances in terms of increased pension and health care and long-term care expenses. At the same time, the financial basis in public finances is narrowing down, as the number of working age people is decreasing with the changing of the age structure. This outlook is further exacerbated by globalisation, which requires that the Finnish economy is able to constantly readjust to restructuring of international production.

The uncertainty surrounding the strength of economic growth, employment prospects and tax competition pressure and the need to make provision for the ageing of the population highlight the importance of enduring fiscal policy. From the viewpoint of sustainable public finances, it is essential to raise the employment rate much higher than it is at present, and it must be boosted in all age groups. Measures to promote growth in productivity also need to be put into practise. Moreover, labour supply will need to be increased by means of work-related migration, efforts will need to be made to structure workforce allocation to foster growth in productivity and efficiency in education and R&D must be promoted.

Thanks to favourable economic developments, tax revenue in central government has accumulated faster than was first estimated early in the election period. Discipline in central government spending has also been strong. A surplus of around 2½ per cent on average is forecast in general government for this programme period. Although the government target of balance in central government finances by the end of this government's term in office, will probably be reached to secure long-term sustainability in general government, a stronger financial position is called for.

This government will leave a better heritage in economic growth, general government finances and government debt ratio than the one it inherited when it came into office. Structural unemployment remains high, however, and coupled with the impending decline in labour supply and other labour market mismatches, it poses a mounting risk to stable economic growth. It is essential to maintain constraint in public expenditure growth so that the tax burden does not become too heavy in the future.

1.2 Broad economic policy guidelines

When revising and updating the Lisbon Strategy in 2005, the European Council sent out a clear message that the biggest challenges facing the European Union in the years ahead are to accelerate economic growth and to boost employment. In line with the Integrated Guidelines for 2005-2008 (Broad Economic Policy Guidelines and the Employment Guidelines) and to achieve the Lisbon Strategy objectives, economic growth potential in the Community should be promoted hand in hand with robust public finances. The aim should be to promote knowledge work, to boost labour supply and to create new jobs.

In its first National Reform Programme progress report, the Commission advised Finland to place more emphasis on improving competition in the service sector and boosting the employment rate among older workers. Furthermore, the most recent broad economic policy guidelines country recommendations (2004) show that the main challenges facing Finland are to reduce the high level of structural unemployment and to improve the efficiency of the public sector. To address these challenges, Finland should:

- continue to reform tax and benefit systems in order to make work pay;
- ensure that wages reflect productivity;
- step up efforts to enforce competition in network industries and non-tradable services;
- increase the efficiency of the public sector; and
- tighten controls on public sector spending.

The Government's economic policy is in line with the Commission's recommendations on the BEPGs for 2004 as well as with the requirements set out in the integrated guidelines for 2005-2008. The economic policy measures taken by the Government relating to the recommendations on general government finances and structural policy are described in more detail later on in this Stability Programme and in the Finnish National Reform Programme adopted by the Government in October 2006. The Stability Programme update and the Finnish National Reform Programme are consistent with each other.

1.3 Stability Programme update and its handling in Finland

This year's Stability Programme update draws on the 2007-2011 spending limits for central government finances and the 2007 budget proposal submitted in September including related economic forecasts. The figures for 2005 supplied by Statistics Finland are calculated in terms of the revised system of national accounts. The expenditure estimates for 2008-2010 include additional expenditure generated by the decisions made in the context of the 2007 budget proposal and the main foreseeable on-budget spending pressure. The document will be delivered to the relevant EU bodies within the agreed time frame (15 October – 1 December 2006) once it has been approved by the Government in plenary session. The contents of the Stability Programme update will be presented to Parliament during the drafting period. As in earlier years, the Commission's assessment and the Council's statement on Finland's Stability Programme will be submitted to Parliament in connection with Ecofin preparations.

The Stability Programme update complies with the Code of Conduct endorsed by the EU Council in October 2005. In line with the Code of Conduct and the 2006 Council conclusions, the Stability Programme covers national fiscal policy procedures and experiences on reforming the procedures. According to the Stability and Growth Pact, which complements the EU Treaty, Member States shall adhere to the medium-term objective of a budget position that is in balance or in surplus. The financial position in general government will remain well in surplus. The surplus in general government is expected to stand at around 2½ per cent of GDP in 2010. The Government is prepared to take corrective measures if achievement of the Stability Programme objectives is jeopardised.

2 ECONOMIC SITUATION AND OUTLOOK

2.1 Recent developments and short-term outlook

Growth in the global economy has been brisk for a number of years already and no significant slowdown is anticipated next year. In spite of the price hike in oil and intermediate goods, international demand expanded in the first half of 2006. Business and consumer confidence has risen to a satisfactory level in the euro area. Growth in total output in the euro area is likely to slacken next year. Economic growth in the United States is also expected to start decelerating following the current cooling on the house markets. The Chinese and Russian economies, instead, are still growing strongly.

The estimates for 2006-2007 in this year's Stability Programme update are based on the Ministry of Finance economic bulletin released in September. The underlying assumptions in the bulletin are well in line with the assumptions published by the Commission. The Finnish economy will grow faster in 2006 than it did in 2005, reaching its peak over the current cycle. Fuelled by both domestic and foreign demand, total output will increase on a broad basis by 4½ per cent this year. The drop in the base for comparison caused by the labour disputes in the paper industry in 2005 influences the imputed growth figure for this year. Stronger household confidence, fast growth in employment and a reasonable improvement in purchasing power coupled with strong growth in borrowing will boost consumption and house investment this year. Henceforth building construction investment will continue to grow due to stronger investment in productive capacity, reflecting in machinery and equipment investment. Public consumption will slow down from last year. Thanks to a favourable cycle in the export markets, exports will perk total output considerably this year. Next year, with household indebtedness constraining consumption and house investment, production growth will slow down.

Exports and imports will continue to grow strongly in 2006. Russia is now Finland's main export market, partly due to a strong increase in transit exports. The volume of exports will rise by 10½ per cent and imports by about 7 per cent this year. Besides goods exports, as a result of a reform in the statistical system service export figures have risen higher than previously anticipated. The terms of trade will continue to deteriorate to some extent but the current account will show a substantial surplus. The current high cost level has increased the share of goods produced in low cost countries both in domestic demand and production for some years already. In 2007, export growth is expected to slacken to its ordinary level of 5 per cent and import growth will also slow down.

With domestic and foreign demand remaining robust, employment will grow fast in 2006, like it did in 2005. Vacancies will increase in the private sector, with new jobs being created especially in business services, social services, construction and a number of industrial activities. Labour supply will also grow. The number of people in employment will increase by 35,000 this year, boosting the employment rate from 68 per cent to 68.8 per cent. The unemployment rate will edge down from 8.4 per cent to 7.7 per cent. The number of people in employment is expected to grow by over 15,000 in 2007, raising the employment rate to 69 per cent and lowering the unemployment rate to about 7½ per cent. Structural bottlenecks in the labour force are becoming a more serious threat to favourable economic and employment prospects than before. Indeed, to secure sufficient labour supply, competent foreign labour will be needed in many sectors of the economy.

Inflation will accelerate in 2006 and the consumer price index will rise to a higher level, on average to 1½ per cent. The world market price hikes in crude oil and other raw materials as well as higher house prices and interest rates play a key role in fuelling inflation. Moreover, competition in the economy will have a smaller impact on slowing down inflation than it did last year. A stronger euro has curbed price rises in imports to some extent. The pay rises contracted in the collective wage agreement will be slightly lower than last year, and the index of wage and salary earnings is estimated to rise by an average of 3 per cent in nominal terms. With labour costs rising at a slower pace and productivity increasing at a faster rate, cost competitiveness in industry is expected to improve on average. Inflation is projected to slightly decelerate next year.

The estimates of economic growth and associated factors in 2006-2007, as presented in Table 1, are based on Ministry of Finance forecasts (Economic Survey) published in September. The impacts on public finance trends of the risks related to economic developments are discussed in section 4.1 below.

1. Growth and associated factors

	2005 bn eur	2005	2006	2007	2008	2009	2010
		change, %					
Macroeconomic prospects							
1. Real GDP		2.9	4.5	3.0	2.9	2.6	2.1
2. Nominal GDP	**157.4**	3.6	6.0	4.0	4.0	3.7	3.2
		Components of real GDP					
3. Private consumption expenditure	**81.5**	3.8	3.6	2.7	2.5	2.3	1.9
4. Government consumption expenditure	**34.8**	1.6	1.0	0.7	1.2	1.0	0.9
5. Gross fixed capital formation	**29.5**	3.6	5.3	3.7	2.8	2.1	1.4
6. Changes in inventories (% of GDP)	**2.1**	1.4	0.9	1.0	0.9	0.9	0.9
7. Exports of goods and services	**65.8**	7.3	10.4	5.2	5.0	4.8	4.4
8. Imports of goods and services	**56.9**	12.3	6.9	4.7	3.7	3.5	3.4
		Contributions to real GDP growth, % points					
9. Final domestic demand	**145.9**	2.9	3.1	2.3	2.1	1.9	1.5
10. Changes in inventories	**2.1**	1.0	-0.4	0.2	0.0	0.0	0.0
11. External balance of goods and services	**9.0**	-1.0	1.9	0.5	0.8	0.8	0.7
Price developments							
1. GDP deflator		0.6	1.4	1.0	1.0	1.0	1.0
2. Private consumption deflator		0.4	2.0	2.1	1.7	1.7	1.7
3. HICP		0.9	1.5	1.3	1.7	1.7	1.7
4. Public consumption deflator		3.2	2.6	2.3	2.8	2.8	2.8
5. Investment deflator		2.7	2.5	1.8	1.6	1.6	1.6
6. Export price deflator		0.9	1.9	-0.7	-0.8	-0.8	-0.8
7. Import price deflator		4.5	4.0	1.4	1.0	1.0	1.0
Labour market developments							
1. Employment, 1 000 persons	**2 401**	1.5	1.5	0.7	0.6	0.5	0.1
2. Employment, 1 000 hours worked	**4 107**	0.8	1.9	0.5	0.4	0.3	-0.1
3. Unemployment rate (%)		8.4	7.7	7.4	6.7	6.1	5.9
4. Labour productivity, persons		1.4	3.0	2.3	2.3	2.1	2.0
5. Labour productivity, hours worked		2.1	2.7	2.6	2.5	2.3	2.2
6. Compensation of employees	**61.6**	4.9	4.7	3.6	4.1	3.8	3.2
Sectoral balances		**% of GDP**					
1. Net lending/borrowing vis-á-vis the rest of the world		4.8	5.4	4.7	4.6	4.4	4.1
of which:							
- Balance on goods and services		5.7	6.5	5.9	5.7	5.5	5.2
- Balance of primary incomes and transfers		-1.1	-1.1	-1.2	-1.2	-1.2	-1.2
- Capital account		0.1	0.1	0.1	0.1	0.1	0.1
2. Net lending/borrowing of the private sector		2.6	3.3	2.7	2.5	2.4	2.4
3. Net lending/borrowing of general government		2.5	2.9	2.8	2.7	2.7	2.4
4. Statistical discrepancy		-0.3	-0.8	-0.7	-0.7	-0.7	-0.7
Basic assumptions*							
Short-term interest rate (3 month money market)		2.2	3.0	3.6			
Long-term interest rate (10 year government bonds)		3.4	3.8	4.1			
USD/EUR exchange rate		1.2	1.3	1.3			
Nominal effective exchange rate		0.0	0.3	0.4			
World GDP growth		4.9	4.7	4.2			
EU-25 GDP growth		1.6	2.3	2.0			
Growth of relevant foreign markets		8.4	11,2	8,1			
World trade growth		7.0	6.0	4.5			
Oil prices (Brent, USD/barrel)		54.4	68.0	68.0			

*No specific underlying assumptions were defined for the medium-term computations. Instead, they are based on general assessments on developments in the operating environment.

2.2 Medium-term macroeconomic scenario

The medium-term projections for 2008-2010 are based on projections and surveys of longer term growth prospects in the economy. The medium-term GDP growth estimate is in line with the estimates of potential output growth based on the production function method as developed by the EU Commission together with Member States. Estimates on potential growth involve a number of uncertainty factors and the risk is that actual growth will fall short of the growth projections set out in the Stability Programme. Thus, apart from the baseline scenario, Chapter 4.1 also describes slower and faster growth scenarios.

While economic growth in Finland has been robust in recent years, medium-term growth prospects, projected until 2010, are nonetheless subdued. Annual growth is forecast to drop below 2 per cent by 2010. The ageing of the population and the ensuing decline in labour supply are likely to hamper growth, reflected in a weaker labour input component in potential production estimates. Household indebtedness and slower growth in employment, in turn, will begin to curb medium-term consumption potential in the household sector. Modest growth in production capacity will also curtail growth prospects, while the relocation of international production will require readjustment of domestic production. With labour and capital inputs expected to grow sluggishly, Finland's economic growth will be driven almost solely by rising productivity in the next few years.

The global economy has reached a cyclical peak but growth is nonetheless expected to remain strong in a number of countries important to the Finnish economy, such as Russia. Growth has picked up in the euro area too, but the medium-term outlook remains modest by international standards. The engine of growth in the EU will be in the new member states also in the next few years. The structural rigidities of the economies and the ageing of the population are hampering European economic growth. The outlook in the world economy is overshadowed by price developments in oil, by the debt burden in the US, and by uncertainty concerning the sustainability of economic growth in China. Fluctuations in oil prices are poorly predictable because oil prices are so closely linked to the global political situation and easily affected by disruptions in the supply of crude oil. Should the current record high oil price level become prolonged, it would hamper economic growth worldwide, and should the US economy undergo a sharp adjustment in its external balance, the repercussions on the dollar exchange rate and the world economy would be even greater.

Annual growth in exports is estimated at just over 4½ per cent, which is lower than what Finland has been used to since the mid-1990s. The underlying assumption is that Finnish export companies, chiefly the electronics industry, will step up production to a greater extent abroad – where it is closer to the end-product markets. The growth opportunities of Finnish export companies are also limited by the continuing strength of the euro and price hikes in raw materials. With export prices still falling, especially in mobile phone exports, and import prices on the rise, the terms of trade are anticipated to continue deteriorating. This, in turn, indicates lower revenue performance and is expected to reduce the current account surplus for its part. Imports are assumed to grow by an average of 3½ per cent a year.

Private consumption having stayed buoyant for some time now, which has resulted in a clear increase in indebtedness. EMU membership improved the stability of the financial markets, making possible a cautious rise in indebtedness without upsetting the economic balance. However, in the medium term, consumer indebtedness and expectations of rising interest rates will soon begin to restrict growth in private consumption. Accordingly, private consumption is estimated to grow slightly slower than total output, by about 2 per cent annually in the next few years.

After rising slightly in recent years, growth in private investments is expected to slacken. Domestic investment is being constrained by sluggish medium-term growth prospects and vigorous Finnish investment abroad in countries with lower production costs and closer to rapidly expanding market areas. In addition, with household indebtedness having risen, growth in housing construction is expected to slow down. Public investment is also likely show only modest growth, meaning that the national investment rate will remain stable in the medium term at close to 20 per cent.

Projections for the development of expenditure and revenue in general government are presented in chapters 3 and 5 below.

According to the population projections produced by Statistics Finland, the working-age population will begin to dwindle around the turn of the decade, and unless the average retirement age is raised significantly, growth in labour supply can be expected to begin diminishing even before then. However, the pension reform introduced at the beginning of 2005 should help restrict the decline in labour supply.

On the whole, employment developments have been favourable in the past few years. Jobs have been created in the service sector and the construction industry, in particular. However, the projected medium-term economic growth rate does not promise prolonged robust growth in employment. On the basis of the present assumptions on economic growth and productivity, around 30,000 new jobs will be created between 2007-2010. Assuming that labour supply declines as anticipated, the number of unemployed will decrease slightly more. The unemployment rate is expected to be 6 per cent at the turn of the decade, largely structural in nature. Unless further economic policy measures are introduced, the employment rate will remain just short of 70 per cent. Growth in productivity is expected to slow down to about 2 per cent, as industry, where productivity is high, is cutting more jobs and the service sector, where productivity is lower, is providing more job opportunities.

The earnings level is forecast to rise by about 3 per cent a year in the medium term. However, labour market mismatches could lead to pressure to raise wages and salaries at a faster pace, which could affect cost-competitiveness and result in a higher payroll in the public sector. Unless productivity can give an extra boost to economic growth, growth will be constrained by shortages in skilled labour.

3 GENERAL GOVERNMENT: BALANCE AND DEBT

3.1 Fiscal policy strategy

One of the Government's key objectives in the Government Programme for 2003-2007 is to secure robust central government finances and the long-term sustainability of fiscal policy. To achieve this, the government debt ratio must be reduced, barring cyclical variation. The challenge is being met by boosting employment and by restraint in the expenditure profile. The Government's declared aim is to ensure balanced central government finances under normal conditions of economic growth at the end of the electoral period, as measured in terms of national accounting. Cyclical or other short-term variation from the path of balanced central government finances are permitted in so far as they do not jeopardise the overall reduction of the central government debt-to-GDP ratio. Furthermore, the Government is committed to the target that even in conditions of adverse economic development, the deficit in central government finances, as measured in national accounting terms, shall not exceed 2¾ per cent of GDP. Taxation, especially that on labour, is being eased during this government's term in office.

Finland's medium-term objective for the budgetary position as specified in the new Stability and Growth Pact is a two per cent surplus in public finances relative to GDP[1]. The target defined for central government finances is based on objectives set out in the present government's programme. The target balance in local government and social security funds is assumed to correspond to the baseline scenario. The fis-

1 Stability and Growth Pact as revised in 2005 presumes that Member States must present a national medium-term budgetary objective for the general government including an adjustment path for achieving the objective in their convergence or stability programme. The medium-term objective must according to the rules provide for a sufficient safety margin with respect to the 3% of GDP reference value. Moreover, the objective for public finances must lead to a reduction in the general government debt ratio and rapid improvement in long-term sustainability in public finances.

cal policy objectives and rules will be redefined and fine-tuned at the beginning of the new electoral period. The two per cent surplus objective is more ambitious than that presented in the Commission's calculations as a fiscal stance that would secure a sufficient margin for the three per cent deficit threshold even in weak economic conditions. The more demanding target is justified for Finland because the ageing population will impact public finances sooner and more strongly in Finland than in the rest of the EU. The balance in public finances is more robust throughout the Programme period than the medium-term objective would require, but the goals set in the baseline and medium-term objective scenario are not sufficient to ensure sustainability in public finances in the long term, as described in section 6.

The measures outlined in the Government Programme are being implemented within the boundaries of the spending limits. The spending limits for 2007-2011 are based on a report submitted to Parliament on 28 March 2006. The report comprises the spending limits for central government with a view to implementing the objectives in the Government Programme and pursuing fiscal policy approach that secures stable economic growth. These spending limits cover the next electoral period too, but are not binding from the viewpoint of the next government. The premise in drawing up the spending limits was a cautious approach where all administrative branches were expected to observe budgetary prudence. The expenditure path in the baseline scenario in the Stability Programme include not only the existing spending limits but also the additional expenditure stemming from the decisions made in the context of the 2007 budget proposal and the main foreseeable on-budget spending pressure. Section 5.3 in this Programme deals with expenditure estimates in more detail. The Ministry of Finance has set up a working group to evaluate the need for revising the system of spending limits, described more specifically in section 7 of this Programme.

3.2 General government balance and debt

The surplus in general government is estimated to average 2.7 per cent of GDP over the next four years. The EMU-debt ratio in public finances is anticipated to edge down below 35 per cent by 2010[2]. Finland will meet the objectives of the Stability and Growth Pact both in terms of the balance in public finances and the debt ratio both this year and in the medium term.

By reforming taxation and setting clear targets for government spending as outlined in the Government Programme, the government has fostered economic growth

2 The EMU debt ratio is slightly higher for 2005-2007 in the stability programme than in the economic bulletin released by the Ministry of Finance in September. This is because Statistics Finland revised its estimates on the EMU debt for 2005 up by 1.2 billion euros in September. The debt estimates also take into account the government's second supplementary budget proposal presented on 16 October 2006.

prospects. With employment having improved and private consumption being brisk, the overall tax accrual has grown more than anticipated. However, weakening growth prospects in production are a constraint on funding available for the mounting public expenditure pressure caused by the ageing of the population.

In spite of higher government spending, central government finances will stay in surplus this year and is likely to remain in a slight surplus throughout the review period. The goal of balance in central government finances will probably be reached by the end of this government's term in office, while the surplus is estimated at 0.4 per cent of GDP in 2010. With the economic outlook and employment prospects remaining favourable and spending being restrained, the preconditions for balance in central government finances are in place. The existing productivity programme of the central government will curb growth in expenditure in the next few years, cutting personnel costs for its part. The anticipated slowdown in economic growth, instead, will dampen growth in revenue bases.

Local government has been in deficit for the past few years now, as spending has increased on average by over 5 per cent a year in nominal terms and tax accrual has been sluggish. The debt burden in local government has nearly doubled in the past five years. This year, however, the financial balance in municipalities will improve thanks to the faster-than-anticipated growth in tax revenue, but will still remain in deficit by about ½ per cent relative to GDP.

Growth in local government expenditure is projected to slow down to around 4 per cent next year and in the medium term. On the aggregate level, local government is expected to reach equilibrium in the next few years. These estimates are based on the views of the Advisory Board for Municipal Economy and Administration and on the overall macroeconomic developments presented above.[3] Should local government spending continue to grow at a rate of over 5 per cent a year, the financial position in municipalities will deteriorate again and the debt burden will mount. The tight financial stance calls for concerted efforts by local authorities to reform municipal structures and services.

The surplus in general government depends almost entirely on employment pension funds, even though combined central and local government finances will shift into a slight surplus this year after three years of deficit. With growth in pension expenditure accelerating, however, the surplus in the employment pension funds will start to decrease already in the medium term. Altogether the surplus in the social security funds will amount to 2.6 per cent of GDP this year but is expected to drop to 2 per cent by 2010. Since pension expenditure will grow, moderate increases in employment pension contribution rates will become necessary in the medium term.

3 The Advisory Board consists of delegates from the Ministry of Finance, Ministry of the Interior, Ministry of Social Welfare and Health, Ministry of Education and the Association of Finnish Local and Regional Authorities.

UNCERTAINTIES IN THE ECONOMIC OUTLOOK

Significant elements of uncertainty are related to the development projected in the baseline scenario, mainly in the magnitude of public spending and the strength of economic growth. The impact on the financial balance in general government generated by alternative developments are presented below:

- Annual growth in local government consumption expenditure has been fast in recent years, averaging around 5½ per cent between 2002 and 2005. The assumption made in the baseline scenario in this Stability Programme is that consumption expenditure will slow down to about 4 per cent in municipalities, as suggested by the Advisory Board for Municipal Economy and Administration. This would mean that the financial position in local government would reach balance by 2010. However, the spending curve in municipalities has proven higher for a number of consecutive years than the estimates drawn up in collaboration between central and local government experts. Should consumption expenditure in the municipalities continue to grow at a rate of 5½ per cent a year, the deficit in local government would climb to nearly 1 per cent of GDP by 2010.

- Central government spending is assumed to grow in the baseline scenario slightly slower than the historical trend. Only the main expenditure pressure items for the next government are taken into account in the baseline scenario, ones that have been numerically calculated. Central government consumption expenditure increased on average by about 4 per cent between 1996 and 2005. Should spending continue at this rate, the surplus in central government finances would disappear almost completely.

- Aspects of uncertainty are also related to the rate of economic growth. If we use the OECD's growth estimate of 1.5 per cent per capita on average to assess growth in total output, the balance in general government would decline by nearly 2 percentage points by 2010 relative to the baseline scenario in the Stability Programme, as estimated using the OECD income and expenditure elasticity estimates.

- Should medium-term economic growth slacken as projected by the OECD and if public consumption expenditure continues at the same rate as between 1996 and 2005 on average, consolidated central and local government finances will drop into deficit and the general government balance-to-GDP will be 3 percentage points weaker than in the baseline scenario in 2010.

All these factors reflect the uncertainties in economic developments. A sensitivity analysis and risks affecting the economy are described in more detail in section 4.1.

3.3 Cyclically adjusted balance in general government finances

The production function method devised by the EU Commission and its member states indicates that the output gap has been negative since 2002, in other words production fell short of output potential. This year, economic growth will exceed potential growth and the negative output gap is closing in. Next year production is expected to grow roughly in line with its potential. Potential output growth is estimated to slacken from a good 3 per cent to 2 per cent by 2010, mainly due to an anticipated drop in the growth contribution of labour input and capital input (Table 4). The change in the labour input will have a negative impact on production potential by the end of the review period, mainly because the population of working age is declining. Output growth potential will in fact rely almost entirely on growth in total factor productivity in the future.

The impact of the output gap on the balance in public finances is gauged by applying OECD income and expenditure elasticity estimates. Fiscal policy supported economic growth in 2001–2004, which is reflected in a decrease in the cyclically adjusted balance in general government. Taxation was in fact eased annually in the first years of this decade. In 2005 imputed fiscal policy was restrictive. Last year's work stoppage in the paper industry, which made the negative output gap larger and thus strengthened the cyclically adjusted balance partly explains the improvement in the cyclically adjusted balance in public finances. An exceptionally high accrual in corporate tax revenue also boosted the cyclically adjusted balance last year. This year, with the output gap being virtually non-existent, the cyclically adjusted balance will be equal to the balance in general government finances. The cyclically adjusted balance is expected to remain practically unchanged between 2005 and 2009, indicating neutral discretionary fiscal policy. The anticipated deterioration in the cyclically adjusted balance in 2010 derives from growth in pension expenditure. Fiscal discipline is based on the spending rules applied in central government finances, to which the government is committed and which have been successful to date.

Substantial elements of uncertainty are involved in the computation of potential output and cyclically adjusted balances, mainly due to the sharp cyclical fluctuations in the Finnish economy in the 1990s and to structural changes in the economy.

2. General government budgetary prospects

	2005 million eur	2005	2006	2007	2008	2009	2010
		% of GDP					
	Net lending (EDP B.9) by sub-sector						
1. General government	**3 880**	2.5	2.9	2.8	2.7	2.7	2.4
2. Central government	**909**	0.6	0.6	0.3	0.2	0.4	0.4
3. Local government	**-1 030**	-0.7	-0.3	-0.1	-0.1	-0.1	0.0
4. Social security funds	**4 299**	2.7	2.6	2.6	2.6	2.4	2.0
	General government (S13)						
6. Total revenue	**82 485**	52.4	51.9	51.4	51.1	50.9	50.8
7. Total expenditure	**78 605**	49.9	49.0	48.6	48.7	48.2	48.4
8. Net lending/borrowing	**3 880**	2.5	2.9	2.8	2.7	2.7	2.4
9. Interest expenditure	**2 333**	1.5	1.5	1.5	1.5	1.4	1.3
10. Primary balance	**6 213**	3.9	4.5	4.3	4.2	4.1	3.7
	Selected components of revenue						
11. Total taxes	**50 277**	31.7	31.0	30.8	30.7	30.6	30.5
11a. Taxes on production and imports	**22 185**	13.9	13.6	13.5	13.4	13.3	13.3
11b. Current taxes on income, wealth, etc	**27 606**	17.5	17.1	17.0	16.9	16.9	16.9
11c. Capital taxes	**486**	0.3	0.3	0.3	0.3	0.3	0.3
12. Social contributions	**19 018**	12.1	12.0	12.0	12.0	12.0	12.0
13. Property income	**4 994**	3.2	3.5	3.3	3.2	3.2	3.2
14. Other	**8 196**	5.4	5.4	5.4	5.3	5.1	5.1
15. = 6. Total revenue	**82 485**	52.4	51.9	51.4	51.1	50.9	50.8
p.m.: Tax burden	**68 927**	43.6	42.8	42.5	42.4	42.3	42.3
	Selected components of expenditure						
16. Collective consumption	**11 988**	7.6	7.4	7.2	7.2	7.1	7.1
17. Total social transfers	**48 660**	30.9	30.2	30.1	30.1	30.2	30.6
17a. Social transfers in kind	**22 856**	14.5	14.3	14.3	14.3	14.4	14.5
17b. Social transfers other than in kind	**25 804**	16.4	15.9	15.8	15.7	15.8	16.1
18. = 9. Interest expenditure	**2 333**	1.5	1.5	1.5	1.5	1.4	1.3
19. Subsidies	**1 984**	1.3	1.3	1.2	1.2	1.2	1.2
20. Gross fixed capital formation	**4 145**	2.6	2.6	2.6	2.6	2.5	2.5
21. Other	**9 495**	6.0	6.0	6.1	5.9	5.8	5.7
22. = 7. Total expenditure	**78 605**	49.9	49.0	48.7	48.4	48.2	48.4
Pm.: compensation of employees	**21 528**	13.7	13.3	13.2	13.1	13.0	13.0

3. General government debt developments

	2005	2006	2007	2008	2009	2010
1. Gross debt, % of GDP	41.3	39.1	37.7	36.2	35.0	33.7
2. Change in gross debt, % ponts	-2.9	-2.2	-1.4	-1.5	-1.2	-1.3
Contributions to changes in gross debt, % points						
3. Primary balance	3.9	4.5	4.3	4.2	4.1	3.7
4. Interest expenditure	1.5	1.5	1.5	1.5	1.4	1.3
5. Stock-flow adjustment	-0.2	0.7	1.4	1.3	1.6	1.4
of which:						
- Differences between cash and accuals	0.1	0.0	0.0	0.0	0.0	0.0
- Net accumulation of financial assets	1.4	2.7	2.5	2.5	2.3	1.9
- of which: privatisation proceeds	-2.4	-0.3	-0.2	-0.2	-0.2	-0.2
- Valuation effects (incl. impact of GDP growth)	-1.7	-1.9	-1.2	-1.2	-0.7	-0.5
Implicit interest rate on debt, %	4.1	3.8	4.0	4.0	4.0	4.0

4. Cyclical developments, % of GDP

	2005	2006	2007	2008	2009	2010
1. Real GDP growth (%)	2.9	4.5	3.0	2.9	2.6	2.1
2. Net lending of general government	2.5	2.9	2.8	2.7	2.7	2.4
3. Interest expenditure	1.5	1.5	1.5	1.5	1.4	1.3
4. Potential GDP growth (%)	3.3	3.4	3.2	2.9	2.6	2.1
contributions:						
- labour	0.5	0.6	0.4	0.2	0.1	-0.2
- capital	0.6	0.6	0.7	0.6	0.4	0.2
- total factor productivity	2.2	2.2	2.1	2.1	2.1	2.1
5. Output gap	-1.2	-0.1	-0.4	-0.4	-0.4	-0.4
6. Cyclical budgetary component	-0.6	-0.1	-0.2	-0.2	-0.2	-0.2
7. Cyclically adjusted balance	3.1	3.0	3.0	2.9	2.9	2.6
8. Cyclically adjusted primary balance	4.5	4.5	4.5	4.4	4.3	3.9

4 SENSITIVITY ANALYSIS AND COMPARISON WITH PREVIOUS PROGRAMME

4.1 Risks in economic developments and risk impact on public finances

The underlying assumptions in this Stability Programme are based on the Ministry of Finance forecast published in September. Assumptions related to the financial markets, raw material prices and growth in the international economy are in line with the Commission's projections released this autumn. Minor differences do not change the economic scenario that underlies the Stability Programme.

The short-term risks to international economic developments are related to not only uncertain oil price developments but also global imbalances, mounting current account surpluses and deficits, and hikes in house prices. Inflationary pressure has grown and doubts surrounding economic and cost developments are hampering economic policy decision-making.

Domestically, structural bottlenecks in the labour market are adding to uncertainties in the short-term economic outlook. Coupled with possible further price escalation in the house markets and mounting household debt, this constitutes a growing threat to stable economic growth. The household debt stock has been clearly rising in recent years, recorded at about 13 per cent. In spite of the rise in interest rates, the debt stock has continued to grow fast, leading to a negative savings rate. The debt ratio has now exceeded the level recorded in the early 1990s and is close to 100 per cent already, i.e. equivalent to average annual disposable income. Owing to higher interest rates and a large stock of loans, average debt service payments are rising to historically high levels. A further factor casting a shadow on domestic economic developments is the heavy dependence of Finnish exports on the intensely competitive ICT products market.

The greatest risks in the medium-term economic outlook are related to employment and productivity developments. The labour market will be the first to be impacted by the challenges brought about by the demographic changes, as the labour supply begins to shrink in the very near future. Unless the steps being taken to improve the functioning of the labour market are successful and if the input of the unemployed remains untapped, access to labour will be hampered to such an extent that the prospects of economic growth will be adversely affected while structural unemployment will remain widespread. Finland's ageing population is a major challenge for the sustainable funding of general government, as spending pressure in pension and welfare services mounts and the labour force contracts, reducing growth in both GDP and the tax base.

The risk is that actual growth falls short of the growth scenario presented in the Stability Programme. For instance the OECD has estimated in its country survey of Finland in 2006 that GDP per capita growth between 2005-2010 will be much slower than that projected in the Programme, averaging around 1½ per cent a year.

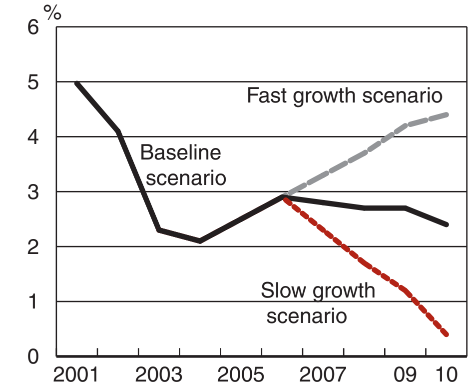
The European Commission's production function method involves uncertainties, particularly with regard to the assessment of labour input. A trend-like increase is expected in Finland's labour participation rate, which is, however, not certain. Were participation rates to remain at current levels in all age groups, the participation rate for the whole population would fall significantly in the future. Economic growth can thus prove to be weaker than in the baseline scenario if the assumptions on the impact of the pension reform prove to be optimistic and labour supply begins to decline faster than in the Programme. There are risks involved in domestic cost developments too. Labour market shortages can lead to higher pay rises than those presented in the baseline scenario, resulting in a detrimental effect on economic competitiveness.

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

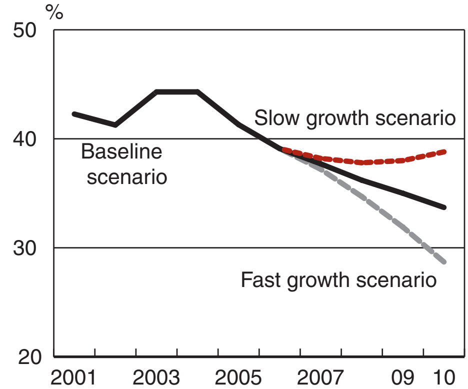
In the slow growth scenario, output growth in 2007-2010 would drop to around 1 per cent at the end of the review period and the unemployment rate would decrease only marginally, down to 7½ per cent. The impacts of economic growth on general government finances are gauged by using OECD income and expenditure elasticity estimates. In the slow growth scenario, the surplus in general government finances would disappear completely at the end of the forecast period and the debt ratio would start rising. This would seriously undermine the sustainability of general government finances as the population continues to age.

In the more favourable scenario, economic growth would remain at over 3 per cent and the unemployment rate would drop below 4½ per cent. The general government surplus would increase to over 4 per cent of GDP and the debt ratio would slip below 30 per cent by 2010.

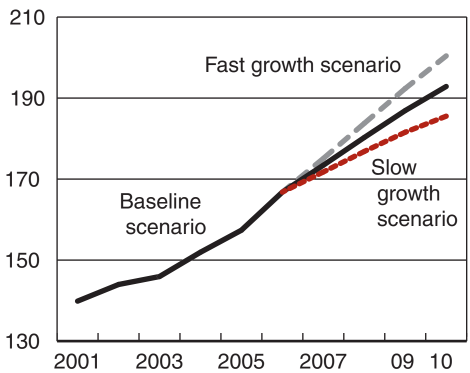
General government net lending
in ratio to GDP



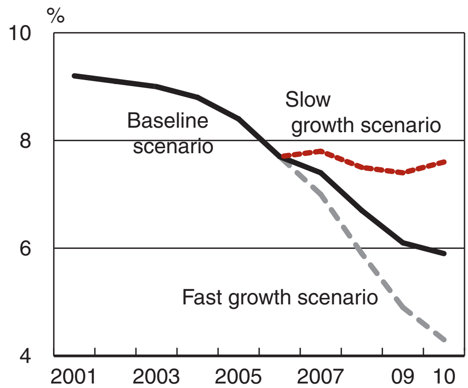
General government gross debt
in ratio to GDP



GDP
Eur bn



Unemployment rate



4.2 Comparison with last year's Stability Programme update

The previous Stability Programme update for 2005 predicted GDP growth at 2.1 per cent, whereas current preliminary data put the figure at 3 per cent. Not only domestic consumption but also investment and export volumes have risen faster than anticipated.

Total output has continued to increase faster in 2006 fuelled by a favourable international climate, so that the current estimate clearly exceeds last year's projection. The rate of growth in production was higher in early 2006 than it has been ever since 2000. Perked by rapid economic growth, employment has also improved more than expected, although unemployment has come down slightly slower than predicted. Unemployment is evaluated by calculating the difference between labour supply and demand, which means that changes in supply affects unemployment numbers. The estimate for labour supply has been raised from last year's prediction, because the average age of retirement has risen and young people have become more active jobseekers since job prospects have improved. The estimates for foreign labour in the Finnish labour market have also been increased.

Beyond 2006, the economic growth path has been placed about ½ percentage point higher than was the case in last year's Stability Programme. This is due to a more positive assessment for growth potential in the Finnish economy, evaluated against a backdrop of favourable developments in the economy and labour markets in the recent past. The labour supply scenario is slightly better than last year. On the demand side, growth estimates in both foreign trade and investment have been raised, and private consumption is also anticipated to increase more than projected a year ago, although the rate of growth is estimated to fall short of growth in total output.

In spite of the price hikes in crude oil, the estimates for inflation have not been changed to any significant degree from last year. This is because prices and charges in communications and information technology came down in 2005 and interest rates rose later than predicted, keeping the average increase in consumer prices in check. A strong euro has curbed price rises in imports this year, in turn. The wage settlement reached in late 2004 applies until autumn 2007. Unless labour market shortages become worse, there is no inflationary pressure on the domestic front.

The estimated surpluses in general government are likewise proving to be larger than anticipated a year ago, largely explained by faster-than-expected economic growth. Contrary to the predicted deficit, the financial position in central government has remained in surplus by about ½ per cent in relation to GDP. Consequently, the projected medium-term balance in central government finances is also stronger than previously estimated. Developments in local government and the social security funds have evolved as anticipated. Against the background of a more robust balance in general government finances the projected debt-to-GDP ratio has been reduced.

5. Divergence from previous update

	2005	2006	2007	2008	2009	2010
Real GDP growth (%)						
SP-2005	2.1	3.2	2.6	2.3	2.1	-
SP-2006	2.9	4.5	3.0	2.9	2.6	2.1
Difference, % points	0.8	1.3	0.4	0.6	0.5	-
General government net lending (% of GDP)						
SP-2005	1.8	1.6	1.6	1.5	1.5	-
SP-2006	2.5	2.9	2.8	2.7	2.7	2.4
Difference, % points	0.7	1.3	1.2	1.2	1.2	-
General government gross debt (% of GDP)						
SP-2005	42.7	41.7	41.1	40.6	40.1	-
SP-2006	41.3	39.1	37.7	36.2	35.0	33.7
Difference, % points	-1.4	-2.6	-3.4	-4.4	-5.1	-

Previous update: Stability programme update, November 2005

Current update: Stability programme update, November 2006

5 QUALITY OF PUBLIC FINANCES

5.1 Government policy

The Government's fiscal policy objective is to maintain strong central government finances. This is essential if public finances are to cope with the implications of population ageing over the next few decades without placing an unreasonable tax burden on future generations. To achieve this, the debt-to-GDP ratio in central government finances needs to be reduced. To ensure stability and sustainability in general government finances, it is necessary to curb growth in public spending, to boost productivity and to strengthen the growth potential of the economy. Moderation in spending applies to both central and local government. More efficient and productive public sector functions are vital not only to ensure stability in general government finances but also to secure growth prospects for the Finnish economy. Better productivity creates significant opportunities to curb expenditure growth and to reallocate resources.

The 2006 Stability Programme update is in line with National Action Plan for Finland published in October 2006.[4] The Action Plan only incorporates reforms included in the Government Programme or which the government has decided to implement during its term in office. All the reforms listed in the Plan are contained within the spending limits and were taken into account in the baseline scenario presented in the Stability Programme.

4 The National Action Plan (NAP) is based on the Government Programme and is being implemented within the scope of central government spending limits and budget proposals. The updated NAP presents a table of examples on measures with a direct budget impact that has already been possible to assess. The overall impact of the NAP measures on the structure of the economy and on public finances can only be evaluated in the longer term.

5.2 General government revenue and taxation

With the aim of improving employment and safeguarding stable economic growth, taxation has undergone major changes during the present Government's term of office. The overall sum of tax cuts will amount to nearly 3.9 billion euros by the end of the election period. In connection with the collective agreement contracted at the end of 2004, it was agreed that taxes on earned income would be cut between 2005 and 2007. In addition, when corporate and capital taxation was reformed in 2005, the corporate tax rate was lowered. Taxes on net wealth were abolished from the beginning of 2006. Intermediate taxation was eased in the context of taxes on alcohol in order to secure favourable developments in the tax bases.

The Stability Programme update figures for central government revenue in 2006-2007 are in line with those presented in the Ministry's Economic Survey for September 2006. Beyond 2007, tax revenues are estimated on the basis of the medium-term macroeconomic scenario. Further cuts in taxes on labour will be introduced in 2007, when income taxes will be eased by 740 million euros by abolishing one income bracket from the tax scales and inflation adjustments will be made. The assumption was made in central government taxation of earned income for 2007-2010 that the tax scales would be adjusted so that tax progression will not make taxes on income heavier. Business profitability has improved in recent years, creating a good basis for tax revenue from corporate taxes. Corporate tax accrual is estimated to increase by an average of 4 per cent a year between 2007 and 2010.

The tax bases used to calculate indirect taxes are assumed to involve no changes. Private consumption has grown fast in recent years. The sharp increase in the household debt ratio will hamper growth potential in private consumption in the medium term, however. This in turn will curtail growth in indirect tax receipts, such as VAT. Indirect tax revenue is estimated to increase on average by 3 per cent a year between 2007 and 2010. Deductions for household work are assumed to reduce tax receipts by 160 million euros in 2006. Lower VAT applied in some service sectors will reduce annual VAT revenue by an estimated 43 million euros.

With the final apportionment of the distribution of costs between central and local government implemented over 2005-2008 having been brought forward and dispensed to the municipalities through the tax system will reduce central government tax revenue by about 250 million euros. The revision will be carried out by lowering the earned income deduction in local government taxation and raising the deduction in central government taxation so that taxpayers are not affected to any significant degree.

Tax revenue in local government is expected to grow by 7 per cent this year, significantly more than in the past few years on average. Tax receipts are calculated to amount to around 15.3 billion euros. Tax revenue is anticipated to increase by 5 per cent in 2007. With growth in the payroll slowing down, the tax base in local government will slacken. On the other hand, the final apportionment of the costs between central and local government being brought forward, tax receipts in municipalities will be boosted by 185 million euros. Local government tax revenue is projected to grow by a good 3½ per cent a year on average between 2008 and 2010.

Over one half of all statutory basic services in municipalities are financed by local government tax revenue. Close to 90 per cent of all local government tax receipts consisted of municipal tax revenue in 2005, while corporate taxes accounted for about 8 per cent and real estate taxes for 5 per cent. The average tax rate is assumed to remain at the 2006 level of 18.4 per cent in the tax estimates for 2007-2010.

The developments in the social security funds are determined by macroeconomic trends on the basis of current legislation and forthcoming changes. The tax rate is expected to drop by about 0.6 percentage points during the programme period. The employment pension contribution rate is assumed to rise slightly in 2007-2010.

5.3 General government expenditure

General government expenditure increased very rapidly in the early 1990s, primarily as a result of the economic recession that swept the country. General government expenditure as a proportion of GDP peaked at 65 per cent in 1993, after which it edged down to 50 per cent in 2005. Measures to restore general government finances and the onset of rapid economic growth changed the developments in the mid-1990s. Most of this reduction has come in social security expenditure and general government interest expenses. The decrease in social security expenditure is mainly due to lowered unemployment security costs following the recovery of employment after the recession.

The general government expenditure-to-GDP ratio is expected to decrease by one percentage point this year, as the value of GDP will grow exceptionally fast in 2006. Between 2007-2010, the ratio of general government expenditure to GDP is expected to remain fairly stable. The Government Programme specifically details the principles for key income transfers over the current electoral period, i.e. through to 2007. The system of central government spending rules also facilitates the management of public spending. Transport infrastructure investments and a number of additional expenditure items already approved will raise the spending rate in 2008 and 2009. In spring 2007 a new government will draw up new spending limits for the period between 2008 and 2011.

Total central government expenditure will grow by an estimated 2½ per cent in 2006 as calculated in national accounts terms. The increase involves mainly various social benefits and transfers. A reform in the system of labour market subsidies and an adjustment in the central government transfers index will augment transfer expenditure to local government. Overall central government expenditure is expected to grow at the same rate next year.

In its Budget Proposal for 2007, the Government aims to provide a package of measures worth 100 million euros to boost the employment rate and foster occupational and regional labour mobility by means of structural reforms, more appropriations and revised taxes bases. Interest expenses will rise slightly, as interest rates are expected to increase interest expenses more than is possible to save by servicing government debt.

The productivity programme will lead to staff reductions during the Stability Programme period and thus slowing down growth in consumption expenditure. The productivity programme is estimated to bring savings totalling around 16 million euros in central government finances in 2007 and about 200 million euros in 2011. The reform in the pension system will create savings in employment pension expenditure and bolster the financial base in spending. Public sector R&D resources totalled 1,597 million euros in 2005, in other words 1.01 per cent of GDP. An estimated 120 million euros in low-pay subsidies for older workers will be granted annually.

The baseline scenario for public spending includes the main foreseeable on-budget expenditure pressures for 2008-2010, such as expenditure in development aid, university funding and state aid to municipalities. The estimated expenditure pressure for 2008 is around 0.6 billion euros, from which it is anticipated to rise to about 1.2 billion euros by 2010 relative to the spending limits of spring 2006.

Local government operating expenditure will continue to grow at a nominal rate of over 5 per cent this year but is expected to slightly decelerate next year, mainly because the growth in the largest single expenditure item, namely payroll expenses, is anticipated to slacken. Purchases of goods and services will continue to grow fast, as in the past few years. Operating expenses are estimated to increase by an average rate of just below 4 per cent a year between 2008 and 2010. This estimate is based on the assumption that both payroll expenses and purchases of goods and services will grow more moderately in the future. Government measures are expected to place less pressure on local government spending than in the past.

Moderation in local government expenditure growth is being jeopardised by faster-than-anticipated growth in payroll expenses and in purchases of goods and services, as the demands of the ageing population start to mount. Moreover, shortages in labour supply threaten to place more pressure on wage drift, as the annual retirement attrition will begin to accelerate and labour supply is anticipated to start declining in the near future.

The biggest public expenditure categories are social welfare and health care expenses and administration costs in the public sector, which accounted for 21.3, 6.7 and

6. General government expenditure by function, % of GDP

	2004	2010
1. General public services	6.5	5.8
2. Defence	1.6	1.4
3. Public order and safety	1.5	1.3
4. Economic affairs	4.7	4.2
5. Environmental protection	0.3	0.3
6. Housing and community amenties	0.3	0.3
7. Health	6.7	7.0
8. Recreation, culture and religion	1.2	1.1
9. Education	6.1	5.8
10. Social protection	21.3	21.3
11. Total expenditure	50.3	48.4

6.5 per cent of GDP respectively in 2004. Although there are no major changes expected in this general structure of functions in 2004-2010, there are already some early indications of future structural changes, i.e. the growing share of social and health care expenditure and the decrease in general administrative costs.

Social security expenditure is predicted to increase clearly after 2010. The pension reforms that are now in place will have begun to slow down growth in pension expenditure and unemployment will have been reduced. The ageing population means that pension expenditure is mounting and there is more demand for healthcare and long-term care services, adding expenditure pressure in social security in the longer term too.

5.4 Productivity in general government

According to international comparisons and poll results among end-users, the standard of service provision in Finland is rated very highly, both in terms of quality and cost effectiveness. Although the measurement of productivity in public services is somewhat problematic, both statistical data and research evidence suggest that productivity has fallen in recent years or at most remained unchanged.

The imminent demographic changes will result in declining labour supply. This means that the Government Programme’s targeted 75 per cent employment rate for 2011 is insufficient to foster growth in the long run unless labour productivity continues to increase consistently both in the public and private sector.

Productivity in central government

The government has launched a package of measures to promote productivity in the public sector. The purpose of the productivity programme is to achieve planned and established productivity growth and productivity benefits in public services and public administration. As specified in the government spending limits, central government productivity will be bolstered in all administrative branches through measures that will revamp structures and administrative practices as well as boost the use of ICT. With productivity improving, staff numbers in government can be judiciously adjusted to existing labour resources in the economy. These measures to increase productivity should reduce staff numbers in central government by about 9,600 person years by 2011, around 7.9 per cent of overall person years in central government. All the measures can be carried out through natural attrition, calculated at around 26,000 employees over the current budget planning period, of which 14,000 are workers retiring on old-age pension.

All service tasks in central government, such as payroll and accounting functions, will be brought together into service centres. Five service centres for financial and personnel administration for central government (including the existing centres) will be created, forming a network that uses uniform principles and information systems. Each ministry and all government agencies will take a decision by the end of 2006 on the required measures to rearrange these activities. All these services will be produced on the service centre principle at the latest by 2009.

Productivity demands have been taken into account in the government's IT strategy and related reform programme. Productivity targets play a key role in the government's strategy relating to government premises. New premises and operating environments are often necessary when novel ways functioning are introduced. Considerable productivity savings can be achieved by centralising procurement volumes and reforming procurement processes. The use of the government's joint procurement unit has been increasing at a fast pace recently.

Reform in restructuring municipalities and services

The government submitted a legislative proposal to Parliament in autumn 2006 on the restructuring of municipalities and services. The new act should enter into force at the beginning of 2007 and be effective until the end of 2012. The reform aims to bolster both municipal and service structures, to enhance the ways in which services are produced and provided, to revamp the municipal financial structures and the system of central government transfers to local government and to review the division of duties between central and local government with a view to ensuring a solid structural foundation and a sound financial basis in the municipalities. The objective is to boost productivity and curb growth in expenditure in the municipalities and to enhance the steering systems used in providing municipal services.

By regrouping and amalgamating municipalities the structure of local government can be bolstered. The aim is to create a municipal structure that is both viable and robust. Amalgamations will be implemented on a voluntary basis. The government ratified 14 municipal amalgamations by autumn 2006, dropping the total number of municipalities to 416 in early 2007. In addition, there are tens of reports on municipal mergers in progress. Revised provisions governing amalgamation subsidies for municipalities will come into force at the beginning of 2007. Where an amalgamation results in a municipality with a total population of over 20,000 inhabitants, the amalgamation subsidy granted is larger.

Service structures will be strengthened by consolidating individual services that require a population base of more than one municipality to be viable and closer cooperation between municipalities will be promoted. This way, good quality services that are accessible to everyone can be ensured throughout the country. Municipalities and partnership areas responsible for providing basic health care services and related social services must have a minimum population base of around 20,000 inhabitants. Where municipalities and partnership areas offer basic vocational training, the minimum population base must be in the range of 50,000 inhabitants. To secure the provision services requiring a large population base, the country is divided into municipal alliances as stipulated in the Act on Specialised Medical Care. To further improve productivity, closer cooperation in service provision between municipalities will be promoted and the operating conditions in the Helsinki metropolitan area and other urban areas suffering from problems in the community structure will be enhanced. Large urban areas will be obligated to collaborate.

6 SUSTAINABILITY OF GENERAL GOVERNMENT FINANCES

6.1 Measures to enhance sustainability

The long term outlook for general government finances in Finland is overshadowed by the impending rise in costs due to population ageing and by the shrinking of the revenue base resulting from the declining labour supply. With the baby boom generation retiring soon and causing a rise in pension expenditure and a fall in labour supply towards the end of this decade, the effects of the ageing population will actually become manifest in economic developments quite soon. The costs of health and long-term care provision for the elderly population will rise most steeply during the 2020s.

Over the next two decades the population in Finland will be ageing faster than in any other EU country and the old-age dependency ratio in 2025 will be the highest in the EU. However, the following measures have been taken to make provision for the expenditure pressure created by the ageing of the population:

- pursuing disciplined fiscal policy to reduce levels of public debt;
- prefunding for future pensions;
- reforming pension schemes for greater financial sustainability; and
- strengthening the financial basis of the general government by means of economic policy that promotes growth and employment.

The reduction in government debt and interest outlays has created room for manoeuvre to ensure that the growth in expenditure and the weakening of the revenue base caused by population ageing will not lead to a new rise in the central government debt ratio. The prefunding of earnings-related pensions has helped considerably to ease the pressures to raise pension contributions in the future. Thanks to prefunding, long-term increases in pension contributions will be no more than one-half of the rise in pension expenditure. The market value of the pension funds' assets is currently 50 per cent higher than public debt.

The pension system has been reformed on several occasions since the early 1990s. The most recent comprehensive reform took effect from the beginning of 2005. The aim is to strengthen the sustainability of the pension system by adjusting pensions to changes in life expectancy and to encourage older workers to stay longer in employment by introducing an accelerated pension accrual. The aim is to postpone retirement by at least three years. Indeed, the employment rate among older workers has been rising considerably, indicating that the pension reforms have been able to serve their purpose. The employment rate in the age group 55-64 has risen from 36 per cent in 1997 to 53 per cent in 2005. It is important that this trend continues among ageing workers in order for the 75 per cent employment rate targeted by the present and previous governments to be reached. In spite of the positive developments, it is the older age group that carries the greatest labour potential.

To strengthen the sustainability of the pension system, the risk-carrying possibilities in the investments of the pension funds will be enhanced as of 2007. The aim is to raise the long-term real return on investment in the pension funds from 3½ per cent to 4 per cent. This would release pressure to raise pension contribution rates by a good 1 percentage point relative to wages. Together with the pension reforms, this means that the pressure to raise contribution rates would drop from 10 percentage points to about 4 percentage points of the wage bill. Risk-carrying equity investments currently account for 40 per cent of the total market value of pension funds.

Employment and sustainability of public finances have been strengthened not only by the pension reform, but also by a reform of the unemployment insurance system. The minimum age for eligibility for the "unemployment pipeline"[5], a relatively common pathway to early retirement in Finland, was raised from the beginning of 2005 by two years to age 57. People in the unemployment pipeline can retire on old-age pension flexibly between ages 62-65.

A temporary low-pay subsidy scheme was launched at the beginning of 2006 running through to 2010. Under this scheme, employers are entitled to a subsidy for all workers in their payroll aged 54 or over who earn between 900 and 2 000 euros a month for a full-time job. The subsidy aims to promote the employment of older workers in low-paid jobs. So far, this subsidy has been used relatively little.

To boost employment, a number of incentive traps have been removed by reforming the tax and social security schemes with a view to encouraging individual initiative and job creation. Steps have also been taken to foster economic growth by investing in knowledge and know-how and by promoting entrepreneurship and innovation.

5 Extended earnings-related unemployment benefit for older workers.

6.2 Sustainability scenario

The purpose of the sustainability scenario is to evaluate the financial position of general government in the long term and to provide decision-makers with information on any adjustment needs that might be required in public finances.

The sustainability scenario starts in 2010 and extends through to 2050. The scenario is based on Eurostat's population forecast for Finland (2004). The macro-economic assumptions used in the scenario, i.e. employment, unemployment, productivity and interest rate, are consistent with the baseline scenario jointly agreed upon in the working group dealing with the economic impacts of population ageing (AWG) under the EU Economic Policy Committee.

In the scenario, the employment rate is expected to rise to over 74 per cent by 2030 and the unemployment rate to settle at around 6.5 per cent by 2013.[6] Labour productivity is assumed to increase on average by 2 per cent annually during the early part of the forecast period and by an average of 1.7 per cent a year from 2030 onwards. Productivity in the public sector is not anticipated to grow at all.[7] The underlying assumption is that changes in the age and industrial sector structure of the labour force has no bearing on labour productivity and that the number of hours worked is constant. The average rate of GDP growth for the whole forecast period is 1.9 per cent per annum. The real interest rate is assumed at 3 per cent, both for public debt and for investments by earnings-related pension funds.

In the sustainability scenario the total tax rate is kept constant at the level forecast for 2010. The increased pressure in pension expenditure is released into the pension contributions, assumed to rise by about 2 percentage points of GDP by 2030. Keeping the total tax rate constant, taxation in other areas is allowed to ease. The primary balance in general government finances is determined on a net basis, i.e. interest expenses and property income are not included.[8]

It is expected that by 2050, age-related expenditure (pensions, health care, long-term care, education and unemployment) will increase by 5.1 percentage points of GDP. Pension expenditure will be up by 2.5 percentage points and spending on health care and long-term care together by 2.8 percentage points of GDP. With unemployment decreasing, unemployment expenses will drop slightly relative to GDP and education expenditure relative to total output will decrease because younger cohorts are smaller (Table 7).

6 The unemployment rate assumption is ½ percentage point higher in the sustainability scenario than that in the Stability Programme medium-term baseline scenario for 2010.

7 The assumed zero growth rate in labour productivity in the public sector means that in the long term prices in public consumption will grow much faster than in the whole economy on average (Baumol's disease).

8 The method used in calculating property income differs from the one used by the Commission.

7. Long-term sustainability of public finances, % of GDP

	2005	2010	2020	2030	2050	2010-2050 change
Total expenditure	**50.1**	**48.4**	**50.4**	**53.6**	**58.0**	**9.6**
Of which: age -related expenditures	25.0	25.6	27.6	30.2	30.7	5.1
Pension expenditure	10.4	11.2	12.9	14.0	13.7	2.5
Old-age and early pension	8.0	8.8	10.7	12.0	12.1	3.2
Other pensions	2.4	2.4	2.2	2.0	1.7	-0.7
Health care	5.5	5.8	6.2	6.6	7.0	1.2
Long-term care	1.8	1.9	2.1	3.0	3.5	1.6
Education	5.9	5.5	5.3	5.4	5.3	-0.2
Unemployment	1.4	1.2	1.1	1.1	1.1	-0.1
Interest expenditure	1.7	1.3	1.4	2.1	5.8	4.5
Total revenue*	**52.6**	**50.9**	**51.9**	**51.8**	**51.6**	**0.7**
Of which: property income*	3.2	3.2	4.1	4.0	3.8	0.6
Of which: pension contributions	9.1	9.0	10.3	11.2	11.2	2.2
Cyclically adjusted balance *	**2.5**	**2.5**	**1.5**	**-1.8**	**-6.4**	**-8.9**
Gross debt	**43.7**	**35.8**	**27.6**	**41.0**	**117.5**	**81.7**
Of which: consolidated debt	41.3	33.7	25.3	38.6	114.0	80.3
Pension funds´ financial assets	**62.6**	**69.8**	**75.1**	**76.4**	**76.0**	**6.2**
Of which: consolidated liquid financial assets	51.7	57.9	62.4	63.8	63.5	5.6

* As of the year 2011, property income and balance include valuation changes and sales profits of equity investments

Assumptions						
Labour productivity growth		1.9	2.1	1.7	1.7	
Real GDP growth		2.2	1.7	1.4	1.4	
Participation rate						
males (20-64)		83.3	85.7	86.4	86.5	
females (20-64)		76.6	80.3	81.5	81.9	
total (20-64)		79.8	82.9	84.0	84.2	
Unemployment rate		6.8	6.5	6.5	6.5	
Population aged 65+ over total population		16.9	22.6	26.1	27.0	
Inflation		1.8	2.0	2.0	2.0	
Real interest rate		3.0	3.0	3.0	3.0	

Calculated on the basis of these assumptions, overall public finances do not seem to be on a totally sustainable foundation. Public finances will slip into deficit in 2026, with the deficit becoming ever larger so that by the end of the projection period it will have reached 6½ per cent of GDP. On closer examination of the different sectors in general government, it can be seen that the situation is dualistic. Owing to raises in contribution rates the pension funds will stay in surplus throughout the forecast period and their assets' market value will amount to 76 per cent of GDP in 2050. The rest of general government (central and local government) is calculated to stay in deficit throughout the period, and the deficit will continue to increase, resulting in a public debt in excess of 60 per cent of GDP by 2036.

The sustainability gap in general government finances is about 1½ per cent of GDP in the baseline scenario. This means that either spending should be reduced or revenue increased by the same amount if public finances are to be kept on a sustainable basis in the long term. The sustainability gap would naturally be larger if the premise for the calculation were weaker than in the baseline scenario owing to the uncertainties presented in section 3.2. Major elements of uncertainty are involved in the long-term projections in terms of the underlying assumptions on both demographic projections and economic developments, so that the sustainability gap should be taken as only indicative.

Preconditions for sustainability in general government finances

The assumption in the sensitivity analysis provided in addition to the baseline scenario is that real rate of return on the pension funds' assets is one percentage point higher than in the baseline scenario, in other words 4 per cent, which corresponds to a challenging target return on pension assets and to the assumed return used in the national calculations (Table 7a). The real return on equity (dividends + appreciation) is assumed to be 5½ per cent. The assumed interest rate on public debt is kept unchanged at 3 per cent in real terms. Total assets in the pension funds are therefore assumed to yield one percentage point more than risk-free government bonds. The purpose of the higher returns on investment in the sensitivity analysis is not to lower pension contribution rates but to accumulate more assets in the pension funds. A one percentage point rise in returns would reduce the deficit in public finances by 3.5 percentage points of GDP in 2050 and would boost the pension funds' assets to 115 per cent of GDP. Thus an increase of one percentage point in the rate of return in the pension funds would reduce the imputed sustainability gap by half. The sustainability gap could be removed altogether if public spending were to be cut by an additional

7a: Balance in general government, debt and pension assets in 2050, % of GDP

	Balance	Debt	Pension assets	Debt minus pension assets
(1) Baseline scenario	-6.4	117.5	76.0	41.5
(2) Real rate of return on pension assets 4 %	-2.9	117.5	115.0	2.5
(3) (2) + 1 percentage point of GDP spending restraint	0.5	69.0	115.0	-46.0

one percentage point of GDP. For example, the Government Productivity Programme launched in 2003 aims to improve cost-efficiency and curb growth in spending.

Hence, if a one percentage point higher rate of return for pension assets could be achieved than for risk-free bonds and if productivity in public services could be boosted so much that the expenditure rate would drop by one percentage point, the sustainability gap could be eliminated.

6.3 Pension fund assets

Finland's earnings-related pension system is a partially pre-funded, defined benefit system in which the benefits are determined according to the length of employment history and the level of earnings. The pre-funding is collective and it does not affect the level of the pension; rather, it is intended to even out the pension contribution rate over time. Within the national accounts framework, the pension funds in the private and municipal sector are counted as social security funds. By contrast, the State Pension Fund is part of central administration. Tables 8-10 show the non-consolidated and consolidated market value of the pension funds in 2000-2005.

The revenue from the investment proceeds of consolidated liquid assets – interest and dividends – amounted to 2.3 billion euros in 2005. Interest and dividends, however, represent only part of the revenue generated by the pensions funds; much of the revenue derives from the appreciation and sales profits on shares and bonds. When these items are included, revenue from proceeds of non-consolidated pension fund assets amounted to 11.1 billion euros in 2005.

8. Financial assets (market value) of earnings-related pension institutions (sector 13141) in Finland, million euros

	2000	2001	2002	2003	2004	2005
A. Non-consolidated liquid assets						
AF21 Currency	0	0	2	0	0	0
AF22 Transferable deposits	134	241	256	257	376	510
AF29 Other deposits	276	228	880	379	377	246
AF331 Short term bills	1 279	2 125	1 838	2 320	2 624	2 666
AF332 Long term bonds	29 559	30 202	32 312	32 821	36 355	38 965
AF34 Derivatives	105	20	80	111	201	156
AF511 Quoted shares	15 347	13 016	10 518	13 807	17 225	20 355
AF52 Mutual fund shares	323	3093	3399	5209	7794	14 142
Total	47 023	48 925	49 285	54 904	64 952	77 040
% of GDP	35.6	35.0	34.2	37.6	42.7	49.0
B. Liabilities of general government (sector 13) to pension funds (sector 13141)						
AF331 Short term bills	20	5	29	26	257	42
AF332 Long term bonds	10 322	6 887	4 786	4 666	3 512	3 606
Total	10 342	6 892	4 815	4 692	3 769	3 648
% of GDP	7.8	4.9	3.3	3.2	2.5	2.3
C. (=A-B) Consolidated liquid assets of pension funds (sector 13141)						
AF21 Currency	0	0	2	0	0	0
AF22 Transferable deposits	134	241	256	257	376	510
AF29 Other deposits	276	228	880	379	377	246
AF331 Short term bills	1 259	2 120	1 809	2 294	2367	2624
AF332 Long term bondst	19 237	2 3315	27 526	28 155	32 843	35 359
AF34 Derivatives	105	20	80	111	201	156
AF511 Quoted shares	15 347	13 016	10 518	13 807	17 225	20 355
AF52 Mutual fund shares	323	3 093	3 399	5 209	7 794	14 142
Total	36 681	42 033	44 470	50 212	61 183	73 392
% of GDP	27.7	30.1	30.9	34.4	40.2	46.6
D. Total assets of pension funds (sector 13141)						
Non-consolidated total assets	60 737	62 480	63 570	69 290	78 377	90 339
% of GDP	45.9	44.7	44.2	47.5	51.6	57.4
Consolidated total assets	49 179	54 667	57 825	63 737	73 854	85 946
% of GDP	37.2	39.1	40.2	43.7	48.6	54.6

Source: Statistics Finland: Financial statistics.

9. Financial assets (market value) of the State Pension Fund

	2000	2001	2002	2003	2004	2005
			million euros			
Non-consolidated assets	3 843	4 427	4 484	5 795	6 867	8 201
Consolidated assets	1 522	1 686	3 099	4 549	6 339	7 963
			% of GDP			
Non-consolidated assets	2.9	3.2	3.1	4.0	4.5	5.2
Consolidated assets	1.2	1.2	2.2	3.1	4.2	5.1

Source: State Pension Fund.

10. Financial assets (market value) of the eanings-related pension institutions (tables 8 and 9)

	2000	2001	2002	2003	2004	2005
			million euros			
Non-consolidated assets	64 580	66 907	68 054	75 085	85 244	98 540
Consolidated assets	50 701	56 353	60 924	68 286	80 193	93 909
Consolidated liquid assets	38 203	43 719	47 569	54 761	67 522	81 355
			% of GDP			
Non-consolidated assets	48.8	47.8	47.3	51.4	56.1	62.6
Consolidated assets	38.3	40.3	42.3	46.8	52.7	59.7
Consolidated liquid assets	28.9	31.3	33.0	37.5	44.4	51.7

Source: Statistics Finland: Financial statistics and State Pension Fund.

7 NATIONAL FISCAL PROCEDURES AND INSTITUTIONS

To promote a sustainable and credible fiscal policy, the present Government is committed to a new system of spending limits. Approximately three-quarters of total budget appropriations are allocated to spending limits that cover the whole electoral term. This spending rule is included in the Government Programme, and a separate Government decision was made on the matter in May 2003, which was presented to Parliament as a government report. The spending limits for the electoral term are expressed at 2004 cost and price levels, and imputed revisions have been made to the limits to adjust to changes in costs and prices and the budget structure.

Expenditures affected by cyclical fluctuations, variable costs not dependent on Government decisions and expenditure stemming from administrative arrangements or technical adjustments in the budget proposal, apart from changes in spending principles, are excluded from the scope of the spending rules. These include the following:

- unemployment security expenditure, housing allowances and transfers to the Social Insurance Institution; these expenditure items are, however, covered by the spending rules insofar as they are affected by changes made to their bases;
- debt interest payments;
- any compensation to other tax recipients deriving from tax changes decided by central government;
- changes in transfers payable to the Social Insurance Institution caused by changes in social security contributions;
- expenditure corresponding to revenues from the European Union;
- expenditure corresponding to national lottery receipts and profit entered as revenue from the Slot Machine Association;
- capital expenditure

Supplementary budget proposals, on the other hand, are included in the spending limits. The Government's declared aim is to secure balanced central government finances under normal conditions of economic growth at the end of the electoral period, measured in terms of national accounting. Furthermore, the Government's commitment is that even in conditions of adverse economic development, the deficit in central government finances, as measured in national accounting terms, shall not exceed 2¾ per cent of GDP. Economic developments as weak as this are not expected to take place during the current government. In addition, the Government has agreed, as a supplement to the Government Programme, that if annual proceeds from the sale of state owned shares exceed 500 million euros, a maximum of 20 per cent of the excess amount can be used on a discretionary basis for non-recurring supplementary expenditures, mainly to invest in infrastructure projects and to fund R&D activities, irrespective of the spending rules or the spending limits for the electoral term.

The allocation of appropriations by administrative branch is revised annually on the basis of a decision on central government spending limits. In preparation of that decisions ministries submit their own four-year action and financial plans as well as their own spending limits proposal for the administrative branch. The spending limits established by the Government provide a framework within which each administrative branch works to prepare their proposals for the following year's budget. The Government Programme requires that more action strategies will be included in ministries' spending limit plans. Steps have been taken to promote the integration of the spending limits procedure into the ministries' operating and financial plans. The aim has been to establish a system whereby resource priorities within and between ministries can be steered by joint Government decisions. Furthermore, the aim has been to strengthen the political control of the Government in the process of drawing up these plans.

The motivating force behind the spending limits for 2007-2011 has similarly been to support the Government's economic policy objectives and to pursue a fiscal policy that secures stable growth. The premise in drawing up the spending limits was a cautious approach where all administrative branches were expected to observe budgetary prudence. This has also helped to create economic room for manoeuvre in political decision-making.

Furthermore, the Government seeks to promote, coordinate and monitor the implementation of the Government Programme by means of a separate Strategy Document. The Strategy Document includes the policy programmes agreed upon in the Government, i.e. the employment policy programme, entrepreneurship policy programme, information society policy programme and civil participation policy programme.

Other inter-administrative policies under special Government supervision are also included in the Document. It sets specific impact and key targets for the policy programmes and the inter-administrative policies and presents concrete measures to achieve the goals. The Strategy Document is implemented within the framework of central government spending limits and the Budget.

In May 2003, the Government set the spending limits for 2004 at 28,049 million euros, which was subsequently revised for technical reasons to 28,089 million euros. The sum total of the 2004 budget and supplementary budgets was around 80 million euros below the revised spending limits, so expenditure was well within the framework established. Spending in 2005 also remained within the limits, with overall spending in the Budget and supplementary budgets being about 24 million euros below the revised spending limits.

The spending limits for 2006 will probably also hold, because there is an undistributed reserve of 12 million euros even when the second supplementary budget expenditure is taken into account.

In its Budget Proposal for 2007, the government submits that expenditure included in the spending limits be kept 112 million euros below the limits set for 2007. The government's aim is to keep the 2007 Budget Proposal within the spending limits established for its term in office. The spring 2007 supplementary budget will probably be presented during the next election period in line with the new government's programme. The final decision on spending limits for 2008-2011 will be taken by the next government.

Prudence in spending also applies to local government. The Government Programme stipulates that balance will be improved in the financing of local government duties and obligations using a basic services programme for central and local government covering the government's whole term in office and a related annual basic services budget. The programme and budget will be drawn up jointly by central and local government representatives and endorsed by the Government. Revenue and expenditure stemming from local government duties and obligations are assessed by municipal groupings and measures to achieve balance are presented in the basic services programme. The programme is part of the central government spending limits and is revised annually in connection with the budget cycle.

The project to restructure municipalities and services and the productivity programme launched by government, which are described in section 5.4., are instrumental in helping to curb public spending. These projects and basic services programme principles are explained in more detail in the Finnish National Reform Programme.

Experiences of the new system of spending limits

The experiences gained from the new system of spending limits for central government have been positive. It can be said that the system has for the most part worked well and has fulfilled its main function of curbing growth in central government spending. The government is highly committed to the spending limits set out for the whole of its term in office. This is evident for instance because spending has remained within the limits set even though a number of unexpected expenditure demands have arisen over the term in office. The system has also helped curtail expenditure in supplementary budgets, as their size has dropped from an annual total of over 400 million euros to less than 300 million during this government compared to the previous one.

Economic developments over the current election period have been better than anticipated. Partly thanks to the spending rules, it has been possible to avoid adopting a pro-cyclical fiscal policy and the surpluses in central government finances have been used to service government debt and to accumulate resources in the pension fund. For the same reason it can be said that it was a good decision to leave automatic stabilisers out of the spending rule.

One of the advantages of the new system from the viewpoint of political commitment is that it sets out a clear numerical goal that can be observed right at the start of budget drafting. International interest in the functioning of the system has further promoted commitment to the system of spending limits.

The new system of spending limits has also been criticised in some contexts. The main problem has been the lack of flexibility and room for manoeuvre in the system. This dates back to the government negotiations of 2003, when additional expenditure totalling 1.12 billion euros for 2007 was agreed on. The level of the spending limits for the whole government term was also settled on the basis of this. The entire additional sum was allocated to specific categories in advance, leaving no room for new expenditure needs. The undistributed reserve for contingencies and political discretion in the first spending limits adopted in May 2003 amounted to 120 million euros, which proved to be too small. An unexpected statutory requirement for adjustment in the cost distribution between central and local government (about 500 million euros annually) has since appeared, which, due to limited reserves, will be implemented in stages. The annual increases of 25 million euros for road and railway maintenance in the government's first spending rules have proven insufficient, so that no initiatives whatsoever have been taken to launch any new road, rail or waterway projects. Partly for these reasons demands have been made to create more flexibility in the system of spending limits and to place infrastructure expenditure and a number of other expenditure items outside the spending rules.

In principle, different types of financial systems falling outside the system of spending limits, such as public-private partnerships and tax subsidies, are also seen to be a problem. A common problem with spending rules is that in practice the rules determine the level of spending, and thus the level of spending limits adopted plays a key role. Finland's system of spending limits is based on agreements between coalition partners, which bear no statutory significance. This government's experience shows, however, that this has not diminished the relevance of the system or reduced the government's commitment to the spending limits.

The Ministry of Finance has set up a working group to evaluate the need for revising the system of central government spending limits. The working group will present a proposal in early 2007 on a system of spending limits for the next government. The working group will also examine the overall picture in fiscal policy rules and make proposals for improvement where necessary.