EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

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ECONOMIC ASSESSMENT OF THE STABILITY PROGRAMME OF FINLAND (UPDATE OF NOVEMBER 2006)

The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term fiscal programme, called "stability programme" for countries that have adopted the euro as their currency and "convergence programme" for those that have not. The most recent update of Finland's stability programme was submitted on 30/11/2006.

The attached technical analysis of the programme, prepared by the staff of, and under the responsibility of, the Directorate-General for Economic and Financial Affairs of the European Commission, was finalised on 29.01.2007. Comments should be sent to Mart Maiväli (mart.maivali@ec.europa.eu). The main aim of the technical analysis is to assess the realism of the budgetary strategy presented in the programme as well as its compliance with the requirements of the Stability and Growth Pact. However, the analysis also looks at the overall macro-economic performance of the country and highlights relevant policy challenges.

Based on this technical analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 07.02.2007. The ECOFIN Council is expected to adopt its opinion on the programme on 27 February 2007.

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All these documents, as well as the provisions of the Stability and Growth Pact, can be found on the following website:

http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm

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SUMMARY AND CONCLUSIONS[1]

As part of the preventive arm of the Stability and Growth Pact, each Member State that uses the single currency, such as Finland, has to submit a stability programme and annual updates thereof. The most recent programme, covering the period 2006-2010, was submitted on 30 November 2006.

Over the past decade, the performance of the Finnish economy has been outstanding. The cyclical recovery from the recession of the early 1990s was reinforced by the restructuring of the economy and the emergence of the ICT sector, which largely accounts for the remarkable advances in productivity. Average economic growth rates have been well above the euro area average while inflation has remained low. The strong expansion of the economy was accompanied by determined fiscal consolidation, restoring a significant surplus to general government finances. In the run-up to EMU, Finland successfully shifted to a low-inflation environment with stability-oriented macroeconomic policies safeguarding competitiveness, which have continued to underpin its good economic performance.

Going forward however, the growth potential of the Finnish economy is predicted to decline. The stimulus to economic growth from labour input will turn negative already around the end of the present decade due to rapid population ageing. The prospects to cover rising ageing related expenditure needs through higher revenue intake are limited by the slowdown of the growth of the tax base, as well as the already high tax burden by international standards. The phenomenal performance of the ICT sector is masking the relatively mediocre productivity advances in other sectors, including public services and administration. Against this background, Finland faces a mounting challenge to enhance productivity of public sector to effectively supply the required amount of welfare services. Productivity developments in the public sector are also crucial for the overall growth potential of the economy.

The macroeconomic scenario underlying the updated stability programme envisages that real GDP growth will decelerate from a cyclical peak of 4 ½ % in 2006 to 2 ½ % on average over the rest of the programme period. Assessed against currently available information, this scenario appears to be based on plausible growth assumptions, with those for 2006 and 2010 appearing cautious. The programme's projections for inflation appear realistic. Finland can be regarded as experiencing neither good nor bad economic times in 2007 and beyond after the good times in 2006.

For 2006, the general government surplus is estimated at 2.9% of GDP in both the Commission services' autumn 2006 forecast and in the current programme update, against a target of 1.6% of GDP set in the previous update of the stability programme. This is due to the carry-over from the better-than-expected outcome in 2005 and the positive growth surprise in 2006 boosting government revenue, while expenditure has remained contained.

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[1]The analysis takes into account (i) the Commission services' autumn 2006 forecast, (ii) the code of conduct ("Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005) and (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

The main goal of the medium-term budgetary strategy in the programme is securing sustainability in general government finances and balanced central government finances under normal conditions of economic growth. The general government headline and primary surpluses are projected to follow a slight downward trend, both declining by ½ % of GDP until 2010. The decline in the revenue ratio, reflecting the gradual phasing in of the tax cuts package up to 2007, is less than fully compensated by the cut in the expenditure ratio owing to the government's budgetary spending ceilings and public sector reform initiatives. While the budgetary strategy has not changed compared with the previous update, the budgetary targets have been revised up by about 1 % of GDP in each year, as a result of the carry-over from the better-than-expected outcome in 2005 and higher growth prospects. Government gross debt, as a per cent of GDP, is set to fall over the entire programme period, from currently 39% to eventually below 34%.

The medium-term objective (MTO) for the budgetary position presented in the programme is a structural surplus of 2% of GDP. The structural balance is projected to remain by a substantial margin above the MTO, at a surplus of close to 3 % of GDP throughout the programme period. The MTO is well above the minimum required level, which is motivated in the programme by the goal of ensuring the long-term sustainability of public finances and the fact that in Finland the impact of an ageing population kicks in at an early stage.

The risks to the budgetary projections in the programme appear broadly balanced. The programme's macroeconomic assumptions as well as the tax revenue projections appear plausible. The risks to the latter emanating from the composition of growth are counterbalanced by conservative tax elasticity assumptions. The most notable risks are considered to be related to developments in local government expenditure.

In view of this risk assessment, the budgetary stance in the programme seems sufficient to meet the MTO by a considerable margin throughout the programme period, as envisaged in the programme. The fiscal policy stance implied by the programme is fully in line with the Stability and Growth Pact.

The long-term budgetary impact of ageing in Finland is higher than on average in the EU, although enacted pension reform measures have helped to contain the increase in pension expenditure to close to the EU average as a share of GDP over the coming decades. The initial budgetary position, with a large structural surplus, contributes significantly to easing the long-term budgetary impact of ageing. Moreover, the large assets accumulated in the public pension fund will finance part of the increase in pension expenditure. However, maintaining high primary surpluses over the medium term would contribute towards containing risks to the sustainability of public finances. Overall, Finland appears to be at low risk with regard to the sustainability of public finances.

The Implementation Report of the National Reform Programme (NRP) of Finland, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 12 October 2006. The NRP identifies as key challenges/priorities: the sustainability of public finances, improving competitiveness and productivity; and improving the functioning of the labour market. The Commission's assessment of this programme (adopted as part of its December 2006 Annual Progress Report[2]) showed that

[2] Communication from the Commission to the Spring European Council, "Implementing the renewed Lisbon strategy for growth and jobs - A year of delivery", 12.12.2006, COM(2006)816.

Finland is making very good progress in the implementation of its NRP. Against the background of progress made, Finland was encouraged to focus on the areas of: competition and productivity in services; recruitment procedures for businesses; local wage bargaining systems; and bottlenecks in the labour market. The stability programme and the NRP are well integrated. In particular, both programmes envisage the implementation of measures to improve the productivity of both central and local governments and confirm the intention to continue applying central government budgetary spending limits beyond the current legislative period.

The overall conclusion is that the medium-term budgetary position is sound and the budgetary strategy provides a good example of fiscal policies conducted in compliance with the Stability and Growth Pact.

Comparison of key macroeconomic and budgetary projections

		2005	2006	2007	2008	2009	2010
Real GDP (% change)	**SP Nov 2006**	**2.9**	**4.5**	**3.0**	**2.9**	**2.6**	**2.1**
	COM Nov 2006	2.9	4.9	3.0	2.6	n.a.	n.a.
	SP Nov 2005	*2.1*	*3.2*	*2.6*	*2.3*	*2.1*	*n.a.*
HICP inflation (%)	**SP Nov 2006**	**0.9**	**1.5**	**1.3**	**1.7**	**1.7**	**1.7**
	COM Nov 2006	0.8	1.3	1.5	1.6	n.a.	n.a.
	SP Nov 2005	*1.0*	*1.3*	*1.5*	*1.8*	*1.8*	*n.a.*
Output gap (% of potential GDP)	**SP Nov 2006[1]**	**-1.3**	**0.1**	**0.2**	**0.1**	**-0.2**	**-0.8**
	COM Nov 2006[5]	-1.5	0.1	0.2	-0.2	n.a.	n.a.
	SP Nov 2005[1]	*-0.7*	*-0.2*	*-0.2*	*-0.5*	*-0.9*	*n.a.*
General government balance (% of GDP)	**SP Nov 2006**	**2.7**	**2.9**	**2.8**	**2.7**	**2.7**	**2.4**
	COM Nov 2006	2.7	2.9	2.9	2.9	n.a.	n.a.
	SP Nov 2005	*1.8*	*1.6*	*1.6*	*1.5*	*1.5*	*n.a.*
Primary balance (% of GDP)	**SP Nov 2006**	**3.9**	**4.5**	**4.3**	**4.2**	**4.1**	**3.7**
	COM Nov 2006	4.1	4.3	4.2	4.1	n.a.	n.a.
	SP Nov 2005	*3.4*	*3.1*	*2.9*	*2.8*	*2.8*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**SP Nov 2006[1]**	**3.3**	**2.9**	**2.7**	**2.7**	**2.8**	**2.8**
	COM Nov 2006	3.4	2.9	2.8	2.9	n.a.	n.a.
	SP Nov 2005[1]	*2.1*	*1.7*	*1.7*	*1.7*	*2.0*	*n.a.*
Structural balance[2] (% of GDP)	**SP Nov 2006[3]**	**3.3**	**2.9**	**2.7**	**2.7**	**2.8**	**2.8**
	COM Nov 2006[4]	3.4	2.9	2.8	2.9	n.a.	n.a.
	SP Nov 2005	*2.1*	*1.7*	*1.7*	*1.7*	*2.0*	*n.a.*
Government gross debt (% of GDP)	**SP Nov 2006**	**41.3**	**39.1**	**37.7**	**36.2**	**35.0**	**33.7**
	COM Nov 2006	41.3	38.8	37.3	35.8	n.a.	n.a.
	SP Nov 2005	*42.7*	*41.7*	*41.1*	*40.6*	*40.1*	*n.a.*

Notes:

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

[2]Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures

[3]There are no one-off and other temporary measures in the programme

[4]There are no one-off and other temporary measures in the Commission services' autumn 2006 forecast

[5]Based on estimated potential growth of 3.2%, 3.1%, 3.0% and 2.9% % respectively in the period 2005-2008.

Source:

Stability programme (SP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

1. INTRODUCTION

The Finnish stability programme update was submitted on 30 November 2006[3]. The programme covers the period from 2006 to 2010. The programme has been approved by the government in a plenary session and was presented to the Finnish parliament for information. The programme draws on the 2007-2011 central government spending limits decision and on the 2007 budget proposal. The programme broadly follows the model structure for stability and convergence programmes specified in the new code of conduct. With regard to data requirements, the programme has gaps in the compulsory and optional data prescribed by the new code of conduct[4]. Beyond the requirements of the code of conduct, the stability programme includes a breakdown of pension fund assets in Finland. Annex 3 provides a detailed overview of all aspects of compliance with the new code of conduct.

2. ECONOMIC TRENDS AND POLICY CHALLENGES

This section is in five parts. The first provides a brief overview of the macroeconomic performance in terms of growth and other major macro-variables. The second part presents the results of a growth accounting exercise and tries to identify the main reasons for low or high average annual economic growth vis-à-vis the reference aggregate (euro area). The third looks at the volatility of growth and other key macroeconomic variables and the stabilising or destabilising role of macro-policies. The fourth part focuses on trends in public finances. The fifth part then identifies major economic challenges with implications for public finances.

2.1. Economic performance

After a severe economic crisis in the early 1990s, Finnish economic growth rebounded strongly, reaching a yearly average growth of 4½ per cent during the second half of the 1990-s, which is about 2 percentage points above the euro-area average (see Figure 1). This was not only the result of a strong cyclical recovery and the restructuring of the economy, but also the impetus from the prominent emergence of the high-growth information and communications technology (ICT) manufacturing sector, as illustrated in Figure 2. The foundations for the advancement of a technology-intensive economy were laid already over several past decades by a well designed technology and innovation policy and the high standard of the Finnish education system[5]. Presently, Finland is consistently rated as one of the most competitive economies in the world, reflecting the transparent institutional setting, healthy macroeconomic environment, innovativeness and favourable business environment[6].

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[3] The English language translation was presented on the same day.

[4] Compulsory data on basic assumptions specified in the "code of conduct" in Annex 2 Table 8 are missing for 2008-2010. Optional data "liquid financial assets" specified in the Code of conduct Annex 2 Table 4 point 6 is not given in the stability programme.

[5] Hirvonen, T. (2004), From wood to Nokia: the impact of the ICT sector in the Finnish economy. European Commission, ECFIN Country Focus, Volume 1, Issue 11

[6] See for example World Economic Forum rankings.

Economic growth was notably exports led in the second half of the 1990-s (see Table 1), boosted by the emerging ICT sector and the devaluation of the currency during the recession. However, since 2001 the contribution to growth from the external sector has even turned marginally negative in line with the cyclical downturn in exports markets and a slump in ICT exports. The stimulus to growth from ICT technology has waned as the early specialisation advantages of an industry leader are gradually eroded by more intensive global competition. Nevertheless, even during 2001-2005 the Finnish economy has expanded at 1 percentage point above the euro area average, primarily supported by buoyant private consumption. The fall in the prices of ICT products and sluggish wood and paper prices has led to a distinct weakening in the terms of trade, which implies that the welfare gains are somewhat smaller than implied by real GDP growth[7].

Average inflation for the whole past decade has been ½ percentage point below the euro area level. Inflation rate was slightly above the euro area average only for a short period between 1998-2001, peaking at an annual 3 % in 2000. The subdued consumer price inflation reflects convergence towards the euro area average from a level about one-fifth higher, driven by increased competition and the effects from entry to the European Union in 1995. On the aggregate level, labour costs have developed in line with productivity increases. However, due to wages rising at similar rates across all sectors, the high productivity sectors take advantage of declining unit labour costs, while low productivity sectors have lost price competitiveness[8]. A deceleration in productivity growth has more recently led to a pick-up in unit labour costs.

The labour market has persistently recovered from the exceptionally harsh effects of the early 1990-s economic crisis, when unemployment shot up to 16% of the labour force and employment decreased by 18%. Although the present labour market indicators compare favourably with the euro area averages, the labour market has still not recovered close to the position enjoyed before the crises or comparable with the present indicators of the other Nordic countries. The unemployment rate has currently declined to about 8 %, as opposed to the average of 4½ % in the 1980-s. The current employment rate of about 68 % of the working age population is still about 5 percentage points lower than the average from previous decades. The principal factor holding back stronger labour market recovery is the hard core of structural unemployment that has built up during the past decade. Consequently, Finland is not utilising its labour reserves to the full extent, even with strong demand for labour creating labour shortages in a number of sectors[9].

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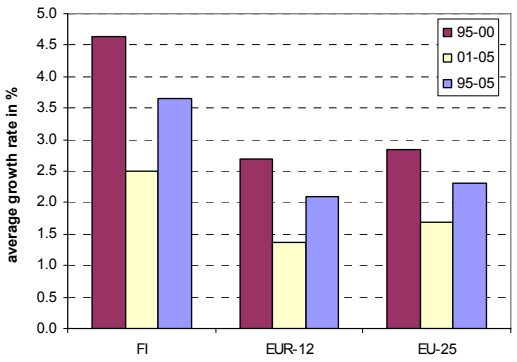
7 OECD (2006), *Economic Surveys- Finland,* Paris OECD.

8 Prime Minister's Office (2004), Finland's competence, openness and renewability. The final report of the 'Finland in the Global Economy' project, Helsinki.

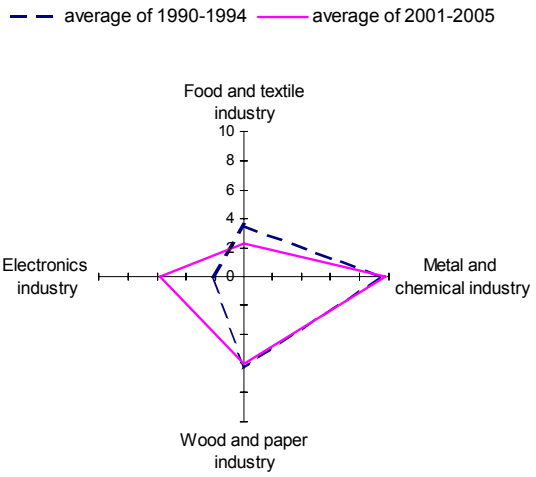
9 Maiväli. M. (2006), Structural unemployment: a blot on the Finnish success story. European Commission, ECFIN Country Focus, Volume 3, Issue 5.

Figure 1: Average GDP growth: Finland vs. euro area or EU average



Source: Commission services

Figure 2: Value added of industry sectors in percent of GDP, average for periods 1990-1994 and 2001-2005



Source: Statistics Finland, Astika database

2.2. Anatomy of medium-term growth

Within the framework of a traditional growth accounting exercise, this section dissects the sources of Finnish average growth as well as possible differences in average economic growth vis-à-vis the euro area. The growth accounting exercise is carried out on the basis of a Cobb-Douglas production function.

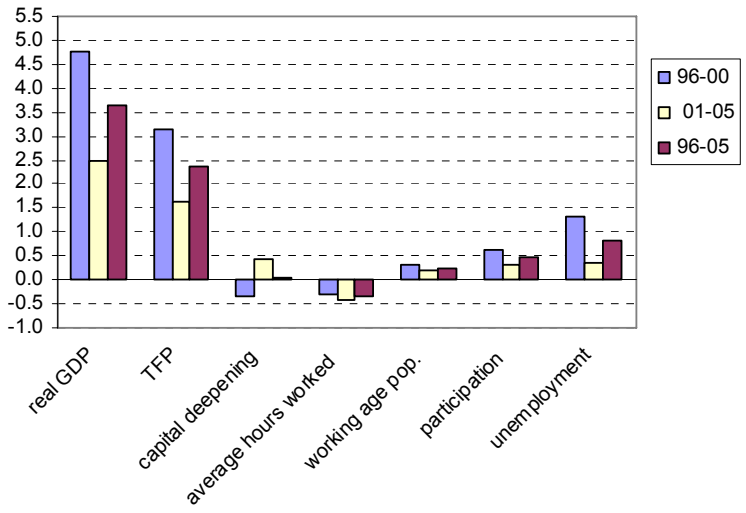
As illustrated in Figure 3, the swift expansion of the Finnish economy is based on the phenomenal growth of TFP, while capital deepening has on average not contributed to growth. GDP growth has also benefited from higher labour input, through a reduction in both unemployment and the inactivity rate. Figure 4 reveals that the difference in growth rates with the euro area is largely explained by TFP and to a smaller degree by the labour components. However, the latter reflects largely the "normalisation" of Finnish unemployment rate from the post 1990-s recession peak. TFP growth appears particularly strong compared with the euro-area since the rapid productivity advances have been achieved in parallel to a decline in the capital-output ratio. The relatively modest levels and growth of physical capital might be compensated by the increase of immaterial capital, as indicated by high and increasing R&D expenditure and the progress towards a knowledge-based economy.

In the period after 2001, the growth difference with the euro area has narrowed in line with a lower contribution from TFP, as the earlier boom of the ICT sector has subsided. The contribution to GDP growth from labour has also dropped, indicating that labour mobilisation is approaching its structural limits.

An industry level analysis of productivity growth reveals major differences between sectors. Rapid TFP growth in Finland is driven by the ICT manufacturing sector while the wood and engineering industries have shown markedly lower or even stagnant

productivity advances, albeit from relatively high levels of productivity by international standards[10]. The productivity in services, including public services provision, is commonly found to be of relatively low level by international standards (even taking account of the difficulties in comparing cross-country public sector productivity). Productivity in the public sector looks unfavourable even though the standard and cost effectiveness of Finnish administrative and social services is rated high in international comparisons. It has been suggested that the good cost effectiveness is derived from relatively low hourly labour costs in the public sector rather than high productivity. Moreover, the productivity in public services is found to have been on a declining trend in recent years[11]. The implications would be greatly exasperated by the imminent negative demographic trends.

Figure 3: Real GDP growth and its components



Note: Assuming a Cobb-Douglas-production function $Y = A(L \cdot H)^{\alpha} K^{1-\alpha}$ where Y denotes the level of *GDP, L* employment, H the average hours worked per person employed, K the capital stock and α the labour share in income, real GDP can be written as $Y = \frac{Y}{H \cdot L} H \cdot L = A \cdot \left(\frac{K}{H \cdot L} \right)^{1-\alpha} H \cdot WP \cdot PART \cdot (1 - ur)$ where *WP* stands for working age population, *PART* denotes the participation ratio as a share of *WP* and *ur* the rate of unemployment. In terms of growth rates *g* this is:

$$g_Y = g_A + (1-\alpha)(g_K - g_L - g_H) + g_H + g_{WP} + g_{PART} - g_{ur} \cdot \frac{ur}{1-ur}$$

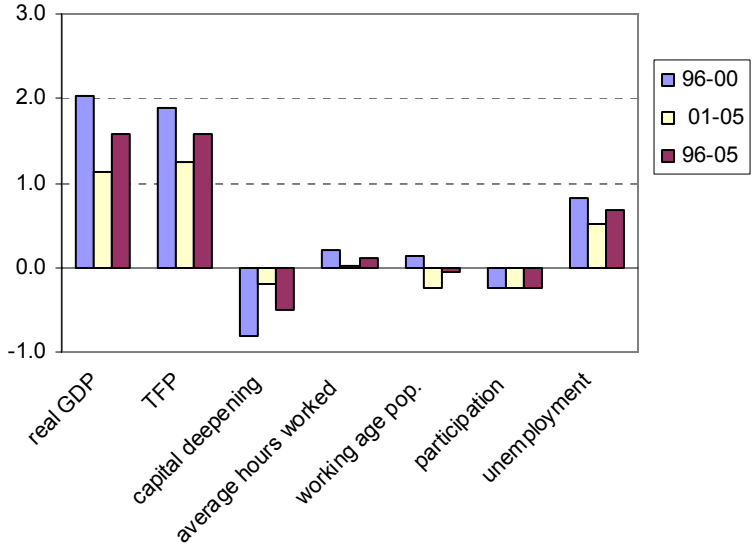
The expression $(g_K - g_L - g_H)$ is referred to as capital deepening, i.e. the increase in the capital labour ratio.

Source: Commission services

[10] Prime Minister's Office (2004), Finland's competence, openness and renewability. The final report of the 'Finland in the Global Economy' project, Helsinki.

[11] Mäkitalo, R. Ruotinen, J. (2006), Julkisen talouden kestävyys ja palvelutuotannon tuottavuus, Finnish Ministry of Finance, Keskusteualoitteita no. 74.

Figure 4: Real GDP growth and its components: Difference vis-à-vis euro area.



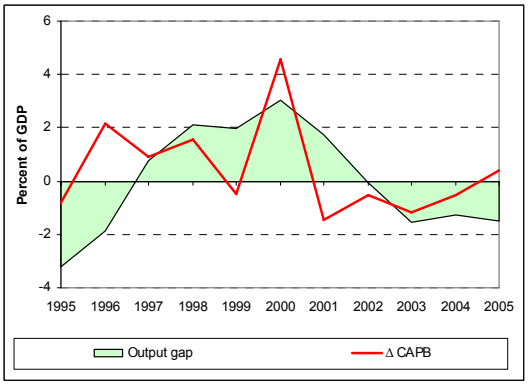
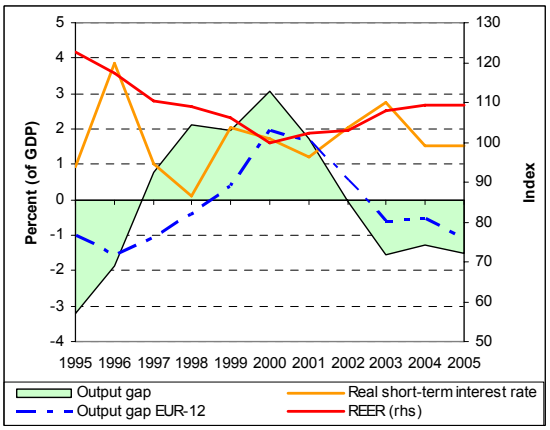
Note: See note of Figure 3

Source: Commission services

2.3. Macro-policies against the backdrop of the economic cycle

During the decades preceding euro adoption, the Finnish economy operated in a high wage growth, inflation and interest rate environment, with frequent devaluations to restore external competitiveness. The amplitude of economic cycles was more pronounced by international standards. In the run-up to EMU, the necessity to bring about a change in the economic environment was widely accepted by the government, social partners and employers. In line with the implementation of stability-oriented macroeconomic policies and pending entry to the EMU, interest rate differentials with Germany disappeared. The heavily centralised wage setting mechanisms, which cover over 90% of salaried employees, were successfully shifted to a low inflation expectation environment, yielding a moderation in wage claims relative to productivity advances.

Still, Finnish output growth has remained somewhat more volatile than in the euro area on average. In the present decade, the ICT manufacturing sector has created distinctive peaks in economic growth. The relatively deep industrial specialisation of the Finnish economy to ICT, wood and engineering industries increases the dependence of the economy on the conditions of these particular sectors in the world market. In the wake of the global economic downturn in 2001 (which affected ICT particularly harshly) the slowdown of economic activity was more pronounced in Finland (see Figure 6) compared with the on-average less technology-intensive euro area economies. Monetary conditions, as measured by the real short-term interest rate, did not appear to have played a role in stabilizing the economic downturn of 2001. However, as illustrated on Figure 5, fiscal policy has been broadly countercyclical over the past decade.

Figure 5: Output gap and fiscal stance	Figure 6: Output gap and monetary stance
	
Note: ΔCAPB is the change in the cyclically-adjusted primary balance *Source*: *Commission services*	*Source:* *Commission services*

2.4. Public finances

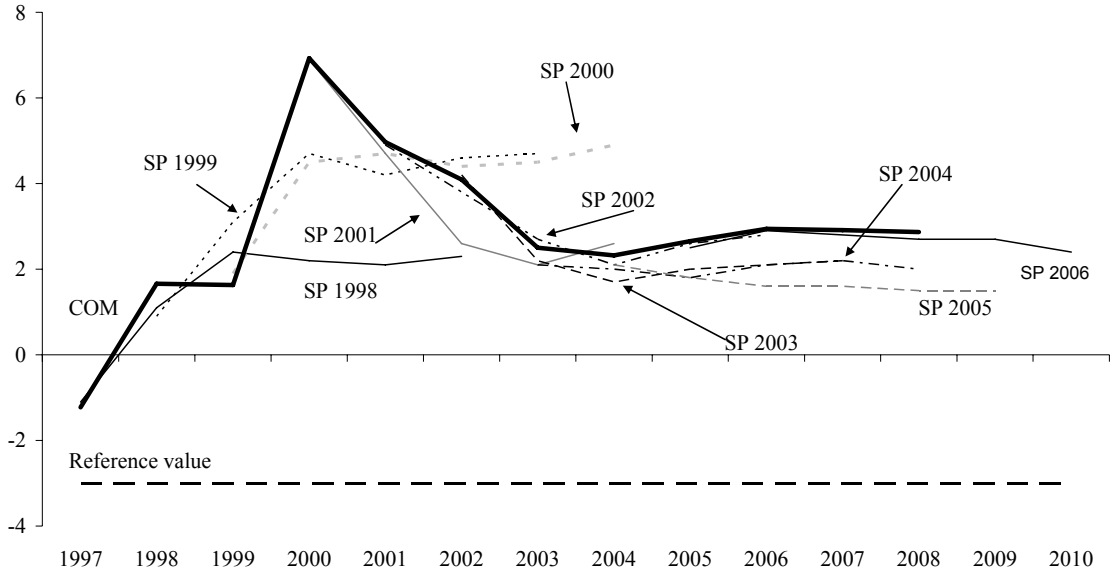
As shown on Figure 7, the past track-record of fiscal policy projections has overall been remarkably reliable. A well functioning central government expenditure planning framework has evolved over time, with credible mid-term expenditure ceilings. While in the earlier years the rules have not always been respected and expenditure overruns were common, the present government (that took office in 2003) redesigned the expenditure rules and made them politically more binding[12]. The current rules have held up well with no major overrun pressures. Local governments are obliged to balance their budgets over a 3 year period, but with no enforcement mechanisms the finances have slipped to a deficit of about ½ % of GDP.

The recovery and restructuring of the economy in the second half of 1990-s was accompanied by a notable fiscal consolidation, which was largely expenditure-based. Over the past decade, the expenditure-to-GDP ratio (that had shot up during the recession years) has declined by over 10 percentage points to about 50% of GDP. This did not result only from an "automatic" saving in welfare expenditure as the economy recovered, but also from streamlining and cost-cutting in the welfare system (for more detailed information, see Box 4). Expenditure restraint and rapid growth of tax bases led to a strong surplus in central government finances, which explains the peak in the general government surplus in 2000 (see Figure 7). In the following years, the strong central government surplus gave room for some spending increases and tax cuts, but still marginal surplus levels were maintained. The remaining sizeable general government surpluses of about 2 ½ % of GDP were fully supported by the accumulation of assets to

[12] See Box 2 in the Commission assessment of the Stability Programme 2004-2005

the pension funds. General government debt has declined from about 57 % of GDP in 1995 to 41 % of GDP over the subsequent decade[13].

Figure 7: General government balance projections in successive stability programme (% of GDP)



Source : Commission services' and snational stability programmes

2.5. Medium and long-term policy challenges for public finances

Over the past decade, the performance of the Finnish economy has been outstanding. The cyclical recovery from the recession of the early 1990s was reinforced by the restructuring of the economy and the emergence of the ICT sector, which largely accounts for the remarkable advances in productivity. Average economic growth rates have been well above the euro area average while inflation has remained low. The strong expansion of the economy was accompanied by determined fiscal consolidation, restoring a significant surplus to general government finances. In the run-up to EMU, Finland successfully shifted to a low-inflation environment with stability-oriented macroeconomic policies safeguarding competitiveness, which have continued to underpin its good economic performance.

In the light of this assessment, the following key medium- and long-term challenges in the area of public finances seem relevant for Finland:

- On efficiency

[13] The decline in the debt ratio that would have resulted from the significant primary surpluses was tempered by a debt-increasing stock-flow adjustment reflecting accumulation of assets in the pension funds.

The potential growth of the Finnish economy is predicted to decline in the following decades. The stimulus to economic growth from labour input will turn negative already around the end of the present decade due to rapid population ageing. The prospects to cover rising ageing related expenditure needs through higher revenue intake are limited by the slowdown of the growth of the tax base, as well as the already high tax burden by international standards. The phenomenal performance of the ICT sector is masking the relatively mediocre productivity advances in other sectors, including public services and administration. Finland will face a mounting challenge to enhance productivity of public sector to effectively supply the required amount of welfare services. The productivity developments in the public sector are also crucial for the overall growth potential of the economy.

Table 1: Key economic indicators

	Finland						Euro area					
	Averages			2003	2004	2005	Averages			2003	2004	2005
	'96–'05	'96–'00	'01–'05				'96–'05	'96–'00	'01–'05			
Economic activity												
Real GDP (% change)	3.6	4.8	2.5	1.8	3.5	2.9	2.1	2.7	1.4	0.8	2.0	1.4
Contributions to real GDP growth:												
Domestic demand	3.0	3.3	2.7	3.6	2.8	4.0	2.0	2.7	1.3	1.4	1.8	1.6
Net exports	0.7	1.7	-0.2	-1.7	0.6	-1.0	0.1	0.1	0.1	-0.7	0.2	-0.2
Prices, costs and labour market												
HICP inflation (% change)	1.5	1.6	1.4	1.3	0.1	0.8	1.9	1.7	2.2	2.1	2.1	2.2
Labour productivity (% change)	2.0	2.4	1.6	1.7	3.1	1.6	1.2	1.5	0.8	0.8	1.6	0.9
Real unit labour costs (% change)	-0.3	-1.3	0.6	1.5	-0.1	1.4	-0.5	-0.6	-0.5	-0.1	-1.0	-0.8
Employment (% change)	1.6	2.3	0.8	0.1	0.4	1.3	1.2	1.5	0.9	0.7	0.7	0.8
Unemployment rate (% of labour force)	10.3	11.7	8.9	9.0	8.8	8.4	9.1	9.8	8.5	8.7	8.9	8.6
Competitiveness and external position												
Real effective exchange rate (% change) (1)	-0.8	-3.6	1.9	4.3	1.3	0.7	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Export performance (% change) (2)	0.8	2.3	-0.7	-5.6	-0.7	0.6	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
External balance (% of GDP)	6.9	6.3	7.6	6.0	7.3	5.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Public finances												
General government balance (% of GDP)	2.2	1.1	3.3	2.5	2.3	2.7	-2.3	-2.1	-2.5	-3.1	-2.8	-2.4
General government debt (% of GDP)	46.2	49.6	42.7	44.3	44.3	41.3	70.9	72.5	69.3	69.3	69.8	70.8
Structural budget balance (% of GDP) (3)	n.a.	n.a.	n.a.	3.3	3.0	3.4	n.a.	n.a.	n.a.	-3.2	-2.9	-2.0
Financial indicators (4)												
Long term real interest rate (%) (5)	3.5	3.8	3.3	4.6	3.5	2.7	3.1	4.1	2.1	2.0	2.2	1.5
Household debt (% of GDP) (6)	n.a.	n.a.	n.a.	37.3	40.7	45.1	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector debt (% of GDP) (7)	n.a.	n.a.	n.a.	67.3	63.8	67.8	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Notes:

More detailed tables summarising the economic performance of the country are included in Annex 4.

(1) Unit labour costs relative to rest of a group of industrialised countries (USD): EU24 (=EU25 excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ.

(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets.

(3) Cyclically-adjusted budget balance net of one-off and other temporary measures.

(4) Data available up to 2004.

(5) Using GDP deflator.

(6) Households' and non-profit institutions serving households' debt, defined as loans and securities other than shares.

(7) Non-financial corporate sector debt, defined as loans and securities other than shares.

Source:
Commission services

3. MACROECONOMIC OUTLOOK

This section is in seven parts, six of which refer to various dimensions of the macroeconomic scenario, notably: the external assumptions, overall economic growth, the labour market, costs and prices, sectoral balances and potential output growth. The final part summarises the assessment and includes (i) an overall judgement on the plausibility of the macroeconomic scenario and (ii) an indication of whether economic conditions over the programme period can be characterised as economic 'good' or 'bad' times.

3.1. External assumptions

The programme's macroeconomic scenario and underlying external assumptions are based on the Ministry of Finance economic forecast of September 2006, which covers 2006-2007. The outlook for 2008-2010 is based on projections of longer term growth prospects. The external assumptions are presented numerically until 2007, after which the external outlook is based on general assessments on the developments in the economic environment. As explained in the programme, the external assumptions do not entirely correspond to the ones used in the Commission services autumn forecast due to earlier publication of the Ministry of Finance forecast. Notable differences relate to lower world- and euro area GDP growth and trade growth assumptions in the programme update. Therefore, the programme's macroeconomic scenario is set on a comparatively conservative external outlook. However, even with less optimistic assumptions, the programme highlights the significance of the presently strong external environment boosting exports. Although the traditional Finnish export markets are predicted to maintain high growth rates, export potential is seen to be reduced by industrial relocation and the continuing strength of the euro. High oil prices have pushed up the inflation rate to 1 ½ % in 2006. The pressure from oil prices is assumed to lessen in the following years, but nevertheless remains a major risk factor.

3.2. Economic activity

As presented in Table 2, the current programme projects real GDP growth to peak in 2006 at 4 ½ %[14], but to slow down markedly to rates close to 3 % during 2007 and 2008 and further to close to 2 % by the end of the programme period in 2010. Strong growth in 2006 is partly impacted by a base effect resulting from a forest industry stoppage in 2005, widely estimated to boost GDP in 2006 by about 1 %. However, even discounting the base effect, the economy is seen to be booming in 2006, with the main GDP components increasing robustly. The contribution from the external sector will be exceptionally strong in 2006 thanks to a favourable cycle in the export markets[15]. Private consumption is boosted by strong household confidence, credit growth, rapidly increasing employment and rising purchasing power. Buoyant household optimism raises residential investment. Also, investment in machinery and equipment is expected to grow strongly due to the positive outlook in industry and the need to increase productive

[14] More recent GDP data indicates that growth remained unexpectedly high in the third quarter 2006. In light of the new data, in late December 2006 the Ministry of Finance has considerably revised upwards it's forecast for 2006, now predicting growth to reach 5.9% in 2006. The forecast for other years was not altered. Also, budgetary targets were kept broadly unchanged for all years, including 2006.

[15] Also, the base effect adds to export data in 2006, presented in Table 2.

capacity. Domestic demand is somewhat cooled by slower rises in government consumption, where expenditure is effectively controlled by restraint in central government spending. The factors feeding the current boom in the economy are expected to moderate from 2007 onwards.

The output gaps and potential growth estimates, as recalculated by Commission services based on the information in the programme, indicate that the economy is growing above potential in 2006, returning close to potential between 2007-2009 and dropping below potential in 2010. Output gap is estimated to remain close to zero until 2009, but widen in 2010 to almost -1 % of potential GDP. The slowdown of growth from 2007 would imply returning closer to the average historic growth between 2001-2005, presented in Table 1 in the previous section. However, compared with the trends in that period, the composition of growth is seen to change substantially. The contribution from domestic demand is seen to lose its importance, notably due to slackening private consumption. While exports growth is assumed to be subdued, below the growth rate of export markets, imports are expected to slow even faster. On the aggregate, the contribution from net exports is seen to regain a positive stance that was lost during the global downturn in 2001.

The shift in the composition of growth is broadly in line with the Commission services' forecast with only minor differences. The Commission services' predict exports and especially imports to grow faster, so that the contribution to GDP growth from net exports is forecast to be marginally lower than in the programme. The outlook for domestic demand and its subcomponent private consumption is similar between the two forecasts.

Table 2: Comparison of macroeconomic developments and forecasts

	2006		2007		2008		2009	2010
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	4.9	4.5	3.0	3.0	2.6	2.9	2.6	2.1
Private consumption (% change)	3.7	3.6	2.9	2.7	2.6	2.5	2.3	1.9
Gross fixed capital formation (% change)	5.1	5.3	3.9	3.7	2.8	2.8	2.1	1.4
Exports of goods and services (% change)	11.2	10.4	6.9	5.2	6.1	5.0	4.8	4.4
Imports of goods and services (% change)	7.7	6.9	6.5	4.7	6.0	3.7	3.5	3.4
Contributions:								
- Final domestic demand	3.1	3.1	2.4	2.3	2.2	2.1	1.9	1.5
- Change in inventories	-0.2	-0.4	0.0	0.2	0.0	0.0	0.0	0.0
- External balance on g&s	1.9	1.9	0.6	0.5	0.4	0.8	0.8	0.7
Output gap[1]	0.1	0.1	0.2	0.2	-0.2	0.1	-0.2	-0.8
Employment (% change)	1.4	1.5	0.6	0.7	0.2	0.6	0.5	0.1
Unemployment rate (%)	7.7	7.7	7.4	7.4	7.3	6.7	6.1	5.9
Labour productivity growth (%)	3.4	3.0	2.5	2.3	2.4	2.3	2.1	2.0
HICP inflation (%)	1.3	1.5	1.5	1.3	1.6	1.7	1.7	1.7
GDP deflator (% change)	1.4	1.4	1.3	1.0	1.4	1.0	1.0	1.0
Comp. of employees (% change)	4.5	4.7	3.2	3.6	3.4	4.1	3.8	3.2
Real unit labour costs (% change)	-1.8	-1.3	-1.2	-0.4	-0.6	0.2	0.1	0.0
External balance (% of GDP)	5.5	5.4	5.2	4.8	4.7	4.6	4.4	4.1

Note:

[1]In percent of potential GDP, with potential GDP growth as reported in Table 2 below.

Source:

Commission services' autumn 2006 economic forecasts (COM); Stability programme

Table 3 illustrates the change in the output gap estimates of given years across successive Commission services' forecast exercises and across stability programmes as recalculated

by Commission services. Compared with previous estimates, the achievement of positive territory in 2006 is a considerable improvement, arising from the growth surprise in 2006. The overall assessment of cyclical conditions has turned more positive also for the outer years of the programme period, due to a more favourable medium-term growth outlook[16].

Table 3: Output gap estimates in successive Commission services' forecasts and Stability programme updates (% of potential GDP)

	2006		2007		2008	
	COM	SP[1]	COM	SP1	COM	SP1
SP Dec 2006		0.1		0.2		0.1
Autumn 2006	0.1		0.2		-0.2	
Spring 2006	-0.4		-0.4			
SP Dec 2005		-0.2		-0.2		-0.5
Autumn 2005	-0.7		-0.5			
Spring 2005	-0.4					
SP Dec. 2004		-0.2		-0.4		-0.6

Note:

[1] Commission services' calculations according to the commonly agreed method based on the information in the programme.

Source: Commission services' forecasts, national Stability programme and Commission services.

3.3. Potential growth and its determinants

Table 4 compares the potential growth estimates of the Commission services' autumn 2006 forecast with the calculations according to the commonly agreed methodology, based on the information provided in the programme. As evident, the results are well in line between the two estimates.

The main driver of growth is projected to be TFP, as contributions from capital accumulation and labour remain limited. The growth potential is seen to be on a slightly declining trend from the estimates of potential growth for previous years and from the average growth rates achieved during the past decade (3 ½ % y-o-y) . The moderation is driven by the negative effects from population ageing.

[16] The output gap estimates should be interpreted with some caution. Simulations indicate that if the output gaps were calculated using the higher GDP growth forecast of 5.9% for 2006 (see footnote 13) instead of the 4.5 % presented in the programme, the positive output gaps would appear about 0.6 percentage points higher for 2006 than in the present calculations. However, as higher actual growth would also raise the estimate of potential growth, the differences would gradually drop to zero by 2010.

Table 4: Sources of potential output growth

	2006		2007		2008		2009	2010
	COM	SP[2]	COM	SP2	COM	SP2	SP2	SP2
Potential GDP growth[1]	3.1	3.1	3.0	2.9	2.9	2.9	3.0	2.8
Contributions:								
- Labour	0.3	0.4	0.2	0.2	0.1	0.2	0.3	0.2
-Capital accumulation	0.7	0.7	0.7	0.7	0.8	0.8	0.8	0.7
- TFP	2.1	2.0	2.0	1.9	2.0	1.9	1.9	1.9

Notes:
[1]based on the production function method for calculating potential output growth
[2]Commission services' calculations on the basis of the information in the programme
Source:
Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

3.4. Labour market developments

The programme foresees the recent positive developments on the labour market to continue, albeit at a slower pace in the outer years in line with the growth profile. Robust economic growth in 2006 is reflected in strong job creation, which is however only partly met by higher labour supply. Vacancies have also risen and the structural bottlenecks on the labour market hinder a more complete use of the labour force. The programme views the structural rigidities of the labour market as an important threat to economic and employment prospects. Even though employment growth is assumed to slow in line with economic growth returning to its potential (broadly maintaining the historic average labour content of GDP growth), unemployment is seen to continue falling significantly by nearly 1 ½ percentage points over the programme period. The labour market developments are close to Commission services' forecast up to 2007, but are assumed somewhat more favourable for 2008 in the programme.

3.5. Costs and price developments

The programme foresees HICP inflation accelerating in 2006 to 1.5% from the exceptionally low level in 2005 (0.9%), influenced by higher oil prices and housing costs. Also, the intense competition in some specific areas that counteracted price rises in 2005 is regarded to soften. On the other hand, the presently stronger euro will curb the rise of imported goods. Inflation is forecast to briefly decelerate in 2007 and pick up thereafter to a steady annual rate of 1.7%. This profile would still imply inflation remaining one of the lowest in the euro area. The inflation outlook and the deflators of GDP components are broadly in line with those of the Commission forecast. The only notable discrepancy arises from a higher estimates for the private consumption deflator in the programme, which also explains the somewhat higher nominal private consumption levels in the programme.

Per capita wage rises are expected to decelerate slightly in 2006 and 2007 to about 3% in nominal terms, following the profile of the present central wage agreement valid until autumn 2007. The initial year of the next wage agreement is seen to produce an acceleration in wage claims in 2008, but falling back in line with productivity advances thereafter. With the exception of 2006, productivity will rise at a slightly slower pace than per capita wages, leading to on average mildly rising unit labour costs. The profile of unit labour costs is in line with the inflation expectations presented in the programme.

Overall, the outlook in the programme regarding price and wage developments is plausible with regard to historic trends outlined in Section 2. It is largely consistent with that of the Commission services' forecast. Minor differences relate to per capita wage growth, which is expected to be higher in the programme.

3.6. Sectoral balances

The programme expects the sectoral balances to maintain overall smooth profiles. The external balance will weaken mildly from a substantial surplus position over the programme period, reflecting primarily the negative terms of trade effect. The outlook does not deviate significantly from the Commission services' forecast.

3.7. Assessment

The assessment of the macroeconomic outlook covers two questions: first, whether the macroeconomic scenario is plausible, and, second, whether the economy should be considered to be in economic 'good' or 'bad' times.

3.7.1. Plausibility of the macroeconomic scenario

The programme update presents a plausible macroeconomic scenario which is broadly in line with the Commission services' forecast extending to 2008. The programme is more cautious on economic growth prospects for 2006 (by ½ percentage point), but the two forecasts are close for 2007 and 2008. Beyond 2008, the programmes' GDP growth is set according to the potential growth estimates of the programme. However, judging from the potential growth estimates as recalculated by the Commission services based on the information provided in the programme, the growth assumption for 2010 appears cautious, being significantly under potential. While the differences in the composition of growth, price and wage developments are individually minor, they coincide to impact the forecast tax bases to some degree, further discussed in Section 4.3.

3.7.2. Economic good vs. bad times

Estimates of the Commission services autumn forecast indicate that the cyclical peak of 2006 enabled the economy to close the persistent output gap of -1 ½ percent of potential output during 2003-2005 to marginally above zero in 2006. These estimates point that the output gap will remain relatively stable close to the potential over the programme period, declining only slightly in 2008 to a marginally negative value (-0.2). Based on the assessment of output gaps, the economic good times of 2006 will turn to broadly neutral times thereafter, with a slight negative trend towards 2008. The broader macroeconomic outlook presented in the Commission forecast confirms this assessment. While the cyclical downturn is expected to be mild, with growth still close to its potential, the more detailed outlook indicates some negative undertones. Job creation is expected to slow considerably from the present strong levels. Growth in exports, private consumption and investments are also seen to soften over the medium term to levels below the averages of the past decade. Working age population will start to decline around the end of the decade, cutting the growth potential to low levels not experienced over the past decade. The overall composite assessment indicates that the economic times after 2006 can be regarded as "neither good nor bad".

4. GENERAL GOVERNMENT BALANCE

This section consists of four parts. The first part discusses budgetary implementation in the year 2006 and the second presents the budgetary strategy in the new update, including the programme's medium-term objective (MTO) for the budgetary position.

The third analyses the risks attached to the budgetary targets in the programme. The final part contains the assessment of the fiscal stance and of the country's position in relation to the budgetary objectives of the Stability and Growth Pact.

4.1. Budgetary implementation in 2006

The general government fiscal targets have been revised upwards for 2006 and over the whole programme period by over one percentage point in comparison with the previous programme update (see Table 5). This is due to a carry-over from the better-than-expected outcome in 2005 and the positive growth surprise in 2006 boosting revenues (especially income taxes, VAT and property income), while expenditure has remained relatively contained on account of central government expenditure ceilings. In nominal terms, the revenues are predicted about 3 1/2 % higher in 2006 than foreseen in the previous update, while expenditures are about 1 % higher (arising largely from local government expenditure). In terms of general government sub-sectors, the upward revision of surplus is solely attributable to the central government.

The expenditure and revenue ratios to GDP were shifted down because of a considerable upward revision to the nominal GDP series (impact from revisions to past GDP series and the 2006 growth surprise). Therefore the ratios are not directly comparable among different vintages of the programme[17]. The programme's outturn for 2006 is closely in line with that of the Commission services' forecast, both estimating a surplus of close to 3% of GDP. The public finance quarterly data, presently available for the first half of 2006, and state budget implementation data on a cash basis up to November 2006, confirm that the general government surplus is likely to be well above the target set in the previous update. Similarly to previous years, several supplementary budgets were adopted in 2006, making adjustments to expenditure and revenue items, and detailing the distribution of the higher-than-expected revenues. The third supplementary budget presented on 8 December 2006 is not directly included in the programme's fiscal projections. It shows an additional cash surplus of 0.4 % of GDP, mostly arising from sales of financial assets held by the State and accumulated funds from previous periods to be used for debt repayment. However, it does not significantly affect net lending in ESA95 terms.

[17] Also the ratios for 2004-2005 are not directly comparable due to revisions to time series for revenue and expenditure ratios undertaken in 2005. For a more detailed explanation see the Commission services' assessment of the previous programme.

Table 5: Evolution of budgetary targets in successive programmes

		2005	2006	2007	2008	2009	2010
General government balance (% of GDP)	**SP Dec 2006**	2.5	2.9	2.8	2.7	2.7	2.4
	SP Dec 2005	1.8	1.6	1.6	1.5	1.5	n.a.
	SP Dec 2004	1.8	2.1	2.0	2.0	1.5	n.a.
	COM Nov 2006	2.7	2.9	2.9	2.9	n.a.	n.a.
General government expenditure (% of GDP)	**SP Dec 2006**	49.9	49.0	48.6	48.4	48.2	48.4
	SP Dec 2005	51.4	50.8	50.5	50.5	50.5	n.a.
	SP Dec 2004	48.4	48.5	48.4	48.5	n.a.	n.a.
	COM Nov 2006	49.9	48.6	48.0	47.8	n.a.	n.a.
General government revenues (% of GDP)	**SP Dec 2006**	52.4	51.9	51.4	51.1	50.9	50.8
	SP Dec 2005	53.2	52.4	52.0	52.0	52.0	n.a.
	SP Dec 2004	50.3	50.6	50.5	50.5	n.a.	n.a.
	COM Nov 2006	52.6	51.5	50.9	50.7	n.a.	n.a.
Real GDP (% change)	**SP Dec 2006**	2.9	4.5	3.0	2.9	2.6	2.1
	SP Dec 2005	2.1	3.2	2.6	2.3	2.1	n.a.
	SP Dec 2004	2.8	2.4	2.2	2.0	n.a.	n.a.
	COM Nov 2006	2.9	4.9	3.0	2.6	n.a.	n.a.

Source:
Stability programmes (SP) and Commission services' autumn 2006 economic forecasts (COM)

4.2. The programme's medium-term budgetary strategy

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

4.2.1. The main goal of the programme's budgetary strategy

The programme's central objective is to ensure stability and sustainability in general government finances in the face of population ageing. While the budgetary targets have been revised considerably upwards (against the background of an improved macroeconomic outlook), as noted in section 4.1, the budgetary strategy has not changed from the previous update. The government's strategy is to reduce further the debt-to-GDP ratio, maintain high fiscal surpluses, take measures to curb growth in public spending, boost productivity and strengthen the overall growth potential of the economy.

The government is committed to sustaining balanced central government finances under normal conditions of economic growth and to ensuring that, even in adverse economic conditions, the central government deficit, measured in national accounting terms, does not exceed 2 ¾ per cent of GDP. To help achieve the central government targets, the government has adopted multi-annual spending limits, usually covering the 3 years following the budget year. The spending limits framework, in place since 2003, is the primary instrument of the Finnish government to maintain budgetary discipline. An agreement on central government spending limits extending to 2011 was reached in spring 2006. Expenditure control is deemed necessary, as tax revenues are constrained by the tax cuts package extending to 2007. Measures are also proposed to improve the public finances of local governments.

Table 6: Composition of the budgetary adjustment

(% GDP)	2005	2006	2007	2008	2009	2010	Change: 2010-2006
Revenues	52.4	51.9	51.4	51.1	50.9	50.8	**-1.1**
of which:							
- Taxes & social contributions	43.8	43.0	42.7	42.6	42.5	42.5	**-0.5**
- Other (residual)	8.6	8.9	8.7	8.5	8.3	8.3	**-0.6**
Expenditure	49.9	49.0	48.6	48.4	48.2	48.4	**-0.6**
of which:							
- Primary expenditure	48.5	47.5	47.1	46.9	46.8	47.1	**-0.4**
of which:							
Consumption	22.1	21.6	21.4	21.5	21.5	21.6	**0.0**
Transfers other than in kind & subsidies	17.7	17.2	17.0	17.0	17.0	17.3	**0.1**
Gross fixed capital formation	2.6	2.6	2.6	2.6	2.5	2.5	**-0.1**
Other (residual)	6.0	6.0	6.1	5.9	5.8	5.7	**-0.4**
- Interest expenditure	1.5	1.5	1.5	1.5	1.4	1.3	**-0.2**
General government balance (GGB)	**2.5**	**2.9**	**2.8**	**2.7**	**2.7**	**2.4**	**-0.5**
Primary balance	**3.9**	**4.5**	**4.3**	**4.2**	**4.1**	**3.7**	**-0.7**
One-offs[1]	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	**2.5**	**2.9**	**2.8**	**2.7**	**2.7**	**2.4**	**-0.5**

Source:
Stability programme update; Commission services' calculations

4.2.2. The composition of the budgetary adjustment

The slight decline in the surplus between 2006-2010 is driven by the decline in revenue ratio (by 1.1 pp. of GDP) more than offsetting expenditure restraint (expenditure ratio declines by 0.6 pp. of GDP). The slightly downward sloping path of headline and primary balance is unchanged from the previous update.

Expenditure is projected to grow more slowly than nominal GDP until 2010, at which point the lower economic growth and mounting ageing related expenditure are projected to turn the trend. In nominal terms, yearly expenditure growth fluctuates between 3 and 3 ½ %. Expenditure is to be kept in check by tight central government spending limits and reform initiatives expected to soften local government spending pressures (see also Section 6). Also, transfers abroad to international organisations and to other states are projected to grow slower than nominal GDP, reflected in the decline of the "other expenditures" category in Table 6. The present update assumes a moderation in the operating expenses of the local governments from the recent average nominal increase of 5 ½ % to about 4 % between 2008-2010, mainly due to an expected easing of growth in payroll expenses. The assumed slowdown is based on the views of municipal and central government authorities and on the assessment of the present local government reform initiatives. Interest expenditure is projected to be on a slightly declining trend and to contribute to the reduction in the overall expenditure ratio. This accounts also for the somewhat steeper decline of the primary surplus. The projections presented in the programme assume that interest savings are not channelled into additional primary expenditure. The budgetary targets do not rely on one-offs or other temporary measures.

The decline in the revenue ratio reflects mainly the phased introduction of the tax cuts package extending up to 2007. The overall sum of tax cuts amounts to 3.9 billion (2.2% of 2007 GDP) over the current legislative period 2004-2007. Cuts related to corporate

and capital taxation, on net wealth and excise taxes have already been enacted. The largest tax measure is the reduction of personal income taxation by roughly € 3 billion (1.7% of 2007 GDP) spanning 4 years, which focuses on people with low and medium incomes and raises the ceilings of tax brackets. The income tax cuts package was part of a political deal to support the 2004 comprehensive incomes policy agreement. Income tax cuts amount to close to € 1 billion for 2006 (corresponding to about 0.6% of GDP) and € 740 million for 2007 (0.4% of GDP). Non-tax revenues are projected to grow slower than nominal GDP, which also contributes to the reduction on revenue ratio.

The fiscal performance of different government sectors is varied but with no sharp fluctuations. The central government surplus is seen to decline slightly from ½ % of GDP in 2006 to only marginally positive levels in 2008, but to rebound in 2009-2010. The significant surpluses of about 2 ½ % of GDP in social security are set to abate to about 2 % by the end of the programme period when pension fund outlays start to increase sharply. Local government is forecast to gradually climb towards balance from a deficit of less than ½ % of GDP in 2006. On the aggregate, the surplus in general government rests mainly on social security. However, according to the budgetary strategy, the weight in supporting the surpluses will shift more towards central government in the outer years.

Box 1: The budget for 2007

The draft central government budget for 2007 was presented on 12 September 2006. Some amendments to both revenues and expenditures were presented on 16 November 2006. The budget was approved by the parliament in December 2006. The budget targets a general government surplus of 2.8% of GDP in 2007. On the central government level, the surplus for 2007 is set below ½ % of GDP, which is marginally lower than the predicted outcome for 2006 (slightly above ½ % of GDP). The primary focus of the 2007 budget is on employment measures, including various targeted tax solutions and new expenditure programmes, totalling € 100 million (0.06 % of GDP). The largest measure is the cuts to income tax, which is part of the larger multi-year package. The impact on overall revenues from the revenue reducing tax measures is broadly offset by a favourable economic situation and overall expenditure restraint so that the surplus declines marginally compared to 2006.

Table: Main measures in the budget for 2007

Revenue measures*	Expenditure measures**
o Income tax cuts of € 590 (-0.3% of GDP) o A 2% inflation adjustment of the income tax brackets, reducing revenues by € 150 million (-0.1% of GDP) o Reduction in electricity tax on industry and greenhouse cultivation with an impact of € 70 million (-0.04% of GDP)	o Comprehensive employment package combining tax and expenditure measures, total impact on budget balance € 100 million (0.06% of GDP) o Increasing development cooperation spending by € 75 million (0.04% of GDP) o Increasing spending on health and social welfare projects by € 75 million (0.04% of GDP)

* Estimated impact on general government revenues.
** Estimated impact on general government expenditure.
Sources: Commission services and Finnish Ministry of Finance 2007 budget publications.

4.2.3. The medium-term objective (MTO) and the structural adjustment

The MTO put forward in the programme is a structural surplus of 2 % of GDP. The previous programme update did not explicitly define an MTO. However, it was inferred in the Council opinion on the previous update from the structural surplus projections in

the previous programme to be a surplus of 1½ % of GDP, as also confirmed by the Finnish national authorities. The present programme plans to maintain a structural surplus throughout the programme period that exceeds the new MTO by a wider margin than foreseen in the previous update.

Box 2: The medium-term objective (MTO) for the budgetary position

According to the Stability and Growth Pact, stability and convergence programmes must present a medium-term objective (MTO) for the budgetary position. The MTO is country-specific to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances.

The MTO should fulfil a triple aim. First, it should provide a safety margin with respect to the 3% of GDP deficit limit. Second, it should ensure rapid progress towards sustainability. Third, taking into account the first two goals, it should allow room for budgetary manoeuvre, considering in particular the needs for public investment. The code of conduct further specifies that, as long as the methodology for incorporating implicit liabilities is not fully developed and agreed by the Council, the country-specific MTOs are set taking into account the current government debt ratio and potential growth (in a long-term perspective), while preserving a sufficient margin against breaching the 3% of GDP deficit reference value. Member States are free to set an MTO that is more demanding than strictly required by these provisions.

The MTO is defined in structural terms, i.e. it is adjusted for the cycle and one-off and other temporary measures are excluded. For countries belonging to the euro area or participating in the exchange-rate mechanism (ERM II), the MTO should be in a range between a deficit of 1% of GDP and balance or surplus (in structural terms).

As the MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1¼ % of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The minimum benchmark is an estimated budgetary position in cyclically-adjusted terms that provides a sufficient safety margin for automatic stabilisers to operate freely during normal economic downturns without breaching the 3% of GDP deficit reference value. The MTO lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and is significantly more demanding than implied by the debt ratio and average potential output growth in the long term. Having an MTO well above the minimum required level is motivated in the programme by concern about the long-term sustainability of public finances and the fact that in Finland the impact of ageing population kicks in at an early stage.

Based on Commission services' calculations on the basis of the programme according to the commonly agreed methodology, the structural balance is set to stay relatively stable over the programme period (see Table 7)[18]. A broadly neutral fiscal policy is maintained over the whole programme period.

Table 7: Output gaps and cyclically-adjusted and structural balances

% of GDP	2005		2006		2007		2008		2009	2010	Change: 2010-2006
	COM	SP[1]	COM	SP[1]	COM	SP[1]	COM	SP[1]	SP[1]	SP[1]	SP[1]
Gen. gov't balance	2.7	2.5	2.9	2.9	2.9	2.8	2.9	2.7	2.7	2.4	-0.5
One-offs[2]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-
Output gap[3]	-1.5	-1.3	0.1	0.1	0.2	0.2	-0.2	0.1	-0.2	-0.8	-
CAB[4]	3.4	3.1	2.9	2.9	2.8	2.7	2.9	2.7	2.8	2.8	-0.1
change in CAB	0.5	0.2	-0.5	-0.2	0.0	-0.2	0.1	0.0	0.1	0.0	-
CAPB[4]	4.9	4.6	4.2	4.4	4.2	4.2	4.2	4.1	4.2	4.2	-0.2
Structural balance[5]	3.4	3.1	2.9	2.9	2.8	2.7	2.9	2.7	2.8	2.8	-0.1
change in struct. bal.	0.5	0.2	-0.5	-0.2	0.0	-0.2	0.1	0.0	0.1	0.0	-
Struct. prim. bal.[5]	4.9	4.6	4.2	4.4	4.2	4.2	4.2	4.1	4.2	4.2	-0.2

Notes:

[1]Output gaps and cyclical adjustment according to the stability/convergence programme (SP/CP) as recalculated by Commission services on the basis of the information in the programme.

[2]One-off and other temporary measures.

[3]In percent of potential GDP. See Table 2 above.

[4]CA(P)B = cyclically-adjusted (primary) balance.

[5]Structural (primary) balance = CA(P)B excluding one-offs and other temporary measures.

Source:

Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

4.3. Risk assessment

Table 8 presents a comparison of fiscal projections in the programme update and in the Commission services' autumn 2006 forecast. The surplus projections are very similar. The expenditure and revenue ratios appear somewhat lower in the Commission services forecast, influenced by a higher nominal GDP (the programmes' cautious growth assumptions for 2006 carry over in relatively lower levels to other years). The differences in nominal expenditure and revenue levels are overall small.

[18] As noted in footnote 15, applying a 5.9% GDP growth forecast for 2006 instead of 4.5% would impact the alternative output gap estimates only in the short term. CAB would then appear about 0.3 percentage points lower for 2006, but show only negligible differences by 2010. A higher 2006 growth forecast by itself, would therefore not noticeably alter the analysis and conclusions of the assessment would not be changed in substance.

Table 8: Comparison of budgetary developments and projections

(% of GDP)	2005	2006		2007		2008		2009	2010
		COM	SP	COM	SP	COM[1]	SP	SP	SP
Revenues	52.6	51.5	51.9	50.9	51.4	50.7	51.1	50.9	50.8
of which:									
- Taxes & social contributions	43.8	43.0	43.0	42.6	42.7	42.6	42.6	42.5	42.5
- Other (residual)	8.8	8.5	8.9	8.3	8.7	8.1	8.5	8.3	8.3
Expenditure	49.9	48.6	49.0	48.0	48.6	47.8	48.4	48.2	48.4
of which:									
- Primary expenditure	48.5	47.2	47.5	46.7	47.1	46.5	46.9	46.8	47.1
of which:									
Consumption	22.1	21.6	21.6	21.5	21.4	21.6	21.5	21.5	21.6
Transfers other than in kind & subsidies	17.7	17.1	17.2	16.9	17.0	16.8	17.0	17.0	17.3
Gross fixed capital formation	2.6	2.6	2.6	2.5	2.6	2.5	2.6	2.5	2.5
Other (residual)	6.0	5.9	6.0	5.7	6.1	5.6	5.9	5.8	5.7
- Interest expenditure	1.5	1.4	1.5	1.3	1.5	1.3	1.5	1.4	1.3
GGB	2.7	2.9	2.9	2.9	2.8	2.9	2.7	2.7	2.4
Primary balance	4.1	4.3	4.5	4.2	4.3	4.1	4.2	4.1	3.7
One-offs[2]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	2.7	2.9	2.9	2.9	2.8	2.9	2.7	2.7	2.4

Notes:

[1]On a no-policy change basis.

[2]One-offs and other temporary measures.

Source:

Commission services' autumn 2006 economic forecast (COM); Stability programme update (SP); Commission services' calculations

The assessment of potential risk factors for budgetary projections is as follows.

The macroeconomic scenario underlying the programme appears plausible, as discussed in section 3.7.1. The sensitivity analysis in the programme highlights several factors that could impact the growth prospects negatively, namely: inflexible labour market, unforeseen effects from demographic changes, relatively high household indebtedness and dependence on ICT products markets. Commission services' simulations of the cyclically-adjusted balance under the assumptions of (i) a sustained 1 percentage point deviation from the real GDP growth projections in the programme over the 2006-2010 period; (ii) trend output based on the HP-filter and (iii) no policy response (notably, the expenditure level is as in the central scenario), reveal that, by 2010, the cyclically-adjusted balance is about 2 percentage point of GDP above/below the central scenario. Hence, in the case of persistently lower real growth, additional measures would be necessary to keep the public finances on the path targeted in the central scenario. The sensitivity analysis presented in the programme broadly confirms these results.

As shown in Table 9, the revenue projections embody broadly plausible assumptions about the tax intensity of economic activity. Compared with the Commission services' forecast, the assumptions are marginally more optimistic for 2007, but more pessimistic for 2008. The discrepancy for 2007 arises mainly from the accumulation of in themselves minor differences in the forecast composition of growth. The programme's marginally higher private consumption deflator, per capita wage growth and, for 2008, employment growth (detailed in sections 3.4 and 3.5) coincide to lead to higher tax bases compared with the Commission services forecast in both 2007 and 2008. Counteracting the composition component, the discretionary and elasticity component is assessed more

conservatively in the programme for 2007 and especially for 2008. A detailed breakdown of tax projections in Annex 5 reveals that the conservative elasticity assessment arises mainly from a cautious revenue assumption for "taxes on production and imports". Beyond 2008, the tax elasticities implied by the programme broadly follow past trends and OECD estimates. Overall, the forecast composition of growth and tax intensity assumptions should not give rise to major risks to budgetary targets and the risks appear balanced.

One-off gains or volatile revenues also do not constitute risks as the programme scenario does not rely on one-off measures or volatile revenues.

On the expenditure side, the budgetary strategy is based on expenditure restraint on both local and central government level. Expenditure restraint has been essential to counteract the significant tax cuts package extending to 2007 and will remain crucial in the coming years when the forecast cyclical cooling of the economy slows growth in the tax bases. The programme draws attention to risks emanating from local and central government expenditure pressures.

While the assumed slowdown in local government expenditure is backed by already approved measures and concrete action, there are several risk factors at play. The reform efforts need not only improve the present situation but also cope with the mounting negative effects from population ageing. The assumption of moderating payroll expenses could be undermined by additional wage pressures in an environment of imminently declining labour supply and labour shortages. Should expenditure growth continue at present rates, the negative effect on the fiscal balance would be 1 percentage point of GDP by 2010.

The risks to central government budgetary targets are largely contained by the mid-term expenditure ceilings. It can be assumed that the next government (expected to take office after the elections in spring 2007) would make every effort to uphold this very successful fiscal planning instrument. As detailed in the programme, the central government expenditure projections include the foreseeable main expenditure pressures and the positive impact from the ongoing productivity and cost saving measures. However, there is a risk that unforeseen expenditure (or revenue) measures will be taken as part of the next government's programme or that additional expenditure pressures materialise in the medium term. The final spending limits for 2008-2011 are expected to be presented by the next government.

The success of the government's productivity-enhancing measures regarding the central and local government is vital to containing those risks (see also section 6). The current progress with the productivity-enhancing measures appears encouraging, as also noted in the Commission assessment of the Annual Progress Report of the National Reform Programme. The assessment of the budgetary impact of these measures, as quantified in the programme, appears overall plausible.

The Finnish track record of meeting the budgetary targets is solid, especially in the more recent past, as detailed in section 2.4 and presented in Figure 7. Though the economic cycle has been favourable so far, effectively counteracting the budgetary impact of the tax cuts and reducing expenditure pressures, maintaining restraint in central government expenditure has required a strong commitment from the government.

The overall assessment of the risks indicates that the programme’s projections are plausible and the risks are broadly neutral over the programme period. The fiscal targets are similar to the ones in the Commission services' no-policy change forecast extending to 2008. The risks emanating from the composition of growth are counterbalanced by

conservative tax elasticity assumptions. While deviations from the projected growth path could have a strong impact on the fiscal outcome, the programme's plausible macroeconomic assumptions should limit such risks. The most notable risks are considered to be related to developments in local government expenditure. Expenditure restraint in all government sectors will remain crucial in the coming years when the forecast cooling of the economy slows growth in the tax bases and the impact of ageing population kicks in.

Table 9: Assessment of tax projections

	2007			2008			2009	2010
	SP	COM	OECD[3]	SP	COM[1]	OECD[3]	SP	SP
Change in tax-to-GDP ratio	-0.2	-0.4	-0.1	-0.2	-0.1	0.0	-0.1	0.0
Difference (SP – COM)	0.2		/	-0.2		/	/	/
of which[2]:								
- discretionary and elasticity component	-0.1		/	-0.3		/	/	/
- composition component	0.3		/	0.2		/	/	/
Difference (COM – OECD)	/	-0.2		/	0.1		/	/
of which[2]:								
- discretionary and elasticity component	/	-0.3		/	-0.1		/	/
- composition component	/	0.1		/	0.3		/	/
p.m.: Elasticity to GDP	0.9	0.8	0.9	0.9	1.0	0.9	0.9	1.0

Notes:

[1]On a no-policy change basis

[2]The decomposition is explained in Annex 5

[3] Based on OECD ex-ante elasticity relative to GDP

Source:

Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

4.4. Assessment of the fiscal stance and budgetary strategy

Table 10 offers a summary assessment of the country's position relative to the budgetary requirements laid down in the Stability and Growth Pact. In order to highlight the role of the preceding analysis of the risks that are attached to the budgetary targets presented in the programme, this assessment is done in two stages: first, a preliminary assessment on the basis of the targets taken at face value is made (middle column) and, second, the final assessment that also takes into account risks (final column).

Table 10: Overview of compliance with the Stability and Growth Pact

	Based on programme[3] (with targets taken at face value)	**Assessment** (taking into account risks to targets)
a. Safety margin against breaching 3% of GDP deficit limit[1]	throughout programme period	throughout programme period
b. Achievement of the MTO	throughout programme period	throughout programme period
c. Fiscal stance in line with Pact[2]?	fully in line	fully in line

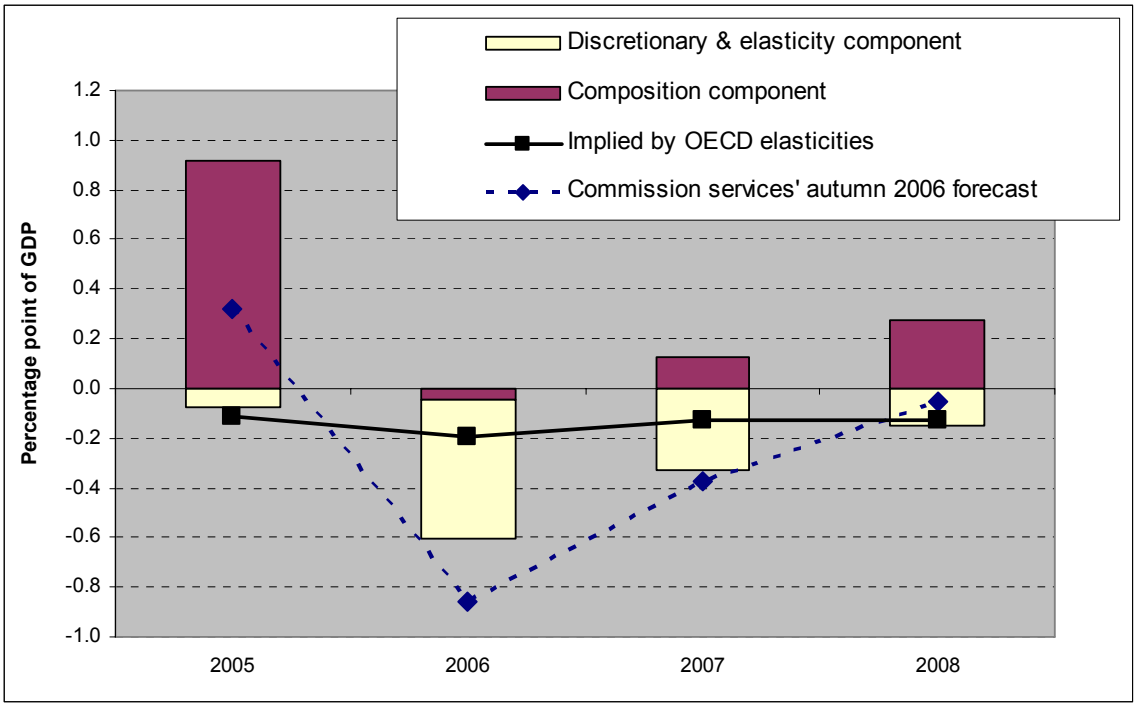
Notes:
[1]The risk of breaching the 3% of GDP deficit threshold with normal cyclical fluctuations, i.e. the existence of a safety margin, is assessed by comparing the cyclically-adjusted balance with the above mentioned minimum benchmark (estimated as a deficit of around 1¼% of GDP for Finland). These benchmarks represent estimates and as such need to be interpreted with caution.
[2]According to the Stability and Growth Pact, countries which have already achieved their MTO should avoid pro-cyclical fiscal policies in "good times".
[3]Targets in structural terms as recalculated by Commission services on the basis of the information in the programme.
Source:
Commission services

Taking into account the risks to the targets, the programme provides a sufficient safety margin against breaching the 3% of GDP deficit ceiling with normal macroeconomic fluctuations for 2006-2010. Also, the budgetary strategy outlined in the programme is considered to allow the MTO to be exceeded throughout the programme period by a large margin.

For countries that have already achieved their MTO, such as Finland, the only requirement in the Stability and Growth Pact is that pro-cyclical fiscal policies be avoided in "good times". As outlined in section 3.7.2 the economic conditions over the programme period can be characterized as "neither good nor bad times" after a cyclical peak in 2006. The behaviour of tax elasticities, measured as the change in the tax-to-GDP ratio (reported in Table 9 and Figure 8) net of the effect of discretionary measures, is broadly in line with the one implied by OECD elasticities.

The policy stance will be broadly neutral for the coming years. Changes in the structural balance over 2006-2010 are not of a significant magnitude. The fiscal policies planned in the programme are not pro-cyclical in good times.

Figure 8: Changes in the tax-to-GDP ratio: actual/projected changes vs. changes implied by OECD elasticity



Note:
The dashed line displays the change in the tax ratio in the Commission services' 2006 autumn forecast, for 2008, on a no-policy-change basis. The solid line shows the change in the tax ratio implied by the ex-ante OECD elasticity with respect to GDP. The difference between the two is explained by the bars. The composition component captures the effect of differences in the composition of aggregate demand (more tax rich or more tax poor components). The discretionary and elasticity component captures the effect of discretionary fiscal policy measures as well as variations of the yield of the tax system that may result from factors such as time lags, variations of taxable income that do not necessarily move in line with GDP e.g. capital gains. Both components may not add up to the total difference because of a residual component, which is generally small. The decomposition is explained in detail in Annex 5.

Source:
Commission services

5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

Government debt is the result of the financing needs of government over the years. It corresponds primarily to an accumulation of deficits, although the build-up of financial assets and other adjustments may also play a role.[19] The reform of the Stability and Growth Pact has raised attention to the crucial importance of government debt and of sustainability in fiscal surveillance.

This section is in two parts: a first part describes recent developments and the medium-term prospects for government gross debt; it describes the stability programmes targets, compares them with the Commission services' forecasts and assesses the associated risks. A second part looks into the government debt from a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

[19] On the factors other than the deficit which explain the evolution of the government debt, see "The dynamics of government debt: decomposing the stock-flow adjustment", chapter II.2.2 of *Public Finances in EMU 2005*, European Economy, N°3/2005.

5.1. Recent debt developments and medium-term prospects

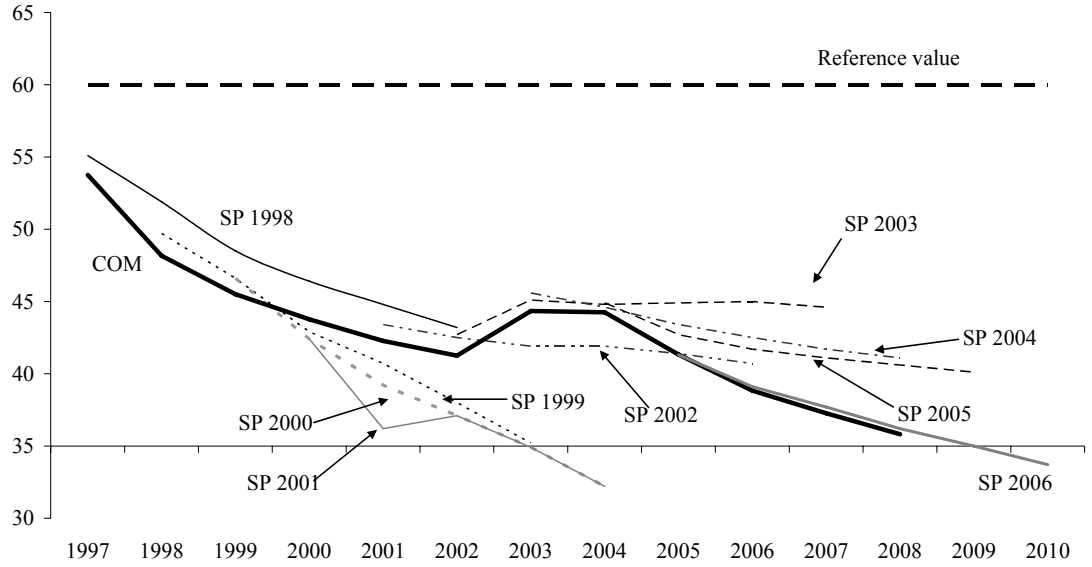
5.1.1. Debt projections in the programme

One of the governments fiscal policy objectives is to reduce the debt-to-GDP ratio in view of the future expenditure pressures stemming from the rapidly ageing population. The general government gross debt ratio is forecast to have abated to 39 % of GDP in 2006, well below 60% of GDP, and maintain its downward path throughout the programme period, as illustrated in Figure 9 and Table 11. The decline in the gross debt ratio that would result from the significant primary surpluses is tempered by a debt-increasing stock-flow adjustment reflecting accumulation of assets by pension schemes. The debt projections look markedly more favourable than the ones set in the previous programme. The debt ratio is estimated almost 5 percentage points lower towards the end of the programme. The improvement stems mainly from the markedly higher primary balance outlook. The debt ratio is also reduced by considerably higher nominal GDP series (the revisions are explained in section 4.1.). As already noted, the programme's debt projections do not include the third supplementary budget for 2006, which further reduced the debt at the end of 2006 by about 0.4% of GDP.

The update's estimates for general government debt are in line with the Commission services' autumn 2006 economic forecast, with the Commission services being slightly more optimistic in 2006-2008 (together with the third supplementary budget, the two projections match closely). Similarly to the previous programme update, the privatisation proceeds are assumed to amount to about 0.2% of GDP per year over the programme period. Even though the privatisation receipts are hard to forecast, judging from past experience, this estimate can be considered as prudent.

The stock of assets controlled by pension schemes has increased rapidly in recent years, reflecting good profitability and accumulation of surpluses. The pension scheme's consolidated financial assets amounted to 60 % of GDP in 2005, i.e. they exceed government gross debt by about 20 % of GDP. This difference will increase further in the future, albeit at a slower pace as the effects from population ageing slow the accumulation of assets.

Figure 9: Debt projections in successive stability programmes (% of GDP)



Source : Commission services' and national stability programmes

Table 11: Debt dynamics

(% of GDP)	average 2000-04	2005	2006		2007		2008		2009	2010
			COM	SP/CP	COM	SP/CP	COM	SP/CP	SP/CP	SP/CP
Gross debt ratio[1]	**44.3**	**41.3**	**38.8**	**39.1**	**37.3**	**37.7**	**35.8**	**36.2**	**35.0**	**33.7**
Change in the ratio	-0.2	-2.9	-2.5	-2.2	-1.6	-1.4	-1.4	-1.5	-1.2	-1.3
Contributions:[2]										
Primary balance	-6.3	-4.1	-4.3	-4.5	-4.2	-4.3	-4.1	-4.2	-4.1	-3.7
"Snow-ball" effect	0.3	0.0	-1.1	-0.8	-0.3	0.0	-0.2	0.0	0.1	0.3
Of which:										
Interest expenditure	2.2	1.5	1.4	1.5	1.3	1.5	1.3	1.5	1.4	1.3
Growth effect	-1.2	-1.3	-1.9	-1.8	-1.1	-1.1	-0.9	-1.0	-0.9	-0.7
Inflation effect	-0.6	-0.3	-0.6	-0.6	-0.5	-0.4	-0.5	-0.4	-0.4	-0.4
Stock-flow adjustment	5.8	1.3	2.9	3.1	3.0	2.8	2.9	2.7	2.8	2.2
Of which:										
Cash/accruals diff.	0.4	-0.4	-	0.0	-	0.0	-	0.0	0.0	0.0
Acc. financial assets	5.3	1.8	-	2.7	-	2.5	-	2.5	2.3	1.9
Privatisation	-0.8	-0.9	-	-0.3	-	-0.2	-	-0.2	-0.2	-0.2
Val. effect & residual	0.1	-0.2	-	0.4	-	0.3	-	0.2	0.5	0.3

Notes:
[1]End of period.
[2]The change in the gross debt ratio can be decomposed as follows:

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

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth (in the table, the latter is decomposed into the growth effect, capturing real GDP growth, and the inflation effect, measured by the GDP deflator). The term in parentheses represents the "snow-ball" effect. The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source:
Stability/Convergence programme update (SP/CP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

5.1.2. Assessment

The path of gross debt projected in the programme is broadly in line with the Commission services' autumn 2006 forecast, the attainment of the reduction in the debt ratio targeted in the stability programme seems plausible and risks to the debt targets

appear limited. It is expected that gross debt will decline to about 35% of GDP by the end of the programme period.

5.2. Long-term debt projections and the sustainability of public finances

The issue of long-term sustainability is a multi-faceted one. It involves avoiding imposing an excessive burden on future generations and ensuring the country's capacity to appropriately adjust budgetary policy in the medium and long run.[20]

Debt sustainability is derived from the government's *intertemporal budget constraint*. It imposes that current total liabilities of the government, i.e. the current public debt and the discounted value of future expenditure including the budgetary impact of ageing populations, should be covered by the discounted value of future government revenue. If current policies ensure that the intertemporal budget constraint is fulfilled, current policies are sustainable.

The approach adopted by the Commission services and the Ageing Working Group of the Economic Policy Committee (EPC) is to project the debt, and to calculate the associated sustainability indicators (see Box 3), on the basis of two different scenarios. The first scenario assumes that the structural primary balance will remain unchanged from 2006 through 2010, the final year of the stability programme; it is called the "2006 scenario". Debt projections in this scenario start in 2007. The second scenario assumes that the macroeconomic and budgetary plans until 2010 provided in the stability programme will be fully respected. This is the "programme scenario". Both projections assume zero stock-flow adjustments. Debt and primary balance projections in this scenario start in 2011. In addition to this quantitative analysis, other relevant factors are taken into account which allows to better qualify the assessment with regard to where the main risks are likely to stem from and to reach an overall assessment.

5.2.1. Sustainability indicators and long-term debt projections

Table 12 shows the evolution of government spending on pensions, healthcare, long-term care for the elderly, education and unemployment benefits according to the EPC's projections.[21] Non age-related primary expenditure and revenue is assumed to remain constant as a share of GDP.

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[20] For a detailed analysis of long-term sustainability issues, see "The Long Term Sustainability of Public Finances – A report by the Commission services", European Economy n°4/2006, published in October 2006 (hereinafter Sustainability Report).

[21] These assumptions cover labour productivity growth, real GDP growth, participation rates, unemployment rate, demographic developments, government spending in pensions, healthcare, long-term care for the elderly, education and unemployment benefits. See Economic Policy Committee and European Commission (DG ECFIN) (2006), "The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health-care, long-term care, education and unemployment transfers (2004-2050)", European Economy, Special Report No 1 (hereinafter Ageing Report).

Table 12: Long-term age-related expenditure: main projections

(% of GDP)	2004	2010	2020	2030	2040	2050	changes
Total age-related spending	25.4	25.6	27.7	30.1	30.7	30.6	5.2
Pensions	10.7	11.2	12.9	14.0	13.8	13.7	3.1
Healthcare	5.6	5.8	6.2	6.6	7.0	7.0	1.4
Long-term care	1.7	1.9	2.1	3.0	3.4	3.5	1.8
Education	6.0	5.6	5.3	5.4	5.3	5.3	-0.7
Unemployment benefits	1.5	1.2	1.1	1.1	1.1	1.1	-0.4

Source: Economic Policy Committee and Commission services.

The projected increase in age-related spending in Finland is above the average of the EU, rising by 5.2% points of GDP between 2004 and 2050. This is particularly due to the expenditure on pensions in Finland, projected to increase more than on average in the EU by 3.1% points. The increase in health-care expenditure is projected to be 1.4% points of GDP, slightly lower than on average in the EU. For long-term care, the projected increase of 1.8% points up to 2050 is above the average in the EU.

Based on the long-term budgetary projections, sustainability indicators can be calculated.

Table 13: Sustainability indicators and the required primary balance

	2006 scenario			Programme scenario		
	S1	S2	RPB	S1	S2	RPB
Value	-3.1	-0.7	3.4	-2.6	-0.2	3.4
of which:						
Initial budgetary position	-4.8	-4.9	-	-4.4	-4.5	-
Debt requirement in 2050	-1.6	-	-	-1.6	-	-
Future changes in budgetary position	3.3	4.2	-	3.3	4.2	-

Source: Commission services.

Box 3 – Sustainability indicators*

- The **sustainability gap S1** shows the permanent budgetary adjustment (often presented as an increase in the tax burden**) required to reach a debt ratio in 2050 of 60% of GDP.
- The **sustainability gap S2**, shows the permanent budgetary adjustment that guarantees the respect of the intertemporal budget constraint of the government. In order to estimate S2, the revenue and expenditure ratios (age-related and non age-related) after 2050 are assumed to remain constant at the 2050 level.
- The sustainability indicators can be decomposed into the:*** (i) **initial budgetary position (IBP)**; and, (ii) **long-term change in the budgetary position (LTC)**.
- In addition, the **required primary balance (RPB)** can be derived from the S2 indicator. It measures the average primary balance over the first five years after the programme horizon (i.e. 2011-2015) that results from a permanent budgetary adjustment carried out to comply fully with the S2 indicator.

Summarizing the sustainability indicators

	Impact of		
	Initial budgetary position		**Long-term changes in the primary balance**
S1*=**	Gap to the debt-stabilizing primary balance	+	Additional adjustment required to finance the increase in public expenditure *up to 2050*
S2=	Gap to the debt-stabilizing primary balance	+	Additional adjustment required to finance the increase in public expenditure *over an infinite horizon*

* For a complete description of the sustainability indicators, see Annex I of the "The Long Term Sustainability of Public Finances – A report by the Commission services", European Economy n°4/2006, published in October 2006.

** Although the sustainability gap indicators (S1, S2) are usually defined as differences between revenue ratios, this does not mean that countries are asked to increase taxes to reach sustainability. There are several ways to ensure sustainability and governments typically choose a combination of budget consolidation over the medium term (either through expenditure reduction and/or tax hikes) and the implementation of structural reforms aiming at curbing long-term public spending (e.g. pension reforms).

*** Moreover, in the case of S1, the decomposition also separates the impact of the debt position (60% of GDP in 2050); the debt requirement in 2050 (DR). In particular, if the current debt/GDP ratio is below 60% of GDP debt is allowed to rise and this component reduces the sustainability gap as measured by the S1 indicator, and vice versa.

Table 13 shows the sustainability indicators for the two scenarios. In the "2006 scenario", the sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be -2.7% of GDP. The sustainability gap (S2) which satisfies the intertemporal budget constraint would be -0.7% of GDP. Compared with the results of the Commission's Sustainability Report, the sustainability gaps are larger in the present assessment, by 0.2 p.p. of GDP. This is mainly due to a lower estimated structural primary balance in 2006 (4.5% of GDP) compared with the structural primary balance in 2005 estimated in spring 2006 (4.7% of GDP) that was used in the Sustainability Report.

The strong initial budgetary position more than offsets the impact of the increase in age-related expenditure up to 2050. The budgetary plans in the programme imply that the structural balance is almost unchanged between 2006 and 2010. However, as gross debt is reduced rapidly over the programme period, interest expenditure are reduced as a share of GDP and the structural primary balance weakens by around 0.4 percentage points of GDP. The estimated reduction in the structural primary balance over the programme period, though limited, has an unfavourable impact on the sustainability gap showing the

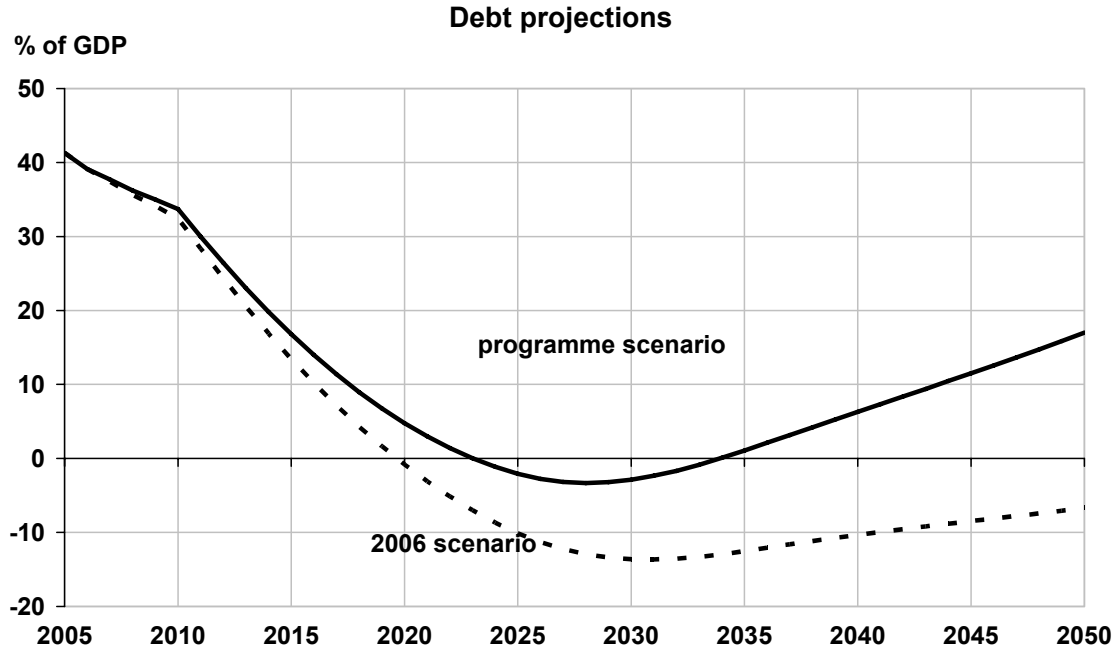
importance of maintaining a strong structural budgetary position to contain risks to the sustainability of public finances.[22] According to both sustainability gaps, the long-term budgetary impact of ageing is relatively high.

The required primary balance (RPB) is about 3½% of GDP, very close to the structural primary balance in the last year of the programme's period.

Another way to look at the prospects for long-term public finance sustainability is to project the debt/GDP ratio over the long-term using the same assumptions as for the calculations of S1 and S2. The long-term projections for government debt under the two scenarios are shown in Figure 3.

The debt ratio is currently below the 60% of GDP reference value, estimated in the programme at close to 39% of GDP in 2006. According to the "2006 scenario", the debt ratio is projected to decrease significantly over the coming 20 years and would turn negative thereafter up to 2050. A similar picture emerges in the "programme scenario", with debt remaining very low throughout the period up to 2050.[23]

Figure 3: Long-term projections for the government debt ratio



Source: Commission's services
Note: The government debt is usually compiled in gross terms, that is, assets are not netted from government liabilities. Therefore, the gross debt can never be negative. In this chart, the negative values for the debt ratio – which appear because of the technical assumption of zero stock-flow adjustment – should be understood as accumulation of financial assets. This issue has no implication on the conclusions drawn from the sustainability assessment.

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[22] Given that the sustainability gaps are negative for Finland, there is no cost of a five-year delay in adjusting the budgetary position according to the S1 and S2.

[23] It should be recalled, however, that being a mechanical, partial-equilibrium analysis, the long-term debt projections are bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels should not be seen as a forecast similar to the Commission services' short-term forecasts, but as an indication of the risks faced by Member States.

5.2.2. *Additional factors*

To reach an overall assessment of the sustainability of public finances, other relevant issues are taken into account which in addition allows to better qualify the assessment with regard to where the main risks are likely to stem from.

First, general government property income in Finland is the highest in the EU, at 3.2% of GDP in 2005, as the government sector holds large assets as part of the strategy to face the impact of ageing populations. According to the analysis in the Sustainability Report (Section IV.3.3, "Changes in property income over time"), the S2 sustainability gap indicator could be larger by about half of this amount, i.e. by some 1½% of GDP. Therefore, a positive sustainability gap could emerge: of about 0.9% of GDP in the "2006 scenario" and about 1.4% of GDP in the "programme scenario" according to the S2 indicator. This is in line with the sustainability gap of 1½% of GDP identified in the update.[24] Yet, this would not significantly alter the relatively favourable prospects for long-term public finance sustainability in Finland.

Second, the programme describes that as of 2007, the authorities aim at increasing the real rate of return of assets held by pension schemes to 4%, by modifying the portfolio towards more risky assets. A sensitivity test in which the real return on pension schemes' assets is one percentage point higher (at 4%) than in the baseline scenario illustrates that this would appreciably improve the sustainability of public finances (by reducing the S2 sustainability gap by around ½ p.p. of GDP according to the update).

Third, Finland has among the highest levels of taxation in the EU, suggesting that there is limited room of manoeuvre to meet expenditure increases by adjusting the budget on the revenue side.

Finally, it can be noted that the programme update projects that social contributions will rise by 2.2% points of GDP between 2010 and 2050.[25] However, the programme also assumes the total tax/GDP ratio to be constant, which implies that other taxes will be reduced. Therefore, the total evolution of tax and contribution would have no impact on the sustainability calculations.

5.2.3. *Assessment*

The long-term budgetary impact of ageing in Finland is higher than on average in the EU, although enacted pension reforms have helped to contain the projected increase in pension expenditure over the coming decades.

The initial budgetary position, with a large structural surplus, contributes significantly to ease the long-term budgetary impact of ageing. Moreover, the large assets accumulated

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[24] In the update of the stability programme, property income of the general government as a share of GDP is projected to increase by 0.6% points of GDP from 2010 to 2050. Such a development results from the fact that the long-term projections in the programme take into account accumulation of assets (i.e. positive stock-flow adjustment). As a result, the gross debt is higher than assuming zero stock-flow adjustments as in the EPC's and Commission services' projections. In case the rate of return of government debt and of government-held assets are the same, both approaches lead to identical conclusions in terms of long-term sustainability.

[25] In Finland, imbalances in the public pension schemes automatically lead to increases in the contribution rate.

by the public pension schemes will be able to finance part of the increase in pension expenditure. However, maintaining high primary surpluses over the medium-term would contribute towards containing risks to the sustainability of public finances.

Overall, Finland appears to be at low risk with regard to the sustainability of public finances.

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

The programme update contains an overview of a number of measures, which, among other objectives, improve the quality and sustainability of public finances already in the medium term. The most notable institutional feature regarding central government finances are the multi-annual spending limits, which have worked well under the present government to contain expenditure growth. Central government spending has remained within the spending ceilings framework during the present legislature with no major overrun pressures. The positive experience will most likely be upheld by future legislatures. A working group has been set up by the Ministry of Finance to evaluate and implement possible revisions to the system based on past experiences. The proposal of the working group will be presented in early 2007 for the next government.

The challenge of increasing productivity in public services and administration, also highlighted in section 2.5 above, has been identified by the government as a major strategic goal. Several programmes and reform initiatives have been developed on the central and local government level to boost public sector productivity and maintain effectiveness under demographic and labour market pressures. These efforts, which are presently in their initial implementation and design stages are expected to yield results in the medium to long term. The central government productivity programme aims to improve productivity by reorganising administrative structures and practices and making better use of ICT. This would allow to adjust the staff numbers down by 9 600 persons by 2011 (around 8 % of person years in the central government). The legislative proposal on the reform of restructuring municipalities and service provision was submitted to the Parliament in autumn 2006, and is expected to be adopted and enter into force at the beginning of 2007). The objective is to curb growth in expenditure and to increase productivity. The effectiveness of the government measures is crucial to upholding the favourable position in public finances and increasing overall productivity and growth potential of the economy.

The government has for the most part already carried out a comprehensive and extensive taxation reform aimed at improving employment and safeguarding economic growth. As already noted in Section 4.2.2, the last notable tax measures from the present government's reform package will take effect in 2007.

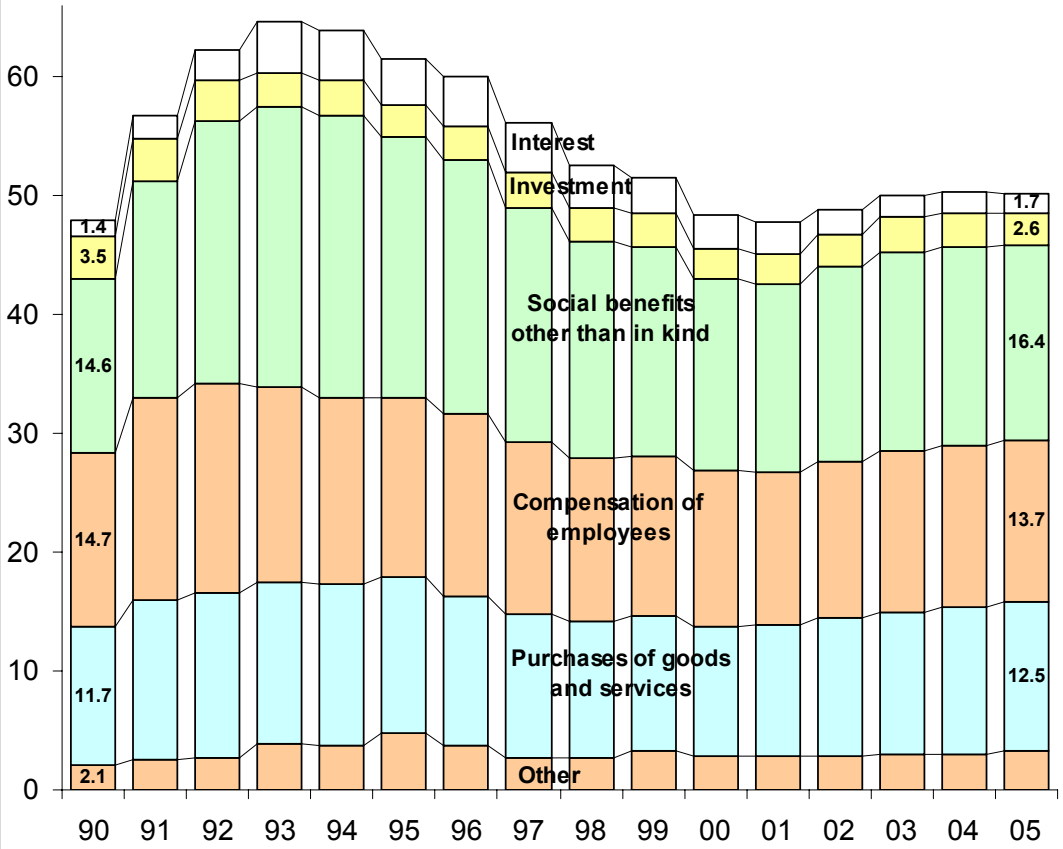
The implementation of the pension reform package is progressing smoothly. The measures will be in the main introduced over an extended period from 2005-2009. Combined with the changes introduced to the unemployment compensation scheme, the pension reform should help to keep control over expenditure in coming years.

Box 4: The level and composition of general government expenditure in Finland since 1990

Since 1990, the economic cycle in Finland has covered periods of extreme booms and busts, which reflect also in government expenditure. The effects of the recession in the early 1990s and the subsequent drive to restore sustainability to public finances have caused dramatic fluctuations

in the expenditure levels. However, the composition of expenditure has proven resilient over the economic cycles. Expenditure ratios have fallen back to broadly their pre-recession levels. In 1990, the year marking the end of the boom cycle of the 1980s, total government expenditure amounted to 48% of GDP, which was somewhat below the average expenditure ratio in the group of countries that now constitute the euro area. The recession pushed dramatically up expenditure on social benefits and interest expenses (see chart below). From 1990 to 1993 the expenditure on social benefits increased by about 50% in nominal terms, reflecting mainly unemployment allowances. Interest expenditure tripled in nominal terms over the same period, albeit from relatively low levels. As a ratio of GDP, other expenditure categories showed also marked rises, impacted by the decline in nominal GDP. The total expenditure ratio shot up 17 percentage points from its 1990 level, resulting in a general government deficit of over 8% of GDP as there was no significant room for revenue-increasing measures. It took 5 years to restore a surplus position to general government finances following the deepest slump of the recession in 1993.

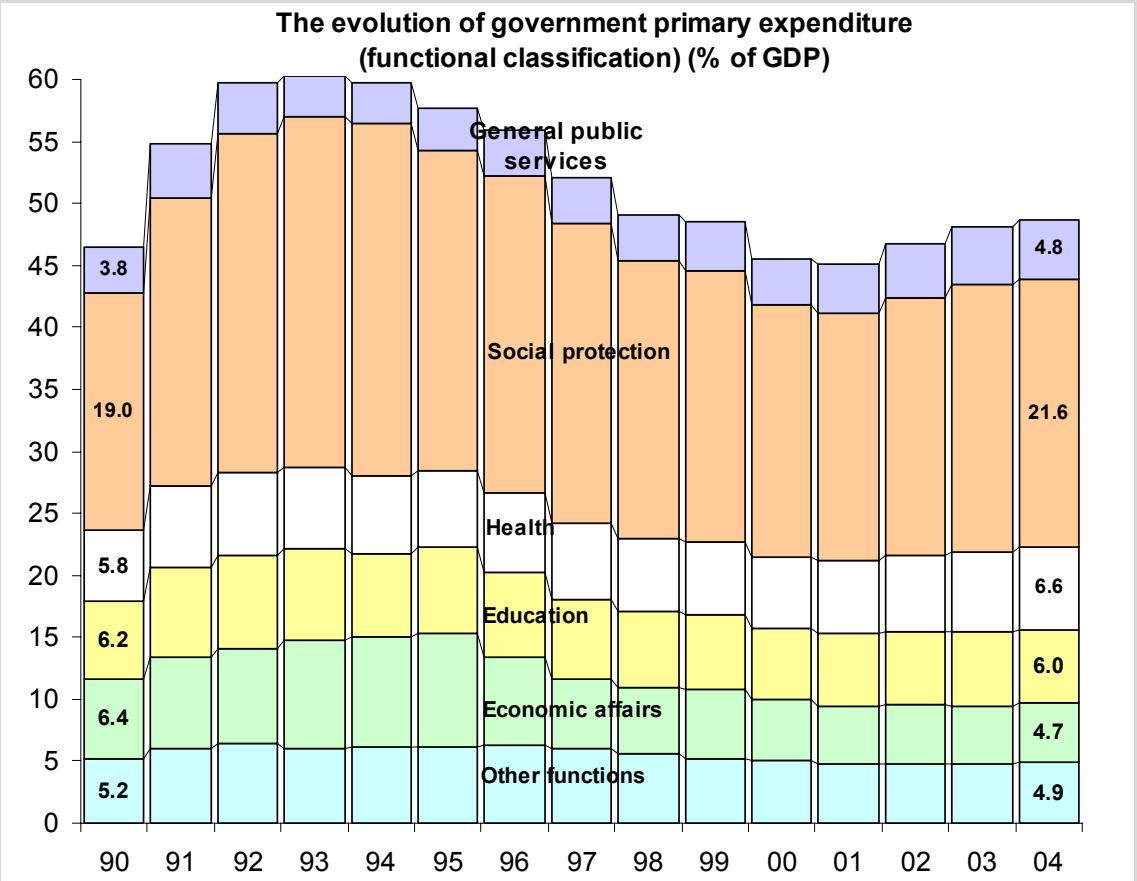
The evolution of government expenditure (economic classification) (% of GDP)



Note: "Other" includes subsidies and other current and capital transfers.

Source: Commission services

In the subsequent recovery and boom phase of the economy, the pressures on expenditures eased. More importantly, successive governments strived to restore fiscal sustainability and instituted comprehensive cost-saving reforms of the welfare system together with overall fiscal austerity. In the second half of the 1990s, nominal expenditure increased by less than 2% per year while GDP growth was at its cyclical peak. The reduced expenditure on social benefits (in the table under social benefits other than in kind) accounts for about half of the 12-percentage point decline in the expenditure ratio from 1993 to 1998. In spite of the rapid decline, as a ratio of GDP, Finnish expenditure on social protection is presently still slightly above the euro-area average and its pre-recession levels. The other important sources of savings were interest expenditure, subsidies and government-paid wages that increased nominally slower than GDP.



Note: "Other functions" include general services, defence, environment, culture, public order and housing.

Source: Commission services

The functional budgetary classification, presented in the above chart, confirms the previous analysis that the economic shock affected primarily expenditures with a cyclical component, most importantly social protection, while health and education costs remained relatively stable. The expenditure ratio has presently stabilised at about 50% of GDP, which is slightly higher than the euro area average, but considerably lower than in the other Nordic countries. The expenditure ratio has been on a moderately increasing trend in 2002-2005, which was a period characterised by a cyclical slowdown of GDP growth and relatively open-handed increases in expenditure (includes also the initial years of the present central government expenditure framework spanning 2004-2007, which foresaw frontloading of expenditure increases to the first years of the government programme). Medium-term forecasts by the Commission and national authorities suggest that the expenditure ratio will turn to a declining trend in 2006-2008, assuming expenditure restraint will be maintained and economic growth remains strong.

7. CONSISTENCY WITH THE NATIONAL REFORM PROGRAMME AND WITH THE BROAD ECONOMIC POLICY GUIDELINES

The measures in the stability programme as described in preceding sections are in line with the National Reform Programme (NRP) and the progress recorded in the Implementation Report of the National Reform Programme (IR-NRP) submitted in October 2006 in the context of the renewed Lisbon strategy for growth and jobs. The measures identified in the IR-NRP to tackle the long-term sustainability challenge are an important factor in containing the risks arising from population ageing (as noted in sections 5.2 above).

The stability programme contains a qualitative assessment of the overall impact of the October 2006 implementation report of the national reform programme within the medium-term fiscal strategy. In addition, it provides systematic information on the direct budgetary costs or savings of the main reforms envisaged in the national reform programme and its budgetary projections explicitly take into account the public finance implications of the actions outlined in the national reform programme. The measures in the area of public finances envisaged in the stability programme seem consistent with those foreseen in the national reform programme. In particular, both programmes envisage the implementation of measures to improve the efficiency of both central and local governments and confirm the intention to continue applying central government budgetary spending limits beyond the current legislative period.

Box 5: The Commission assessment of the implementation report of the National Reform Programme

The Implementation Report of the National Reform Programme of Finland, provided for in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 12 October 2006. The Commission's assessment of this report, which was adopted on 13 December 2006 as part of its Annual Progress Report, can be summarised as follows.

The 2005-2008 National Reform Programme (NRP) focused on three broad medium-term challenges: the sustainability of public finances in the face of population ageing, improving competitiveness and productivity, and improving the functioning of the labour market. These key priority areas are addressed by an interlinked, mutually supportive strategy to secure steady growth of welfare and maintain sustainable public finances. Structural challenges are particularly evident in the operation of labour markets, as well as goods and services markets, indicated by persistently high unemployment and high relative price levels. The Commission broadly shared the analysis of the NRP and considered that the 2006 Implementation Report responds well to most of Finland's key challenges across the macro and micro-economic and employment areas.

Finland is generally making good progress with the implementation of its 2005-2008 NRP. In the Commission's assessment, the comprehensive action to strengthen the sustainability of public finances and prepare for population ageing was particularly well received. Finland was also commended for its excellent human capital infrastructure and measures to further strengthen its knowledge base. Employment rates have recently increased substantially across all age groups, especially for the elderly, which underlines the effectiveness of the measures taken in this regard. Nevertheless, against the backdrop of emerging bottlenecks on the labour market, it was felt that further activation measures and increases in the employment rate would be highly desirable. In that respect, the Commission highlighted the high structural unemployment, the high youth unemployment and employment-based immigration as areas requiring particular attention. The Commission called for stronger focus on improving competition and productivity in services. Also, the relatively burdensome recruitment procedures for firms and the lack of progress in developing local wage bargaining systems were criticised.

Table 14 provides an overview of whether the strategy and policy measures in the programme are consistent with the broad economic policy guidelines in the area of public

finances, which are included in the integrated guidelines for the period 2005-2008. The assessment of guideline 1 corresponds to the evaluation in Section 0 above, whereas that of the pace of debt reduction in guideline 2 (relevant for high-debt countries only) is covered in Section 5.1.2 above. Information on the different elements covered by the remaining guidelines in the table can be found in Sections 5.2 and 6.

Overall, the budgetary strategy in the stability programme is broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008.

Table 14: Consistency with the broad economic policy guidelines

Broad economic policy guidelines	Yes	Steps in right direction	No	Not applicable
1. To secure economic stability				
– Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it[1].	X			
– Member States should avoid pro-cyclical fiscal policies[2].	X			
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits[3].				X
– Member States posting current account deficits that risk being unsustainable should work towards (…), where appropriate, contributing to their correction via fiscal policies.				X
2. To safeguard economic and fiscal sustainability In view of the projected costs of ageing populations,				
– Member States should undertake a satisfactory pace of government debt reduction to strengthen public finances.				X
– Member States should reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible (…)	X			
3. To promote a growth- and employment-orientated and efficient allocation of resources				
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages.	X			

Notes:
[1]As further specified in the Stability and Growth Pact and the code of conduct, i.e. with an annual 0.5% of GDP minimum adjustment in structural terms for euro area and ERM II Member States.
[2]As further specified in the Stability and Growth Pact and the code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in "good times".
[3]As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure.

Source:
Commission services

* * *

Annex 1: Glossary

Automatic stabilisers Various features of the tax and spending regime which tend to have a dampening effect on economic fluctuations without requiring a discretionary intervention of the fiscal authorities. As a result, the budget balance in percent of GDP tends to improve in years of high growth and deteriorate during economic slowdowns. See also *cyclically-adjusted balance*, *structural balance* and *minimum benchmark*.

Broad economic policy guidelines (BEPGs) Guidelines for the economic and budgetary policies of the Member States. Together with the Employment Guidelines, they form the Integrated Guidelines, prepared by the Commission and adopted by the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN). See also *Lisbon strategy*.

Budget balance The balance between total public revenue and expenditure (according to *ESA95*); with a positive balance indicating a surplus (also know as *government net lending*) and a negative balance indicating a deficit (also known as *government net borrowing*). For the monitoring of Member States' budgetary positions, the EU uses *general government* aggregates. See also *cyclically-adjusted balance*, *primary balance, structural balance* and *reference values*.

Budget constraint A basic condition applying to the public finances, according to which total public expenditure in any one year must be financed by taxation, borrowing or changes in the monetary base; the latter is prohibited in the EU. See also *stock-flow adjustment* and *long-term sustainability*.

Budgetary sensitivity The variation in the *budget balance* brought about by a change in the *output gap*. In the EU, it is estimated to be 0.5 on average, i.e. for any percentage point of GDP below or above potential, the budget-balance-to-GDP ratio deteriorates or improves by half a percentage point. The size of the budgetary sensitivity essentially reflects (i) the revenue and expenditure elasticities of the budget and (ii) the size of discretionary government expenditure. See also *cyclically-adjusted balance, structural balance* and *tax elasticity*.

Code of conduct Policy document adopted by the Economic and Financial Committee (an advisory committee gathering high-level officials from national governments, national central banks, the European Central Bank and the European Commission which prepares the meetings of the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN)) and endorsed by the ECOFIN Council in October 2005, containing specifications on the implementation of the *Stability and Growth Pact* and guidelines on the format and content of *stability programmes* and *convergence programmes*.

Contingent liabilities A possible government obligation to pay, the existence of which will be confirmed by the occurrence of one or more uncertain events in the future not wholly under the control of the government. For instance, government guarantees on debt issued by private or public companies are contingent liabilities since the government obligation to pay depends on the non-ability of the original debtor to honour its obligations. See also *implicit liabilities*.

Convergence programme Medium-term budgetary strategy presented by each Member State that has not yet adopted the euro; updated annually, according to the provisions of the *Stability and Growth Pact*. See also *stability programme, code of conduct* and *medium-term objective*.

Cyclically-adjusted balance The *budget balance* adjusted for its cyclical component (which captures the part of public revenue and expenditure that is linked to the *output gap*), i.e. the budget balance that would prevail if GDP were at its potential level. See also *structural balance, budgetary sensitivity* and *output gap*.

Cyclically-adjusted primary balance The *cyclically-adjusted balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Debt dynamics The evolution of *government debt* as a ratio to GDP; it depends on the primary deficit, the debt-increasing impact of interest payments, the dampening effect of GDP growth on the ratio and the *stock-flow adjustment*.

EDP notification See *notification of deficit and debt*.

ERM II Exchange rate mechanism linking some currencies of non-euro Member States to the euro, which is the centre of the mechanism. For the currency of each Member State participating in the mechanism, a central rate against the euro and a standard fluctuation band of ±15% are defined.

ESA95 European accounting standards for the compilation and reporting of macroeconomic (including budgetary) data by the EU Member States.

Excessive deficit procedure (EDP) A procedure, laid down in the EC Treaty, according to which the Commission and the Council monitor the development of national *budget balances* and *public debt* in relation to the *reference values*, in order to assess the existence (or risk) of an excessive deficit in each Member State and to ensure its correction. Its application has been further clarified in the *Stability and Growth Pact*.

Fiscal stance A measure of the thrust of discretionary fiscal policy such as, in this document, the change in the *structural balance* (or in the *structural primary balance*) relative to the preceding year. When the change is positive (negative) the fiscal stance is said to be restrictive (expansionary).

Funded pension scheme Pension system in which current pension expenditures are financed by running down assets accumulated over the years on the basis of contributions by the scheme beneficiaries. According to *ESA95*, defined-contribution funded pension schemes are not considered as part of the *general government* sector. See also *pay-as-you-go pension scheme*.

Government debt See *public debt*.

General government The focus of EU budgetary surveillance under the *Stability and Growth Pact* and the *excessive deficit procedure* is on general government aggregates, with the general government sector covering national, regional and local government, as well as social security. In principle, public enterprises are excluded.

Government net lending/borrowing See *budget balance*.

Implicit liabilities Future government expenditure which has not yet been funded, even when future expenditure is not backed by law or contractual obligations, but is simply grounded in strong expectations of the public. To be meaningful for economic analysis, implicit liabilities should be assessed net of future revenue assuming that the government will keep collecting taxes (and other non-tax revenue) at rates comparable to current levels. See also *contingent liabilities*.

Interest burden *General government* interest expenditure on *government debt* as a share of GDP.

Intertemporal budget constraint A basic condition imposing that current total liabilities of the government, i.e. the current public debt and the discounted value of future expenditure including the budgetary impact of ageing populations, be covered by the discounted value of future government revenue.

Lisbon strategy Partnership between the EU and Member States for growth and more and better jobs. Originally approved in 2000, the Lisbon Strategy was revamped in 2005. Based on the Integrated Guidelines (merger of the *broad economic policy guidelines* and the employment guidelines, dealing with macro-economic, micro-economic and employment issues) for the period 2005-2008, Member States drew up 3-year national reform programmes in autumn 2005. They reported on the implementation of the national reform programmes for the first time in autumn 2006. The Commission analyses and summarises these reports in an EU Annual Progress Report each year, in time for the Spring European Council.

Long-term sustainability A combination of *budget balance* and *public debt* that ensures that the latter does not grow without bound. While conceptually intuitive, an agreed operational definition of sustainability has proven difficult to achieve.

Maturity structure of public debt The profile of *public debt* in terms of when it is due to be paid back. Interest rate changes affect the *budget balance* directly to the extent that the *general government* sector has debt with a relatively short maturity structure. Long maturities reduce the sensitivity of the *budget balance* to changes in the prevailing interest rate. See also *interest burden*.

Medium-term objective (MTO) According to the *Stability and Growth Pact*, *stability programmes* and *convergence programmes* must present a medium-term objective for the budgetary position. It is country-specific to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances, and is defined in structural terms (see *structural balance*).

Minimum benchmark Estimated budgetary position (in *cyclically-adjusted* terms) that provides a "safety margin" that is enough for the *automatic stabilisers* to operate freely during normal economic slowdowns without breaching the 3% of GDP deficit *reference value*. The minimum benchmarks are estimated by the European Commission. They do not cater for other risks such as unexpected budgetary developments and interest rate shocks.

National reform programme (NRP) See *Lisbon strategy*.

Notification of deficit and debt (EDP notification) Twice a year (by 1 April and 1 October), EU Member States have to notify their *general government* deficit and debt figures (and a number of associated data) to the Commission, the quality of which is then checked by Eurostat, the Commission department in charge of statistics. See also *budget balance* and *public debt*.

One-off and temporary measures Government transactions having a transitory budgetary effect that does not lead to a sustained change in the intertemporal budgetary position. See also *structural balance*.

Output gap The difference between actual GDP and potential GDP in any given year, usually expressed as a percent of potential GDP. Potential GDP is an unobserved variable and needs to be estimated from actual data. It is the level of real GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, then constraints on capacity begin to bind and inflationary pressures build; if output falls below potential, then resources are lying idle and inflationary pressures abate. See also *production function method*.

Pay-as-you-go pension scheme (PAYG) Pension system in which current pension expenditures are financed by the contributions of current employees. Also known as *unfunded pension scheme*. See also *funded pension scheme*.

Primary balance The *budget balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Pro-cyclical fiscal policy A *fiscal stance* which amplifies the economic cycle by lowering the *structural balance* when the *output gap* is positive or improving, or by increasing the *structural balance* when the *output gap* is negative or widening, as opposed to a counter-cyclical fiscal policy stance. A neutral fiscal policy keeps the *structural balance* unchanged over the economic cycle by letting the *automatic stabilisers* work.

Production function method A method to estimate potential GDP typically based on a Cobb-Douglas production function. Potential GDP is estimated as the level of GDP consistent with a full utilisation of capital, an unemployment rate that does not accelerate inflation and factor productivity at its trend level. See also *output gap, cyclically-adjusted balance, budgetary sensitivity*.

Public debt (or government debt) Consolidated gross debt for the *general government* sector. It includes the total nominal value of all debt owed by government units, except that part of the debt which is owed to government units in the same Member State. It is a gross debt measure meaning that government financial assets on other sectors are not netted out. See also *debt dynamics* and *reference values*.

Public investment The component of total public expenditure which consists in the acquisition of durable assets and through which governments increase and improve the stock of capital employed in the production of the goods and services they provide. Also known as government gross fixed capital formation (GFCF).

Public-private partnerships (PPP) Agreements between government and corporations according to which the latter build and operate public-use infrastructure (roads, tunnels, bridges, but also hospitals, prisons, concert halls, etc.) which were traditionally directly controlled by government. In exploiting the infrastructure, the corporation receives prices paid by final users, rentals or fees from the government or both. Infrastructure built under PPPs is considered as either *public investment* or corporate investment depending on a number of specific criteria.

Quality of public finances A multi-dimensional concept which refers to the contribution that public finances make to the efficient allocation of resources in the economy and to achieving the government's strategic objectives (sustainable growth, macroeconomic stability, competitiveness, social cohesion etc.). It concerns notably the overall level of expenditure and taxation, their composition, the budgeting and control mechanisms and the institutional arrangements for deciding on public finance issues.

Reference values for public deficit and debt Respectively, a 3 percent *general government* deficit-to-GDP ratio and a 60 percent *general government* debt-to-GDP ratio. See also *excessive deficit procedure, government debt* and *budget balance*.

Sensitivity analysis An econometric or statistical simulation designed to test the robustness of an estimated economic relationship or projection to changes in the underlying assumptions.

'Snow-ball' effect The self-reinforcing effect of *public debt* accumulation or decumulation arising from a positive or negative differential between the implicit interest rate on public debt and the GDP growth rate. See also *debt dynamics*.

Stability and Growth Pact (SGP) Approved in 1997 and reformed in 2005, the SGP clarifies the provisions on budgetary surveillance in the EC Treaty. The "preventive" arm of the SGP obliges Member States to submit annual *stability programmes* or *convergence programmes*, while the "corrective" arm of the SGP clarifies and speeds up the *excessive deficit procedure*.

Stability programme Medium-term budgetary strategy presented by each Member State that has already adopted the euro; updated annually, according to the provisions of the *Stability and Growth Pact*. See also *convergence programme, code of conduct* and *medium-term objective*.

Stock-flow adjustment (SFA) The stock-flow adjustment (also known as the debt-deficit adjustment) ensures consistency between *government net borrowing*, which is a flow variable, and the variation in *government debt*, which is a stock variable. It includes differences between cash and accrual accounting, accumulation of financial assets, changes in the value of debt denominated in foreign currency and remaining statistical adjustments. See also *debt dynamics.*

Structural balance The *budget balance* in *cyclically-adjusted* terms and excluding *one-off and temporary measures*. See also *fiscal stance*.

Structural primary balance The *structural balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Tax elasticity A parameter measuring the relative change in tax revenues with respect to a relative change in GDP. The tax elasticity is an input to the *budgetary sensitivity*.

Annex 2: Summary tables from the programme update

The tables below present the information provided in the programme in the format prescribed by the code of conduct (Annex 2 thereof).

Table 1a. Macroeconomic prospects

	ESA Code	2005 Level	2005 rate of change	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change
1. Real GDP	B1*g	-	2.9	4.5	3.0	2.9	2.6	2.1
2. Nominal GDP	B1*g	157.4	3.6	6.0	4.0	4.0	3.7	3.2
Components of real GDP								
3. Private consumption expenditure	P.3	81.5	3.8	3.6	2.7	2.5	2.3	1.9
4. Government consumption expenditure	P.3	34.8	1.6	1.0	0.7	1.2	1.0	0.9
5. Gross fixed capital formation	P.51	29.5	3.6	5.3	3.7	2.8	2.1	1.4
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	2.1	1.4	0.9	1.0	0.9	0.9	0.9
7. Exports of goods and services	P.6	65.8	7.3	10.4	5.2	5.0	4.8	4.4
8. Imports of goods and services	P.7	56.9	12.3	6.9	4.7	3.7	3.5	3.4
Contributions to real GDP growth								
9. Final domestic demand		145.9	2.9	3.1	2.3	2.1	1.9	1.5
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	2.1	1.0	-0.4	0.2	0.0	0.0	0.0
11. External balance of goods and services	B.11	9.0	-1.0	1.9	0.5	0.8	0.8	0.7

Table 1b. Price developments

	ESA Code	2005 level	2005 rate of change	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change
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[1]		-	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 (goods and services)		-	0.9	1.9	-0.7	-0.8	-0.8	-0.8
7. Import price deflator (goods and services)		-	4.5	4.0	1.4	1.0	1.0	1.0

Table 1c. Labour market developments

	ESA Code	2005 Level	2005 rate of change	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change
1. Employment, persons[1]		2401.0	1.5	1.5	0.7	0.6	0.5	0.1
2. Employment, hours worked[2]		4107.4	0.8	1.9	0.5	0.4	0.3	-0.1
3. Unemployment rate (%)[3]			8.4	7.7	7.4	6.7	6.1	5.9
4. Labour productivity, persons [4]			1.4	3.0	2.3	2.3	2.1	2.0
5. Labour productivity, hours worked[5]			2.1	2.6	2.5	2.5	2.3	2.2
6. Compensation of employees	D.1	61.6	4.9	4.7	3.6	4.1	3.8	3.2

[1] Occupied population, domestic concept national accounts definition.
[2] National accounts definition.
[3] Harmonised definition, Eurostat; levels.
[4] Real GDP per person employed.
[5] Real GDP per hour worked.

Table 1d. Sectoral balances

% of GDP	ESA Code	2005	2006	2007	2008	2009	2010
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	4.8	5.4	4.8	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	B.9/EDP B.9	2.6	3.3	2.7	2.5	2.4	2.4
3. Net lending/borrowing of general government	B.9	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

Table 2. General government budgetary prospects

	ESA code	2005 Level	2005 % of GDP	2006 % of GDP	2007 % of GDP	2008 % of GDP	2009 % of GDP	2010 % of GDP
Net lending (EDP B.9) by sub-sector								
1. General government	S.13	3880.0	2.5	2.9	2.8	2.7	2.7	2.4
2. Central government	S.1311	909.0	0.6	0.6	0.3	0.2	0.4	0.4
3. State government	S.1312	-	-	-	-	-	-	-
4. Local government	S.1313	-1030.0	-0.7	-0.3	-0.1	-0.1	-0.1	0.0
5. Social security funds	S.1314	4299.0	2.7	2.6	2.6	2.6	2.4	2.0
General government (S13)								
6. Total revenue	TR	82485.0	52.4	51.9	51.4	51.1	50.9	50.8
7. Total expenditure	TE[1]	78605.0	49.9	49.0	48.6	48.4	48.2	48.4
8. Net lending/borrowing	EDP B.9	3880.0	2.5	2.9	2.8	2.7	2.7	2.4
9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	2333.0	1.5	1.5	1.5	1.5	1.4	1.3
pm: 9a. FISIM		-	-	-	-	-	-	-
10. Primary balance	[2]	6213.0	3.9	4.5	4.3	4.2	4.1	3.7
Selected components of revenue								
11. Total taxes (11=11a+11b+11c)		50277.0	31.7	31.0	30.8	30.7	30.6	30.5
11a. Taxes on production and imports	D.2	22185.0	13.9	13.6	13.5	13.4	13.3	13.3
11b. Current taxes on income, wealth, etc	D.5	27606.0	17.5	17.1	17.0	16.9	16.9	16.9
11c. Capital taxes	D.91	486.0	0.3	0.3	0.3	0.3	0.3	0.3
12. Social contributions	D.61	19018.0	12.1	12.0	12.0	12.0	12.0	12.0
13. Property income	D.4	4994.0	3.2	3.5	3.3	3.2	3.2	3.2
14. Other (14=15-(11+12+13))		8196.0	5.4	5.4	5.4	5.3	5.1	5.1
15=6. Total revenue	TR	82485.0	52.4	51.9	51.4	51.1	50.9	50.8
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[3]		68927.0	43.6	42.8	42.5	42.4	42.3	42.3
Selected components of expenditure								
16. Collective consumption	P.32	11988.0	7.6	7.4	7.2	7.2	7.1	7.1
17. Total social transfers	D.62 + D.63	48660.0	30.9	30.2	30.1	30.1	30.2	30.6
17a. Social transfers in kind	P.31 = D.63	22856.0	14.5	14.3	14.3	14.3	14.4	14.5
17b. Social transfers other than in kind	D.62	25804.0	16.4	15.9	15.8	15.7	15.8	16.1
18.=9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	2333.0	1.5	1.5	1.5	1.5	1.4	1.3
19. Subsidies	D.3	1984.0	1.3	1.3	1.2	1.2	1.2	1.2
20. Gross fixed capital formation	P.51	4145.0	2.6	2.6	2.6	2.6	2.5	2.5
21. Other (21=22-(16+17+18+19+20))		9495.0	6.0	6.0	6.1	5.9	5.8	5.7
22=7. Total expenditure	TE[4]	78605.0	49.9	49.0	48.6	48.4	48.2	48.4
Pm: compensation of employees	D.1	21528.0	13.7	13.3	13.2	13.1	13.0	13.0

[1] Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.
[2] The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41 + FISIM recorded as intermediate consumption, item 9).
[3] Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.
[4] Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

Table 3. General government expenditure by function

% of GDP	COFOG Code	**2004**	**2009**
1. General public services	1	6.5	5.8
2. Defence	2	1.6	1.4
3. Public order and safety	3	1.5	1.3
4. Economic affairs	4	4.7	4.2
5. Environmental protection	5	0.3	0.3
6. Housing and community amenities	6	0.3	0.3
7. Health	7	6.7	7.0
8. Recreation, culture and religion	8	1.2	1.1
9. Education	9	6.1	5.8
10. Social protection	10	21.3	21.3
11. Total expenditure (= item 7=26 in Table 2)	TE[1]	**50.3**	**48.4**

[1] Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

Table 4. General government debt developments

% of GDP		2005	2006	2007	2008	2009	2010
1. Gross debt[1]		41.3	39.1	37.7	36.2	35.0	33.7
2. Change in gross debt ratio		-2.9	-2.2	-1.4	-1.5	-1.2	-1.3
Contributions to changes in gross debt							
3. Primary balance[2]		3.9	4.5	4.3	4.2	4.1	3.7
4. Interest expenditure (incl. FISIM) [3]		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
- Differences between cash and accruals[4]		0.1	0.0	0.0	0.0	0.0	0.0
- Net accumulation of financial assets[5]		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 and other[6]		-1.7	-1.9	-1.2	-1.2	-0.7	-0.5
p.m. implicit interest rate on debt[7]		4.1	3.8	4.0	4.0	4.0	4.0
Other relevant variables							
6. Liquid financial assets[8]		-	-	-	-	-	-
7. Net financial debt (7=1-6)		-	-	-	-	-	-

[1] As defined in Regulation 3605/93 (not an ESA concept).
[2] Cf. item 10 in Table 2.
[3] Cf. item 9 in Table 2.
[4] The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.
[5] Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.
[6] Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.
[7] Proxied by interest expenditure (incl. FISIM recorded as consumption) divided by the debt level of the previous year.
[8] AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

Table 5. Cyclical developments

% of GDP	ESA Code	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	EDP B.9	2.5	2.9	2.8	2.7	2.7	2.4
3. Interest expenditure (incl. FISIM recorded as consumption)	EDPD.41 + FISIM	1.5	1.5	1.5	1.5	1.4	1.3
4. Potential GDP growth (%) (1)		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 (2-6)		3.1	3.0	3.0	2.9	2.9	2.6
8. Cyclically-adjusted primary balance (7-3)		4.5	4.5	4.5	4.4	4.3	3.9

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

Table 6. Divergence from previous update

	ESA Code	2005	2006	2007	2008	2009	2010
Real GDP growth (%)							
Previous update		2.1	3.2	2.6	2.3	2.1	-
Current update		2.9	4.5	3.0	2.9	2.6	2.1
Difference		0.8	1.3	0.4	0.6	0.5	-
General government net lending (% of GDP)	EDP B.9						
Previous update		1.8	1.6	1.6	1.5	1.5	-
Current update		2.5	2.9	2.8	2.7	2.7	2.4
Difference		0.7	1.3	1.2	1.2	1.2	-
General government gross debt (% of GDP)							
Previous update		42.7	41.7	41.1	40.6	40.1	-
Current update		41.3	39.1	37.7	36.2	35.0	33.7
Difference		-1.4	-2.6	-3.4	-4.4	-5.1	-

Table 7. Long-term sustainability of public finances

% of GDP	2000	2005	2010	2020	2030	2040	2050
Total expenditure	-	**50.1**	**48.4**	**50.4**	**53.6**	-	**58.0**
Of which: age-related expenditures	-	**25.6**	**25.6**	**27.6**	**30.2**	-	**30.7**
Pension expenditure	-	10.4	11.2	12.9	14.0	-	13.7
Social security pension	-	-				-	
Old-age and early pensions	-	8.0	8.8	10.7	12.0	-	12.1
Other pensions (disability, survivors)	-	2.4	2.4	2.2	2.0	-	1.7
Occupational pensions (if in general government)	-	-	-	-	-	-	-
Health care	-	5.5	5.8	6.2	6.6	-	7.0
Long-term care *(this was earlier included in the health care)*	-	1.8	1.9	2.1	3.0	-	3.5
Education expenditure	-	5.9	5.5	5.3	5.4	-	5.3
Other age-related expenditures	-	-				-	
Interest expenditure	-	1.7	1.3	1.4	2.1	-	5.8
Total revenue	-	**52.6**	**50.9**	**51.9**	**51.8**	-	**51.6**
Of which: property income	-	**3.2**	**3.2**	**4.1**	**4.0**	-	**3.8**
of which : from pensions contributions (or social contributions if appropriate)	-	9.1	9.0	10.3	11.2	-	11.2
Pension reserve fund assets	-	**62.6**	**69.8**	**75.1**	**76.4**	-	**76.0**
Of which: consolidated public pension fund assets	-	**51.7**	**57.9**	**62.4**	**63.8**	-	**63.5**
(assets other than government liabilities)	-	-	-	-	-	-	-
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 (aged 20-64)	-	-	**83.3**	**85.7**	**86.4**	-	**86.5**
Participation rates females (aged 20-64)	-	-	**76.6**	**80.3**	**81.5**	-	**81.9**
Total participation rates (aged 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**

Table 8. Basic assumptions

	2004	2005	2006	2007	2008	2009	2010
Short-term interest rate[1] (annual average)	-	2.2	3.0	3.6	-	-	-
Long-term interest rate (annual average)	-	3.4	3.8	4.1	-	-	-
USD/€ exchange rate (annual average) (euro area and ERM II countries)	-	1.24	1.25	1.25	-	-	-
Nominal effective exchange rate	-	0.0	0.3	0.4	-	-	-
World excluding EU, GDP growth	-	4.9	4.7	4.2	-	-	-
EU GDP growth	-	1.6	2.3	2.0	-	-	-
Growth of relevant foreign markets	-	8.4	11.2	8.1	-	-	-
World import volumes, excluding EU	-	7.0	6.0	4.5	-	-	-
Oil prices, (Brent, USD/barrel)	-	54.4	68.0	68.0	-	-	-

Annex 3: Compliance with the code of conduct

The table below provides a detailed assessment of whether the programme respects the requirements of Section II of the code of conduct. It is in four parts, covering compliance with (i) the window for the date of submission of the programme; (ii) the model structure (table of contents) in Annex 1 of the code; (iii) the data requirements (model tables) in Annex 2 of the code; and (iv) other information requirements.

Guidelines in the code of conduct	Yes	No	Comments
1. Submission of the programme			
Programme was submitted not earlier than mid-October and not later than 1 December[1].	X		
2. Model structure			
The model structure for the programmes in Annex 1 of the code of conduct has been followed.	X		
3. Model tables (so-called data requirements)			
The quantitative information is presented following the standardised set of tables (Annex 2 of the code of conduct).	X		
The programme provides all compulsory information in these tables.		X	Data on basic assumptions specified in the "code of conduct" in annex 2 table 8 are only presented up to 2007, but not for 2008-2010.
The programme provides all optional information in these tables.		X	"Code of conduct" annex 2 table 4 point 6 "liquid financial assets" is not given in the stability programme.
The concepts used are in line with the European system of accounts (ESA).	X		
4. Other information requirements			
a. Involvement of parliament			
The programme mentions its status vis-à-vis the national parliament.	X		
The programme indicates whether the Council opinion on the previous programme has been presented to the national parliament.	X		
b. Economic outlook			
Euro area and ERM II Member States uses the "common external assumptions" on the main extra-EU variables.		X	
Significant divergences between the national and the Commission services' economic forecasts are explained[2].	X		
The possible upside and downside risks to the economic outlook are brought out.	X		
The outlook for sectoral balances and, especially for countries with a high external deficit, the external balance is analysed.	X		
c. Monetary/exchange rate policy			
The convergence programme presents the medium-term monetary policy objectives and their relationship to price and exchange rate stability.			Not applicable
d. Budgetary strategy			
The programme presents budgetary targets for the general government balance in relation to the MTO, and the projected path for the debt ratio.	X		
In case a new government has taken office, the programme shows continuity with respect to the budgetary targets endorsed by the Council.			Not applicable

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

Notes:

[1]The code of conduct allows for the following exceptions: (i) Ireland should be regarded as complying with the deadline in case of submission on "budget day", i.e. traditionally the first Wednesday of December, (ii) the UK should submit as close as possible to its autumn pre-budget report; and (iii) Austria and Portugal cannot comply with the deadline but will submit no later than 15 December.

[2]To the extent possible, bearing in mind the typically short time period between the publication of the

Guidelines in the code of conduct	Yes	No	Comments
Commission services' autumn forecast and the submission of the programme. *Source:* *Commission services*			

Annex 4: Key economic indicators of past economic performance

This Annex includes two tables. The first displays key economic indicators that summarise the economic performance of the country. To put the country's performance into perspective, the second table displays the same set of indicators for the euro area.

Finland- Key economic indicators	Averages			2003	2004	2005
	1996 – 2005	1996 – 2000	2001 - 2005			
Economic activity						
Real GDP (% change)	3.6	4.8	2.5	1.8	3.5	2.9
Private consumption % change	3.4	3.4	3.4	4.8	3.2	3.8
Government consumption % change	1.8	1.8	1.8	1.5	1.7	1.6
Investment % change	5.3	8.0	2.7	4.0	4.9	3.3
Exports % change	7.6	11.5	3.6	-1.7	7.5	7.3
Imports % change	7.3	9.3	5.2	3.3	7.4	12.3
Contributions to real GDP growth						
Demand						
Domestic demand	3.0	3.3	2.7	3.6	2.8	4.0
Net exports	0.7	1.7	-0.2	-1.7	0.6	-1.0
Output gap	0.3	1.2	-0.5	-1.5	-1.3	-1.5
Prices and costs						
HICP inflation % change	1.5	1.6	1.4	1.3	0.1	0.8
Unit labour costs % change	1.1	0.5	1.6	1.1	0.5	2.0
Labour productivity % change	2.0	2.4	1.6	1.7	3.1	1.6
Real unit labour costs % change	-0.3	-1.3	0.6	1.5	-0.1	1.4
Comparative price levels (EUR25=100)	112.7	112.8	112.7	114.1	112.5	112.8
Labour market						
Employment % change	1.6	2.3	0.8	0.1	0.4	1.3
Employment % of pop work age	65.9	63.9	67.9	67.8	67.9	68.7
Unemployment rate in %	10.3	11.7	8.9	9.0	8.8	8.4
NAIRU in %	10.0	11.9	8.1	8.0	7.6	7.3
Participation rate in %	73.5	72.5	74.6	74.5	74.5	75.0
Working age population % change	0.3	0.3	0.2	0.2	0.1	0.2
Competitiveness and external position						
Real effective exchange rate % change (1)	-0.8	-3.6	1.9	4.3	1.3	0.7
Export performance % change (2)	0.8	2.3	-0.7	-5.6	-0.7	0.6
External balance of g & s	8.8	8.9	8.7	8.3	8.1	5.7
Net borrowing v-à-v RoW	6.9	6.3	7.6	6.0	7.3	5.0
FDI	n.a.	n.a.	n.a.	2.1	1.9	2.4
Public finances						
Total expenditure % of GDP	51.6	53.7	49.4	50.0	50.3	50.1
Total revenue % of GDP	53.7	54.8	52.6	52.4	52.4	52.6
General government balance % of GDP	2.2	1.1	3.3	2.5	2.3	2.7
General government debt % of GDP	46.2	49.6	42.7	44.3	44.3	41.3
Structural budget balance % of GDP	n.a.	n.a.	n.a.	3.3	3.0	3.4
Fin.a.ncial indicators (3)						
Short term real interest rate (4)	1.8	1.7	1.8	2.7	1.5	1.5
Long term real interest rate (4)	3.5	3.8	3.3	4.6	3.5	2.7
Household credit % change	n.a.	n.a.	n.a.	12.9	13.6	13.3
Corporate sector credit % change (5)	n.a.	n.a.	n.a.	4.4	-1.2	8.6
Household debt in % of GDP	n.a.	n.a.	n.a.	37.3	40.7	45.1
Corporate sector debt in % of GDP	n.a.	n.a.	n.a.	67.3	63.8	67.8

Notes:

(1) ulc relative to rest of a group of industrialised countries (usd): EUR24 (excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ

(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets (2000=100).

(3) Data available up to 2004

(4) Using GDP deflator

(5) Households' and non-profit institutions serving households' debt defined as loans and securities other than shares

(6) Non-financial corporate sector debt, defined as loans and securities other than shares

Euro area- Key economic indicators

	Averages			2003	2004	2005
	1996 – 2005	1996 – 2000	2001 - 2005			
Economic activity						
Real GDP (% change)	2.1	2.7	1.4	0.8	2.0	1.4
Private consumption % change	2.0	2.6	1.4	1.2	1.5	1.3
Government consumption % change	1.7	1.7	1.7	1.8	1.2	1.4
Investment % change	2.6	4.3	1.0	1.0	2.2	2.5
Exports % change	5.8	8.1	3.5	1.1	6.8	4.3
Imports % change	5.9	8.4	3.4	3.1	6.7	5.3
Contributions to real GDP growth						
Demand						
Domestic demand	2.0	2.7	1.3	1.4	1.8	1.6
Net exports	0.1	0.1	0.1	-0.7	0.2	-0.2
Output gap	-0.1	-0.1	0.0	-0.6	-0.5	-1.1
Prices and costs						
HICP inflation % change	1.9	1.7	2.2	2.1	2.1	2.2
Unit labour costs % change	1.3	0.8	1.7	2.0	0.9	1.0
Labour productivity % change	1.2	1.5	0.8	0.8	1.6	0.9
Real unit labour costs % change	-0.5	-0.6	-0.5	-0.1	-1.0	-0.8
Comparative price levels (EUR25=100)	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A
Labour market						
Employment % change	1.2	1.5	0.9	0.7	0.7	0.8
Employment % of pop work age	63.7	62.0	65.4	65.4	65.6	65.8
Unemployment rate in %	9.1	9.8	8.5	8.7	8.9	8.6
NAIRU in %	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Participation rate in %	69.9	68.5	71.2	71.4	71.7	71.8
Working age population % change	0.3	0.2	0.4	0.5	0.5	0.5
Competitiveness and external position						
Real effective exchange rate % change (1)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Export performance % change (2)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
External balance of g & s	1.9	1.7	2.0	2.1	2.1	1.5
Net borrowing v-à-v RoW	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
FDI	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Public finances						
Total expenditure % of GDP	48.2	48.7	47.7	48.2	47.6	47.6
Total revenue % of GDP	45.8	46.5	45.1	45.1	44.8	45.1
General government balance % of GDP	-2.3	-2.1	-2.5	-3.1	-2.8	-2.4
General government debt % of GDP	70.9	72.5	69.3	69.3	69.8	70.8
Structural budget balance % of GDP	#N/A	#N/A	#N/A	-3.2	-2.9	-2.0
Fin.a.ncial indicators (3)						
Short term real interest rate (4)	1.7	2.7	0.7	0.2	0.2	0.3
Long term real interest rate (4)	3.1	4.1	2.1	2.0	2.2	1.5
Household credit % change	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector credit % change (5)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Household debt in % of GDP	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector debt in % of GDP	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Notes:

(1) ulc relative to rest of a group of industrialised countries (usd): EUR24 (excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ

(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets (2000=100).

(3) Data available up to 2004

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(5) Households' and non-profit institutions serving households' debt defined as loans and securities other than shares

(6) Non-financial corporate sector debt, defined as loans and securities other than shares

Annex 5: Assessment of tax projections

Table 9 in the main text compares the tax projections of the programme with those of the Commission services' autumn 2006 forecast and those obtained by using standard ex-ante elasticities, as estimated by the OECD. It summarises the results for the total tax-to-GDP ratio. The underlying analysis exploits information for the four major tax categories, i.e. indirect taxes, corporate and private income taxes and social contributions (see results in the table below)[26].

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

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

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

To the extent that ε_{T_i,B_i} is derived from observed or projected data, it will typically reflect (i) the effect of discretionary measures (including one-offs) and (ii) the tax elasticity[27]. By contrast, if ε_{T_i,B_i} is the standard *ex-ante* elasticity, as estimated by the OECD, it will be net of discretionary measures.

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

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

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

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

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

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

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

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[26] Private and corporate income taxes are generally not provided, neither in the programme nor in the Commission services' autumn 2006 forecast. Only the aggregate, direct income taxes, is given. For the purpose of this exercise the breakdown is obtained using the average shares over the past ten years, i.e. the composition of direct taxes is assumed to stay constant.

[27] The observed or projected elasticity (ex-post elasticity) of the *i*-th tax also includes the effect of other factors (OF) such as discretionary measures: $\frac{\Delta T_i}{T_i} = \varepsilon_{T_i,B_i ex ante}\frac{dB_i}{B_i} + \frac{OF_i}{T_i} = \varepsilon_{T_i,B_i ex post}\frac{dB_i}{B_i}$.

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

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

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

Table 9: Assessment of tax projections by major tax category

	2007			2008			2009	2010
	SP/CP	**COM**	**OECD[1]**	**SP/CP**	**COM[2]**	**OECD[1]**	**SP/CP**	**SP/CP**
Taxes on production and imports:								
Change in tax-to-GDP ratio	-0.1	0.0	0.0	-0.1	0.0	0.0	-0.1	0.0
Difference SP/CP – COM	-0.1			-0.1			/	/
of which[3]:								
- discretionary & elasticity component	-0.2			-0.1			/	/
- composition component	0.1			0.0			/	/
Difference COM – OECD	/	0.0		/	0.0		/	/
of which[3]:								
- discretionary & elasticity component	/	0.0		/	0.0		/	/
- composition component	/	0.0		/	0.0		/	/
p.m.: Elasticity								
- of taxes to tax base[4]	0.7	1.0	1.0	0.8	1.0	1.0	0.7	0.9
- of tax base[4] to GDP	1.2	1.0	1.0	1.1	1.1	1.0	1.1	1.1
Social contributions:								
Change in tax-to-GDP ratio	0.0	-0.1	-0.2	0.0	-0.1	-0.2	0.0	0.0
Difference SP/CP – COM	0.1		/	0.1		/	/	/
of which[3]:								
- discretionary & elasticity component	0.0		/	0.0		/	/	/
- composition component	0.1		/	0.1		/	/	/
Difference COM – OECD	/	0.1		/	0.1		/	/
of which[3]:								
- discretionary & elasticity component	/	0.0		/	0.0		/	/
- composition component	/	0.1		/	0.1		/	/
p.m.: Elasticity								
- of taxes to tax base[5]	1.1	1.1	1.0	1.0	1.0	1.0	1.0	1.0
- of tax base[5] to GDP	0.9	0.7	0.6	1.0	0.8	0.6	1.0	1.0
Personal income tax[6]:								
Change in tax-to-GDP ratio	-0.1	-0.2	0.0	-0.1	0.0	0.0	0.0	0.0
Difference SP/CP – COM	0.1		/	-0.1		/	/	/
of which[3]:								
- discretionary & elasticity component	0.0		/	-0.1		/	/	/
- composition component	0.1		/	0.1		/	/	/
Difference COM – OECD	/	-0.2		/	0.0		/	/
of which[3]:								
- discretionary & elasticity component	/	-0.2		/	-0.1		/	/
- composition component	/	0.1		/	0.2		/	/
p.m.: Elasticity								
- of taxes to tax base[5]	0.9	0.8	1.5	0.8	1.1	1.5	1.0	1.0
- of tax base[5] to GDP	0.9	0.7	0.6	1.0	0.8	0.6	1.0	1.0
Corporate income tax[6]:								

Change in tax-to-GDP ratio	0.0	-0.1	-0.2	0.0	0.0	-0.2	0.0	0.0
Difference SP/CP – COM	0.0		/	0.0		/	/	/
of which[3]:								
- discretionary & elasticity component	0.1		/	0.0		/	/	/
- composition component	0.0		/	0.0		/	/	/
Difference COM – OECD	/	0.1		/	0.1		/	/
of which[3]:								
- discretionary & elasticity component	/	0.0		/	0.0		/	/
- composition component	/	0.1		/	0.1		/	/
p.m.: Elasticity								
-of taxes to tax base[7]	0.8	0.5	1.0	0.9	0.9	1.0	1.0	1.0
-of tax base[7] to GDP	1.1	1.3	0.6	1.0	1.1	0.6	1.0	1.0

Notes:

[1]Based on OECD ex-ante elasticities

[2]On a no-policy change basis

[3]The decomposition is explained in the text above

[4]Tax base = private consumption expenditure

[5]Tax base = compensation of employees

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

[7]Tax base = gross operating surplus

Source:

Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)