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FINLAND: MACRO FISCAL ASSESSMENT

AN ANALYSIS OF THE NOVEMBER 2007 UPDATE OF THE STABILITY PROGRAMME

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 29 November 2007.

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 (DG ECFIN) of the European Commission, was finalised on 22 January 2008. Comments should be sent to Mart Maiväli (mart.maivali@ec.europa.eu). The main aim of the 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.

The analysis takes into account (i) the Commission services' autumn 2007 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. Technical issues are explained in an accompanying "methodological paper" prepared by DG ECFIN.

Based on this technical analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 30 January 2008. The ECOFIN Council is expected to adopt its opinion on the programme on 12 February 2008.

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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

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 2007-2011, was submitted on 29 November 2007.

Finland's macroeconomic performance has been strong and balanced over the last years, with growth in the recent years significantly exceeding earlier expectations. The present cyclical upswing in economic activity has been appropriately used to build up budgetary surpluses and to prepare for the effects of population ageing, reducing considerably the risks to the sustainability of public finances. However, the imminent demographic shift is predicted to dampen economic growth already at the end of the programme period and lead to a smaller fiscal surplus. The macroeconomic scenario underlying the programme envisages that real GDP growth will moderate from the present cyclical peak to about 3% in 2008-2009 and slow further to just above 2% by 2011. Judging from currently available information, this scenario appears to be based on plausible growth assumptions**,** leaning towards the cautious side for 2010 and 2011. While the economic conditions are expected to shift from "good times" to neutral during 2008, it is not implausible that the favourable economic conditions of the previous years extend longer into 2008. Therefore, the judgement of economic conditions could change to “good times” for that year.

For 2007, the general government surplus is estimated at 4.5% of GDP in the current programme update, broadly in line with the Commission services’ autumn 2007 forecast. This is considerably higher than the surplus target of 2.8% of GDP set in the previous update of the stability programme. The higher surplus is due to the carry-over from the better-than-expected outcome in 2006 and the positive growth surprise in 2007, boosting government revenue, while expenditure has been largely contained in line with earlier plans.

The programme's central objective is to ensure sustainability of public finances in the face of population ageing. As in the previous programme, Finland's medium-term objective (MTO) for the budgetary position is defined as a general government surplus of 2% of GDP in structural terms. The headline and the primary balance are set to decline in each year, albeit from a high level in 2007. The programme plans to maintain structural surpluses above the MTO throughout the programme period. Compared with the previous programme, the new update projects the structural surplus to be 1½ percentage points higher in 2007, but by 2010 both updates project the same structural balance. The steeper fall in the surplus in the most recent update is explained by the expenditure ratio declining only marginally while the revenue ratio drops more substantially. The latter reflects the phasing in of announced tax cuts as well as cautiously projected revenues in response to GDP growth. The less marked decline in the expenditure ratio compared with the previous programme reflects a step increase in the multi-annual budgetary ceilings for central government, with expenditure increases being frontloaded to 2008, the first budget year of the new government.

The risks to the budgetary projections in the programme appear broadly balanced. In 2008, the budgetary outcome could be better than projected in the programme given the markedly cautious tax revenue assumptions for that year. Some risks could arise from rapid wage growth in the public sector, putting upward pressure on expenditure. On the

other hand, the cautious growth projections for the outer years, combined with conservative revenue assumptions, counterbalance the negative risks.

In view of this risk assessment, the budgetary stance in the programme would allow to meet the MTO by a comfortable margin throughout the programme period. This is in line with the Stability and Growth Pact. However, a fiscal expansion is planned in 2008, indicated by a decline in the structural surplus of ½ percentage point of GDP according to the Commission services' autumn forecast and 1 percentage point according to the programme. While economic conditions are expected to shift from "good times" to neutral during 2008, as mentioned above, it is not implausible that the favourable economic conditions of the previous years extend into 2008. Moreover, this period immediately follows the 2006-2007 cyclical peak in the economy, when some demand pressures have built up. Therefore, there is a risk that the fiscal policy stance implied by the programme may turn out to be pro-cyclical in 2008. Nevertheless, the potential pro-cyclical stimulus to the economy would likely be limited, given that a sizeable budgetary surplus would still be maintained and fiscal policy would assume a broadly neutral stance already in the following year.

In terms of the sustainability of public finances, Finland appears to be at low risk. While the long-term budgetary impact of ageing is higher than on average in the EU, enacted pension reforms have helped to contain the projected increase in pension expenditure over the coming decades. The budgetary position in 2007 as estimated in the programme, with a large structural surplus, contributes significantly to offsetting the long-term budgetary impact of ageing and the large assets accumulated by the public pension schemes will help finance part of the increase in pension expenditure. Maintaining high primary surpluses over the medium term would contribute to limiting risks to the sustainability of public finances.

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of the October 2007 implementation report of Finland's national reform programme.[1] Finland identified as key challenges the sustainability of public finances in the face of population ageing, improving competitiveness and productivity, and improving the functioning of the labour market. The Commission's assessment was that Finland had made very good progress in implementing its National Reform Programme. Against the background of strengths and weaknesses identified and the evidence on progress made, the Commission recommended that Finland should focus on the areas of competition and productivity in services, measures to reach its Kyoto target, labour market reforms with a particular view to structural unemployment, unemployment of low skilled workers and young people, and promoting economic migration. The stability programme seems to be consistent with the implementation report of the National Reform Programme. In particular, the measures to contain the population ageing risks are an integral part of both programmes' strategy. The multi-annual expenditure ceilings of the central government, which form the basis of the stability programme projections, will provide a firm limit to the costs of the National Reform Programme measures. The budgetary strategy in the stability programme is consistent with the broad economic policy guidelines for euro area Member States issued in the context of the Lisbon strategy.

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[1] Communication from the Commission to the European Council, "Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)", 11.12.2007, COM(2007)803.

The overall conclusion is that the programme envisages continued high surpluses, albeit declining over the programme period. While the risks attached to the budgetary targets are balanced overall, the programme's fiscal projections appear somewhat cautious for 2008. The medium-term budgetary position is sound and should limit the risks to long-term sustainability. Continuing with expenditure restraint will remain crucial to stem the risk of a pro-cyclical fiscal policy stance in 2008 and to adjust to the lower growth path and the implied slower growth of tax revenue over the programme period.

Comparison of key macroeconomic and budgetary projections

		2006	2007	2008	2009	2010	2011
Real GDP (% change)	**SP Nov 2007**	**5.0**	**4.4**	**3.3**	**3.0**	**2.5**	**2.1**
	COM Nov 2007	5.0	4.3	3.4	2.8	n.a.	n.a.
	SP Dec 2006	*4.5*	*3.0*	*2.9*	*2.6*	*2.1*	*n.a.*
HICP inflation[4] (%)	**SP Nov 2007**	**1.6**	**2.4**	**2.4**	**2.2**	**2.0**	**2.0**
	COM Nov 2007	1.3	1.5	2.4	2.1	n.a.	n.a.
	SP Dec 2006	*1.5*	*1.3*	*1.7*	*1.7*	*1.7*	*n.a.*
Output gap[1] (% of potential GDP)	**SP Nov 2007**	**-0.3**	**0.6**	**0.7**	**0.5**	**-0.1**	**-0.7**
	COM Nov 2007[2]	-0.4	0.4	0.5	0.1	n.a.	n.a.
	SP Dec 2006	*0.1*	*0.2*	*0.1*	*-0.2*	*-0.8*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**SP Nov 2007**	**4.8**	**4.9**	**4.6**	**5.0**	**5.0**	**4.8**
	COM Nov 2007	5.9	5.3	5.2	5.1	n.a.	n.a.
	SP Dec 2006	*5.4*	*4.8*	*4.6*	*4.4*	*4.1*	*n.a.*
General government balance (% of GDP)	**SP Nov 2007**	**3.8**	**4.5**	**3.7**	**3.6**	**2.8**	**2.4**
	COM Nov 2007	3.8	4.6	4.2	4.0	n.a.	n.a.
	SP Dec 2006	*2.9*	*2.8*	*2.7*	*2.7*	*2.4*	*n.a.*
Primary balance (% of GDP)	**SP Nov 2007**	**5.3**	**6.0**	**5.2**	**5.0**	**4.1**	**3.6**
	COM Nov 2007	5.3	6.0	5.6	5.3	n.a.	n.a.
	SP Dec 2006	*4.5*	*4.3*	*4.2*	*4.1*	*3.7*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**SP Nov 2007**	**4.0**	**4.2**	**3.3**	**3.3**	**2.8**	**2.8**
	COM Nov 2007	4.1	4.4	3.9	4.0	n.a.	n.a.
	SP Dec 2006	*2.9*	*2.7*	*2.7*	*2.8*	*2.8*	*n.a.*
Structural balance[3] (% of GDP)	**SP Nov 2007**	**4.0**	**4.2**	**3.3**	**3.3**	**2.8**	**2.8**
	COM Nov 2007	4.1	4.4	3.9	4.0	n.a.	n.a.
	SP Dec 2006	*2.9*	*2.7*	*2.7*	*2.8*	*2.8*	*n.a.*
Government gross debt (% of GDP)	**SP Nov 2007**	**39.2**	**35.3**	**32.8**	**30.4**	**29.0**	**27.9**
	COM Nov 2007	39.2	35.7	32.4	29.8	n.a.	n.a.
	SP Dec 2006	*39.1*	*37.7*	*36.2*	*35.0*	*33.7*	*n.a.*

Notes:

[1]Output gaps and cyclically-adjusted balances from the programmes as recalculated by Commission services on the basis of the information in the programmes.

[2]Based on estimated potential growth of 3.4%, 3.4%, 3.2% and 3.2% respectively in the period 2006-2009.

[3]Cyclically-adjusted balance excluding one-off and other temporary measures. No one-offs have been identified in the most recent programme or in the Commission services' autumn forecast.

[4] Instead of HICP, the programme gives the national CPI index, which is markedly higher for 2007, but the difference between the indexes is minimal from 2008 onwards. The Finnish authorities have indicated that the correct HICP values would be 1.3%, 1.6%, and 2.3% for 2006-2008 respectively. In the outer years there is no difference between the two series.

Source:

Stability programme (SP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

1. INTRODUCTION

The Finnish stability programme update was submitted on 29 November 2007[2]. The programme covers the period from 2007 to 2011. The programme has been approved by the government in a plenary session and was presented to the Finnish parliament for a debate without a vote. The programme builds on the 2008-2011 central government spending limits decision and on the 2008 budget proposal, as well as related economic policy guidelines.

This assessment is further structured as follows. Section 2 discusses key challenges for public finances in Finland, with a particular focus on fiscal policy to prepare for slowing potential growth. Section 3 assesses the plausibility of the macroeconomic scenario underpinning the public finance projections of the stability programme against the background of the Commission services' economic forecasts. Section 4 analyses budgetary implementation in the year 2007 and the medium-term budgetary strategy outlined in the new programme. Taking into account risks attached to the budgetary targets, it also assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact. Section 5 reviews recent debt developments and medium-term prospects, as well as the long-term sustainability of public finances. Section 6 discusses the quality of public finances and structural reforms, while Section 7 analyses the consistency of the budgetary strategy outlined in the programme with the National Reform Programme and its implementation reports and with the broad economic policy guidelines. The annexes provide a detailed assessment of compliance with the code of conduct, including an overview of the summary tables from the programme (Annex 1) and selected key indicators of past economic performance (Annex 2).

2. KEY CHALLENGES FOR PUBLIC FINANCES WITH A PARTICULAR FOCUS ON FISCAL POLICY TO PREPARE FOR SLOWING POTENTIAL GROWTH

Over the past decade, the performance of the Finnish economy has been outstanding. Average economic growth rates have been well above the euro area average while inflation has remained low. 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. However, in the medium to long term, new challenges will arise principally from population ageing. Additionally, it is likely that the gradually maturing ICT sector, which boosted growth in the past decade, will not add to growth to the same exceptional degree. The rate of growth will hinge on the performance of the already mature and inherently slower-growing industry and service sectors. Slower growth would imply also less room for public expenditure growth. Ultimately, it is the pace of economic expansion that will define the limits for growth in public revenues, expenditure and provision of public goods. The following sections will analyse some of the principal challenges to the Finnish economy (potential output growth) and its implications for public finances and policy.

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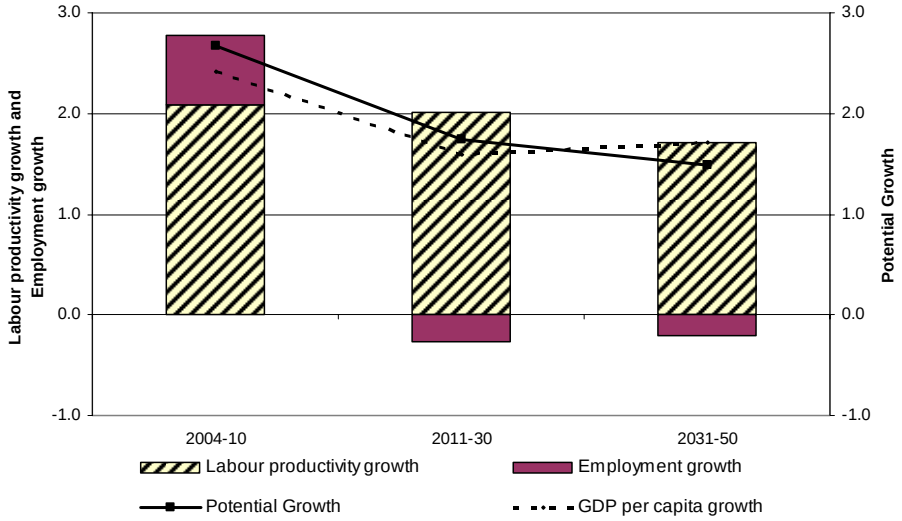
[2] The English language translation was presented on the same day.

2.1. Challenges to potential growth

As a consequence of population ageing, Finnish growth potential is assumed to drop significantly lower than in the previous decades. Annual GDP growth in the long term is assumed to be about 1 percentage point lower on average than presently (Figure 1). This arises principally from the decline in the labour input, while labour productivity is assumed to grow relatively stable at about 2% per annum. However, also productivity growth would be about ½ percentage point lower than the average over the past decade (1996-2005). In the absence of a growth contribution from employment, labour productivity would become the sole driver of growth in the coming decades. The latter is in effect determined by TFP growth.

Figure 1: Projected potential growth rates and its determinants



Source:

Commission services (ECFIN special report no 1/2006 "The impact of ageing on public expenditure")

There is a fair degree of uncertainty attached to these estimates. The growth performance could well be weaker or stronger depending on several factors. While acknowledging that the factors influencing a country's potential growth are complex and difficult to foresee for the long term, the following section will present the main assumed challenges to the future growth potential.

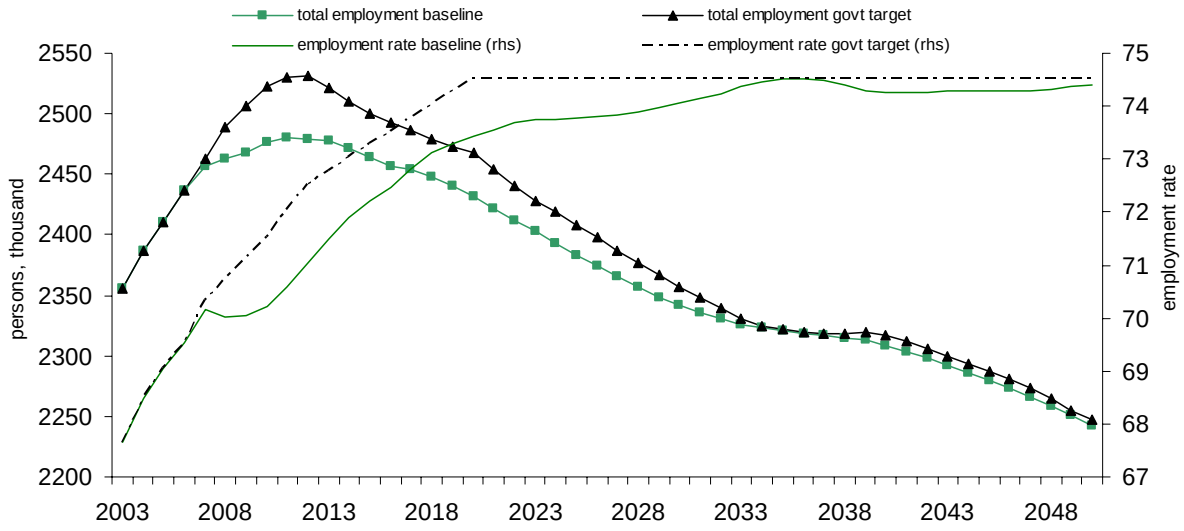
2.1.1. Smaller and older workforce

In a 50 year perspective, the decline in the working age population is projected to be slightly less severe in Finland than on average in the other Member States[3]. However, for Finland the challenge of ageing population is particularly immediate as it is one of the first countries in Europe where labour supply will start to shrink. Working age population will turn to a sudden decline already at the turn of the present decade, which will result in a negative impact on the labour input component of GDP growth. During

[3] European Commission, DG ECFIN (2006), "The impact of ageing on public expenditures: projections for the EU-25 Member States on pensions, healthcare, long--term care, education and unemployment transfers (2004-2050)", European Economy, Special Report No 1

the first decades of the 50 year projection period, Finland will likely have to cope with the highest old-age dependency ratio in the EU[4]. As a result, the potential growth estimates presented above in Figure 1 indicate that about 1 percentage point is shaved off annually from growth during the 2010-2030 period. The decline in the working age population can be partly offset by raising the employment rate. Although the current Finnish employment rate of about 70% of the working age population is already at a high level by European standards, it still lags behind its Nordic peers. The economic strategy of the new government attaches great importance to employment measures to boost the growth potential of the economy[5]. The government has set the ambitious target of increasing employment to about 72% of the working age population by 2011 (which would translate to about 80 000 new employees) and further to 75% in the long term. This would imply that between 2010 and 2020 employment would be on average about 40 000 higher than in the baseline scenario (see Figure 2). Still, in the long term the projected decline in working age population will inevitably cause a dramatic fall in employment.

Figure 2: Number of employed based on two alternative employment rate assumptions



Source:

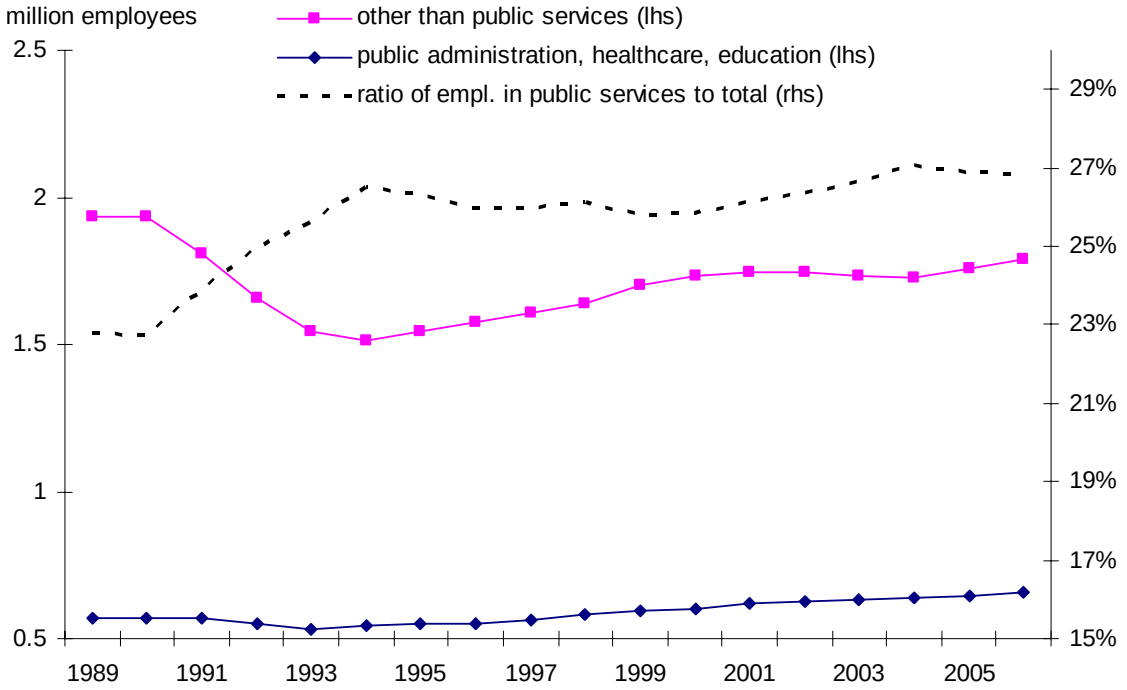
Commission services (ECFIN special report no 1/2006 "The impact of ageing on public expenditure")

Besides the purely quantitative effects, changes in the population structure are also assumed to impact qualitative factors, which might affect negatively TFP growth. The working age population cohorts will shift towards older generations. The cohorts between the ages of 30-50, considered to be at the prime working age, will be reduced by 2050 by about 140 thousand or 11% from the present levels, while the cohort of workers above 50 years of age will even increase marginally.

[4] The most recent population projection by Statistics Finland in 2007, referred to also in the current Stability Programme update, forecasts an even more elevated dependency ratio, arising mostly from a higher projected number of senior citizens.

[5] Economic Strategy 2007, Ministry of Finance, 6/2007

Figure 3: Employment in public services (public administration, healthcare, education)



Source: Statistics Finland, labour force survey

Figure 3 tracks the employment trends in public administration-, health- and education services, the bulk of which are provided by the public sector. Although the provision of these services can be transferred to a larger extent from public to private sector, the underlying structure of the economy and implications for the growth potential would not change from merely switching the service provider. The share of employment in these sectors has been on a moderately rising path over the past decade even without ageing pressures. Notably, while the recession in the beginning of the 1990s cut employment in most sectors considerably, employment in public services remained inelastic to overall economic conditions, causing a sudden and permanent upward shift in its ratio to total employment. In the years to come, the decline in working age population might have a disproportionately large negative effect on private sector employment and output, unless employment linked to the provision of public services would decline proportionally. Output in the ageing related services should grow to match population ageing. This might crowd out employment in the other sectors of the economy. Projections indicate that by 2050 employment will decline by about 200 000 people, representing a decline of about 8% from overall employment. However, if employment in public sector related services were to remain constant, the decline in private sector employment alone would be 12%.

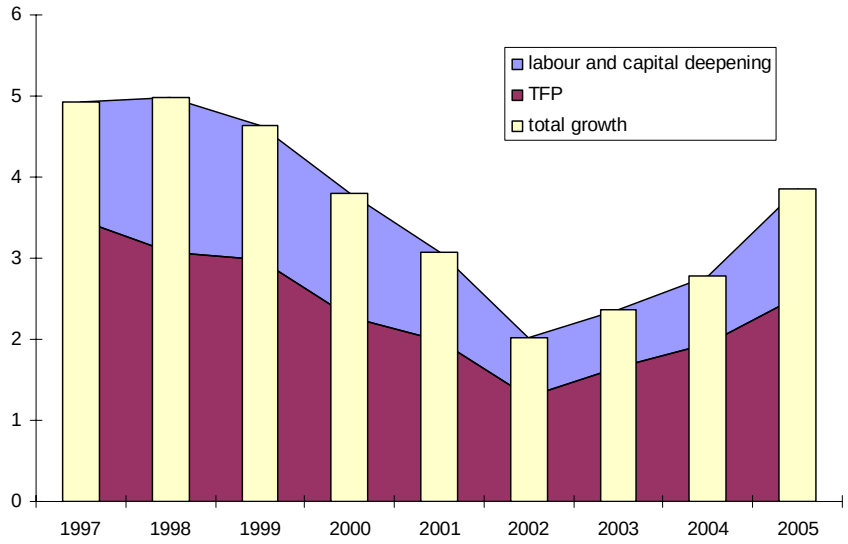
The threat of public sector employment crowding out private sector recruitment could materialise already in the medium term. Due to the present age structure in the Finnish public services, it is estimated that retirement from municipal and state employment will increase markedly from the end of the present decade, indicating higher staff replacement needs. This coincides with a reduction in the size of younger age cohorts entering the labour market. As a result, private sector recruitment possibilities will be constrained.

The government expects to ease the crowding out effects through its central government productivity programme, reducing state employment by about 10 thousand units by 2011 and by a further 5 thousand thereafter in the medium term (see Section 6). Increasing labour productivity in local government service provision and downscaling employment is not in the direct control of the central government. The government expects that the newly redesigned local government incentive systems and service provision models will increase productivity. However, the challenge is to downscale employment in an environment of rising service needs, as the local governments are responsible for providing the bulk of the ageing related services. The Stability Programme update assumes that by the end of the programme period in 2011, local government staff numbers would grow by 4 000 per year on account of health care and social welfare sector employment needs. Considering the overall magnitude of ageing pressures, it is likely that the efforts to downscale public sector will not entirely offset the overall employment decline and the relative size of the public sector will rise.

2.1.2. Weakening productivity growth due to maturing ICT sector

An outstanding feature of the economic performance of the Finnish economy over the past decade has been the dominance of total factor productivity (TFP) as the growth driver (see also section 2 of the Commission services technical assessment of the 2006 update of the stability programme). It accounted for about 2/3 of growth (see Figure 4). It also explains the large positive growth difference with the euro area average performance. Capital deepening did on average hardly contribute to growth and the contribution from the increase in labour input was overall marginal.

Figure 4: Share of TFP contribution to GDP growth



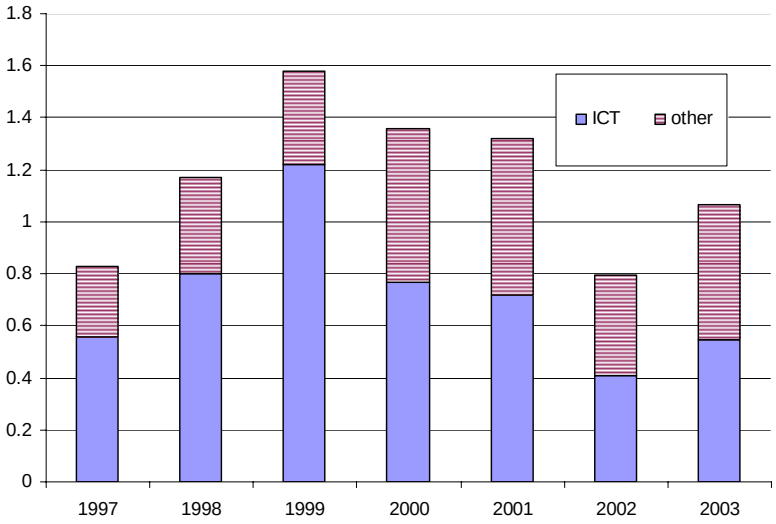
Note: Data is smoothed by using 3 year moving averages.

Source: Growth accounting data from previous stability programme assessment, Ameco

The TFP growth peak in the second half of 1990s reflected largely the restructuring of the economy after the crises of the early 1990s and the rapid rise of the emerging

telecommunications sector. Based on EU Klems data[6], it is evident that over half of the TFP growth was driven by manufacturing sectors. The overall trend indicates that the share of manufacturing in TFP growth has also been consistently increasing over the period. A further breakdown of TFP contributions by industry branches shows that the ICT sector is the main driver of industry TFP, but its importance has been declining (see Figure 3). The slowing growth contribution from ICT can be explained by the maturing and globalisation of the telecommunications sector, as the emerging markets increasingly enter this sector.

Figure 5: Contribution to industry TFP growth from ICT (percentage points of VA growth)



Notes:
- Data is smoothed by using 3 year moving averages.
- Figure 1 and 2 are not directly comparable due to different data sources and concepts of TFP used.

Source: EU Klems database and Commission services' calculations.

The above estimations do not take account of the terms of trade effects. In principle, the advances in productivity will be mirrored in falling product prices in a fiercely competitive world market (unless sufficiently compensated by producing more complex and expensive products). In effect, the productivity gains are passed on to consumers in the form of lower prices at the expense of producers. The falling export prices of ICT products means that the GDP measured in volume terms, as is the standard, somewhat overstates the gains to Finnish welfare[7].

In contrast to telecommunications manufacturing, most other industry sectors, including the dominant paper and metal engineering, have posted relatively modest productivity advances. This is partly due to productivity having already reached high levels by international standards and providing less growth opportunities in mature markets. The service sector, including public services, is found to be at relatively low productivity

[6] EU Klems data is not directly comparable with the growth accounting TFP data in the previous SP assessment due to differences in data and in concepts used.

[7] OECD (2004), Economic Surveys: Finland

levels by international standards[8]. From a forward-looking point of view, this indicates opportunities for faster growth in the service sector. The projections for the future would have to rely on the conservative assumption that the economy will not receive a similar exceptional boost as it did from the emergence of the ICT cluster. The overall TFP growth performance will likely be determined by the advances in the already mature industry and service sectors, including the public services.

Besides TFP growth, capital investment can also be an important determinant of labour productivity growth. The effects of demographic shifts on investment could be in opposite directions. On the one hand, there might be a drive to replace scarce labour input with capital. On the other hand, the declining working age population in Finland might discourage some investment oriented to the domestic market.

Notable effects on the economic growth potential could arise from factors that have little to do with population ageing. Finland might be highly susceptible to globalisation-driven shifts in the economy. Currently, the share of industry in total output is relatively high in Finland compared with the other euro area economies. Industry accounts for 26% of value added in Finland, while the euro area average is 20% (Ameco data). Conversely, the service sector is relatively small. In terms of employment in industry as a share of total, the difference with the euro area average is much smaller at just about 1 percentage point. This reflects the high productivity level of Finnish industry. Based on the experience of other highly developed mature European economies with high cost bases, it is often assumed that the Finnish economy might de-industrialise to some extent in the long term due to globalisation pressures. Relocation of manufacturing is already increasingly evident, especially in some labour intensive sectors. The trends in the past decade confirm that the share of industry in total output and in employment has gradually declined, both dropping by about 2 percentage points from 2000 to 2006. On the other hand, it is expected that many high value added industry functions, like R&D, and capital and skill intensive manufacturing are less likely to relocate. Finland benefits in this respect from its excellent education system, which provides for high-skilled labour.

The Finnish authorities have devoted much attention to the globalisation phenomenon and designed comprehensive strategies to succeed in the rapidly changing economic setting. The Finnish globalisation study[9] estimates that overall the country has benefited and could benefit also in the future from globalising markets. At the same time, globalisation would pose significant challenges. In theory, a shift in the structure of the economy from industry to services might in itself bring about consequences for economic growth. Over the past decade, growth of value added per person employed in services has been about one percentage point lower than in industry (Ameco data). This might be partly explained by the notion that many service sectors are inherently labour intensive and on average can not benefit from labour-capital substitution to the same extent as industry. Overall, it remains a challenge for Finland to achieve higher output growth in services to compensate for the possibly smaller growth contribution from industry sectors.

[8] See the previous stability programme assessment section 2.

[9] Finland's response to the challenge of globalisation, Report by the Secretariat of the Economic Council, Prime Minister's Office Publications, 19/2006

2.2. Policy responses

As presented in the above sections, it is likely that the pace of GDP growth will be considerably lower in the future decades. While some of the factors behind the slowdown are inevitable, policy measures can have an important impact on strengthening the growth potential. Nevertheless, fiscal policy should also prepare for the high likelihood that the growth performance will be lower than the norm in the past decades.

2.2.1. Structural measures to raise growth potential

In terms of productivity growth, the eventual success of the Lisbon-related government measures to increase competition in product and service markets are crucial. Especially the underperforming service sector indicates potential to stimulate competition and productivity. Based on current trends, it is likely that the overall productivity performance will be increasingly based on the advances in the service sectors and the already mature industry sectors. The growth contribution from the ICT sector could prove volatile and non-permanent. Furthermore, fostering productivity increases in the government sector itself would be important in order to curb public sector expenditure and employment pressures. Appropriately, the government has designed programmes to increase productivity in the state and local government level by means of substituting scarce labour with a more efficient organisation of functions and better utilisation of ICT. The aim of the government to raise R&D expenditure from the present 3.5% of GDP to 4% of GDP in the medium term would also contribute to TFP growth.

Increasing the employment rate would have significant positive effects on the growth performance. The ambitious targets of the government are well justified in this respect. However, as the employment rate is already at high levels and taking account of the relatively high NAIRU estimate, it will be challenging to bring about substantial additional increases in employment. Progress in meeting the employment targets will hinge on the effectiveness of the new government labour market measures to stimulate labour supply (including the review of tax and benefits disincentives to taking up a job) and on the strength of economic activity creating labour demand. In addition to the employment targets, it is also essential to increase the productivity of the existing workforce. As the older population cohorts will grow in relative size, the life-long-learning programmes and maintaining the flexibility of skills development in the labour market will become increasingly important.

2.2.2. Adapting public finances to lower growth and ageing

The lower growth potential will pose a major challenge for fiscal policy. Ageing-related expenditure will rise by about 5 percentage points of GDP by 2050 (See Table 9 in Section 5.2). This is higher than in the EU on average and Finland is one of the first countries where the ageing related effects will kick in. Financing problems are aggravated by the predicted slow-down of potential economic growth in the long term and correspondingly slower growth in the tax bases. Nevertheless, simulations indicate that Finnish public finances are relatively well prepared for the ageing challenge, on account of its current high structural surplus and having already accumulated sizeable assets to pre-fund future pension payments. However, these simulations imply that in the long-term expenditure outlays other than the already mentioned ageing related costs (which are assumed to be covered at the expense of the present surplus) can only grow at the same pace as overall revenue growth. Since the already high tax burden by international standards will limit the potential to raise taxes, revenue growth is likely to

be highly correlated with the pace of economic growth. For public finances this implies that the room to increase central and local government expenditure will be smaller than what the citizens have grown accustomed to.

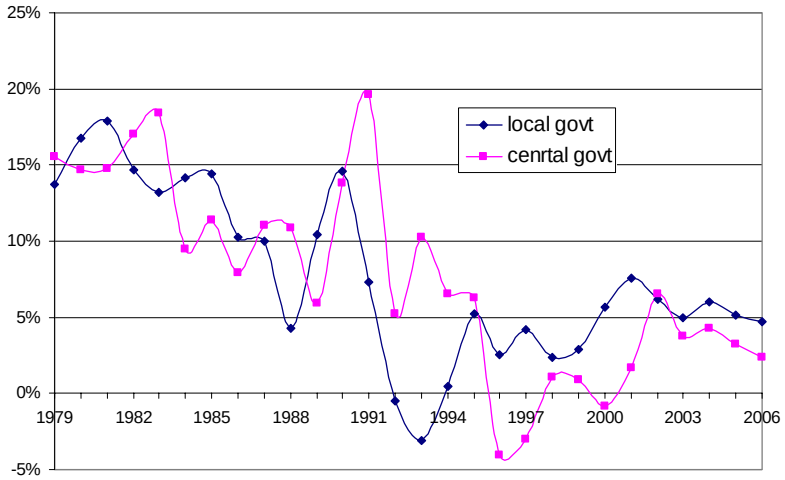
Central and local government expenditure planning needs to adapt to the new environment of persistently lower economic growth and weaker revenue flows. Broadly, if the potential of economic growth would be about 1 percentage point lower than presently, then ceteris paribus revenue and expenditure growth would be lower by about the same amount. In practice, it could mean that the present yearly average nominal general government expenditure growth of about 4% should be cut to about 3%.

The government has presently designed two principal tools for expenditure control: the central government expenditure ceilings system and public sector productivity programmes (see the Finnish National Reform Programme), including the redesigning of local government service provision. There appears to be ample room to increase public sector productivity. The phenomenal performance of the ICT sector has masked the relatively mediocre productivity advances in other sectors, including public services and administration. The future productivity developments in the public sector are key to containing expenditure pressures.

Central government spending ceilings have recently worked well to contain spending while revenue intake has been above expectations. However, when revenue surprises would tend to be negative, the pre-fixed medium term expenditure commitments could produce a deficit bias. The expenditure setting framework would have to adjust to the imminent change in the economic environment.

It would be crucial to design appropriate expenditure control mechanisms also for the local governments, where expenditure growth has been persistently higher than in the central government in recent years (see Figure 6). In addition, expenditure on those ageing related services which are provided by the local governments will rise by 2½ percentage points of GDP by 2050 (see Table 9 in section 5.2).

Figure 6: Nominal growth in central and local governments



Source: Statistics Finland

Since local governments account for about 40% of all public expenditures, the burden of adjusting to a lower expenditure growth path would be too high to be borne solely by the central government.

2.3. Conclusion

The strong initial position of public finances has enabled Finland to limit the ageing-related risks to public finances. However, it is likely that the growth rate of the Finnish economy will be increasingly determined by the performance of the already mature and inherently slow-growing industry sectors and services. Additionally, the effects from population ageing will cut considerably the growth potential of the economy. As a consequence, local and central government tax revenue growth would be considerably slower than in the previous decade, which sets a strong constraint on expenditure growth. Finnish public finances need to adjust already in the medium term to an environment of on average permanently slower growth.

The long-term policy challenge is twofold: increasing the growth potential of the economy and containing expenditure pressures. The largest effect on the growth potential could be expected from structural measures to boost employment and promote productivity growth. Expenditure restraint would have to be achieved not only at the central government level, where progress has been visible, but also at the level of local governments. In the same vein, efficiency in the public sector should be improved with a view to scaling down public sector employment in line with the overall decline in employment, while maintaining the quality of services. The Finnish government appears to be taking steps in the right direction on both issues through its Lisbon agenda reform measures to boost growth and jobs and its central government productivity programme and redesigning local government service provision. Considering the past trends in local government expenditure growth and public sector employment, it appears that the main challenge lies in controlling local government expenditure growth.

3. MACROECONOMIC OUTLOOK

This section assesses the plausibility of the macroeconomic scenario (economic activity, labour market, costs and prices) underpinning the public finance projections of the programme. It also examines whether good or bad economic times in the sense of the Stability and Growth Pact prevail.

3.1. Economic activity

At close to 4½ %, GDP growth in 2007 turned out significantly higher than expected at the beginning of the year. In the medium term, the programme update projects real GDP growth to weaken continuously, dropping significantly to just above 2% by 2011 (see Table 1). The slowdown of growth is expected to be especially steep in 2008, reflecting the weakening cyclical position after the economic boom in 2006-2007. A further downward shift in the growth path is expected towards the end of the programme period due to the population ageing effects. The slowdown is driven by the domestic demand components. Both private consumption and investment growth are projected to decelerate steeply. At the same time the external sector is seen to remain strong, so that its share as the driver of growth would increase over time. The weaker growth performance would imply returning closer to the average growth rates between 2001-2005 (see Annex 2), a period which covers the previous cyclical trough.

Table 1: Comparison of macroeconomic developments and forecasts

	2007		2008		2009		2010	2011
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	4.3	4.4	3.4	3.3	2.8	3.0	2.5	2.1
Private consumption (% change)	3.5	4.0	3.4	3.8	2.3	2.3	1.6	1.3
Gross fixed capital formation (% change)	5.3	5.0	4.0	3.1	3.1	2.5	2.4	2.2
Exports of goods and services (% change)	5.8	5.7	5.2	4.7	5.1	5.0	4.5	4.0
Imports of goods and services (% change)	3.9	4.4	4.6	3.8	4.2	3.0	2.8	2.6
Contributions to real GDP growth:								
- Final domestic demand	3.1	3.2	3.0	2.9	2.2	2.0	1.6	1.4
- Change in inventories	0.2	0.4	0.0	-0.3	0.0	0.0	0.0	0.0
- Net exports	1.0	0.8	0.5	0.6	0.6	1.0	0.9	0.7
Output gap[1]	0.4	0.6	0.5	0.7	0.1	0.5	-0.1	-0.7
Employment (% change)	1.8	1.8	0.8	0.6	0.3	0.4	0.1	-0.1
Unemployment rate (%)	6.7	6.7	6.4	6.3	6.3	5.8	5.6	5.6
Labour productivity (% change)	2.5	2.5	2.7	2.7	2.5	2.6	2.4	2.2
HICP inflation (%)[2]	1.5	2.4	2.4	2.4	2.1	2.2	2.0	2.0
GDP deflator (% change)	1.9	2.7	2.3	2.7	1.8	2.0	1.8	1.8
Comp. of employees (per head, % change)	3.3	3.7	5.1	5.1	4.3	5.0	4.0	4.0
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	5.3	4.9	5.2	4.6	5.1	5.0	5.0	4.8

Note:

[1] In percent of potential GDP, with potential GDP growth according to the programme as recalculated by Commission services.

[2] The most recent programme provides inflation projections on the basis of the national CPI rather than the HICP. CPI inflation was markedly higher than HICP inflation in 2007. The Finnish authorities have indicated that the corresponding HICP inflation projections are 1.3%, 1.6%, and 2.3% for 2006-2008 respectively and that there would be no difference between both series in the remaining years.

Source:

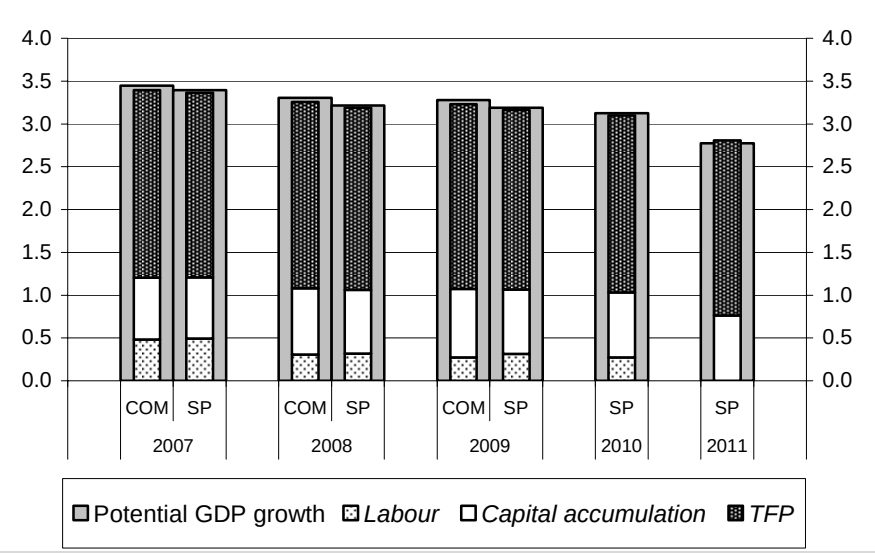
Commission services' autumn 2007 economic forecasts (COM); Stability programme (SP)

The growth projection and profile is broadly in line with that of the Commission services' forecast extending to 2009, with some discrepancies, however[10]. The programme predicts private consumption growth to be somewhat more robust in 2007 and 2008, but the two projections are in line for 2009 in that respect. Conversely, the Commission services forecast higher growth in investment, so that the differences on the aggregate domestic demand level are minor. The contribution to growth from net exports is seen to develop similarly up to 2008, but is forecast by the Commission services to be somewhat weaker in 2009. The projected deceleration of GDP growth in 2010 and 2011 to just 2.5% and 2.1% respectively is conceivable, taking regard of the ageing effects. However, judging by the growth potential of about 3% for these years, as recalculated by the Commission services based on the information in the programme (see Box 1), the programmes' growth projections appear somewhat cautious for the outer years of the programme.

Box 1: Potential growth and its determinants

The figure below compares the potential growth estimates of the Commission services' autumn 2007 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.

Potential growth and its determinants



Potential growth is predicted to fall below 3% by the end of the programme period. This would be over half a percentage point lower than the average growth in the past ten years (see Annex 2). The lower growth potential is largely explained by the decline in the labour input component, while the contribution from TFP and capital accumulation are assumed to remain relatively stable.

The output gap and potential growth estimates, as recalculated by Commission services, indicate that the economy is growing well above potential in 2007, returning towards its potential in 2008 and 2009. While growth decelerates strongly in 2008, it would still

[10] The external outlook behind the programme's macroeconomic scenario is broadly in line with that in the Commission services' autumn 2007 forecast.

remain slightly above the estimated potential. Thus, the positive output gap estimate remains unchanged in 2008. However, from 2009 to 2011, the output gap would widen continuously to clearly negative levels (see Table 1).

3.2. Labour market and cost and price developments

Robust economic growth during the past years has been reflected in strong job creation and a sharp fall in unemployment, declining by about 1 percentage point from the previous year to settle under 7% of the labour force in 2007. However, vacancies have also consistently risen and structural bottlenecks in the labour market are weighing on further rapid labour market improvements. The programme expects that the government labour market measures would ease labour market mismatches to some extent, further increasing employment and reducing unemployment, albeit at a considerably slower pace in line with the slowing growth profile. The historic average labour content of GDP growth would be broadly maintained. The programme's expectations for labour market developments are in line with those in the Commission services' forecast up to 2008, but are assumed somewhat more favourable for 2009 concerning unemployment reduction. The programme expects unemployment to still decline significantly in 2009, by close to half a percentage point, even though employment growth is assumed to slow down markedly by 2009. The outer years of the programme horizon are characterised by a combination of low growth (as measured by the widening output gap) and declining labour supply, resulting in a halt in labour market improvements. Wage growth in both private and public sectors will accelerate sharply in 2008 and remain unusually high also in the following years. Wage growth in some public sector branches (for example healthcare) is even set to exceed considerably the national average. Wages are largely determined by the recently concluded sectoral wage agreements, which provided for exceptionally high rises for the next 2-3 years. This reflects the wage pressures that have built up over the previous years and the increasingly tight labour market.

The programmes' inflation outlook is similar to that of the Commission services' forecast. Inflation is seen to accelerate from the markedly low levels recorded in the past years (see Annex 2) and stabilise at slightly above 2%[11]. This is in line with the sharp rise in wages in 2008 and 2009 whilst productivity growth is seen to remain flat. The forecast for wage growth are similar for 2007 and 2008, but slightly higher in the programme for 2009. While presently the external competitiveness of Finland appears strong after several years of relatively moderate unit labour cost rises, the implied strong labour cost pressures indicate a deterioration of external competitiveness in the medium term. This might undermine the programmes' expectation of the external sector retaining its strength over the medium term.

The programme projects a substantially higher GDP deflator for 2007 than the Commission services. Therefore, nominal GDP growth appears higher in the programme projections for that year, even though in volume terms growth is similar with the Commission services forecast. The discrepancy in the GDP deflator arises notably from a difference in the private consumption deflator for 2007. As mentioned above, private

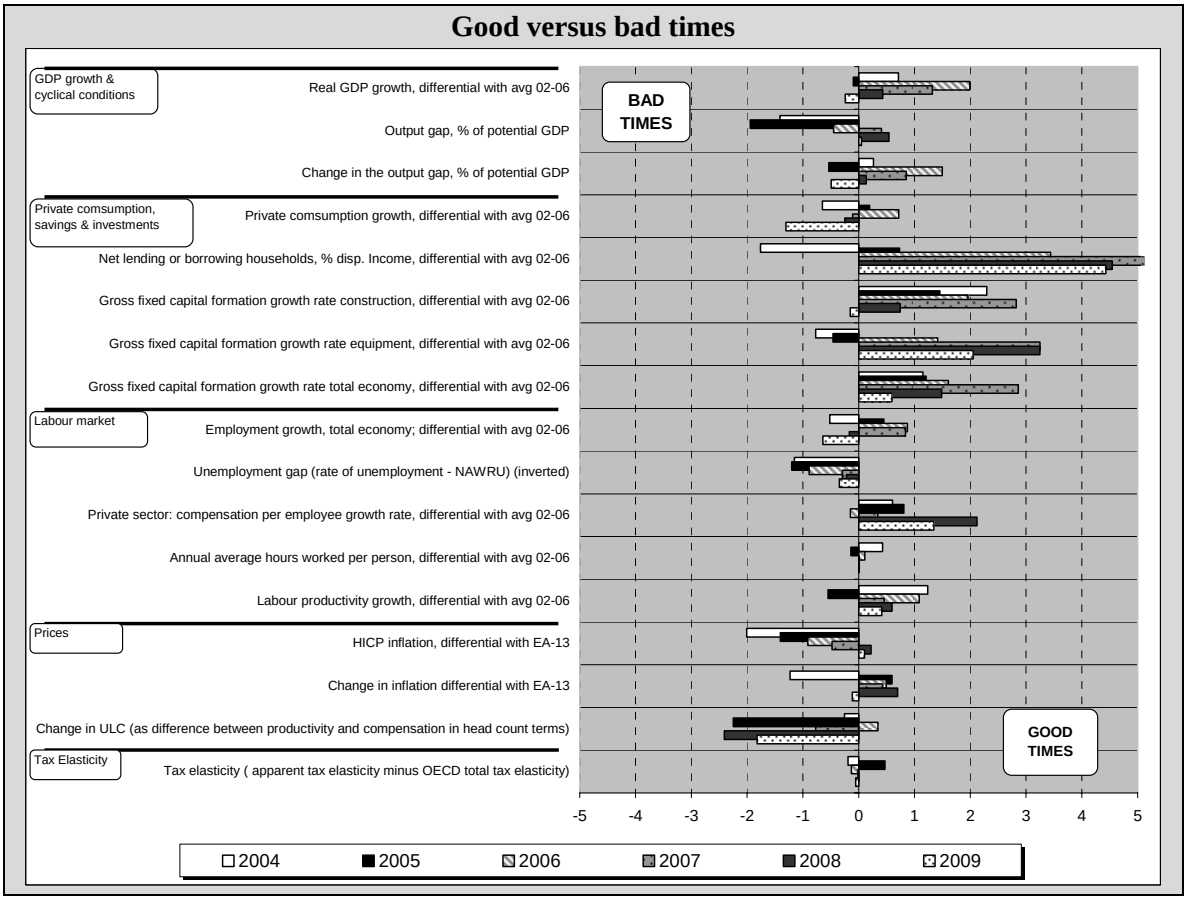
[11] Instead of HICP, the national CPI is given in the programme, incorrectly under the HICP name. There is currently a large divergence between the two index values due to differences in the index basket. The national one is about 1 percentage point higher in 2007, but the discrepancy is forecast to fade by 2008. The Finnish authorities have indicated that the corresponding HICP inflation projections are 1.3%, 1.6%, and 2.3% for 2006-2008 respectively and that there would be no difference between both series in the remaining years.

consumption volume growth is also forecast higher in the programme. In the aggregate, nominal private consumption growth, which is the principal tax base for VAT, is projected about one percentage point higher in the programme than in the Commission services forecast. However, discrepancies of smaller magnitude regarding investment projections work in the opposite direction and balance the differences in tax bases to some extent.

Box 2: Good or bad economic times?

According to the code of conduct, the assessment of whether the economy is experiencing good or bad economic times starts from the output gap, but draws on an overall economic assessment, which should also take into account tax elasticities. The figure below presents a set of macroeconomic indicators drawn from the Commission services' autumn 2007 forecast.

The indicators presented in the figure confirm that economic activity is set to cool continuously from the 2006-2007 cyclical peak. 2008 can be characterised as a turning point from good to neutral times. While the output gap is still positive in 2008, the slowdown from the previous years is marked. Growth is predicted to remain at close to potential in 2008 and 2009. Private consumption and employment growth is forecast to weaken below its past average growth rate already in 2008. Investment growth is also forecast to abate. Contrary to the cyclical slowdown, the recently concluded wage bargaining round provided for a sharp rise in wage growth, well above its historical averages. As a result, inflation is also forecast to accelerate. The sharp rise in wages might give an additional boost to private consumption in the short run. Provided that the external sector would continue to benefit from solid global demand, the favourable economic conditions of the previous years might prevail longer. The tax elasticities presented in the figure compare the apparent tax elasticity in the Commission services' 2007 autumn forecast with the OECD ex-ante elasticity. The tax elasticities appear in line with the OECD ex-ante elasticity estimates. However, as the Commission autumn forecast includes the impact of tax cuts and such discretionary measures are not included in the OECD estimates, the underlying elasticities are therefore somewhat more favourable. Overall, while in the central scenario the economic conditions are expected to shift from "good times" to neutral during 2008, it is not implausible that the favourable economic conditions of the previous years extend into 2008. This would change the judgement of economic conditions to "good times" for that year.



4. GENERAL GOVERNMENT BALANCE

This section consists of four parts. The first part discusses budgetary implementation in the year 2007 and the second presents the medium-term budgetary strategy in the new update. The third analyses the risks attached to the budgetary targets in the programme. The final part assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact.

4.1. Budgetary implementation in 2007

Table 2 compares the 2007 revenue and expenditure targets (as a percentage of GDP) from the previous update of the stability programme with the results of the Commission services' autumn 2007 forecast. The difference between the revenue and expenditure targets for 2007 and the projected outcome is decomposed into a base effect, a GDP growth effect on the denominator and a revenue / expenditure growth effect[12]:

- The base effect captures the part of the difference that is due to the actual outcome for 2006 being different from what was projected in the previous update in the programme (either because the actual revenue / expenditure level in 2006 was different from the estimated outturn in the previous programme or because GDP turned out to be different from the scenario in the previous update of the programme). The base effect therefore also captures the effect of revisions to the GDP series.

[12] A fourth, residual component is usually small, except if there are very large differences between the autumn forecast and the target (the full mathematical decomposition is in the methodological paper mentioned above).

- The GDP growth effect on the denominator captures the part of the difference that is related to current GDP growth projections for 2007 turning out higher or lower than anticipated in the previous update of the programme (therefore reducing / increasing the denominator of the revenue and expenditure ratio).

- The revenue / expenditure growth effect captures the part of the difference related to the revenue / expenditure growth rate in 2007 turning out to be higher or lower than targeted in the previous update of the programme. This would typically be due to GDP developments different from those expected in the previous update of the programme, or as a result of apparent tax elasticities different from the ex ante tax elasticities (or both).

Table 2: Budgetary implementation in 2007

	2006		2007	
	Planned SP Dec 2006	**Outcome SP Nov 2007**	**Planned SP Dec 2006**	**Outcome SP Nov 2007**
Revenue (% of GDP)	51.9	52.6	51.4	51.9
Expenditure (% of GDP)	49.0	48.7	48.6	47.4
Government balance (% of GDP)	2.9	3.8	2.8	4.5
Nominal GDP growth (%)			4.0	7.2
Nominal revenue growth (%)			3.0	5.8
Nominal expenditure growth (%)			3.2	4.3
Revenue surprise compared to target (% of GDP)			**0.5**	
Of which [1]: 1. Base effect			0.7	
2. GDP growth effect on the denominator			-1.5	
3. Revenue growth effect			1.3	
Of which: due to a marginal elasticity of total revenue w.r.t. GDP larger than1 [2]			*-0.2*	
Expenditure surprise compared to target (% of GDP)			**-1.2**	
Of which [1]: 1. Base effect			-0.3	
2. GDP growth effect on the denominator			-1.4	
3. Expenditure growth effect			0.5	
Government balance surprise compared to target (% of GDP)			**1.7**	
Of which: 1. Base effect			1.0	
2. GDP growth effect on the denominator			-0.1	
3. Revenue / expenditure growth effect			0.8	

Notes:

[1] A positive base effect points to a higher-than-anticipated outcome of the revenue / expenditure ratio in 2006. A positive GDP growth effect (on the denominator) indicates lower-than-anticipated economic growth in 2007. A positive revenue / expenditure growth effect points to higher-than-anticipated revenue / expenditure growth in 2007. The three components may not add up to the total because of a residual component, which is generally small.

[2] Equal to (2)+(3). A positive sign means that the marginal elasticity of revenue with respect to GDP exceeds one.

Source:

Commission services

For 2007, the general government surplus is estimated at 4.6% of GDP in the Commission services' autumn 2007 forecast, against a target of 2.8% of GDP set in the previous update of the stability programme (see Table 2). The programme update's fiscal projections for 2007 are similar to those of the Commission services and thus broadly confirm the data in the above table. The higher-than-expected surplus arises mainly from the base effect and the revenue growth effect. These categories largely reflect the economic growth surprise in both 2006 and in 2007, which boosted tax revenue. In the central government, expenditure growth was largely contained by the expenditure ceilings, resulting in a higher-than-planned surplus. Local governments are predicted in the programme to record only a marginally stronger fiscal outcome compared with expectations a year ago.

4.2. The programme's medium-term budgetary strategy

This section describes the medium-term budgetary strategy outlined in the programme - and how it compares with the one in the previous update - as well as the composition of the budgetary adjustment, including the broad measures envisaged.

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

The programme's central objective is to ensure sustainability of public finances in the face of population ageing. As in the previous programme, Finland's medium-term objective (MTO) for the budgetary position is defined as a general government surplus of 2% of GDP in structural terms, i.e. in cyclically-adjusted terms net of one-off and other temporary measures. The programme plans to maintain structural surpluses well above the MTO throughout the programme period.

Moreover, the new government intends to make additional provisions for the ageing challenge. The government expects that structural reforms boosting employment could result in a surplus of 1% of GDP by 2011 in central government finances, which would be equivalent to a surplus of 3½ % of GDP on the general government level. This aim is about 1 percentage point higher compared with the previous programme update which aimed for balance in central government finances. Appropriately, the current programme projections do not factor in the potentially surplus-enhancing effects of the intended reforms.

Additionally, the government is committed to ensuring that, even in adverse economic conditions, the central government deficit does not exceed 2½ per cent of GDP. Taking account of the surplus in social security funds, this would keep general government finances close to balance even during economic downturns.

Table 3: Evolution of budgetary targets in successive programmes

		2006	2007	2008	2009	2010	2011
General government balance (% of GDP)	**SP Nov 2007**	**3.8**	**4.5**	**3.7**	**3.6**	**2.8**	**2.4**
	SP Dec 2006	*2.9*	*2.8*	*2.7*	*2.7*	*2.4*	*n.a.*
	COM Nov 2007	3.8	4.6	4.2	4.0	n.a.	n.a.
General government expenditure (% of GDP)	**SP Nov 2007**	**48.7**	**47.4**	**47.3**	**47.0**	**47.0**	**47.2**
	SP Dec 2006	*49.0*	*48.6*	*48.4*	*48.2*	*48.4*	*n.a.*
	COM Nov 2007	48.7	47.6	47.6	47.4	n.a.	n.a.
General government revenue (% of GDP)	**SP Nov 2007**	**52.6**	**51.9**	**51.0**	**50.6**	**49.8**	**49.6**
	SP Dec 2006	*51.9*	*51.4*	*51.1*	*50.9*	*50.8*	*n.a.*
	COM Nov 2007	52.5	52.1	51.8	51.4	n.a.	n.a.
Structural balance[1] (% of GDP)	**SP Nov 2007**	**4.0**	**4.2**	**3.3**	**3.3**	**2.8**	**2.8**
	SP Dec 2006	*2.9*	*2.7*	*2.7*	*2.8*	*2.8*	*n.a.*
	COM Nov 2007	4.1	4.4	3.9	4.0	n.a.	n.a.
Real GDP (% change)	**SP Nov 2007**	**5.0**	**4.4**	**3.3**	**3.0**	**2.5**	**2.1**
	SP Dec 2006	*4.5*	*3.0*	*2.9*	*2.6*	*2.1*	*n.a.*
	COM Nov 2007	5.0	4.3	3.4	2.8	n.a.	n.a.

Note:

[1]Cyclically-adjusted balance excluding one-off and other temporary measures. No one-offs have been identified in the most recent programme or in the Commission services' autumn forecast.

Source:
Stability programmes (SP); Commission services' autumn 2007 economic forecasts (COM)

The headline, primary and structural balances are set to decline in all years over the programme period, albeit from a high level in 2007 (see Tables 3 and 4). The decline in the surplus is especially steep in 2008, when the programme foresees a close to one percentage point weakening in the structural surplus, as recalculated by Commission services on the basis of the information in the programme. The Commission services' autumn forecast indicates a more modest ½ percentage point decline in the structural surplus in that year. A less marked weakening in surpluses is expected by the programme in 2010, when the ageing effects are expected to kick in strongly. Other years are broadly neutral in terms of the fiscal impulse.

Compared with the previous programme, the new update projects the structural surplus 1½ percentage points higher in 2007, but declining to the same level by 2010. The steeper fall in the surplus, compared with the previous programme, is explained by the expenditure ratio to GDP declining less while the revenue ratio drops more substantially, reflecting the phasing in of announced tax cuts, as well as cautiously projected tax elasticities. The higher expenditure reflects notably a step increase in central government multi-annual budgetary ceilings, with expenditure increases being frontloaded to the first yearly budget of the new government in 2008. The slightly downward sloping path of the nominal and structural balance in the outer years of the programme is unchanged from the previous programme.

Table 4: Composition of the budgetary adjustment

(% of GDP)	2006	2007	2008	2009	2010	2011	Change: 2011-2007
Revenue	**52.6**	**51.9**	**51.0**	**50.6**	**49.8**	**49.6**	**-2.3**
of which:							
- Taxes on production and imports	13.6	13.2	13.1	12.9	12.5	12.3	**-0.9**
- Current taxes on income, wealth, etc.	17.2	17.3	17.0	17.0	16.6	16.6	**-0.7**
- Social contributions	12.2	12.0	11.8	11.8	11.9	11.9	**-0.1**
- Other (residual)	9.6	9.4	9.1	8.9	8.8	8.8	**-0.6**
Expenditure	**48.7**	**47.4**	**47.3**	**47.0**	**47.0**	**47.2**	**-0.2**
of which:							
- Primary expenditure	47.3	45.9	45.8	45.7	45.7	46.0	**0.1**
of which:							
Compensation of employees	13.4	13.0	12.9	12.7	12.6	12.6	**-0.4**
Intermediate consumption	9.2	8.9	8.8	8.8	8.9	8.9	**0.0**
Social payments	18.0	17.3	17.3	17.3	17.5	17.8	**0.5**
Subsidies	1.3	1.3	1.3	1.3	1.2	1.2	**-0.1**
Gross fixed capital formation	2.4	2.5	2.6	2.5	2.5	2.4	**-0.1**
Other (residual)	2.9	2.9	3.1	3.1	3.1	3.1	**0.2**
- Interest expenditure	1.4	1.5	1.5	1.3	1.3	1.2	**-0.3**
General government balance (GGB)	**3.8**	**4.5**	**3.7**	**3.6**	**2.8**	**2.4**	**-2.1**
Primary balance	**5.3**	**6.0**	**5.2**	**5.0**	**4.1**	**3.6**	**-2.4**
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	0.0	**0.0**
GGB excl. one-offs	**3.8**	**4.5**	**3.7**	**3.6**	**2.8**	**2.4**	**-2.1**
Output gap[1]	-0.3	0.6	0.7	0.5	-0.1	-0.7	**-1.4**
Cyclically-adjusted balance[1]	4.0	4.2	3.3	3.3	2.8	2.8	**-1.4**
Structural balance[2]	**4.0**	**4.2**	**3.3**	**3.3**	**2.8**	**2.8**	**-1.4**
Change in structural balance		*0.2*	*-0.8*	*0.0*	*-0.5*	*-0.1*	
Structural primary balance[2]	5.4	5.7	4.8	4.6	4.1	4.0	**-1.7**
Change in structural primary balance		*0.3*	*-0.8*	*-0.2*	*-0.5*	*-0.2*	

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance as recalculated by Commission services on the basis of the information in the programme.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability programme; Commission services' calculations

4.2.2. The composition of the budgetary adjustment

As evident from Table 4, the decline in the surplus is driven by a notable decline in the revenue-to-GDP-ratio by 2.3 percentage points. In comparison, the expenditure ratio remains broadly stable. Even though government expenditure will rise strongly in 2008 (see Box 3), expenditure as a ratio to GDP would remain unchanged due to the exceptionally rapid rise in nominal GDP by about 6% in the same year. The peak in expenditure growth is also not evident when compared with the projections in the previous programme because the projection for nominal GDP growth has been raised by 2 percentage points. In 2009, nominal expenditure growth is projected to slow down substantially, broadly in line with nominal GDP growth, contained by the spending ceiling provisions. In the outer years of the programme period, ageing is expected to lead to a slowdown in economic growth and simultaneously to rising social expenditure. This would lead the expenditure ratio to rise. In terms of expenditure categories, social expenditure is seen to rise the fastest by about ½ percentage point of GDP over the

programme period, while the wage bill would decline as a ratio to GDP. The programme states that it takes account of the most recent wage settlements in its projections, provided that they were contracted to the date of the programme publication. However, there might be some upward risks associated with this expenditure category (see also Section 4.3). Interest expenditure as a ratio to GDP is set to decline, which also explains the steeper decline in the primary surplus.

The rapid decline in the revenue ratio by almost 2½ % of GDP is impacted by the several tax cuts of the new government, spread mostly to the final years of the legislative period. The largest tax cuts specified in the programme update relate to labour taxation by a total of € 2.4 billion (1.3% of 2007 GDP) and VAT on foodstuffs by € 500 million annually (0.3% of GDP) scheduled at the end of 2009. Energy taxes will be raised by €300 million (0.2% of GDP) in 2008. The exact timing of the income tax cuts will be decided by the government in a mid-term assessment, conditional on pay settlements and cyclical conditions. As indicated by the programme, the magnitude of cuts to taxes on labour might also change in the course of the legislative period, but the current programme includes, under a no-policy change assumption, the above mentioned amounts and provisional timing.

In net terms, the announced tax cuts amount to 1½ % of GDP. The total decline in the tax-to-GDP-ratio is almost one percentage point higher (2½ % of GDP). The programme assumes therefore a steeper decline in the overall revenue ratio to GDP than is implied by the net effect of the tax cuts. After taking into account the impact of the discretionary tax cuts, the elasticity of revenues to GDP seems on the low side. The elasticity appears especially unfavourable in 2008, where the tax to GDP ratio is set to decline by almost one percentage point, while the tax cuts to be implemented in that year account for just about 0.2% of GDP in net terms (see Box 3). The rapid decline in the revenue ratio to GDP is therefore for the most part explained by the assumed weakening of the tax to GDP ratio. As presented in more detail in the following Section 4.3 and Table 6, the programme appears to have used cautious tax elasticities particularly for 2008, possibly making extra provisions for the export-driven GDP growth composition (which is by nature less tax rich).

The fiscal performance of different government sectors is varied. The current social security surplus of over 3% of GDP is predicted to decline by about ½ pp. by 2011, in line with the demographic shifts. The overall decline in the general government surplus is seen to be driven by the central government, where the surplus of about 1½% of GDP falls to close to balance by 2010. Local government finances are predicted to remain close to balance, boosted somewhat by higher central government transfers and strong income tax receipts reflecting the wage rises. In the medium term, the general government surpluses will be solely upheld by social security .

Box 3: The budget for 2008

The draft central government budget for 2008 was presented on 13 September 2007. Significant amendments to both revenues and expenditures were presented on 23 November 2007 and the final version of the central government budget was adopted on 21 December 2008. Together with the amendments, the budget revenues amount to 45.5 billion euros and expenditures 43.6 billion euros, leaving a surplus of 1.9 billion euros. As also evident from the multi-annual expenditure ceilings decision, the new government has frontloaded its expenditure increases to its first legislative year in 2008. Expenditure is set to grow by almost 7% in nominal terms compared with the projected outcome in 2007. At the central government level, the budget targets a surplus

of about 1% of GDP in 2008, which is about ½ percentage point lower than the expected outcome for 2007. The target for the general government surplus in 2008 is 3.8% of GDP. The primary focus of the 2008 budget is on various employment measures, including the redesign of some of the existing ones, which would have little budgetary impact. There is no single large expenditure measure that would account solely for the sharp expenditure rise. A number of social and health programmes will lead to higher expenditure. Also, the rise in wage costs and public investment are responsible for some of the additional spending.

Main measures in the budget for 2008

Revenue measures*	Expenditure measures**
o Income tax cuts by € 500 million (-0.3% of GDP) o Lowering tax on pension income €200 million (-0.1% of GDP) o Increasing energy taxes € 300 million (0.2% of GDP)	o Various health and social welfare projects €224 million (0.1% of GDP o Education and R&D € 106 million (0.05% of GDP) o Subsidy for employment of young and disabled € 50 million (0.03% of GDP)

* Estimated impact on general government revenues.
** Estimated impact on general government expenditure.
Sources: Commission services and Budget Review 2008.

4.3. Risk assessment

This section discusses the plausibility of the programme's budgetary projections by analysing various risk factors. For the period until 2009, Table 5 compares the detailed revenue and expenditure projections in the Commission services' autumn 2007 forecast, which are derived under a no-policy change scenario, with those in the updated programme. While the table shows that the programme's revenue and expenditure ratios are significantly lower for 2007, the discrepancy arises for the most part from the higher denominator effect as the projected nominal level of GDP is higher in the programme (see Section 3.12). The underlying nominal revenue and expenditure levels in 2007 are similar in the Commission services' forecast and the programme. In 2008, the projections show a more notable discrepancy in nominal revenue and expenditure levels. Especially income tax and social security revenue accrual is assumed stronger by the Commission services, resulting in a higher surplus projection. Overall, the programme's surplus projections appear somewhat cautious for 2007 and more so for 2008, when the Commission services forecast a surplus of 4.2% of GDP against 3.7% of GDP in the programme. Due to the base effect, the difference persists in 2009.

A special factor which could result in an upward level shift in the surplus is related to statistical revisions regarding the treatment of property income from social security assets in investment funds. The Finnish employment pension schemes have in recent years rapidly increased their investment fund portfolio. A major part of investment funds' property income is not distributed to shareholders, but re-invested on their behalf (capitalization). Presently only the part being distributed is recorded as income of the pension funds. However, according to ESA95, also the reinvested part should be included in property income in national accounts. Statistics Finland and Eurostat are in the middle of discussions on the issue. If the revisions would be made, it would raise general government surplus retroactively from 2001 onwards. The impact on 2007 would be almost 0.4% of GDP, and likely of similar magnitude on the future years. Nevertheless, as noted in Section 5, this has no impact on the prospects of long-term sustainability.

Table 5: Comparison of budgetary developments and projections

(% of GDP)	2006	2007		2008		2009		2010	2011
	COM	COM	SP	COM	SP	COM[1]	SP	SP	SP
Revenue	**52.5**	**52.1**	**51.9**	**51.8**	**51.0**	**51.4**	**50.6**	**49.8**	**49.6**
of which:									
- Taxes on production and imports	13.6	13.4	13.2	13.3	13.1	13.2	12.9	12.5	12.3
- Current taxes on income, wealth, etc.	17.2	17.3	17.3	17.3	17.0	17.2	17.0	16.6	16.6
- Social contributions	12.2	12.1	12.0	12.0	11.8	12.0	11.8	11.9	11.9
- Other (residual)	9.5	9.3	9.4	9.2	9.1	9.1	8.9	8.8	8.8
Expenditure	**48.8**	**47.7**	**47.4**	**47.7**	**47.3**	**47.5**	**47.0**	**47.0**	**47.2**
of which:									
- Primary expenditure	47.3	46.2	45.9	46.2	45.8	46.1	45.7	45.7	46.0
of which:									
Compensation of employees	13.4	13.1	13.0	13.1	12.9	13.1	12.7	12.6	12.6
Intermediate consumption	9.2	9.1	8.9	9.1	8.8	9.2	8.8	8.9	8.9
Social payments	18.0	17.4	17.3	17.4	17.3	17.1	17.3	17.5	17.8
Subsidies	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.2	1.2
Gross fixed capital formation	2.4	2.4	2.5	2.5	2.6	2.6	2.5	2.5	2.4
Other (residual)	2.9	2.9	2.9	2.9	3.1	2.9	3.1	3.1	3.1
- Interest expenditure	1.6	1.5	1.5	1.5	1.5	1.4	1.3	1.3	1.2
General government balance (GGB)	**3.8**	**4.6**	**4.5**	**4.2**	**3.7**	**4.0**	**3.6**	**2.8**	**2.4**
Primary balance	**5.3**	**6.0**	**6.0**	**5.6**	**5.2**	**5.3**	**5.0**	**4.1**	**3.6**
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	**3.8**	**4.6**	**4.5**	**4.2**	**3.7**	**4.0**	**3.6**	**2.8**	**2.4**
Output gap[2]	-0.4	0.4	0.6	0.5	0.7	0.1	0.5	-0.1	-0.7
Cyclically-adjusted balance[2]	4.1	4.4	4.2	3.9	3.3	4.0	3.3	2.8	2.8
Structural balance[3]	**4.1**	**4.4**	**4.2**	**3.9**	**3.3**	**4.0**	**3.3**	**2.8**	**2.8**
Change in structural balance		*0.3*	*0.2*	*-0.5*	*-0.8*	*0.1*	*0.0*	*-0.5*	*-0.1*
Structural primary balance[3]	5.5	5.8	5.7	5.3	4.8	5.3	4.6	4.1	4.0
Change in structural primary balance		*0.3*	*0.3*	*-0.5*	*-0.8*	*0.0*	*-0.2*	*-0.5*	*-0.2*

Notes:

[1]On a no-policy-change basis.

[2]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission services on the basis of the information in the programme.

[3]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability programme (SP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

The macroeconomic scenario underlying the fiscal projections should not give rise to major risks. In the medium term, risks are limited by the somewhat cautious growth assumptions from 2010 onwards. Additionally, growth is assumed to be increasingly export-driven with a declining contribution from domestic demand. Since export-driven growth is generally less tax intensive than domestic-demand-based growth, the tax elasticities would also be conservatively set. This is confirmed by the underlying data of Table 6 by tax categories, adjusted for the announced tax measures. If the external environment or Finnish external competitiveness turned out weaker than assumed in the programme, it would entail less risks for tax accrual.

As noted in section 3.1, the projections for nominal growth of private consumption could be somewhat optimistic in the programme, implying a higher tax base for 2008. On the other hand, as evident from the underlying data of Table 6, this is balanced by the low tax elasticity assumptions specifically for 2008, concerning VAT and also direct taxes. As a result, the projected nominal VAT revenue is closely in line with the Commission services forecast.

Table 6: Assessment of tax projections

	2008			2009			2010	2011
	SP	COM	OECD[3]	SP	COM[1]	OECD[3]	SP	SP
Change in tax-to-GDP ratio (total taxes)	-0.6	-0.2	-0.2	-0.2	-0.3	-0.2	-0.7	-0.2
Difference (SP – COM)	-0.4		/	0.1		/	/	/
of which[2]:								
- discretionary and elasticity component	*-0.5*		/	*0.0*		/	/	/
- composition component	*0.1*		/	*0.1*		/	/	/
Difference (COM - OECD)	/	0.0		/	-0.1		/	/
of which[2]:								
- discretionary and elasticity component	/	*-0.4*		/	*-0.4*		/	/
- composition component	/	*0.6*		/	*0.4*		/	/
p.m.: Elasticity to GDP	0.8	0.9	0.9	0.9	0.9	0.9	0.6	0.9

Notes:

[1]On a no-policy change basis.

[2]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 and variations of taxable income that do not necessarily move in line with GDP, e.g. capital gains. The two components may not add up to the total difference because of a residual component, which is generally small.

[3]OECD ex-ante elasticity relative to GDP.

Source:

Commission services' autumn 2007 economic forecasts (COM); Stability programme (SP); Commission services' calculations; OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434).

The new government has maintained the expenditure ceilings system, which worked well under the previous government term, to contain central government expenditure. Some modifications were made, essentially increasing the flexibility of expenditure planning. This does not constitute a loophole for expenditure overruns. However, the expenditure ceilings, fixed at the beginning of the government's 4-year term, do not avoid possible step increases in expenditure at the onset of the new legislative period. Compared with the budget ceilings set in the previous year, the new government has revised upwards the spending levels over its legislative term, frontloading its expenditure package to 2008 (see Box 3). Based on the experience from past years, the ceilings should prove effective in cutting back central government budget expenditure growth in the following years.

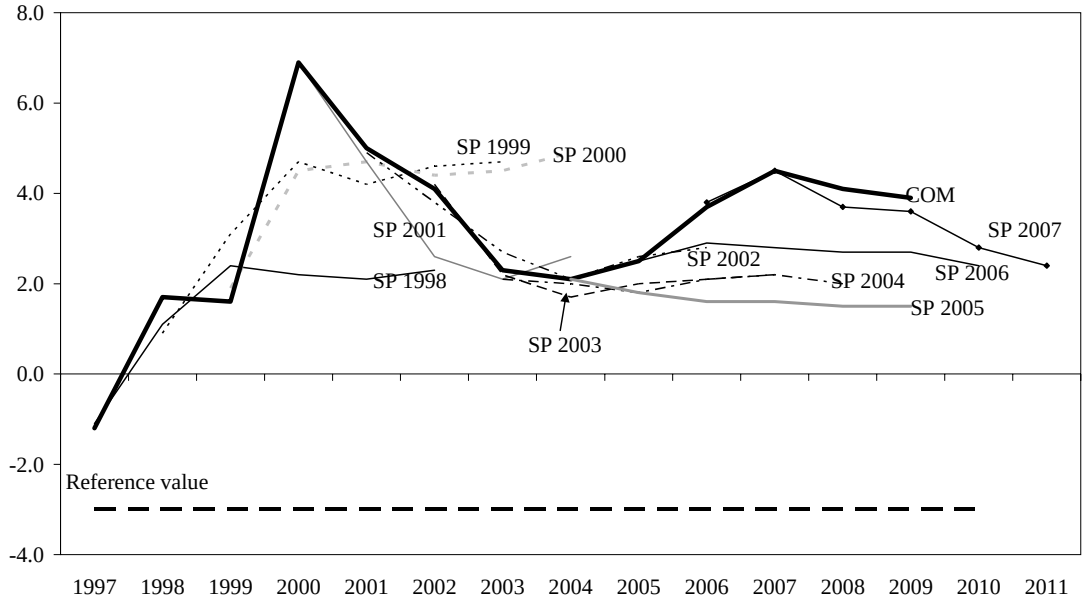
An important risk to the budgetary targets arises from potentially higher wage costs. The 2007 wage negotiation rounds provided for exceptionally high wage increases over the next 2-3 years (see Section 3). The programme envisages a marked reduction in the public sector wage bill to GDP over the programme period, even with the impact from the recently concluded wage agreements included in the projections, as affirmed by the programme. However, if in the medium term public sector wages would spiral further upward, it would directly affect central and local government expenditure. Since the central government expenditure ceilings are set in real terms, wage increases would in effect be treated as cost rises and be outside the ceilings. In the medium term, the risks arising to public finance surpluses could be mitigated, if needed, by rescheduling the government tax cut package. As mentioned above, the government programme announced tax cuts on labour totalling 2.4 billion (1.3% of GDP), but also stated that the exact timing and magnitude will be decided during a legislative period mid-term assessment, taking regard of cyclical conditions and pay settlements.

The ambitious aim of the government to reach a 1 percent surplus at the central government level by the end of its legislative term in 2011 indicates a strong

commitment to achieve even higher fiscal surpluses than projected in the present programme. The government will likely take additional measures (not yet fully specified, but expected to remain within the spending ceilings) to boost economic growth and employment, which would lead to a higher fiscal surplus. The stability programme targets do not rely on the implementation of these as yet unspecified measures. By contrast, the negative revenue impact of the announced tax cuts has been included in the projections. The programme does not rely on one-off or temporary measures.

As detailed in Figure 7, Finland has consistently overachieved its budgetary targets in the recent years. This is not only true for the years of economic boom, but also for the periods when the economy was growing below potential in 2001-2004. The good track record has required strong commitment from the successive governments for relative expenditure restraint and preparing for the ageing challenge.

Figure 7: Government balance projections in successive programmes (% of GDP)



Source: Commission services' autumn 2007 forecast (COM) and successive stability programmes

Overall, the risks to the budgetary projections in the programme appear broadly balanced. Nevertheless, in 2008, the budgetary outcome could be better than projected in the programme given the markedly cautious tax elasticity assumptions for that year. Notable risks could arise from rapid wage growth in the public sector, putting upward pressure on expenditure. On the other hand, the cautious growth projections for the outer years, combined with conservative tax elasticity assumptions, counterbalance the negative risks.

4.4. Assessment of the fiscal stance and budgetary strategy

The table below 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 and, second, the final assessment also taking into account risks.

Table 7: Overview of compliance with the Stability and Growth Pact

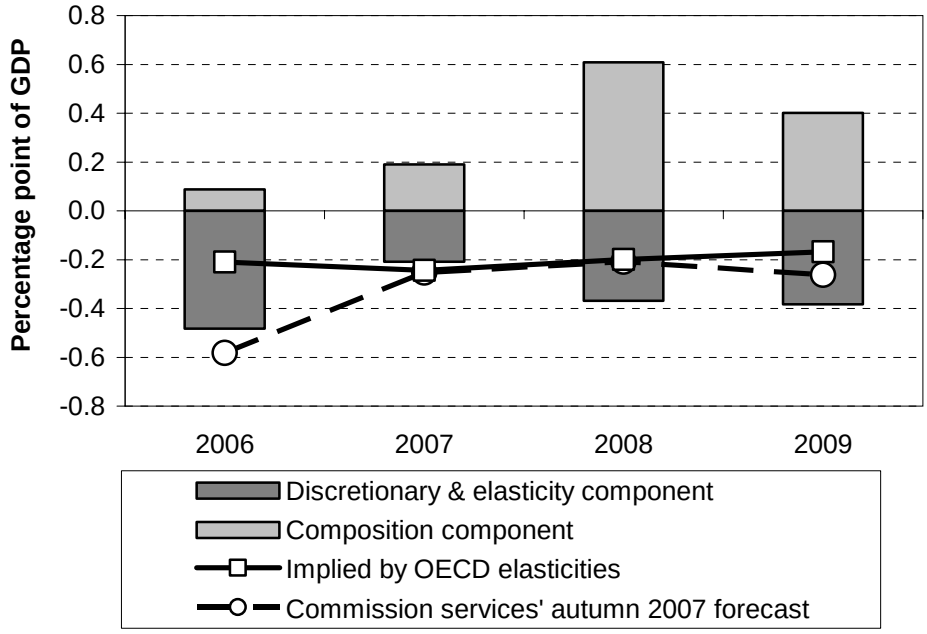
	Based on programme[3] (with the targets taken at face value)	**Assessment** (taking into account risks to the targets)
a. Safety margin against breaching 3% of GDP deficit limit[1]	throughout programme period	throughout programme period
b. Achievement of the MTO	throughout programme period	throughout programme period
c. Fiscal stance in line with Pact[2]?	risk of pro-cyclical fiscal policy in 2008	risk of pro-cyclical fiscal policy in 2008

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 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

In view of the risk assessment, the budgetary stance in the programme seems sufficient to meet the MTO by a comfortable margin throughout the programme period, as envisaged in the programme. This is in line with the Stability and Growth Pact. 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". Subsequent to the cyclical peak in 2006-2007, economic conditions are expected to turn to broadly neutral during 2008. However, this period immediately follows the recent cyclical peak in the economy, when some demand pressures have built up. Moreover, it is not implausible that the favourable economic conditions of the previous years extend longer into 2008, which would change the judgement of economic conditions to "good times". Additionally, the behaviour of tax elasticities, measured as the change in the tax-to-GDP ratio (see Figure 8), indicates that tax accrual would benefit in 2008 from a tax rich growth composition. In this setting, a fiscal expansion is planned. The programme indicates a close-to-one-percentage-point decline in the structural surplus in 2008 but, taking into account the risk assessment above, the deterioration may turn out more limited than planned. The Commission services' autumn forecast expects the structural surplus to decline by ½ percentage point in 2008. Overall, there is thus a risk that the fiscal policy stance implied by the programme may turn out to be pro-cyclical in 2008. However, the potential pro-cyclical stimulus to the economy would likely be limited, given that a sizeable budgetary surplus would still be maintained and fiscal policy would assume a broadly neutral stance already in the following year.

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' 2007 autumn forecast (for 2009, 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 and variations of taxable income that do not necessarily move in line with GDP, e.g. capital gains. The two components may not add up to the total difference because of a residual component, which is generally small.

Source:
Commission services

5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

This section is in two parts. A first part describes recent debt developments and medium-term prospects, including risks to the outlook presented in the programme. A second part takes a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

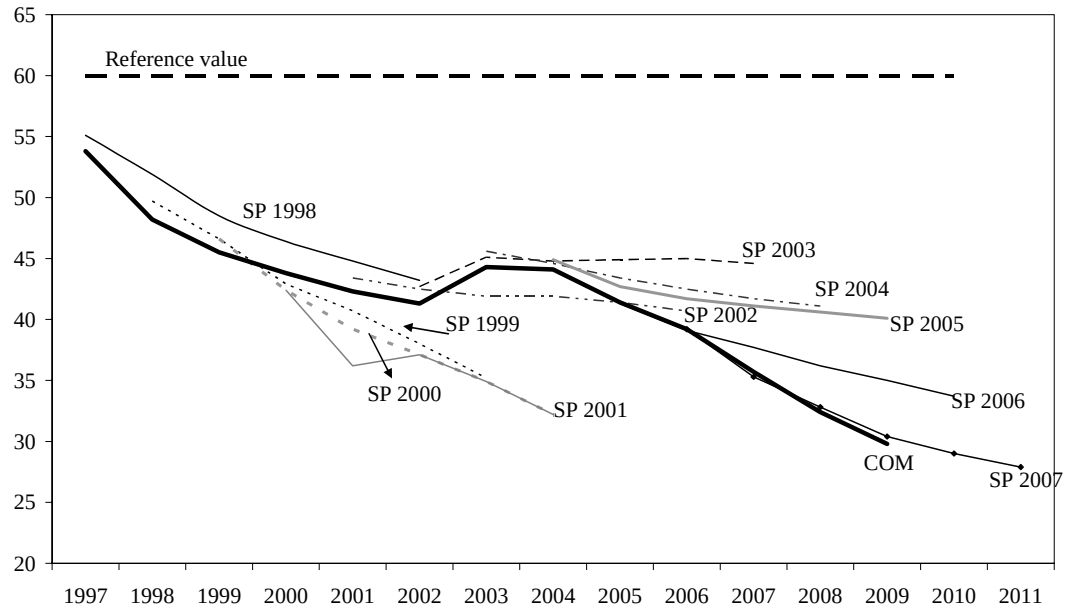
5.1. Recent debt developments and medium-term prospects

5.1.1. Debt projections in the programme

The general government gross debt ratio is forecast to have abated well below 36% of GDP in 2007 and maintain its downward path throughout the programme period, as illustrated in 9 and Table 8. The debt ratio has in most years declined faster than initially planned in the stability programmes. This reflects the higher-than-expected surpluses, as well as rapid nominal GDP growth, which is reported in Table 8 under "growth-" and "inflation effect". As a significant part of the surpluses reflect the accumulation of assets to pension schemes, the stock-flow adjustment is very large in all years over the programme period. 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 liquid financial assets amounted to around 56% of GDP in 2006, i.e. they exceed substantially government gross debt. The assets 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 programmes (% of GDP)



Source: Commission services' autumn 2007 forecast (COM) and successive stability programmes

Table 8: Debt dynamics

(% of GDP)	average 2002-05	2006	2007		2008		2009		2010	2011
			COM	SP	COM	SP	COM	SP	SP	SP
Gross debt ratio[1]	**42.8**	**39.2**	**35.7**	**35.3**	**32.4**	**32.8**	**29.8**	**30.4**	**29.0**	**27.9**
Change in the ratio	-0.2	-2.2	-3.5	-3.9	-3.4	-2.5	-2.6	-2.4	-1.4	-1.1
Contributions[2]*:*										
Primary balance	**-4.6**	**-5.3**	**-6.0**	**-6.0**	**-5.6**	**-5.2**	**-5.3**	**-5.0**	**-4.1**	**-3.6**
"Snow-ball" effect	**0.5**	**-1.0**	**-0.9**	**-1.1**	**-0.5**	**-0.5**	**-0.1**	**-0.2**	**0.0**	**0.1**
Of which:										
Interest expenditure	1.7	1.4	1.4	1.5	1.4	1.5	1.3	1.4	1.3	1.2
Growth effect	-1.1	-1.9	-1.6	-1.6	-1.2	-1.1	-0.9	-0.9	-0.7	-0.6
Inflation effect	-0.2	-0.5	-0.7	-1.0	-0.8	-0.9	-0.6	-0.6	-0.5	-0.5
Stock-flow adjustment	**3.9**	**4.1**	**3.4**	**3.2**	**2.8**	**3.2**	**2.9**	**2.8**	**2.7**	**2.4**
Of which:										
Cash/accruals diff.	0.0	0.1		n.a.		n.a.		n.a.	n.a.	n.a.
Acc. financial assets	4.1	4.1		3.8		3.0		3.0	2.9	2.7
Privatisation	*-0.9*	*-1.0*		*-0.2*		*-0.2*		*-0.2*	*-0.2*	*-0.2*
Val. effect & residual	-0.1	0.0		-3.2		-1.9		-1.7	-1.4	-1.4

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 programme (SP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

5.1.2. Assessment

The update's estimates for general government debt are in line with the Commission services' autumn 2007 economic forecast, with the Commission services being slightly more optimistic in 2008-2009. 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 well below 30% of GDP already during the last years of the programme period.

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

This section analyses the long-term sustainability of public finances. It uses long-term projections of age-related expenditures to calculate sustainability gap indicators and make long-term government debt projections so as to assess the sustainability challenge the country concerned is facing.

5.2.1. Sustainability indicators and long-term debt projections

Table 9 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 and property income received by general government according to an agreed methodology. [13] Non age-related primary expenditure and primary revenue is assumed to remain constant as a share of GDP.

Table 9: Long-term age-related expenditure: main projections

(% of GDP)	2004	2010	2020	2030	2040	2050	Change up to 50
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
Property income received	3.2	3.2	3.1	2.7	2.4	2.2	-1.0

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 5.2p.p. 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 3.1p.p. of GDP. The increase in health-care expenditure is projected to be 1.4p.p. of GDP, slightly lower than on average in the EU. For long-term care, the projected increase of 1.8p.p. of GDP up to 2050 is above the average in the EU. Under the hypothesis of no stock flow adjustment assumed in the long-term debt projections, property income received by the general government should decrease over the long-term by 1.0 p.p. of GDP, one of the largest decrease in the EU.[14]

Table 10: Sustainability indicators and the required primary balance

	2007 scenario			Programme scenario		
	S1	**S2**	**RPB**	**S1**	**S2**	**RPB**
Value	-3.1	-0.5	4.8	-1.3	1.3	4.8
of which:						
Initial budgetary position (IBP)	-4.9	-4.6	-	-3.2	-2.8	-
Debt requirement in 2050 (DR)	-1.5	-	-	-1.4	-	-
Long-term change in the primary balance (LTC)	3.3	4.2	-	3.3	4.2	-

Source: Commission services.

Based on the long-term budgetary projections, sustainability indicators can be calculated. Table 10 shows the sustainability indicators for the two scenarios; the 2007 scenario

[13] See the accompanying "methodological paper" for a description of the property income projections.

[14] Projections of property income received by the general government in the Finnish programme point to higher property income over the projection period than in the projections used in the calculations of the sustainability indicators. This is to a large extent due to the fact that in the programme, property income includes, as of 2011, valuation changes and sales profits of equity investment (see footnote of Table 7 in the Stability Programme update). As mentioned by the programme, taking valuation changes and sales profits of equity investment increases by 1 p.p. of GDP property income received by the general government. This change is essentially of a presentational nature and does not change the prospects of long-term sustainability. Without this presentational change, prospects for property income used in the programme are close to those used in the Commission services' calculations.

assumes that the structural primary balance in 2007 is unchanged for the rest of the programme period and the programme scenario assumes that the programme's budgetary plans are fully attained. In the "2007 scenario", the sustainability gap (S2) which satisfies the intertemporal budget constraint would be negative at -0.5p.p. of GDP.[15]

The sustainability gap in the present assessment is close to the result of last year's assessment. Indeed, while the primary balance has improved in structural terms by around 1¼ p.p. of GDP between 2006 (4.5% of GDP as measured in last year's assessment) and 2007 (5.7% of GDP) [16], the inclusion of property income projections has increased substantially the sustainability gap by around 1½ % of GDP. Yet, it should be noted that the inclusion of property income projections in the indicators is neutral in terms of overall assessment of long-term sustainability of public finances as property income developments used to be assessed as a qualitative factor in the assessment of last year update of the stability programme. Overall, the long-term budgetary prospects of Finland have improved compared to last year.

The initial strong budgetary position with a structural primary balance of 5.7% of GDP contributes to the reduction of gross debt and the accumulation of financial assets. According to both sustainability gaps, the long-term budgetary impact of ageing is relatively high. The estimated reduction in the structural primary balance of around 2p.p. of GDP over the programme period has a negative impact on the sustainability gap, showing the importance of maintaining a strong structural budgetary position to contain risks to the sustainability of public finances.[17]

The required primary balance (RPB) is around 4¾ % of GDP, somewhat higher that the structural primary balance of about 4p.p. of GDP 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 the sustainability indicators. The long-term projections for government debt under the two scenarios are shown in Figure 4. The debt ratio is currently below the 60% of GDP reference value, estimated in the programme at close to 35% of GDP in

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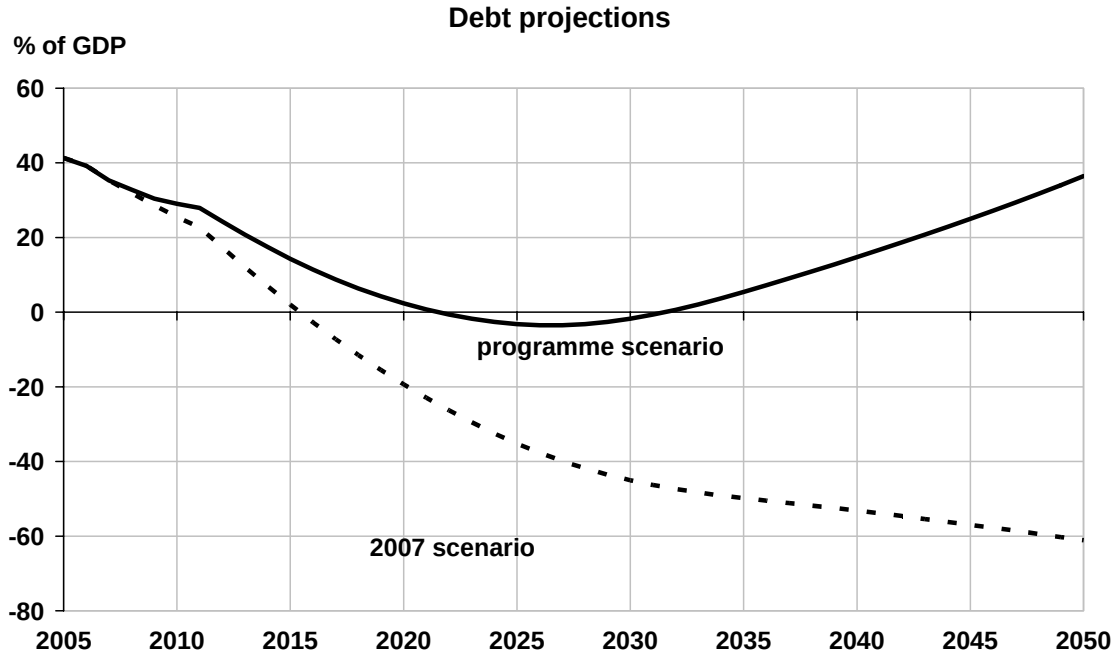
[15] The sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be -3.1% of GDP.

[16] As noted in Section 4.3., the general government surplus could be recorded higher by about 0.4% of GDP in 2007 and in the following years' projections. According to ESA95, property income of investment funds that is capitalised (i.e. not paid out in cash in a regular basis) should be treated as revenue and therefore improve the general government surplus, in relation to the investment funds' shares owned by government. Direct Information regarding capitalised income is available for domestic funds but not for foreign funds; therefore only the former used to be included so far in national accounts statistics. Recent methodological work undertaken by Statistics Finland has enabled to estimate capitalised income of foreign investment fund shares owned by social security. If taken into account, this methodological improvement would increase the surplus in the general government, but according to the above sustainability calculations it would be compensated by higher (debt-increasing) stock-flow adjustment of the same size. Said otherwise, it does not change the dynamics of general government debt nor of assets accumulated in social security funds and is therefore neutral in terms of sustainability of public finances.

[17] The sustainability indicator in the programme scenario (1.3% of GDP) is close to that estimated in the programme (1½% of GDP).

2007. In both scenarios, the debt ratio is projected to remain below the 60% of GDP threshold over the projection period.[18] The calculations in Figure 10 point to a somewhat lower debt level in 2050 compared to the projections in the update of the Finnish stability programme. This is essentially due to a higher accumulated level of financial assets in public pension funds in 2050 compared with the above mentioned calculations, which are made under the assumptions of no stock flow adjustment (i.e. no net sale or purchase of assets).[19] This however has no impact on the assessment of long-term sustainability.

Figure 10: Long-term projections for the government debt ratio



5.2.2. Additional factors

To reach an overall assessment of the sustainability of public finances, other relevant factors are taken into account, which in addition allow to better appreciate where the main risks to sustainability are likely to stem from.

First, the current level of debt, net of the substantial financial assets accumulated in view of paying public pensions, is negative (at around -20% of GDP)[20]. Maintaining sound

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[18] 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.

[19] In practice, the Finnish authorities model separately the pension scheme (and its assets) and the rest of the general government (and its debt). This leads to a different path of liabilities and assets but does not change the level of net liabilities.

[20] Gross debt is 35.3% of GDP in 2007 and the consolidated financial assets amounts to around 57% in 2007.

government finances, in line with the budgetary plans over the programme period would contribute to containing the risks to the long-term sustainability of public finances.

Second, it can be noted that the programme update projects that social contributions will rise by 2.2% points of GDP between 2010 and 2050.[21] 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. However, 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 easing the long-term budgetary impact of ageing and the large assets accumulated by the public pension schemes will enable to finance part of the increase in pension expenditure. Maintaining high primary surpluses over the medium-term would contribute to limiting 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 government's priority in public finance strategy is to tackle the imminent population ageing challenge (see also Section 2). The government's announced aim is to raise the growth capacity of the economy and to continue implementing reforms increasing public administration efficiency, with a view to curbing expenditure pressures. The government expects to raise the growth potential principally through labour market measures. It is intended to implement various tax cuts on labour to increase work incentives (see also Section 4.2.1.), carry out structural reforms, review incentive traps and increase some targeted appropriations. These measures are defined in broad terms in the government economic programme and less so in the current programme update. The detailed content of the reform package has not yet been announced and its potential impact on employment can not be gauged at the present moment.

The new government has maintained the commitment to implement the public sector productivity measures concerning the central and local government. It is intended to further strengthen the central government productivity programme and decide on additional measures in the context of the 2008 spring spending limits decision. It is planned to reduce staff numbers by a further 4 800 person years in the mid-term, in addition to the already announced saving target of 9 600 person years. The implementation of some productivity measures has already commenced, mostly related to centralisation of administrative functions like procurement, IT and human resources

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

management, allowing to reap economies of scale. The legislative changes expected to boost the restructuring of municipal service structures and provide incentives for productivity entered into force in February 2007. The effectiveness of the measure to curb local government expenditure growth is crucial in view of the imminent spending pressures especially affecting the local governments (see Section 2).

The main tool in controlling central government budget expenditure continues to be the spending limits procedure, that has worked well during the previous legislative period. The new government has made some modifications to the spending limits system, essentially increasing the flexibility of its application. The institutional setup has remained otherwise fairly stable. However, the new ceilings provided for a step increase in expenditures, frontloaded largely to the first yearly budget of the new government in 2008 (see section 4.2).

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 2007. The measures identified in the IR-NRP to tackle the long-term sustainability challenge, in particular improving the efficiency of both central and local governments and applying central government spending ceilings, are an integral part of the stability programme strategy to contain the population ageing risks.

The stability programme states that all the NRP reforms are contained within the spending limits and are taken into account in the baseline stability programme scenario. The programme contains a qualitative assessment of the overall impact of the October 2007 implementation report of the national reform programme within the medium-term fiscal strategy. It does not provide systematic information on the direct budgetary costs or savings of the main reforms envisaged in the national reform programme. However, its budgetary projections apparently take into account the public finance implications of the actions outlined in the national reform programme. Overall, the two programmes seem to be integrated.

Box 4: The Commission assessment of the October 2007 implementation report of the national reform programme

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of the October 2007 implementation report of Finland's national reform programme[22] and is summarised as follows.

Finland's national reform programme identifies as key challenges the sustainability of public finances in the face of population ageing, improving competitiveness and productivity, and improving the functioning of the labour market.

The Commission's assessment was that Finland had made very good progress in implementing its National Reform Programme over the 2005-2007 period.

[22] Communication from the Commission to the European Council, "Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)", 11.12.2007, COM(2007)803.

Against the background of strengths and weaknesses identified and the evidence on progress made, the Commission recommended that Finland should focus on the areas of: competition and productivity in services, measures to reach its Kyoto target, labour market reforms with a particular view to structural unemployment, unemployment of low skilled workers and young people, and promoting economic migration.

The tables below provide an overview of whether the strategy and policy measures in the stability programme are consistent with the broad economic policy guidelines in the area of public finances issued in the context of the Lisbon strategy for growth and jobs. The first table makes the assessment against the integrated guidelines for the period 2005-2008, adopted by the Council in July 2005. The second table makes the assessment against the recommendations for the euro area, adopted by the Council in March 2007. The budgetary strategy in the stability programme is broadly consistent with the recommendations for the euro area.

Table 11: Consistency with the broad economic policy guidelines (integrated guidelines)

Broad economic policy guidelines (integrated 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

Table 12: Consistency with the broad economic policy guidelines (country-specific recommendations and points to watch)

Broad economic policy guidelines (country-specific recommendations and points to watch)	Yes	Steps in right direction	No	Not applicable
1. Country-specific recommendations				
– *none*				X
2. Points to watch				
– *none*				X
3. Recommendations for euro area Member States				
– Make use of the favourable cyclical conditions to aim at or pursue ambitious budgetary consolidation towards their medium-term objectives in line with the Stability and Growth Pact, hence striving to achieve an annual structural adjustment of at least 0.5% of GDP as a benchmark				X
– Improve the quality of public finances by reviewing public expenditure and taxation, with the intention to enhance productivity and innovation, thereby contributing to economic growth and fiscal sustainability	X			
Source: *Commission services*				

* * *

Annex 1: Compliance with the code of conduct

This annex provides an assessment of whether the programme respects the requirements of Section II of the code of conduct (guidelines on the format and content), notably as far as (i) the model structure (Annex 1 of the code of conduct); (ii) the formal data provisions (Annex 2 of the code of conduct); and (iii) other information requirements is concerned.

(i) Model structure

The programme broadly follows the model structure for stability and convergence programmes specified in Annex 1 of the code of conduct.

(ii) Data requirements

With regard to data requirements, the programme has gaps in the compulsory and optional data prescribed by the new code of conduct (see Table below). Compulsory data on "one-off and other temporary measures" is not explicitly given neither in the tables nor is it mentioned anywhere in the text. The external assumptions for the outer years are not provided. Optional data "liquid financial assets" specified in the Code of conduct Annex 2 Table 4 point 6 is not given for 2007-2011 in the stability programme. One gap relates to the amendments to the data requirements agreed by the September 2007 EFC. Since in Table 5 "cyclical developments" one-offs are not specified, line 10 "structural balance", which is calculated through one-offs, is also missing.

Also, in Table 1b, instead of HICP the national CPI is given, incorrectly in the HICP line. There is currently a large divergence between the two series due to differences in the index basket. The national one is about 1 percentage point higher in 2007, but the discrepancy is forecast to fade by 2008. The Finnish authorities have indicated that the correct HICP values would be 1.3%, 1.6%, and 2.3% for 2006-2008 respectively. In the outer years there is no difference between the two series.

Beyond the requirements of the code of conduct, the stability programme includes a breakdown of pension fund assets in Finland.

The tables on the following pages show the data presented in the November 2007 update of stability programme, following the structure of the tables in Annex 2 of the code of conduct. Compulsory data are in bold, missing data are indicated with grey-shading.

(iii) Other information requirements

The table below provides a summary assessment of the adherence to the other information requirements in the code of conduct.

The SCP…	Yes	No	Comments
a. Involvement of parliament			
… mentions status vis-à-vis national parliament.	X		
… indicates whether Council opinion on previous programme has been presented to national parliament.	X		
b. Economic outlook			
… uses "common external assumptions" on main extra-EU variables.	X		
… explains significant divergences with Commission services' forecasts[1].			*not applicable*
… bears out possible upside/downside risks to economic outlook.	X		
… analyses outlook for sectoral balances and, especially for countries with high external deficit, external balance.	X		
c. Monetary/exchange rate policy			
… presents medium-term monetary policy objectives and their relationship to price and exchange rate stability.			*not applicable*
d. Budgetary strategy			
… presents budgetary targets for general government balance in relation to MTO and projected path for debt ratio.	X		
… (in case new government has taken office) shows continuity with respect to budgetary targets endorsed by Council.	X		

The SCP…	Yes	No	Comments
… (when applicable) explains reasons for deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify situation (+ provides information on them).	X		
… backs budgetary targets by indication of broad measures necessary to achieve them and analyses their quantitative effects on balance.	X		
… specifies state of implementation of measures.	X		
e. "Major structural reforms"			
… (if MTO not yet reached or temporary deviation is planned from MTO) includes comprehensive information on economic and budgetary effects of possible 'major structural reforms' over time.			*not applicable*
… includes quantitative cost-benefit analysis of short-term costs and long-term benefits of reforms.		X	
f. Sensitivity analysis			
… includes comprehensive sensitivity analyses and/or develops alternative scenarios showing impact on balance and debt of: a) changes in main economic assumptions b) different interest rate assumptions c) (for CP only) different exchange rate assumptions d) if common external assumptions are not used, changes in assumptions for main extra-EU variables.	X		
… (in case of "major structural reforms") analyses how changes in assumptions would affect budget and potential growth.			*not applicable*
g. Broad economic policy guidelines			
… provides information on consistency with broad economic policy guidelines of budgetary objectives and measures to achieve them.	X		
h. Quality of public finances			
… describes measures to improve quality of public finances, both revenue and expenditure sides.	X		
i. Long-term sustainability			
… outlines strategies to ensure sustainability.	X		
… includes common budgetary projections by the AWG and all necessary additional information (esp. new relevant information).	X		
j. Other information (optional)			
… includes information on implementation of existing national budgetary rules and on other institutional features of public finances.	X		

Notes: SCP = stability/convergence programme; CP = convergence programme

[1]To the extent possible, bearing in mind the typically short time period between the publication of the Commission services' autumn forecast and the submission of the programme.

Source:
Commission services

Table 1a. Macroeconomic prospects

	ESA Code	2006	2006	2007	2008	2009	2010	2011
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	*n.a.*	5.0	4.4	3.3	3.0	2.5	2.1
2. Nominal GDP	B1*g	*167.1*	6.3	7.2	6.0	5.1	4.4	3.9
Components of real GDP								
3. Private consumption expenditure	P.3	*85.9*	4.3	4.0	3.8	2.3	1.6	1.3
4. Government consumption expenditure	P.3	*36.3*	1.0	0.8	1.8	1.5	1.7	1.5
5. Gross fixed capital formation	P.51	*32*	4.2	5.0	3.1	2.5	2.4	2.2
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	*2.4*	1.4	2.0	2.1	2.5	2.8	3.1
7. Exports of goods and services	P.6	*74.4*	10.4	5.7	4.7	5.0	4.5	4.0
8. Imports of goods and services	P.7	*65.7*	8.3	4.4	3.8	3.0	2.8	2.6
Contributions to real GDP growth								
9. Final domestic demand		-	3.2	3.2	2.9	2.0	1.6	1.4
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	0.4	0.4	-0.3	0.0	0.0	0.0
11. External balance of goods and services	B.11	-	1.3	0.8	0.6	1.0	0.9	0.7

Table 1b. Price developments

	ESA Code	2006	2006	2007	2008	2009	2010	2011
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator		*n.a.*	1.2	2.7	2.7	2.0	1.8	1.8
2. Private consumption deflator		*n.a.*	1.4	2.4	2.8	2.2	2.0	2.0
3. HICP[1]		*n.a.*	1.6	2.4	2.4	2.2	2.0	2.0
4. Public consumption deflator		*n.a.*	3.1	2.9	3.8	3.2	2.9	2.9
5. Investment deflator		*n.a.*	3.2	3.1	2.0	2.0	2.0	2.0
6. Export price deflator (goods and services)		*n.a.*	2.5	2.2	0.1	-0.5	-0.5	-0.5
7. Import price deflator (goods and services)		*n.a.*	6.5	2.7	1.2	1.0	1.0	1.0

[1] Optional for stability programmes. Instead of HICP, the programme gives the national CPI index, which is markedly higher for 2007, but the difference between the indexes is minimal from 2008 onwards. The Finnish authorities have indicated that the correct HICP values would be 1.3%, 1.6%, and 2.3% for 2006-2008 respectively. In the outer years there is no difference between the two series.

Table 1c. Labour market developments

	ESA Code	2006	2006	2007	2008	2009	2010	2011
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[1]		*2446*	1.8	1.8	0.6	0.4	0.1	-0.1
2. Employment, hours worked[2]		*4189*	1.7	1.8	0.4	0.2	-0.1	-0.3
3. Unemployment rate (%)[3]		*n.a.*	7.7	6.7	6.3	5.8	5.6	5.6
4. Labour productivity, persons[4]		*n.a.*	3.1	2.5	2.7	2.6	2.4	2.2
5. Labour productivity, hours worked[5]		*n.a.*	3.2	2.5	2.6	2.8	2.6	2.4
6. Compensation of employees	D.1	*64.7*	5.0	5.7	6.0	5.4	4.1	3.9
7. Compensation per employee		*n.a.*	2.8	3.7	5.1	5.0	4.0	4.0

[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	2006	2007	2008	2009	2010	2011
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	4.8	4.9	4.6	5.0	5.0	4.8
of which :							
- Balance on goods and services		5.2	5.5	5.4	5.5	5.5	5.4
- Balance of primary incomes and transfers		-0.5	-0.7	-0.8	-0.6	-0.6	-0.6
- Capital account		0.1	0.1	0.1	0.1	0.1	0.1
2. Net lending/borrowing of the private sector	B.9	2.1	1.6	2.1	2.5	3.4	3.6
3. Net lending/borrowing of general government	EDP B.9	3.8	4.5	3.7	3.6	2.8	2.4
4. Statistical discrepancy		-1.2	n.a.	n.a.	n.a.	n.a.	n.a.

Table 2. General government budgetary prospects

	ESA Code	2006	2006	2007	2008	2009	2010	2011
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector								
1. General government	S.13	*6401*	3.8	4.5	3.7	3.6	2.8	2.4
2. Central government	S.1311	*1534*	0.9	1.5	0.7	0.7	0.1	0.2
3. State government	S.1312	*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
4. Local government	S.1313	*-315*	-0.2	-0.1	0.1	0.1	0.0	-0.1
5. Social security funds	S.1314	*5182*	3.1	3.1	2.9	2.8	2.6	2.3
General government (S13)								
6. Total revenue	TR	*87797*	52.6	51.9	51.0	50.6	49.8	49.6
7. Total expenditure	TE[1]	*81396*	48.7	47.4	47.3	47.0	47.0	47.2
8. Net lending/borrowing	EDP B.9	*6401*	3.8	4.5	3.7	3.6	2.8	2.4
9. Interest expenditure	EDP D.41	*2414*	1.4	1.5	1.5	1.3	1.3	1.2
10. Primary balance[2]		*8815*	5.3	6.0	5.2	5.0	4.1	3.6
11. One-off and other temporary measures[3]		*n.a.*	0.0	0.0	0.0	0.0	0.0	0.0
Selected components of revenue								
12. Total taxes (12=12a+12b+12c)		*52391*	31.1	30.8	30.4	30.1	29.3	29.0
12a. Taxes on production and imports	D.2	*23150*	13.6	13.2	13.1	12.9	12.5	12.3
12b. Current taxes on income, wealth, etc	D.5	*28736*	17.2	17.3	17.0	17.0	16.6	16.6
12c. Capital taxes	D.91	*505*	0.3	0.3	0.3	0.2	0.2	0.2
13. Social contributions	D.61	*20431*	12.2	12.0	11.8	11.8	11.9	11.9
14. Property income	D.4	*3095*	3.6	3.7	3.6	3.6	3.6	3.6
15. Other[4]		*8880*	5.6	5.4	5.2	5.1	5.0	5.0
16=6. Total revenue	TR	*87797*	52.6	51.9	51.0	50.6	49.8	49.6
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[5]			43.1	42.6	42.0	41.7	41.0	40.8
Selected components of expenditure								
17. Compensation of employees + intermediate consumption	D.1+P.2	*37758*	**22.6**	**21.9**	**21.6**	**21.5**	**21.5**	**21.5**
17a. Compensation of employees	D.1	*22320*	13.4	13.0	12.9	12.7	12.6	12.6
17b. Intermediate consumption	P.2	*15438*	9.2	8.9	8.8	8.8	8.9	8.9
18. Social payments (18=18a+18b)		*30153*	18.0	17.3	17.3	17.3	17.5	17.8
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	*3557*	2.1	2.1	2.1	2.2	2.2	2.3
18b. Social transfers other than in kind	D.62	*26596*	15.9	15.2	15.2	15.1	15.3	15.5
19=9. Interest expenditure	EDP D.41	*2414*	1.4	1.5	1.5	1.3	1.3	1.2
20. Subsidies	D.3	*2144*	1.3	1.3	1.3	1.3	1.2	1.2
21. Gross fixed capital formation	P.51	*4070*	2.4	2.5	2.6	2.5	2.5	2.4
22. Other[6]		*4857*	2.9	2.9	3.1	3.1	3.1	3.1
23=7. Total expenditure	TE[1]	*81396*	48.7	47.4	47.3	47.0	47.0	47.2
p.m.: Government consumption (nominal)	P.3	*36266*	21.7	21.1	20.9	20.9	20.9	21.0

[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, item 9).

[3]A plus sign means deficit-reducing one-off measures.

[4] P.11+P.12+P.131+D.39+D.7+D.9 (other than D.91).

[5]Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

[6] D.29+D4 (other than D.41)+ D.5+D.7+D.9+P.52+P.53+K.2+D.8.

Table 3. General government expenditure by function

% of GDP	COFOG Code	2005	2010
1. General public services	1	6.8	5.9
2. Defence	2	1.6	1.3
3. Public order and safety	3	1.5	1.3
4. Economic affairs	4	4.7	4.1
5. Environmental protection	5	0.3	0.3
6. Housing and community amenities	6	0.2	0.2
7. Health	7	6.8	6.9
8. Recreation, culture and religion	8	1.2	1.0
9. Education	9	6.1	5.6
10. Social protection	10	21.2	20.6
11. Total expenditure (=item 7=23 in Table 2)	TE[1]	50.5	47.2

[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	ESA Code	2006	2007	2008	2009	2010	2011
1. Gross debt[1]		39.2	35.3	32.8	30.4	29.0	27.9
2. Change in gross debt ratio		-2.2	-3.9	-2.6	-2.4	-1.3	-1.1
Contributions to changes in gross debt							
3. Primary balance[2]		5.3	6.0	5.2	5.0	4.1	3.6
4. Interest expenditure[3]	EDP D.41	1.4	1.5	1.5	1.3	1.3	1.2
5. Stock-flow adjustment		1.7	0.6	1.1	1.2	1.4	1.3
of which:							
- Differences between cash and accruals[4]		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
- Net accumulation of financial assets[5]		3.4	3.8	3.0	3.0	2.9	2.7
of which:		-	-	-	-	-	-
- privatisation proceeds		-0.7	-0.2	-0.2	-0.2	-0.2	-0.2
- Valuation effects and other[6]		-1.7	-3.2	-1.9	-1.7	-1.4	-1.4
p.m.: Implicit interest rate on debt[7]		3.9	4.2	4.3	4.2	4.3	4.3
Other relevant variables							
6. Liquid financial assets[8]		97.6	n.a.	n.a.	n.a.	n.a.	n.a.
7. Net financial debt (7=1-6)		-58.4	n.a.	n.a.	n.a.	n.a.	n.a.

[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 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	2006	2007	2008	2009	2010	2011
1. Real GDP growth (%)		5.0	4.4	3.3	3.0	2.5	2.1
2. Net lending of general government	EDP B.9	3.8	4.5	3.7	3.6	2.8	2.4
3. Interest expenditure	EDP D.41	1.4	1.5	1.5	1.3	1.3	1.2
4. One-off and other temporary measures[1]		0.0	0.0	0.0	0.0	0.0	0.0
5. Potential GDP growth (%)		3.3	3.7	3.3	3.1	2.6	2.2
contributions:							
- labour		0.4	0.6	0.3	0.1	-0.2	-0.4
- capital		0.7	0.8	0.8	0.7	0.6	0.4
- total factor productivity		2.2	2.2	2.2	2.2	2.2	2.2
6. Output gap		-0.2	0.4	0.3	0.2	0.1	0.0
7. Cyclical budgetary component		-0.1	0.2	0.2	0.1	0.1	0.0
8. Cyclically-adjusted balance (2 - 7)		3.9	4.3	3.5	3.5	2.7	2.4
9. Cyclically-adjusted primary balance (8 + 3)		5.4	5.8	5.0	0.8	4.0	3.6
10. Structural balance (8 - 4)		3.9	4.3	3.5	3.5	2.7	2.4

[1]A plus sign means deficit-reducing one-off measures.

Table 6. Divergence from previous update

	ESA Code	2006	2007	2008	2009	2010	2011
Real GDP growth (%)							
Previous update		4.5	3.0	2.9	2.6	2.1	n.a.
Current update		5.0	4.4	3.3	3.0	2.5	2.1
Difference		0.5	1.4	0.4	0.4	0.4	n.a.
General government net lending (% of GDP)	EDP B.9						
Previous update		2.9	2.8	2.7	2.7	2.4	n.a.
Current update		3.8	4.5	3.7	3.6	2.8	2.4
Difference		0.9	1.7	1.0	0.9	0.4	n.a.
General government gross debt (% of GDP)							
Previous update		39.1	37.7	36.2	35.0	33.7	n.a.
Current update		39.2	35.3	32.8	30.4	29.0	27.9
Difference		0.1	-2.4	-3.4	-4.6	-4.7	n.a.

Table 7. Long-term sustainability of public finances

% of GDP	2000	2005	2010	2020	2030	2050
Total expenditure	n.a.	50.1	47.0	48.9	51.7	55.1
Of which: age-related expenditures	n.a.	23.6	24.4	26.5	29.0	29.5
Pension expenditure	n.a.	10.4	11.2	12.9	14.0	13.7
Social security pension	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Old-age and early pensions	n.a.	8.0	8.8	10.7	12.0	12.1
Other pensions (disability, survivors)	n.a.	2.4	2.4	2.2	2.0	1.7
Occupational pensions (if in general government)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Health care	n.a.	5.5	5.8	6.2	6.6	7.0
Long-term care *(this was earlier included in the*	n.a.	1.8	1.9	2.1	3.0	3.5
Education expenditure	n.a.	5.9	5.5	5.3	5.4	5.3
Other age-related expenditures	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Interest expenditure	n.a.	1.7	1.3	0.9	1.2	4.1
Total revenue	n.a.	52.6	49.8	51.5	51.1	50.0
Of which: property income	n.a.	3.2	3.6	5.1	4.7	3.6
Of which : from pensions contributions (or social contributions if appropriate)	n.a.	9.1	9.0	10.3	11.2	11.2
Pension reserve fund assets	n.a.	62.6	70,0	76.2	74.3	62.8
Of which : consolidated public pension fund assets (assets other than government liabilities)	n.a.	51.7	59.6	64.9	63.3	53.5
Assumptions						
Labour productivity growth	n.a.	n.a.	1.9	2.1	1.8	1.8
Real GDP growth	n.a.	n.a.	2.2	1.7	1.4	1.4
Participation rate males (aged 20-64)	n.a.	n.a.	83.3	85.7	86.4	86.5
Participation rates females (aged 20-64)	n.a.	n.a.	76.6	80.3	81.5	81.9
Total participation rates (aged 20-64)	n.a.	n.a.	79.8	82.9	84.0	84.2
Unemployment rate	n.a.	n.a.	6.8	6.5	6.5	6.5
Population aged 65+ over total population	n.a.	n.a.	16.9	22.6	26.1	27.0

Table 8. Basic assumptions

	2006	2007	2008	2009	2010	2011
Short-term interest rate[1] (annual average)	3.1	4.3	4.4	4.3	n.a.	n.a.
Long-term interest rate (annual average)	3.8	4.3	4.4	4.5	n.a.	n.a.
USD/€ exchange rate (annual average) (euro area and ERM II countries)	1.30	1.40	1.40	1.40	n.a.	n.a.
Nominal effective exchange rate	0.5	2.2	1.0	0.0	n.a.	n.a.
(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
World excluding EU, GDP growth	5.5	5.6	5.3	5.4	n.a.	n.a.
EU GDP growth	2.7	2.9	2.4	2.4	n.a.	n.a.
Growth of relevant foreign markets	8.8	6.4	5.9	5.7	n.a.	n.a.
World import volumes, excluding EU	9.4	7.8	7.1	7.7	n.a.	n.a.
Oil prices (Brent, USD/barrel)	64.2	70.6	78.8	76.0	n.a.	n.a.

[1]If necessary, purely technical assumptions.

Annex 2: Key indicators of past economic performance

This annex displays key economic indicators that summarise the past economic performance of Finland. To put the country's performance into perspective, right-hand side of the table displays the same set of indicators for the euro area.

	Finland						Euro area					
	Averages			2005	2006	2007	Averages			2005	2006	2007
	'96 - '05	'96 - '00	'01 - '05				'96 - '05	'96 - '00	'01 - '05			
Economic activity												
Real GDP (% change)	3.7	4.8	2.5	2.9	5.0	4.3	2.1	2.7	1.4	1.5	2.8	2.6
Contributions to real GDP growth:												
Domestic demand	*3.0*	*3.3*	*2.7*	*4.1*	*3.1*	*3.3*	*2.0*	*2.7*	*1.3*	*1.7*	*2.6*	*2.4*
Net exports	*0.8*	*1.7*	*-0.1*	*-1.1*	*1.3*	*1.0*	*0.1*	*0.0*	*0.1*	*-0.1*	*0.2*	*0.2*
Real GDP per capita (PPS; EU27 = 100)	119	116	121	124	126	127	113	114	112	110	110	109
Real GDP per capita (% change)	3.4	4.5	2.3	2.6	4.6	3.9	1.6	2.5	0.8	0.9	2.3	2.2
Prices, costs and labour market												
HICP inflation (%)	1.5	1.6	1.4	0.8	1.3	1.5	1.9	1.5	2.2	2.2	2.2	2.0
Labour productivity (% change)	2.1	2.4	1.7	1.5	3.1	2.5	1.2	1.5	0.8	1.0	1.4	1.1
Real unit labour costs (% change)	-0.3	-1.3	0.7	2.0	-1.5	-1.2	-0.5	-0.6	-0.5	-0.8	-0.9	-0.8
Employment (% change)	1.6	2.3	0.9	1.4	1.8	1.8	1.2	1.5	0.9	0.9	1.5	1.6
Unemployment rate (% of labour force)	10.3	11.7	8.9	8.4	7.7	6.7	9.1	9.8	8.5	8.9	8.3	7.3
Competitiveness and external position												
Real effective exchange rate (% change)	-1.1	-3.9	1.8	0.4	-1.2	-0.1	-1.3	-5.5	2.8	-2.6	-0.6	0.6
Export performance (% change)[1]	0.9	2.3	-0.6	0.2	1.5	-0.6	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	7.0	6.3	7.7	5.1	5.9	5.3	0.8	0.9	0.7	0.3	0.0	0.1
Public finances												
General government balance (% of GDP)	2.2	1.1	3.3	2.7	3.8	4.6	-2.3	-2.1	-2.5	-2.5	-1.5	-0.8
General government gross debt (% of GDP)	46.1	49.6	42.7	41.4	39.2	35.7	70.6	72.2	69.0	70.3	68.6	66.6
Structural balance (% of GDP)[2]	n.a.	n.a.	3.4	3.7	4.1	4.4	n.a.	n.a.	-2.6	-2.1	-1.1	-0.7
Financial indicators												
Short-term real interest rate (%)[3]	1.8	1.7	1.9	1.9	1.8	2.3	1.3	2.5	0.6	0.3	1.2	2.0
Long-term real interest rate (%)[3]	3.6	3.8	3.3	3.1	2.5	2.3	n.a.	n.a.	1.9	1.5	1.9	2.1

Notes:

[1]Market performance of exports of goods and services on export-weighted imports of goods and services of 35 industrial markets.

[2]Cyclically-adjusted balance net of one-off and other temporary measures; available since 2003.

[3]Using GDP deflator.

Source:
Commission services