

October 1999

IMF Staff Country Report No. 99/122

## **Finland: Selected Issues**

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INTERNATIONAL MONETARY FUND

FINLAND

Selected Issues

Prepared and approved by the European I Department

September 14, 1999

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**PUBLIC EXPENDITURE POLICIES AND THE FISCAL FRAMEWORK IN FINLAND:  
EXPERIENCE AND ISSUES<sup>1</sup>**

**I. INTRODUCTION AND OVERVIEW**

1. ***Finland's fiscal consolidation over the past five years has been strikingly successful, but the challenge of a heavy tax burden on labor income remains.*** A major consolidation effort began in the aftermath of a severe recession in the early 1990s. This effort reduced public expenditure by nearly 10 percentage points of GDP, and shifted the general government finances from a deficit of 7 percent of GDP in 1993 to a surplus of 1½ percent of GDP in 1998. The medium-term expenditure framework adopted for this purpose proved very effective, and may be of interest to other countries. In the process of consolidation, on the road to euro area membership, the scope for tax cuts was limited, however, and the tax burden on labor remains very high by advanced economy standards. Lowering this burden is recognized to be an essential component in any strategy to raise the level of employment—a key priority of policy-makers.<sup>2</sup>

2. ***The economic program of the present government sets a high priority on maintaining public spending restraint, with a view to eliminating the deficit of the central government and proceeding with a phased reduction in the tax burden on labor income.*** The scope for progress in this direction appears considerable. Public expenditure, presently, remains almost 10 percentage points of GDP higher than at the beginning of the 1990s, and 25 percentage points higher than in the early seventies—despite the significant restraint achieved in recent years, in a setting of strong economic recovery.

3. ***The next few years present a window of opportunity for structural expenditure reform and a substantial reduction in taxation before demographic developments exert growing pressures on public spending.*** Together with structural reforms to strengthen the supply side of the economy—and, in particular, to reduce incentives for early withdrawal from the labor force—this strategy would foster job creation, underpin the public finances, and safeguard international competitiveness, thus extending the impressive economic performance of the 1990s. To have a significant effect, however, such reforms need to be pressed through before the expenditure pressures generated by a rapidly aging population begin to limit the room for maneuver.

4. ***This paper outlines Finland's recent experience in the field of public expenditure policies, illustrates alternative medium-term approaches to fiscal policy, and discusses prospects for efficient expenditure management in the future.*** The remainder of the paper is organized as follows. Section II illustrates the evolution of public expenditures from the creation of the welfare state to the crisis of the early 1990s. Section III discusses the post-crisis

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<sup>1</sup> Prepared by Christina Daseking, in collaboration with Craig Beaumont and C.M. Watson.

<sup>2</sup> Notwithstanding the sharp drop in the unemployment rate from 18 percent in early 1994 to less than 11 percent five years later—the second most rapid improvement registered in OECD history—the rate is still more than twice as high as its pre-recession long-term average.

consolidation process, including the institutional reforms that facilitated adjustment. Section IV illustrates the future challenges and policy trade-offs in the context of alternative long-term scenarios. Section V concludes with a discussion of some issues of implementation for the future.

## II. BACKGROUND TO THE CRISIS OF THE EARLY 1990S

5. *The expansion of Finland's public expenditure occurred over a period of two decades.* In the early 1970s public spending accounted for just 30 percent of GDP, a ratio similar to that in the United States and clearly below that in other Nordic countries (Figure 1). The size of the public sector began to increase in the mid-1970s, and by the second half of the 1980s the public expenditure-to-GDP ratio had reached 45 percent. However, the expenditure ratio in Finland only began to exceed the EU average and approach other Nordic levels of about 60 percent of GDP when a severe recession in the early 1990s led to a cumulative drop in real GDP by nearly 10 percent between 1990 and 1993.<sup>3</sup> Since then, the expenditure ratio has fallen considerably—broadly in parallel with that of other Nordic countries—and was less than 50 percent of GDP in 1998.

6. *The rise in Finland's expenditure ratio in the late 1970s and the 1980s reflected a shift toward a larger role of the state in the provision of welfare services and the achievement of social objectives.*<sup>4</sup> As a consequence, the share of welfare-related public consumption—comprising expenditures on education, health care, and other social services—grew by some two-fifths in relation to GDP (from 9¼ to 13¼ percent of GDP) between 1977 and 1987, accompanied by a sharp increase in public sector employment (Figure 2). By 1987 total welfare spending, including current transfers and social security benefits, accounted for almost one-quarter of GDP and more than half of total public expenditure (see Box 1 for the key features of the Finnish welfare system).

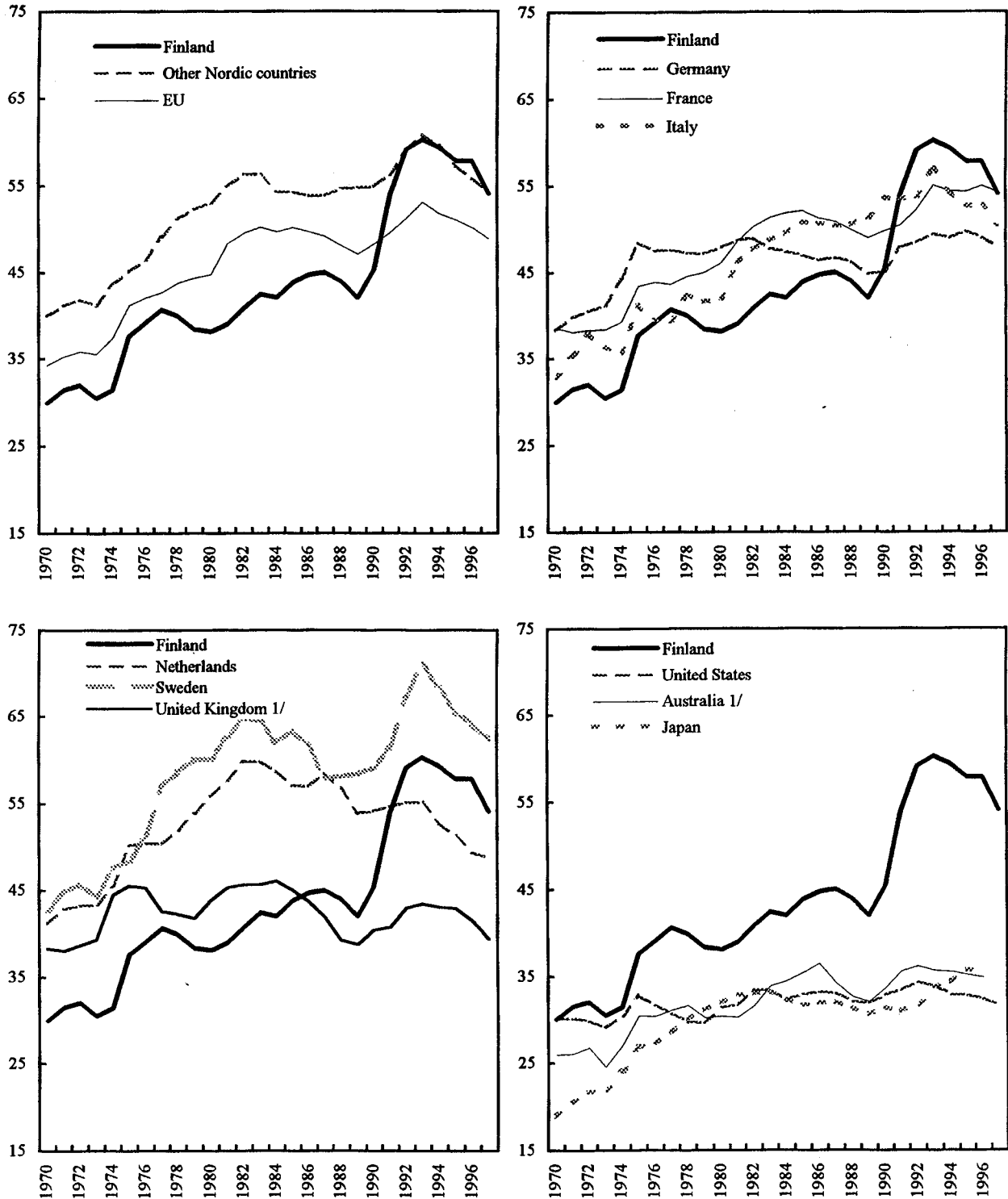
7. *Despite the expansion of the welfare system during this period, Finland's expenditure ratio remained below that of other European countries, and the public finances continued to be in surplus.* Two structural factors were important in this regard: a low unemployment rate and a favorable population structure, with a relatively small proportion of old people. In addition, the budgetary consequences of the increase in public expenditure were offset by a steady increase in the tax ratio from 35 percent of GDP in the early seventies to 46 percent in 1990—an approach which raised the tax burden to a high level but avoided the sizeable deficits experienced by some other advanced economies over this period.

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<sup>3</sup> The recession was caused by a combination of adverse factors, including the collapse of trade with the former Soviet Union, a terms of trade shock, the bursting of an asset price bubble, and an overvalued exchange rate.

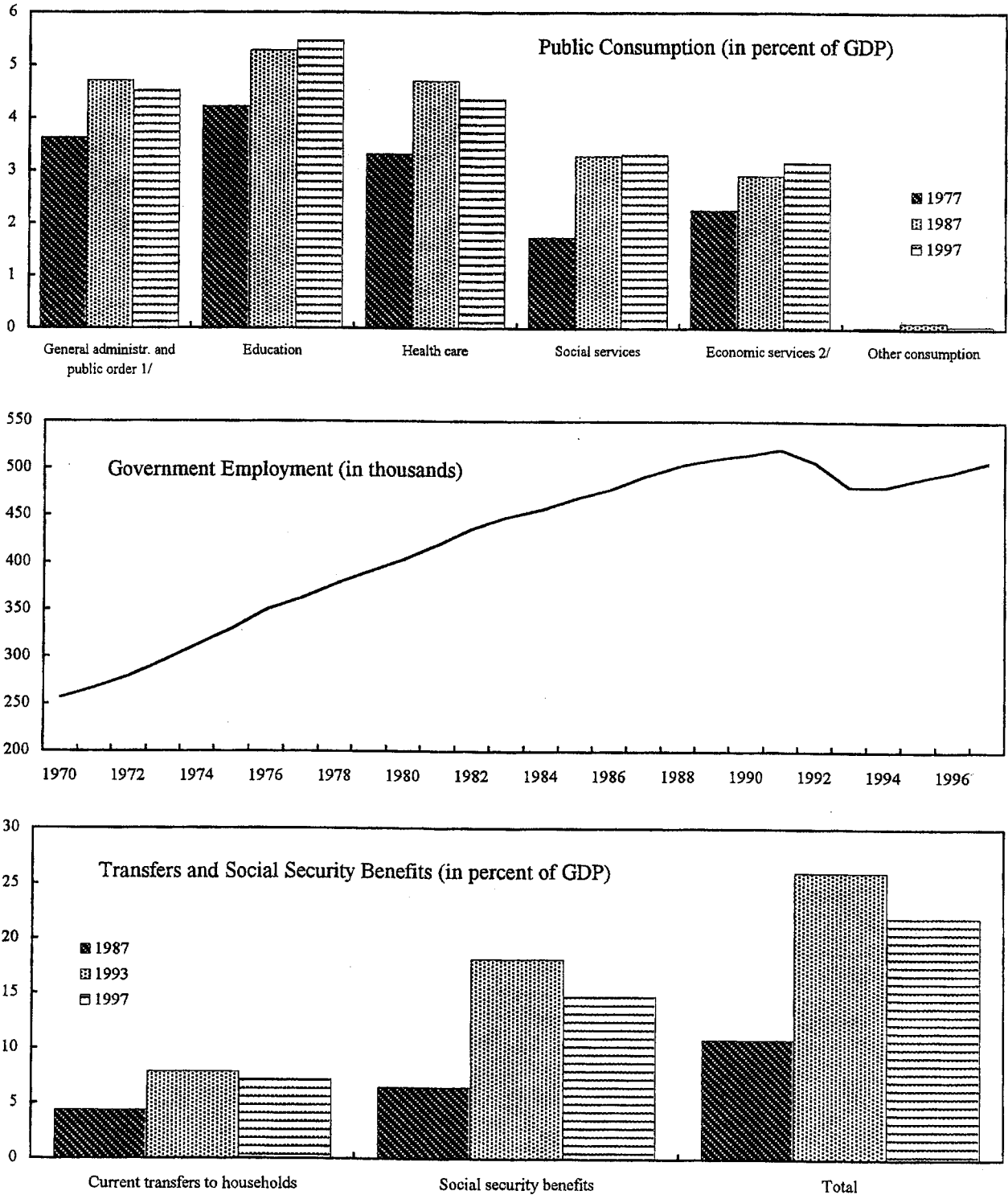
<sup>4</sup> Welfare spending in the context of this paper is defined in a broad sense, covering all outlays related to the social mandate of the government, including the provision of social services, such as health and education, current transfers to households, and social security benefits.

Figure 1. Public Expenditure in Selected Countries, 1970-97  
(In percent of GDP)



Sources: OECD, World Economic Outlook, and staff estimates.  
1/ Based on World Economic Outlook data.

Figure 2. Finland: Size of the Public Sector-Selected Indicators



Sources: Ministry of Finance, OECD, and staff estimates.

1/ Including defense.

2/ Includes housing and community amenities, recreation and culture, transport and communications, and other economic services.

### **Box 1: The Welfare System<sup>1</sup>**

The Finnish social welfare system is comparable with those of the other Nordic countries, being characterized by relatively high social expenditures and high levels of government employment in social services. In 1998, more than two-thirds of Finland's public expenditures (one-third of GDP) were welfare related, which is high by international standards. Comparisons of welfare spending across countries are problematic, however, as in some countries current transfers are handled entirely by the public sector, while they are part of a private insurance system in others. Also, the same benefits that are provided in the form of direct benefits in one country may be provided in others via tax relief, i.e., without increasing public expenditure. The provision of public welfare services in Finland includes pensions, sickness and unemployment benefits, health care, education, day care for children, child allowances, housing support, and basic subsistence security, and follows three alternative principles, depending on the type of service provided:

- Universal benefits, which are provided to every eligible citizen, irrespective of income level or other discriminatory factors. These include education, child allowances, maternity benefits, the basic pension, and a large portion of social and health services;
- Targeted benefits, which are granted only to persons below a certain income level or on the basis of a need defined in another way. Examples include subsistence assistance, housing subsidies, and children's day-care fees; and
- Earnings-related benefits, which are tied to the level of earned income, such as earnings-related pensions and daily allowances for unemployment and sickness.

The Finnish welfare system embodies a comprehensive scheme of current transfers, which played an important role in cushioning the adverse effects of the recession in the early 1990s. In combination with high income taxation, this system has led to a distribution of disposable income that is one of the most even in the world, and the proportion of people living in poverty is the lowest in the EU. However, the combination of high marginal tax rates—which exceed 50 percent for average income levels—and social benefits that are insufficiently tied to efforts to find a job, create serious employment disincentives. A number of measures have been taken recently to reduce these incentive problems, including a tightening of unemployment benefit eligibility; the lifting of inflation indexation on unemployment benefits during the past few years; and a considerable increase in the level of earned income exempt from local government taxation. As a result, the threshold wage—i.e., the gross wage at which the take-home pay is equal to an unemployed person's net income—has fallen significantly since 1996 (by up to 35 percent for single people without children). However, the reduction started from a high base and unemployment traps still exist.

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<sup>1</sup>See OECD (1995) and Prime Minister's Office (1999), for a more detailed discussion of the Finnish welfare system.



8. ***With the severe recession of the early 1990s, however, the public finances deteriorated sharply.*** The number of social benefit recipients soared as a result of a dramatic rise in the unemployment rate—from 3½ percent in 1990 to over 16 percent in 1993 (and 18 percent in early 1994). In consequence, current transfers and social security expenditures increased to more than a quarter of GDP, compared with only 10 percent five years earlier (Figure 2), and total welfare spending rose to some 40 percent of GDP. In parallel, the total expenditure ratio, which had hovered around 45 percent of GDP between 1985 and 1990, peaked at close to 60 percent in 1993, and the debt ratio quadrupled in the course of three years (Table 1).

### III. FISCAL CONSOLIDATION IN THE 1990S

9. ***Following the deterioration of the public finances in the early 1990s, the remainder of the decade was marked by strong fiscal consolidation, based on restraint in public spending.*** The adjustment was supported by a number of institutional reforms, which affected all subsectors of the general government. The key components of the reformed system are: (i) a medium-term framework for central government expenditure, with annual ceilings for individual ministries (also covering transfers to other subsectors of government); (ii) formal spending and taxation autonomy for local governments, who tend in practice to observe a balanced budget rule; and (iii) a comprehensive and mandatory social security system, under partly private management but subject to public regulation.

10. ***The keystone of Finland's expenditure management system was the introduction of cabinet-level agreement on medium-term public spending plans for the central government.*** Though this approach focused operationally on the central government, the plans and priorities set at this level were conceived as the main vehicle to carry forward a strategy for the broad general government finances, embracing deficit, debt, and tax reduction goals. To clarify the way in which this system has operated, the following discussion first provides a background on key features of the local government and social security finances; second, outlines the medium-term framework, with its focus on the central government; and finally, presents an overview of the public expenditure consolidation achieved via this framework through the 1990s.

#### A. Local Governments and the Social Security Funds

11. ***Local governments in Finland play a major role as the provider of most basic services in the areas of primary and secondary education, health and social services, and public utilities.*** Given their wide range of responsibilities, local governments are also the main public sector employer, with about 400,000 employees, equivalent to some three-quarters of total public sector employment. Although local governments enjoy formal autonomy in their expenditure decisions, many of their functions are statutory, thus reducing the scope for discretionary actions.

12. ***Local governments finance their expenditures mainly by direct taxes, but this revenue base itself is strongly influenced by the central government.*** Tax revenues accounted for some two-thirds of total local government revenue in 1998, including a proportional income tax, a

Table 1. Finland: General Government Finances, 1990-99

	1990	1991	1992	1993	1994	1995	1996	1997	1998 Prel.	1999 Proj.
	(In percent of GDP)									
Revenue	50.0	51.8	52.1	51.9	52.5	51.7	52.8	51.4	51.0	50.7
Taxes	44.6	46.6	46.1	45.5	47.4	45.3	46.6	45.6	45.9	45.9
Direct taxes	17.6	17.7	16.7	15.8	17.3	17.5	18.9	18.5	19.0	18.9
Indirect taxes	15.4	15.4	15.1	14.8	14.5	13.1	13.7	13.9	14.0	14.0
Social security contributions	11.6	13.5	14.4	14.9	15.7	14.7	14.0	13.3	12.9	13.0
Property and entrepreneurial income	3.8	4.7	5.3	5.8	4.6	5.0	5.0	4.6	4.2	3.8
of which: interest income	3.2	3.9	4.5	4.8	3.8	4.1	3.9	3.5	3.0	2.9
Other nontax revenue	1.5	0.5	0.6	0.7	0.5	1.4	1.2	1.2	0.9	1.0
Expenditure	44.5	52.8	57.6	59.1	58.3	56.1	55.8	52.9	49.5	47.7
Current expenditure	42.6	50.7	56.0	58.2	57.1	55.4	54.7	52.3	48.9	47.2
Consumption	21.6	24.8	25.3	24.2	23.3	22.8	23.0	22.2	21.2	20.9
Social security benefits	12.7	15.5	18.3	18.2	17.4	16.2	15.9	14.8	13.5	13.2
Transfers to households	3.9	5.1	6.2	7.9	8.3	7.9	7.4	7.2	6.8	6.5
Subsidies to enterprises	2.9	3.4	3.5	3.3	3.1	3.3	2.7	2.5	2.2	2.1
Interest payments	1.4	1.9	2.6	4.5	4.9	5.1	5.5	5.4	5.0	4.4
Other current expenditure	0.1	0.1	0.1	0.2	0.0	0.2	0.2	0.2	0.2	0.2
Gross capital formation	3.9	4.1	3.7	3.0	3.1	3.0	2.9	3.1	2.9	2.7
Depreciation and capital transfers, net	-2.0	-2.0	-2.1	-2.2	-1.9	-2.3	-1.8	-2.5	-2.3	-2.2
Balance	5.4	-1.1	-5.5	-7.1	-5.8	-4.4	-3.0	-1.6	1.5	3.0
<i>Memorandum items:</i>										
Primary balance 1/	3.7	-3.0	-7.5	-7.5	-4.7	-3.4	-1.4	0.3	3.4	4.5
Primary revenue	46.8	47.9	47.5	47.1	48.7	47.6	48.8	47.9	48.0	47.8
Primary expenditure	43.1	50.9	55.0	54.6	53.4	51.0	50.2	47.5	44.6	43.3
Public debt (EMU definition)	14.4	22.7	40.7	56.8	58.4	56.9	56.5	53.9	48.4	45.8
	(Real index, GDP deflator basis, 1992 = 100)									
Primary expenditure	86.0	95.6	100.0	98.6	100.0	99.3	101.8	101.7	100.7	101.3
Consumption	84.5	94.4	100.0	99.9	100.6	100.8	102.5	103.3	102.2	103.2
Household benefits and transfers	74.4	86.9	100.0	105.9	108.2	105.3	106.1	106.1	103.0	103.6
Subsidies to enterprises	90.5	99.8	100.0	94.1	92.1	99.8	85.2	83.1	79.2	76.8
Gross capital formation	115.9	114.0	100.0	80.9	86.7	85.6	88.4	98.8	97.6	93.2

Source: Ministry of Finance.

1/ Defined as noninterest revenue minus noninterest expenditures.

share of the corporate tax, and a real estate tax. The rate of the municipal income tax—which generates about 80 percent of local governments' tax revenues—is determined by the municipalities themselves; but the central government decides on the threshold income subject to local taxation, and thus, on the revenue base. The central government also has a significant influence on local governments' other revenue sources, most directly through the level of state transfers.<sup>5</sup> Such transfers had played an increasing role in the financing of local governments until 1993, when they covered 45 percent of local government expenditures. In conjunction with a reform that linked transfers to certain municipal indicators (such as population, age distribution, and the level of unemployment) rather than actual outlays, their share in total local government spending has declined to a little more than a quarter in 1998—a proportion equivalent to that at the beginning of the 1960s.<sup>6</sup>

13. *The expenditures of the social security funds are to a large extent exogenous in the short run—being driven by cyclical and demographic developments—but the underlying parameters, such as the scope and duration of benefits, are determined by central government policy decisions.* The social security funds encompass the national social insurance institution, the unemployment benefit funds, and the employment pension schemes of both the private sector and local governments.<sup>7</sup> The financing of these funds is primarily via contributions from the employers and employees, based on wage and salary payments, but the funds also receive significant transfers from the central government (averaging one-third of annual revenues since 1993) to cover outlays on the national pension and the basic unemployment benefit. Although the pension funds of private sector employees are privately managed, they are included in the general government, primarily because participation is mandatory and comprehensive, and because they are tightly regulated by the state (see Box 2 for a description of the Finnish pension system). Reforms undertaken in recent years have aimed at containing the long-run cost of the social security system, and are beginning to discourage early withdrawal from the labor force and to influence significantly the real growth of public spending (for details, see C below).

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<sup>5</sup> The state also determines the share of corporate tax revenues accruing to local governments (which was reduced by 4¾ percentage points to 40 percent in 1998); the upper and lower bounds for real estate taxes; and the fee basis for various social services (e.g., health service fees), many of which, such as basic education, are free.

<sup>6</sup> To equalize income levels across municipalities, state transfers are adjusted on the basis of revenues. Specifically, municipalities with a tax income (on a per capita basis) of less than 90 percent of the national average receive the difference in the form of a state grant, financed largely by reduced transfers to municipalities with a tax income of more than 90 percent of the national average (with the reduction equivalent to 40 percent of the tax income above the 90 percent threshold).

<sup>7</sup> The state employment pension fund (VEL) for central government employees is included in the central government.

### **Box 2: The Pension System**

The Finnish pension system consists of **two parallel statutory systems**—the national (or basic) pension scheme and the employment pension scheme. In addition, group pension insurance—most common in large companies and primarily paid by employers—as well as personal pension plans are available, on a voluntary basis, to supplement the statutory schemes. Neither of the two voluntary schemes plays an important role in overall pension provision, reflecting the relatively high pension level and comprehensive coverage under the statutory schemes. Nevertheless, more recently the voluntary schemes have been growing quite rapidly, in part stimulated by tax incentives.

Both statutory schemes are **defined-benefit systems** and provide old-age, disability, survivor's, and unemployment pensions (the latter for unemployed persons aged 60 and over). The national pension scheme provides pensions on the basis of residence, with the amount dependent on a person's employment pension level, to guarantee a minimum income. The share of national pensions has fallen from one-third to one-quarter of all statutory pension expenditures between 1994 and 1998, and will be falling further, with rising employment pension levels. The employment pension scheme is based on employment and related to earnings. The maximum pension (obtained after 40 years of employment) is 60 percent of the pensionable wage, determined as the average wage during the last 10 years of employment.

The employment pension scheme **covers virtually the entire working population**, either as employees or self-employed. Its main components are the public sector scheme, which is entirely on a **pay-as-you-go basis**, and various private sector schemes (TEL), which are privately managed and **partially funded** (currently one-third of the total contributions). In 1998, contributions to the TEL were equivalent to 21½ percent of the wage bill, with more than three-quarters financed by employers. Pension funds are regulated by the Insurance Supervision Agency, in particular through a "solvency system", determining the actuarial capital required by pension funds in relation to the composition of their portfolios.

Both the TEL and the pension scheme of local government employees were traditionally classified as private financial institutions, and were only **integrated into the public sector** in 1994. Due to the Finnish pension scheme being predominantly a pay-as-you-go system, where contributions and benefits are independent of an individual's risk characteristics, the new classification was consistent with the practice then followed by Eurostat. Under the new European System of Accounts (ESA95), to be applied uniformly in the euro area after the end of this year, inclusion of pension schemes in the general government will depend on new criteria, namely, whether the schemes are (i) mandatory; (ii) comprehensive; and (iii) "managed" by the government, with regard to the determination of contributions and benefits. While this will likely result in some reclassifications in a number of euro-area countries, it is not expected to affect the classification of Finland's two statutory pension schemes as part of the general government.

## **B. The Medium-Term Framework for Central Government Expenditure**

14. *In 1991, the Finnish authorities initiated a shift toward a medium-term expenditure framework by merging the formerly separate processes of multi-year planning and annual budget preparation.* A cabinet decision was issued which set the maximum level of total central government expenditure, and expenditure ceilings for each ministry, both covering the budget year and the two following years. Roughly in parallel with the adoption of medium-term expenditure ceilings, the government also began to replace the system of line-item budgeting at the agency level with lump-sum appropriations. Such lump-sum appropriations (for all expenditures other than those related to the purchase of real estate and financial assets) are now standard in all agencies. Building on these reforms, the government entering office in 1995 adopted a fully-fledged medium-term framework, covering annual central government expenditure for its entire four-year term—a practice that has been continued by the current government, which was elected in March 1999.

15. *The shift to a medium-term expenditure framework offered a number of potential advantages.* Most notably, it facilitated a strategic and transparent approach to prioritizing resource use, geared to medium-term fiscal objectives; and it provided spending departments with greater autonomy in managing their resources. Indeed, Finland is among a growing number of countries to set their public expenditure policies in some form of medium-term framework, with a view to achieving these gains.

16. *Among countries adopting medium-term expenditure frameworks, specifics of implementation have differed, and it is helpful to set the Finnish approach in a somewhat wider context.* To this end, a comparison of selected features of medium-term public expenditure frameworks in Finland, the Netherlands, and the United Kingdom is provided in Table 2. Among the common features in these countries are:

- Formulation by the government of ceilings for the budget year, and also for the following two or three years, which cover relatively broad expenditure aggregates (albeit with variations in the coverage of cyclically-sensitive items) and are set in the context of medium-term goals for the fiscal deficit, public debt ratio, and tax burden.
- Development of spending norms, consistent with the aggregate ceiling, for individual ministries or departments, to whom a significant degree of implementation autonomy is then allowed, with formal or informal accountability for the quality of results achieved.
- An emphasis on securing political commitment to these spending goals, typically through formal understandings endorsed by the cabinet of ministers, which in effect tie the government's own hands, without being legally binding beyond the budget year.
- Performance targets, formal rules, or traditional goals, that govern gross or net spending by lower levels of government.

Table 2. Medium-Term Public Expenditure Programming in Finland, the Netherlands, and the United Kingdom

	Finland	Netherlands	United Kingdom	Pros and Cons
Horizon	Four years, on annually rolling basis	Four years, set at outset of coalition period	Three years on a two-year rolling basis (i.e., with successive frameworks overlapping by one year) for non-cyclical expenditures (see coverage); cyclical or volatile spending is managed on an annual basis	Longer horizon and fixed ceilings provide more certainty and discipline to managers, but reduce flexibility in case of changing circumstances
Objective	In past, mainly geared to deficit reduction; in future also to provide room for tax cuts	To achieve a parallel reduction in the deficit and tax burden	Over the cycle, to balance the current budget and maintain investment (and hence borrowing) at a sustainable level, while meeting the Government's priorities	Prominence of deficit goal should reflect considerations of public debt sustainability (factoring in demographics), plus room for stabilizers; goal for taxes should reflect, inter alia, extent tax wedge distorts labor market and thus long-run fiscal outlook
Coverage of medium-term spending targets	Total central government expenditures and subceilings for individual ministries, including transfers to local governments and social security funds; excludes local governments' self-financed expenditure	Expenditures of central government (excluding infrastructure fund) and social security funds; subceilings on central government, health, and social security	Departmental Expenditure Limits (DELs), covering most non-cyclical primary expenditures (some half of total expenditures); includes central government support for local government but not local authority's self-financed expenditure	Comprehensive coverage is more transparent and effective but may constrain automatic stabilizers unduly; inclusion of local governments requires their autonomy to be limited, with risks of adverse incentive/accountability effects
Statutory nature of medium-term spending targets	Budget year binding; outer years agreed by cabinet as nonbinding norm to ministries; published but not submitted to parliament	Budget year binding; outer years politically but not legally binding; submitted to parliament for information; contingency reserve to deal with changing circumstances	Budget year binding; outer years not legally binding but overall DELs announced in parliament; contingency reserve to deal with changing circumstances	Politically binding targets favor discipline and credibility; legally binding limits might constrain flexibility unduly

Table 2 (concluded). Medium-Term Public Expenditure Programming in Finland, the Netherlands, and the United Kingdom

	Finland	Netherlands	United Kingdom	Pros and Cons
Nominal or real targets	Medium-term at constant prices of budget year; for new budget translated to current prices based on specific price and cost deflators	Medium-term at constant prices; for one-year budget, translated to current prices based on projected GDP deflator	All targets set in current prices	Medium-term based on constant prices facilitates real resource planning; one-year budget must be nominal as inflation anchor; use of category-specific deflators may risk discouraging desired adjustment to relative price changes
Macroeconomic assumptions	Underlying assumptions reflect central forecast	Growth forecast cautious; rule splits "growth dividend" between additional deficit and tax cuts	Growth forecast at conservative end of potential output range	Reasonably prudent assumptions on growth, inflation, and interest rates essential; but, if unduly so, may over time create credibility problems and "second-guessing"
Adjustments in target levels for outer years	Ceilings for outer years can be adjusted; automatic adjustment for wage and salary increases	No adjustment in real expenditure; only "automatic" translation of targets into current prices based on aggregate inflation forecast	Medium-term DELs in current prices are adjusted only if new inflation forecasts differ significantly from original projections	Adjustments provide flexibility in case of unanticipated exogenous developments or desired policy changes but reduce imposed discipline, transparency, and credibility of the system
Autonomy and incentives at lower levels	Ministries and agencies bound by annual budget; some appropriations transferable, avoiding "forced" consumption at end of fiscal year	Ministries and agencies bound by annual budget; part of funds can be carried over to next year; no penalties have been imposed for repeated healthcare overruns	Individual departments bound by DELs; within these limits departments can recycle any efficiency savings they make; unspent DEL funds can be carried over to next year; overruns are avoided by strict DELs.	Carry-over discourages excessive spending at end of fiscal year; tolerance of overruns lowers credibility but is difficult to avoid, if coverage includes cyclical items or other expenditures, that are difficult to control
Output objectives and quality control	Agencies establish result and efficiency targets, with ex-post evaluation by ministries	No formalized output objectives	Publication of Public Service Agreements alongside spending plans, stating departments' goals and setting specific quantified policy and efficiency targets.	Experience with performance objectives positive; but tensions between output objectives and spending restraint possible, if output objectives introduced before budgetary discipline is inculcated

These features offer the potential to combine fiscal discipline with setting allocative priorities transparently across government programs, and providing incentives for administrative units to achieve goals efficiently.<sup>8</sup>

17. ***Seen in this context, one notable feature of the medium-term framework in Finland is the comprehensive coverage of central government expenditure.*** Cyclical spending components, such as the basic unemployment benefit, are included in the ceilings, as are interest expenditures (a feature that Finland has in common with the Netherlands but not with the United Kingdom). While this inclusion of cyclically-sensitive items has advantages in terms of fiscal discipline and control, it restrains the operation of automatic stabilizers on the expenditure side.

18. ***The approach in Finland is flexible in implementation in several respects.*** First, while there is no specific contingency reserve for unexpected outlays, the Finnish system allows for some revisions in the ceilings, which are binding for the budget year only. Second the “outyears” of the medium-term expenditure program are formulated in constant prices, which are subsequently translated into current prices based on specific price and cost deflators (adjustments are made for ongoing wage and salary settlements once these have been concluded). This contrasts with the practice in the Netherlands, where the outyears are also programmed in real terms but the GDP deflator is used for translation into prices of future years, irrespective of wage agreements (with the exception of wage awards agreed before the negotiation of the ceilings). It also contrasts with the approach in the United Kingdom, which uses nominal ceilings for the entire medium-term period.

19. ***Considerable administrative autonomy at the ministerial and agency levels has been complemented by the setting of performance targets to enhance accountability.*** Performance targets have been developed between ministries and their agencies to improve the productivity and profitability of certain services; and *ex ante* budget controls have been replaced with *ex post* auditing and evaluation. Similar to recent developments in the United Kingdom, this approach has been instrumental in achieving the government’s expenditure restraint goals by inducing ministries and agencies to become more cost-conscious.<sup>9</sup>

### C. Experience with Expenditure Control

20. ***Since the introduction of medium-term expenditure ceilings in 1991, two successive governments have been able to limit the primary spending of the general government to around its 1992 level in real terms (Table 1).*** This restraint was achieved against the background of cumulative real GDP growth of over 20 percent during 1992–98. As a consequence, while

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<sup>8</sup> For an elaboration of the key principles of sound budgeting and financial management, see World Bank (1998) and Potter, Diamond (1999).

<sup>9</sup> In fact, the introduction of result targets has led to overperformance of agencies, with unused balances averaging 10 percent of the original budget. Another country that illustrates strikingly the scope to combine implementation autonomy with performance objectives is New Zealand (see Scott (1996)).



interest payments doubled as a ratio to GDP (rising from 2½ percent in 1992 to 5 percent in 1998), the total expenditure ratio dropped from a peak of 59 percent of GDP in 1993 to less than 50 percent in 1998.

21. ***Estimates of cyclically-adjusted primary expenditures in the 1990s show a degree of restraint similar to that observed in actual spending.*** To help assess the overall discretionary expenditure efforts undertaken by the government since 1990, Figure 3 (upper panel) shows, in addition to the actual primary expenditure ratio, the development in structural primary spending (i.e., primary spending corrected for the cyclical component of unemployment benefits), as a ratio to GDP. Some caution is needed with regard to this measure, as it depends on estimates of structural unemployment and potential output, both of which are subject to considerable uncertainties (see Box 3 for a discussion of different measures of potential output in Finland). Reflecting the fall in cyclical unemployment benefits after 1993, the adjustment in structural primary expenditure was slightly smaller than the reduction in the actual spending ratio. However, with a relatively small share of unemployment-related benefits in overall expenditure (averaging some 6½ percent in the period 1992-98), and a significant increase in structural unemployment, the cumulative drop in both primary expenditure ratios between 1992 and 1998 was of a similar magnitude, equivalent to some 10½ percent of GDP.<sup>10</sup>

22. ***This expenditure restraint was a key factor in the strengthening of Finland's fiscal position after the recession of the early 1990s.*** The overall fiscal stance during 1992-98 was clearly contractionary, evidenced by an average improvement in the structural primary balance of about 1 percent of GDP a year (Figure 3, lower panel). Based on this measure, an estimated 30 percent of the cumulative recovery in the fiscal position between 1992 and 1998 was due to cyclical factors (primarily on the revenue side) and the remainder to discretionary actions, with the broad stability in structural primary revenues implying that expenditure restraint was the most important contributor to the structural consolidation.<sup>11</sup>

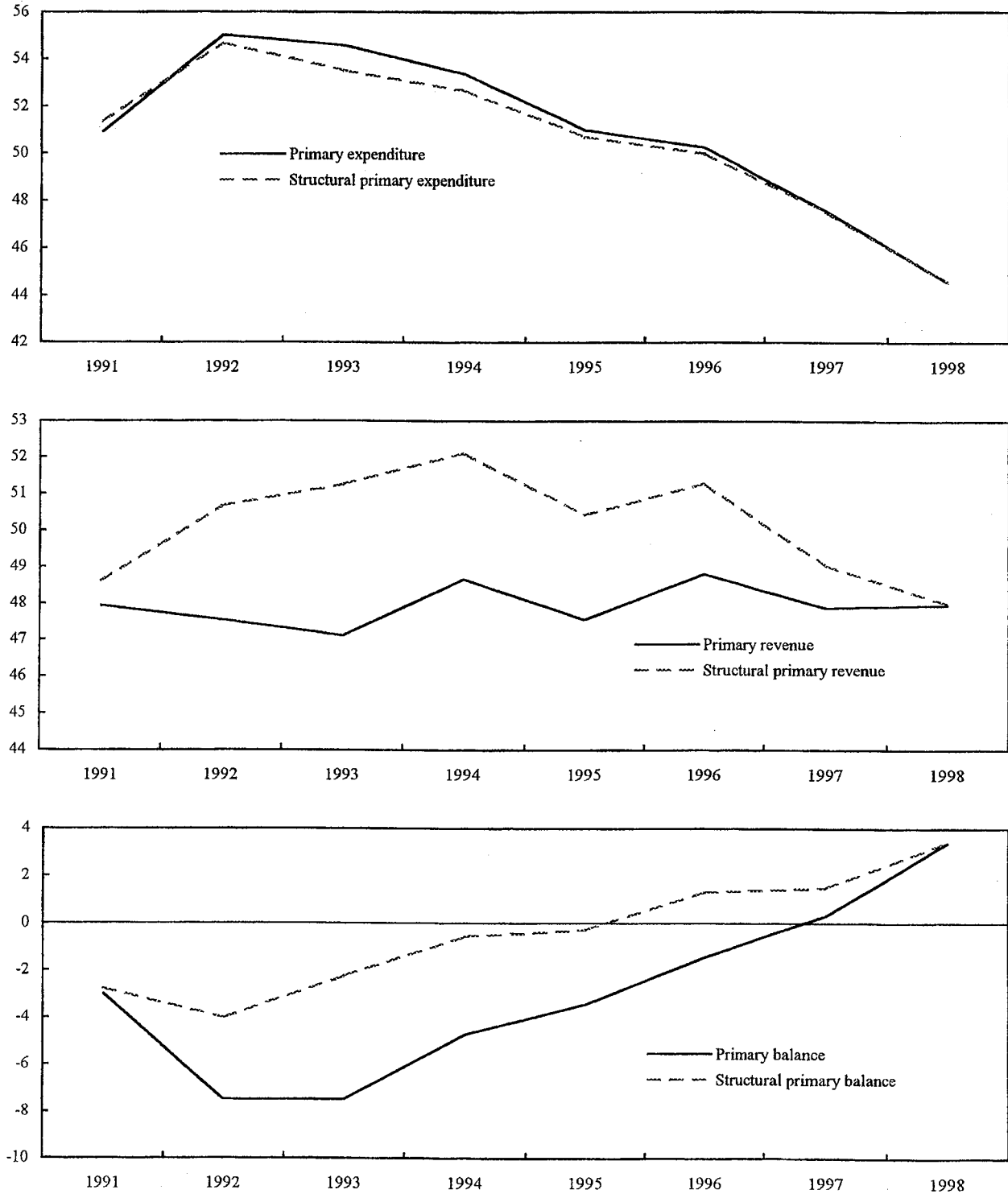
23. ***All categories of public spending have responded to the pressures for expenditure restraint, though the impact has been evident only recently in the area of social transfers.*** Of the overall 10½ percent of GDP reduction in the primary spending ratio from 1992 to 1998, public consumption and household benefits and transfers (social security benefits plus other transfers to households) each contributed just over 4 percentage points, while enterprise subsidies and public investment fell some 1¼ and ¾ percentage points respectively (Table 1). Proportionately, the initial burden of restraint fell most heavily on the latter two items. Public investment, in particular, was cut by almost 20 percent in real terms in 1993, with some recovery

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<sup>10</sup> The rise in structural unemployment is explained, *inter alia*, by the permanent redundancy of part of the capital stock.

<sup>11</sup> An alternative approach to assess the fiscal stance, suggested by Blanchard (1990), which derives revenue and expenditure trends on the basis of an unchanged unemployment rate between two years, produces similar results. For a comparison of the different approaches see Brunila *et al* (1999).

Figure 3. Finland: Indicators of Fiscal Adjustment, 1991-98



Sources: Ministry of Finance and staff estimates.

### **Box 3: Alternative Measures of Potential Output**

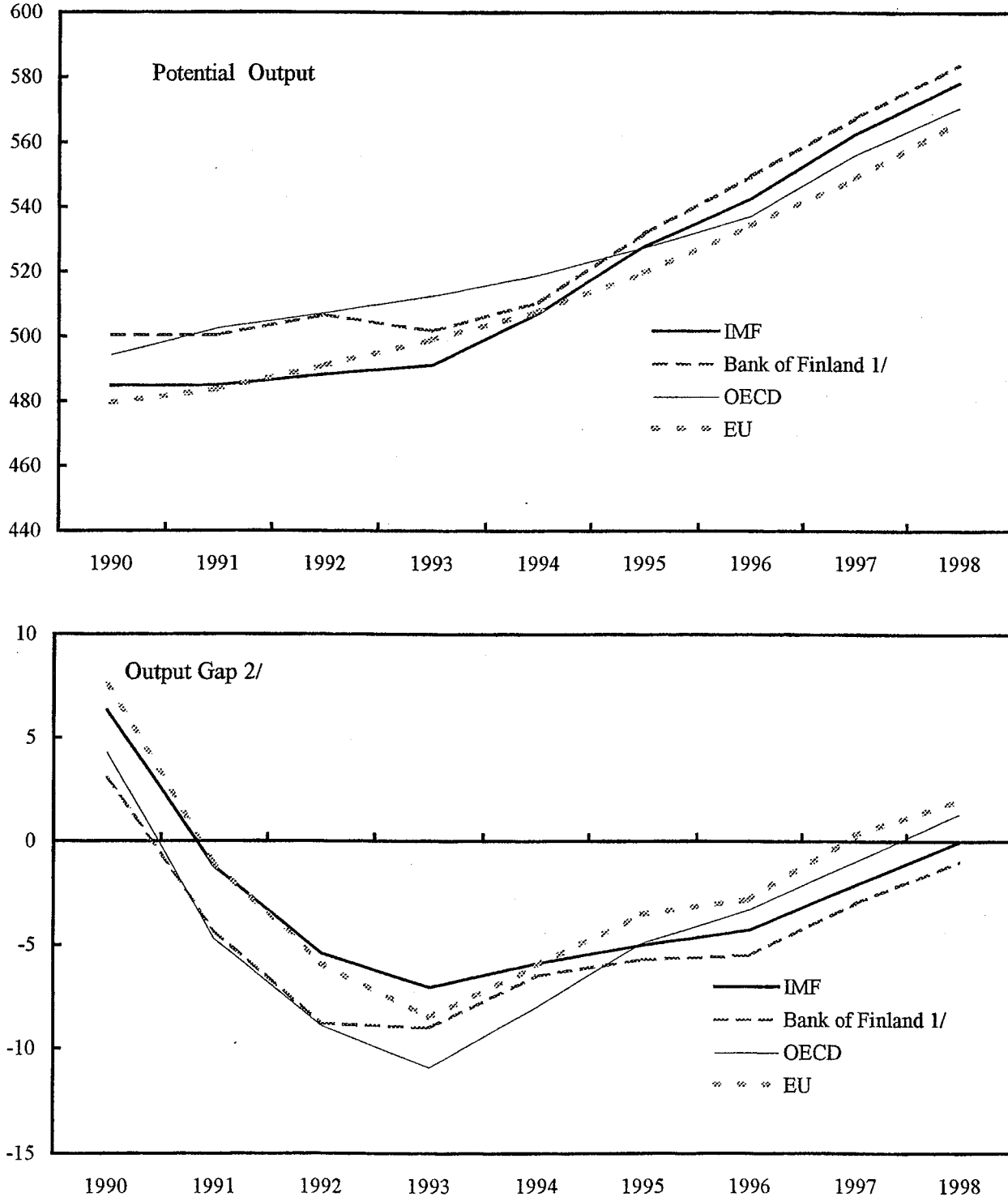
Potential output is defined as the output level consistent with the economy operating at full capacity. The two principal methods commonly used to calculate potential output and the corresponding output gap are the time-series (or filter) and the production-function approaches. The **filter method** derives potential output as the trend component of GDP. It is technically straightforward and can be applied without additional assumptions (aside from decisions on the appropriate trend-estimation technique). The caveat that applies, however, lies in the implicit assumption that output gaps (i.e., the difference between actual and potential output) sum up to zero over time, which makes the results sensitive to the particular period selected, with typically higher weight attached to the final observations.

The **production function approach** links the estimate of potential output to the stock of capital and labor at full capacity, which requires an estimate of the capital stock and the unobserved level of full employment. It also relies on a stable production structure, in order to generate reasonable results. In the case of Finland, this latter assumption is problematic, given both the severe shock at the beginning of the decade (namely the collapse of trade with the former Soviet Union, which made productive capital in several industries obsolete) and the rapid reorientation and growth of industrial production following the crisis.

**Estimates by the European Commission** on the basis of a Hodrick-Prescott filter suggest an “positive” output gap (with GDP above potential) on the order of 2 percent of potential output in 1998 (Figure 4). **OECD estimates**, on the basis of a production function, indicate an positive gap of 1¼ percent for the same year. However, a production-function approach applied by the **Bank of Finland** suggests a negative gap (GDP below potential) of some 1 percent.

As a complement to the above measures, the **staff’s current approach** combines the production-function method, applied to the pre-crisis period of 1960-90, with a method for subsequent years that directly links the output gap to the employment gap, thus avoiding the need for estimating the “true” capital stock. Potential output during the pre-crisis period is derived on the basis of a Cobb-Douglas production function with labor (at the full employment level) and capital as inputs. Similar to the methodology followed by the OECD in the tradition of the *Phillips* curve, an estimate of full employment is obtained via a wage equation. Subject to greater uncertainty about the NAIRU in a centralized bargaining system, it is assumed that wage increases above (below) expected inflation and productivity growth indicate an unemployment rate below (above) the “natural” rate (i.e., the rate consistent with full employment). For the period after 1990, the methodology for estimating full employment is maintained, but estimates of the capital stock are circumvented by deriving the output gap—in line with *Okun’s law*—on the basis of the “employment gap” and the historical correlation between the two. The resulting estimate of potential output in 1998 falls within the range of those derived by the other institutions, with an output gap of close to zero.

Figure 4. Finland: Potential Output and Output Gap, 1990-98



Sources: OECD Economic Outlook, 1998; Bank of Finland, Discussion Papers, 1/99; and staff estimates.

1/ Based on production function approach.

2/ Defined as actual GDP minus potential output, in percent of potential output.

in later years. Real public consumption was kept relatively steady after 1992, suggesting that education, health care, public administration, and social and economic services were responsive to public expenditure control efforts, although only about half were attributed to the central government, and thus covered by expenditure ceilings. Household benefits and transfers, however, initially continued to rise after 1992, reflecting the “entitlement” features of these expenditures, along with the exclusion of a large part (most importantly, the earnings-related unemployment benefits, and old-age, unemployment, and disability pensions paid by the social security funds) from the coverage of the expenditure ceilings. Nevertheless, these expenditures have fallen more recently, reflecting both economic recovery, and the gradual effects of implementing various structural reforms in the unemployment allowance and pension systems.<sup>12</sup>

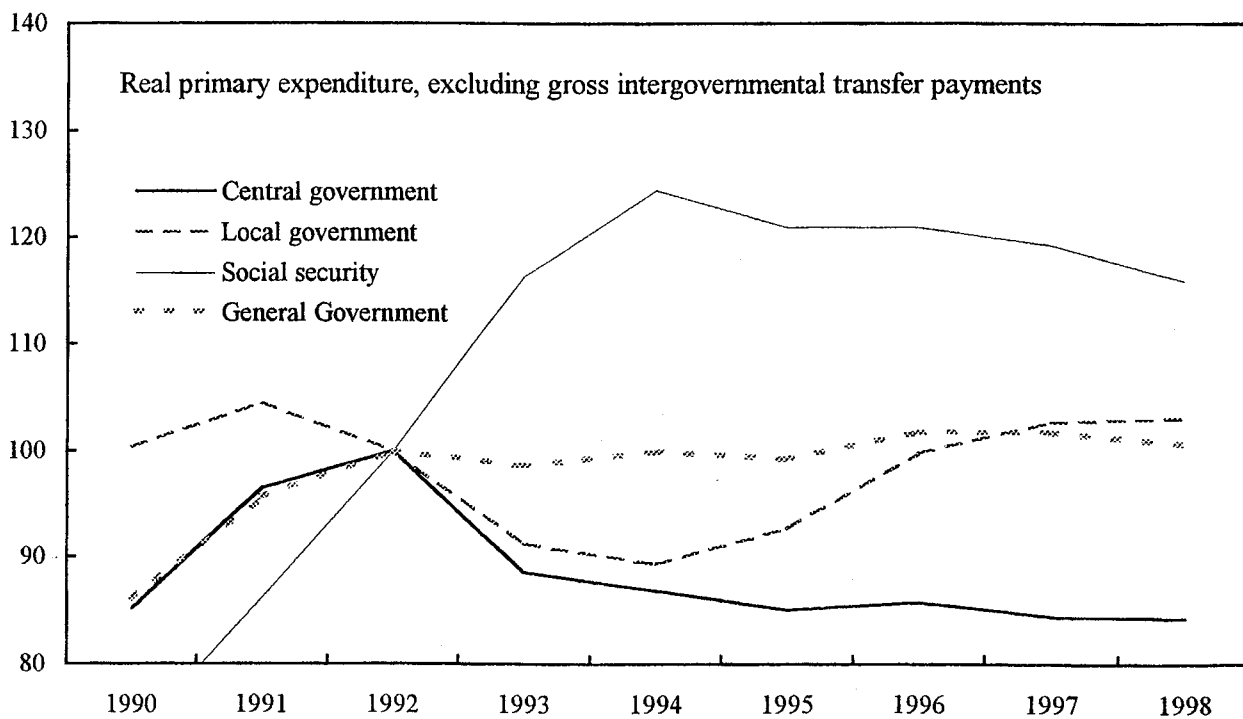
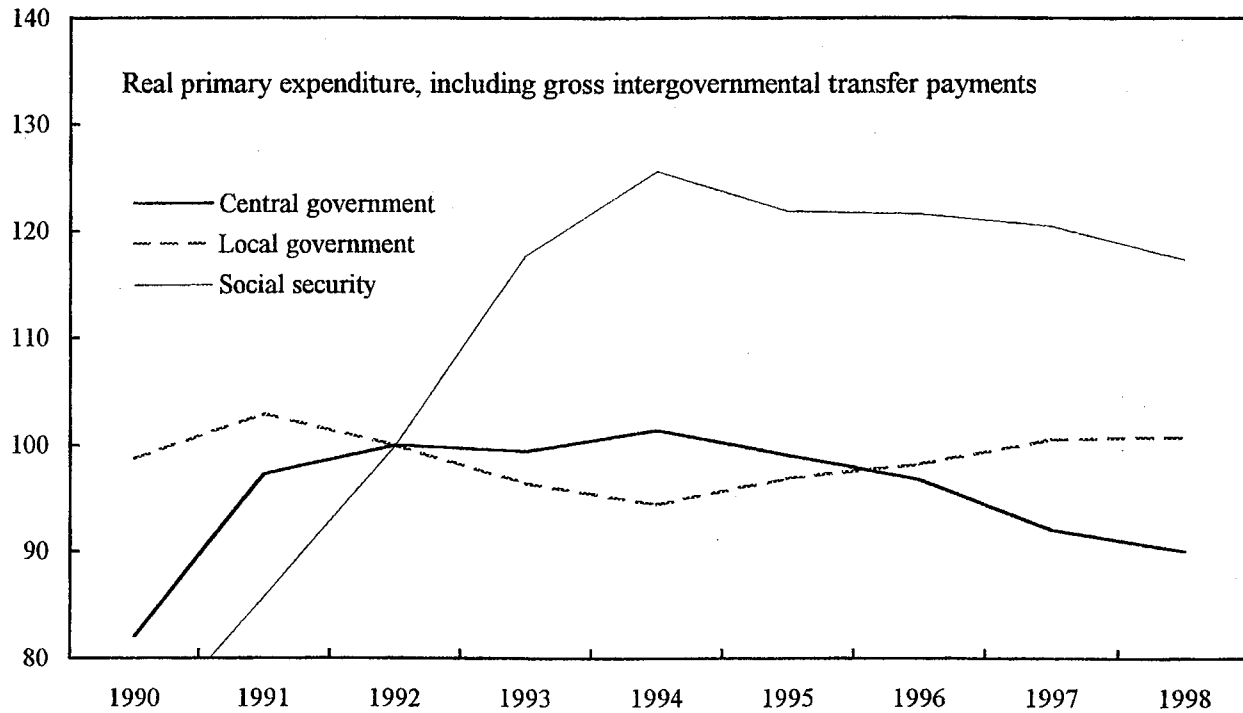
24. *An analysis of expenditure performance by level of government confirms that the medium-term framework has, with some lags, achieved restraint at all levels.* This result was achieved even though the ceilings apply only at the central government level:

- The central government was able to stabilize its own real primary expenditure, inclusive of transfers to other levels of government, over 1992–94, and subsequently to reduce spending by an annual average of 3 percent over 1994–98 (Figure 5, upper panel). While transfers to social security funds grew by an annual average of 3½ percent, in real terms, over the period 1992–98 (with a cumulative increase equivalent to some 4½ percent of GDP in 1993/94), transfers to local governments fell by 8 percent annually, contributing significantly to the successful consolidation of central government finances. Though local governments were able to raise income taxes and also obtain a higher share of the profit tax to keep their total revenues broadly stable in real terms, the reduction in state transfers, together with a relaxation of central controls over state-supported services, promoted expenditure savings and efficiency gains at the local level. Many municipalities reacted by redefining priorities and introducing new management techniques, thus enabling them to maintain aggregate real spending roughly at the 1992 level.
- To assess the individual contributions to the consolidated savings effort of the general government, the lower panel of Figure 5 shows expenditures, exclusive of those arising from transfers to other levels of government. Both central and local governments cut their own spending sharply in 1993/94, which is also reflected in a drop in public employment (Figure 2). These cuts were sufficient to cover ballooning social security outlays. In the subsequent years, local government expenditure, excluding intergovernmental transfers, has recovered to slightly above the 1992 level, while the central government has been able to lock-in the savings made. Social security outlays were stabilized only after 1994, but since then have declined significantly, in real terms.

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<sup>12</sup> See Sections IV and V below, and in particular Box 5, for a summary of labor market and pension reforms taken during the 1990s.

Figure 5. Finland: Real Primary Expenditure, 1990-98 1/  
(1992 = 100)



Sources: Ministry of Finance and staff estimates.  
1/ Nominal primary expenditure, deflated by GDP deflator.

25. ***While public expenditure restraint within the system of medium-term ceilings has made a key contribution to rebuilding the public finances, the current fiscal situation still presents significant challenges.*** The general government position shifted from a deficit of 7 percent of GDP at the low point of the recession to a surplus of 1½ percent of GDP in 1998. At the same time, the public debt ratio, on a consolidated basis (EMU definition), dropped by 10 percentage points to less than 50 percent of GDP. However, the revenue ratio remains in excess of 50 percent of GDP, and the structure of public expenditure is dominated by welfare spending, accounting for more than two-thirds of total public expenditure and one-third of GDP in 1998—which is high even by the standard of other EU economies.

#### IV. MEDIUM AND LONG-TERM POLICY OPTIONS

26. ***Looking ahead, the government faces three medium- and long-term fiscal concerns:*** (i) to prepare for anticipated expenditure pressures posed by a rapidly aging population; (ii) to maintain a fiscal position that can accommodate cyclical fluctuations within the 3 percent of GDP deficit limit of the EU Stability and Growth Pact (SGP); and (iii) to allow for cuts in indirect taxes, in line with agreed EU policies. From a broader macroeconomic perspective, however, the key challenge will be to combine the above with structural reforms in the labor market and pension system, thereby creating room for a substantial alleviation of the heavy tax burden. These are prerequisites for a significant and durable increase in the employment ratio.

27. ***To illustrate possible trade-offs between different policy options, this section presents two alternative scenarios.*** The *current policy scenario* assumes that tax cuts are limited to those already indicated by the government in its policy program, while expenditures are in line with current medium-term spending plans and, over the longer run, determined by exogenous developments. By capturing the government's prudent medium-term policy commitments, as well as the positive impact of recent structural reforms, this scenario is by no means a "non-adjustment" scenario. However, its implications, particularly for employment, remain suboptimal. To demonstrate the trade-offs, the alternative *high employment scenario* combines additional expenditure restraint with further structural reforms in the labor market and pension system, allowing stronger tax cuts, with favorable macroeconomic implications.

28. ***Both scenarios are based on projections through 2030, to capture the full impact of demographic pressures on the public finances in the future.*** From 2000 on, the government is assumed to maintain a position of surplus or balance—at both the central and general level—to ensure long-run compliance with the SGP.<sup>13</sup> However, the means for assuring this differ. In the

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<sup>13</sup> Earlier staff estimates indicated that, based on Finland's past output volatility (including the exceptional recession in the early nineties), a structural surplus in the general government's position of 1½ percent of GDP would provide a 95 percent probability of staying within the deficit ceiling. In the future, with increased diversification of the economy and integration into the EU market, output fluctuations are expected to be substantially less erratic, suggesting that long-term fiscal balance should provide sufficient room to deal with cyclical fluctuations within the limits of the SGP. The government's objective of achieving a parallel structural balance at the

current policy scenario, without further structural reforms and deeper expenditure restraint, the long-run pressures on public finances are ultimately addressed by high taxes. The high employment scenario, on the other hand, tackles structural reforms upfront, which—together with stronger expenditure restraint—creates scope for substantial tax cuts, setting off a virtuous circle of strong employment generation, higher growth, and fiscal savings. The key economic assumptions for the two scenarios are summarized in Box 4 and Table 3.

### A. Current Policy Scenario

29. *The current policy scenario incorporates the policy measures indicated in the government's medium-term program.* These include tight expenditure ceilings, with real spending in 2000–2003 (prior to real wage and salary increases) assumed to remain at the projected 1999 level, and tax cuts on labor income, on the order of 1½ percent of 1999 GDP—one-third of which is assumed to be offset by increases in other taxes. In addition, the scenario assumes a reduction in indirect taxes, in compliance with EU guidelines, by some ¾ percent of GDP, phased evenly between 2003 and 2004.

30. *Beyond the medium term, the government finances are assumed to be driven by exogenous developments, to illustrate the magnitude of expenditure pressures and their macroeconomic implications in the absence of further policy measures.* The detailed assumptions are as follows:

- **Current primary expenditures** grow in line with demographic developments and labor productivity, with the latter determining both real wage increases and cost increases for non-wage outlays, as well as the indexation of transfers and social security benefits.<sup>14</sup> Regarding the demographic impact, it is assumed that health expenditures respond to changes in the population structure, with higher cost attributed to higher ages.<sup>15</sup> Education expenditures are linked to trends in the age group of 7–19 year-olds; pensions to those aged 59 and older (assuming no change in the current effective retirement age); unemployment expenditure to the unemployment rate; and all other current expenditure to total population

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central level is consistent with this long-term strategy and, over the medium term, with its primary responsibility for fiscal stabilization, as local governments traditionally pursue a balanced budget policy and the position of the social security funds is regarded as primarily structural to accommodate increasing pension outlays in the future.

<sup>14</sup> The assumed development of nonwage outlays—while highly uncertain in its magnitude—reflects the assumption that the technology-induced increase in the real cost of providing government services will continue, with a particularly high potential in the area of health care.

<sup>15</sup> It is assumed that the per capita health care cost increase with age: expenses for persons below 20 years are two-thirds of those in the core age group (20–54 years), whereas costs for persons of 55–64 years, 65–74 years, and above 74 years are double, triple, and five times the expenses for the core group, respectively. The resulting long-term increase in health spending is in line with national projections (see Prime Minister's Office (1999)).



#### Box 4: Key Assumptions for Medium and Long-Term Fiscal Scenarios

- **Real GDP** growth is determined by developments in employment and labor productivity. The growth in **labor productivity** is assumed to taper off from around 2¼ percent over the medium-term to 2 percent by 2005 and 1½ percent by 2020.
- **Employment** is a function of the unemployment rate and the evolution of the **labor force**, with the latter determined by projections for the “effective” working-age population—defined as the population between 15 years and the effective retirement age—and the tax wedge. Beyond the initial positive impact of reforms already in place, it is assumed that every 1 percent of GDP reduction (increase) in the tax ratio (direct taxes and social security contributions) raises (reduces) the labor force by 0.2 percentage points. The **participation ratio** is then determined endogenously, as the share of the labor force in the *actual* working-age population (15-64 years).
- In the long-run (with output assumed to be at potential) the unemployment rate follows the **NAIRU**, which is derived on the basis of a wage equation. **Real wages** paid by the employer are assumed to grow in line with labor productivity and changes in the tax wedge. Reductions (increases) in the wedge imply that paid wages grow by less than productivity, resulting in higher (lower) demand for labor and a commensurate fall (rise) in the NAIRU (of ¼ percentage point for each 1 percent of GDP change in the tax wedge).
- The above assumptions are consistent with an **elasticity of the employment rate** to changes in the tax ratio of approximately one-third—a figure at the conservative end of both cross-country estimates and the findings of Finland-specific research.
- The **interest rate** paid on public debt is assumed to gradually decline from 7 percent in 1999 to 4¾ percent by 2005, reflecting the retirement of high-interest debt of the central government. The current negative interest differential between general government assets and liabilities is assumed to be eliminated by 2005.
- All real variables are translated into nominal values on the basis of the **GDP deflator**. After a temporary increase over the medium term, the inflation rate on this measure is assumed to stay at 1¾ percent in the long run.
- Based on national projections, the **population age structure** in Finland is assumed to deteriorate sharply after 2010, with a near doubling of the old-age dependency ratio (persons aged over 64, in percent of working-age population) from currently about 22 percent to 43 percent in 2030.

Table 3. Finland: Key Macroeconomic and Demographic Assumptions, 1998-2030  
(In percent, unless otherwise indicated)

	1998	1999	2000	2001	2002	2003	2004	2005	2010	2020	2030	Average		
												1999-2004	2005-2010	2011-2030
<b>Macroeconomic assumptions</b>														
Output gap (in percent of potential output) 1/	-0.1	0.1	0.4	0.6	0.4	0.2	0.0	0.0	0.0	0.0	0.0	0.3	0.0	0.0
Labor productivity growth	3.1	2.1	2.5	2.4	2.4	2.3	2.3	2.0	1.8	1.5	1.5	2.3	1.9	1.6
Inflation rate (GDP deflator)	2.7	1.9	2.2	2.4	2.4	2.3	2.2	1.7	1.7	1.7	1.7	2.2	1.7	1.7
Interest rate														
On government debt	7.6	7.0	6.8	6.5	6.1	5.7	5.2	4.7	4.7	4.7	4.7	6.2	4.7	4.7
On government assets	4.0	4.0	4.1	4.1	4.2	4.3	4.5	4.7	4.7	4.7	4.7	4.2	4.7	4.7
<b>Demographic factors</b>														
Total population (in thousands)	5,128	5,124	5,119	5,122	5,126	5,131	5,141	5,151	5,308	5,311	5,228	5,127	5,225	5,282
Age distribution (in percent of total population)														
Age 0-6	8.4	8.3	8.2	8.0	7.9	7.8	7.7	7.7	7.3	7.3	7.1	8.0	7.5	7.3
Age 7-19	16.5	16.6	16.6	16.5	16.4	16.3	16.1	16.0	15.1	14.1	14.2	16.4	15.5	14.2
Age 20-54	49.9	49.6	49.4	49.1	48.8	48.5	48.1	47.7	45.1	42.6	41.7	48.9	46.4	42.8
Age 55-64	10.5	10.6	10.7	11.1	11.5	11.9	12.4	12.8	14.9	13.5	11.9	11.4	13.8	13.4
Age 65-74	8.6	8.6	8.6	8.7	8.7	8.7	8.7	8.7	10.1	13.1	12.2	8.7	9.4	12.4
Over 74	6.2	6.3	6.4	6.6	6.7	6.8	6.9	7.1	7.5	9.4	13.0	6.6	7.3	9.9
Old-age dependency ratio 2/	21.8	22.2	22.6	22.8	23.1	23.3	23.5	23.7	26.8	36.7	42.7	22.9	25.2	36.3

Source: IMF staff estimates.

1/ A positive output gap, is defined as the actual GDP exceeding the level of potential output.

2/ Ratio of persons above 64 in proportion to the working age population (15-64).

growth. In contrast to other current expenditures, pensions are assumed to remain indexed to wages and prices in proportions of 20 percent and 80 percent, respectively, implying a gradual fall in the maximum replacement income from currently 60 percent of average earnings to some 50 percent by 2030.

- **Capital expenditures**, after falling in real terms in 1998–2000, are assumed to grow by some 1¾ percent annually over the medium term, and in line with GDP from 2005 onward.
- **Intergovernmental transfers** from the central to local governments, are assumed to fall in real terms, in 1999 and 2000, and to increase by an annual average of 3 percent, thereafter, allowing local governments to maintain a balanced position, despite increased spending pressures (particularly in the area of health).<sup>16</sup> Central government transfers to social security funds are driven by the number of pensioners and unemployed, and gross transfers from local governments and social security funds to other subsectors of government are assumed to remain constant, in real terms.

31. *The functional breakdown of different expenditure categories illustrates that the main expenditure pressures are generated in the demographically sensitive areas of health and pensions (Table 4).* The effect of higher spending on health, equivalent to some 1½ percent of GDP over the long term, is borne by local governments (though, by assumption, largely absorbed by central government transfers), while rising pension expenditures affect both the central government and social security funds. The size of the “pension shock” is estimated to be on the order of 4½ percent of GDP, relative to current outlays, despite a fairly strict indexation rule.<sup>17</sup> The increased consumption expenditures of the central and local governments are reflected in a continuously high and growing level of government employment, assuming that total wage cost—and employment—rise proportionately with non-wage outlays.

32. *As a result, the large surplus in the general government finances over the medium term—peaking at some 5¾ percent of GDP in 2005—is gradually eliminated over the long run, while taxes have to be raised toward the end of the projection period (Table 5).* Central government finances also continue to improve over the medium term, reaching a surplus of 2¼ percent of GDP in 2005, before falling to a balanced position in the outer years. However, maintenance of a balanced position at the general and central government level requires an increase in the tax ratio (including social security contributions) from some 45 percent of GDP in 2000–2020 to 48 percent in 2030. As a consequence of the temporarily very high and continuing

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<sup>16</sup> This is a stylized assumption that allows to abstract from the complicated issue of appropriate transfer levels. The implications, however, would be identical, if it was assumed alternatively that transfers remained constant, while local governments reacted to expenditure pressures by raising income taxes, which, in turn, would be offset by tax cuts at the central level.

<sup>17</sup> A return to the former indexation rule, with a 50 percent weighting of both prices and real wages, would raise the magnitude of the pension shock to some 5½ percent of GDP.

Table 4. Finland: Public Expenditure by Function, 1998-2030  
Current Policy Scenario  
(In percent of GDP, unless otherwise indicated)

	1998	1999	2000	2001	2002	2003	2004	2005	2010	2020	2030
Central government	27.5	26.0	25.0	24.1	23.5	23.1	22.6	22.3	22.5	23.6	24.8
Consumption	6.6	6.5	6.3	6.2	6.2	6.2	6.2	6.2	6.4	6.7	7.0
Of which:											
Public order and safety 1/	2.6	2.6	2.5	2.5	2.4	2.4	2.5	2.5	2.5	2.7	2.8
Education	1.4	1.4	1.4	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Other	2.6	2.5	2.5	2.4	2.4	2.4	2.4	2.4	2.5	2.7	2.8
Interest payments	4.7	4.1	3.8	3.4	2.9	2.5	2.1	1.7	1.0	0.2	0.0
Intragovernmental transfers	9.7	9.1	8.7	8.2	8.1	8.0	8.0	8.0	8.4	9.2	9.9
Other current expenditure	6.2	5.9	6.0	6.0	6.0	6.0	6.0	6.0	6.3	7.0	7.4
Of which:											
Subsidies	2.1	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.1	2.2	2.3
Transfers	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.1	2.2	2.3
Social security benefits	1.9	1.9	1.9	1.9	1.9	2.0	2.0	2.0	2.3	2.7	3.0
of which: pensions	1.5	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.6	1.9	2.1
Capital spending 2/	1.2	1.2	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1
Local governments	15.2	14.8	14.5	14.3	14.3	14.3	14.3	14.3	14.8	15.9	17.0
Consumption	13.3	13.0	12.9	12.8	12.7	12.7	12.7	12.8	13.2	14.2	15.2
Of which:											
Health	4.1	4.1	4.0	4.0	4.0	4.1	4.1	4.1	4.5	5.2	5.7
Education	3.9	3.8	3.8	3.7	3.7	3.7	3.6	3.6	3.5	3.5	3.7
Social security and welfare services	2.6	2.6	2.5	2.5	2.5	2.5	2.5	2.5	2.6	2.8	2.9
Other consumption	2.6	2.6	2.5	2.5	2.5	2.5	2.5	2.5	2.6	2.8	2.9
Interest payments	0.3	0.3	0.2	0.2	0.2	0.1	0.1	0.1	0.0	0.0	0.0
Intragovernmental transfers	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.3	0.3	0.3
Other current expenditure	1.1	1.0	0.9	0.9	0.9	0.9	0.9	0.9	0.9	1.0	1.0
Capital spending 2/	1.5	1.5	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Social security funds	17.5	16.8	16.2	15.9	15.8	15.9	15.9	16.0	17.3	19.5	20.9
Consumption	1.4	1.4	1.3	1.3	1.3	1.3	1.3	1.3	1.4	1.5	1.5
Social security benefits and grants	15.4	14.9	14.4	14.1	14.0	14.1	14.1	14.2	15.5	17.6	18.9
Of which:											
Pensions	8.8	8.6	8.4	8.4	8.4	8.4	8.5	8.6	9.7	11.5	12.5
Unemployment	2.7	2.3	2.0	1.8	1.7	1.7	1.7	1.7	1.7	1.7	1.9
Other	3.9	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.1	4.4	4.6
Interest payments	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Intragovernmental transfers	0.7	0.4	0.4	0.4	0.4	0.4	0.4	0.3	0.3	0.3	0.3
Other current expenditure	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Capital spending 2/	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1

1/ Including national defense

2/ Gross fixed capital formation.

Table 5. Finland: Public Finances, 1998-2030

## Current Policy Scenario

(In percent of GDP, unless otherwise indicated)

	1998	1999	2000	2001	2002	2003	2004	2005	2010	2020	2030	Average		
												1999-2004	2005-2010	2011-2030
Revenue	51.0	50.7	50.5	50.2	50.0	49.7	49.5	49.7	49.8	49.3	52.2	50.1	49.7	50.2
Central government	25.9	25.8	25.7	25.5	25.3	24.9	24.6	24.6	24.5	24.3	24.7	25.3	24.5	24.4
Local government	15.2	14.9	14.6	14.6	14.5	14.5	14.5	14.5	14.9	15.9	17.0	14.6	14.7	16.0
Social security	20.6	20.0	19.6	19.1	19.0	19.1	19.1	19.2	19.4	18.9	20.8	19.3	19.3	19.6
Intergovernmental transfers	-10.7	-10.0	-9.5	-9.0	-8.8	-8.8	-8.7	-8.7	-9.0	-9.8	-10.4	-9.1	-8.8	-9.8
Tax ratio 1/	45.9	45.9	45.7	45.5	45.2	44.9	44.5	44.5	44.5	44.5	48.2	45.3	44.5	45.5
Interest receipts	3.0	2.9	2.9	2.9	2.9	3.0	3.1	3.3	3.4	2.9	2.2	3.0	3.4	2.8
Expenditure	49.5	47.7	46.3	45.3	44.8	44.4	44.1	43.9	45.6	49.1	52.2	45.4	44.7	49.2
Primary expenditure	44.6	43.3	42.3	41.8	41.7	41.8	41.9	42.1	44.5	48.9	52.2	42.1	43.3	48.9
Central government	22.8	21.9	21.3	20.7	20.6	20.5	20.5	20.6	21.5	23.4	24.7	20.9	21.0	23.4
Local government	14.9	14.6	14.3	14.1	14.1	14.1	14.2	14.2	14.8	15.9	17.0	14.2	14.5	15.9
Social security	17.5	16.8	16.2	15.9	15.8	15.9	15.9	16.0	17.3	19.5	20.9	16.1	16.6	19.4
Intergovernmental transfers	-10.7	-10.0	-9.5	-9.0	-8.8	-8.8	-8.7	-8.7	-9.0	-9.8	-10.4	-9.1	-8.8	-9.8
Interest payments	5.0	4.4	4.0	3.5	3.1	2.6	2.2	1.8	1.1	0.2	0.0	3.3	1.4	0.3
Balance	1.5	3.0	4.1	4.9	5.2	5.3	5.4	5.7	4.2	0.2	0.0	4.6	5.0	1.0
Central government	-1.6	-0.2	0.6	1.4	1.8	1.9	2.0	2.3	2.0	0.8	0.0	1.2	2.2	0.8
Local government	0.0	0.0	0.1	0.2	0.2	0.2	0.2	0.2	0.1	0.0	0.0	0.2	0.1	0.0
Social security	3.0	3.1	3.4	3.2	3.2	3.2	3.2	3.2	2.1	-0.6	0.0	3.2	2.7	0.2
<i>Memorandum items:</i>														
Primary balance 2/	3.4	4.5	5.2	5.6	5.4	4.9	4.5	4.3	1.9	-2.6	-2.1	5.0	3.1	-1.6
Structural balance	1.5	3.0	3.8	4.5	4.9	5.1	5.4	5.7	4.2	0.2	0.0	4.5	5.0	1.0
Structural primary balance 2/	3.4	4.4	4.9	5.2	5.1	4.8	4.5	4.3	1.9	-2.6	-2.1	4.8	3.1	-1.6
Output gap 3/	-0.1	0.1	0.4	0.6	0.4	0.2	0.0	0.0	0.0	0.0	0.0	0.3	0.0	0.0
Public debt (EMU definition)	48.4	45.8	42.6	38.9	35.6	32.4	29.4	26.5	14.7	2.8	0.8	37.4	20.3	4.1
Central government debt	62.2	58.9	54.9	50.4	46.1	42.2	38.4	34.7	19.4	2.9	0.2	48.5	26.7	4.7
Net financial assets of the public sector	18.6	20.6	23.6	27.1	31.0	34.8	38.7	43.1	59.2	62.4	48.1	29.3	51.9	59.5
	(Real growth rate, in percent)													
Total expenditure	-1.2	-0.2	0.9	1.2	1.4	1.6	1.6	1.6	2.4	1.3	1.7	1.1	2.3	1.6
Primary expenditure, incl. gross intergov. transfers	-1.7	-0.1	0.9	1.5	2.2	2.5	2.4	2.3	2.7	1.4	1.6	1.5	2.7	1.7
Central government	-2.1	-0.7	0.9	0.8	1.9	2.4	2.2	2.2	2.5	1.3	1.4	1.3	2.5	1.7
Local government	0.2	1.1	1.6	2.5	2.5	2.5	2.5	2.3	2.3	1.5	1.7	2.1	2.4	1.7
Social security	-2.6	-0.6	0.2	1.4	2.2	2.7	2.5	2.5	3.2	1.3	1.7	1.4	3.1	1.9
Primary expenditure, excl. gross intergov. transfers	-1.0	0.6	1.5	2.2	2.5	2.6	2.6	2.5	2.7	1.4	1.7	2.0	2.8	1.8
Central government	-0.2	0.3	2.7	2.6	2.6	2.6	2.5	2.4	2.4	1.4	1.5	2.2	2.5	1.6
Local government	0.4	0.9	1.6	2.6	2.6	2.6	2.6	2.4	2.4	1.5	1.7	2.1	2.5	1.7
Social security	-2.9	0.7	0.4	1.4	2.2	2.7	2.6	2.6	3.3	1.4	1.7	1.7	3.2	1.9

Source: Fund staff calculations.

1/ Includes taxes and social security contributions.

2/ Primary balance is defined as noninterest revenue minus noninterest expenditure.

3/ A positive output gap is defined as actual GDP in excess of potential output.

surpluses, the public debt level falls rapidly and virtually disappears by 2030, with net financial assets equivalent to 48 percent of GDP by 2030.<sup>18</sup>

33. *While the scenario meets the fiscal constraints outlined above, trade-offs are apparent in its unimpressive growth and employment implications (Table 6).* In particular, after the positive effects of tax cuts and recent measures to improve incentives in the labor market, unemployment is not projected to fall significantly below 8 percent, with a rising trend after 2020. The employment rate peaks at less than 68 percent in the medium term—2 percentage points below the government’s official target—and falls to 66 percent in the long run. As a consequence of the relatively weak employment performance and the assumed moderation in labor productivity growth, GDP growth decelerates quickly to 1¾ percent in 2005–2010 and 1 percent over the long term.

### B. High Employment Scenario

34. *To illustrate the impact of an alternative policy strategy, the following scenario assumes prompt implementation of structural reforms, notably in the areas of early retirement and the labor market (see Box 5 for a discussion of key reform priorities).* These reforms, in combination with spending restraint, clear the way for substantial and lasting tax cuts, and ensure that the reductions in the tax wedge are translated into strong employment creation. The key assumptions are as follows:

- Moderate **expenditure restraint** is assumed to apply throughout the projection period to all categories of current public expenditures, other than pensions—which are affected, however, by an increase in the effective retirement age from currently 59 to 62 years by 2010.<sup>19</sup> The cut in non-pension expenditures is modeled by a reduction in the “indexation parameter”, keeping the growth rates in real public sector consumption, including the total wage bill and the indexation of transfers and benefits, below the increase in labor productivity by some ½ percentage point throughout the projection period. In terms of public sector employment, this would imply a reduction in the civil service, assuming that real wages grow in line with (aggregate) labor productivity (Table 6).
- Starting in 2000, the **tax ratio** is reduced gradually from currently 46 percent of GDP to 36 percent of GDP by 2010, affecting both unemployment and labor force developments. Cuts in taxes are assumed to apply to both direct taxes of central and local governments (the latter

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<sup>18</sup> With a balanced general government position in the outer years, the nominal value of net public assets remains constant, explaining their fall, as a percent of GDP.

<sup>19</sup> This reflects a simplified assumption, avoiding judgements on the government’s policy priorities. In reality, the distribution of savings across functions involves difficult policy choices, and their scope in particular areas (such as health care) may be limited.

Table 6. Finland: Summary of Fiscal Scenarios, 1998-2030  
(In percent, unless otherwise indicated)

	1998	1999	2000	2001	2002	2003	2004	2005	2010	2020	2030	Average		
												1999-2004	2005-2010	2011-2030
<b>Output</b>														
<i>Current Policy Scenario</i>														
Real GDP growth	5.6	3.6	3.8	3.5	2.7	2.4	2.3	1.9	1.6	1.0	1.0	3.0	1.7	0.9
Nominal GDP (in billions FIM)	686.0	724.5	768.8	814.8	856.8	897.7	938.7	973.0	1,151.1	1,503.5	1,947.4	833.5	1,060.7	1,536.5
<i>High Employment Scenario</i>														
Real GDP growth	5.6	3.6	3.8	4.1	3.7	3.5	3.4	3.2	2.9	1.0	1.1	3.7	3.0	1.0
Nominal GDP (in billions FIM)	686.0	724.5	768.8	818.4	868.2	918.3	969.7	1,017.3	1,282.9	1,678.2	2,191.5	844.7	1,146.7	1,719.2
<b>Employment</b>														
<i>Current Policy Scenario</i>														
Employment rate	64.1	65.4	66.7	67.6	67.8	67.8	67.7	67.5	65.9	66.2	66.1	67.2	66.7	66.1
Unemployment rate	11.4	10.3	9.2	8.2	7.9	7.9	7.9	7.8	7.8	7.8	8.6	8.6	7.8	8.0
Employment growth	2.4	1.5	1.3	1.1	0.3	0.1	0.0	-0.1	-0.1	-0.5	-0.5	0.7	-0.1	-0.6
Labor force growth	0.9	0.2	0.1	-0.1	0.0	0.1	0.0	-0.1	-0.1	-0.5	-0.4	0.1	-0.2	-0.6
Labor force participation ratio	72.3	72.9	73.5	73.6	73.6	73.6	73.4	73.2	71.5	71.9	72.3	73.5	72.4	71.9
<i>High Employment Scenario</i>														
Employment rate	64.1	65.4	66.7	68.0	68.9	69.6	70.2	70.8	73.8	74.3	74.7	68.1	72.3	74.3
Unemployment rate	11.4	10.3	9.2	8.2	7.8	7.6	7.3	7.0	5.8	5.5	5.5	8.4	6.4	5.5
Employment growth	2.4	1.5	1.3	1.6	1.3	1.2	1.1	1.1	1.2	-0.5	-0.4	1.3	1.1	-0.6
Labor force growth	0.9	0.2	0.1	0.5	0.9	1.0	0.8	0.8	1.0	-0.5	-0.4	0.6	0.9	-0.6
Labor force participation ratio	72.3	72.9	73.5	74.0	74.7	75.3	75.8	76.2	78.3	78.6	79.0	74.4	77.3	78.6
<b>Fiscal and Pensions</b>														
<i>Current Policy Scenario</i>														
Tax ratio 1/	45.9	45.9	45.7	45.5	45.2	44.9	44.5	44.5	44.5	44.5	48.2	45.3	44.5	45.5
Indexation parameter 2/	...	2.1	2.5	2.4	2.4	2.3	2.3	2.0	1.8	1.5	1.5	2.3	1.9	1.6
Primary current spending, real (1998=100) 3/	100.0	101.1	103.5	106.1	108.7	111.4	114.1	116.7	131.6	156.2	181.1	107.5	124.1	157.1
Government employment (in thousands) 4/	546.0	545.2	542.6	542.9	543.4	544.1	544.7	545.7	558.7	560.9	561.2	543.8	552.1	559.4
In percent of total employment	24.6	24.2	23.8	23.5	23.5	23.5	23.5	23.5	24.3	25.9	27.5	23.6	23.9	26.0
Pension funds assets (in percent of GDP)	47.1	47.7	48.3	48.9	49.7	50.6	51.6	53.0	57.0	48.8	35.7	49.5	55.4	47.7
Share of pensioners in total population 5/	15.3	15.5	15.7	16.0	16.2	16.5	16.8	17.1	19.3	22.3	23.5	16.1	18.2	22.1
Replacement income of pensioners 6/ 7/	60.0	58.8	57.7	56.8	56.0	55.3	54.7	54.2	52.0	50.6	49.7	56.6	53.0	50.7
<i>High Employment Scenario</i>														
Tax ratio 1/	45.9	45.9	45.7	44.1	42.7	41.5	40.3	39.0	36.0	36.0	36.0	43.4	37.4	36.0
Indexation parameter 2/	...	2.1	2.5	1.8	1.8	1.7	1.7	1.4	1.2	1.0	0.9	1.9	1.3	1.0
Primary current spending, real (1998=100) 3/	100.0	101.1	103.5	105.4	107.4	109.4	111.3	113.1	123.6	139.7	154.2	106.4	118.4	139.9
Government employment (in thousands) 4/	546.0	545.2	542.6	539.9	537.4	535.2	532.8	531.0	528.8	502.3	475.5	538.9	529.7	499.8
In percent of total employment	24.6	24.2	23.8	23.3	22.8	22.5	22.1	21.8	20.5	20.7	20.6	23.1	21.2	20.7
Pension funds assets (in percent of GDP)	47.1	47.7	48.3	48.7	49.3	50.2	51.2	52.3	54.4	54.0	38.1	49.2	53.6	51.2
Share of pensioners in total population 5/	15.3	15.5	15.7	15.7	15.7	15.7	15.7	15.7	16.1	19.4	20.9	15.7	15.9	19.2
Replacement income of pensioners 6/ 7/	60.0	58.8	57.7	56.8	56.0	55.2	54.5	53.9	51.4	51.0	50.5	56.5	52.6	51.1

Source: IMF staff estimates.

1/ Includes taxes and social security contributions.

2/ Indexation for total government consumption (including wages and salaries), subsidies, transfers and benefits (pensions only with a factor of 20 percent).

3/ Central and local governments only, excluding transfers to other subsectors of government.

4/ Assumes that growth in the wage bill is proportional to growth in total government consumption and that wages grow in line with real productivity.

5/ Estimates based on assumed average retirement age.

6/ In percent of average wage income, starting from maximum replacement income after 40 years of employment.

7/ Varies between scenarios, due to different composition of pensioners, with "new" pensioners receiving, on average, higher benefits than "old" ones.

### **Box 5: The Scope for Labor Market and Pension Reforms**

Higher employment would make Finland's demographic shock more manageable by expanding the resources available for rising pension and health care needs. Substantial domestic and international analysis of the factors affecting employment in Finland has identified the following key problems: the high rate of early retirement (less than half of the people in the age group of 55-65 are currently employed, implying an effective retirement age of 59); the high rate of structural unemployment, estimated by various analysts at 8-10 percent of the labor force; and the relatively small private services sector, reflected in a low level of self-employment and few part-time jobs.

The authorities have implemented a range of reforms through the 1990s to address these issues. These included: a tightening of qualification rules for unemployment benefits (with an extension of prior employment requirements, and the removal of entitlements to labor market support for untrained young persons refusing a job offer or training); a temporary lifting of inflation adjustments for unemployment benefits; an increase in the public sector retirement age from 63 to 65, consistent with the private sector; an increase in the minimum age for early retirement due to disability or unemployment by 3 and 5 years, respectively; a higher weight on the consumer price index relative to wages in the pension indexation; the determination of the pensionable wage on the basis of the last ten, as opposed to the last four, years of employment; a higher accrual rate for the old-age pension for employees above the age of 59, and a lower rate for disability pensions; provision of the flat rate pension (which will be phased out), contingent on the level of the employment pension; and a reduction in benefits for early retirement. In addition, the level of earned income exempt from local income taxation was raised, increasing take-home pay relative to net unemployment income; active labor market policies were strengthened, including through targeting training to the needs of local employers; restrictions on retail opening hours were relaxed, and decentralized agreements on working time were permitted. The benefits of these reforms have been observable—with, for example, a 25 percent drop in youth unemployment between 1994 and 1997.

To help achieve their goal of raising the employment rate towards 70 percent, the authorities intend to deepen these structural reforms, see Council of State (1999). Analysis in OECD (1999) and European Commission (1999) has focused on a number of problematic areas. Unemployment replacement rates remain high relative to after-tax wages, and the benefit level is constant for 2 years, with especially strong work disincentives for families receiving housing and other allowances. These disincentives could be mitigated by enforcing benefit eligibility requirements more strictly, and by shortening eligibility periods and/or tapering benefits over time. Increases in the earned income tax exemption, and cuts in earned income tax rates, could be coupled with a restructuring of means-tested allowances. To fully realize the potential for growth in low-skill and part-time jobs—which can be a helpful stepping-stone for many—it will also be necessary to permit exemptions from any agreed sectoral minimum wages, and to reduce the burden of tax and regulatory compliance costs.

The authorities also aim to raise the effective retirement age by 2-3 years, and are discussing the necessary reforms with the social partners. Key factors contributing to the high level of early retirement include: the exemption of unemployed persons aged 55 and over from requalification requirements for unemployment benefits (commonly referred to as the “unemployment pipeline” to retirement); the loosely conditioned availability of early retirement through unemployment and disability pensions; the rather small reduction in pension benefits when retiring early, due to the rule setting pensions according to wages in only the last 10 years of employment; and finally, the disability pension liability facing larger firms, which encourages layoffs of workers approaching 58 as well as low investment in the training of older workers.



mitigate unemployment traps) and social security contributions, whereas indirect taxes are determined on the same basis as in the current policy scenario.

35. *As a result of the above assumptions, the surplus in public finances peaks in 2000, at some 4 percent of GDP, and falls gradually to a balanced position by the end of the projection period (Table 7).* In contrast to the current policy scenario, the central government surplus after 1999 fluctuates in a narrow margin around ½ percent of GDP throughout most of the projection period, with a slight increase in the outer years. The local governments' position deteriorates slightly, reflecting adjustment pressures, but the deficit remains below ½ percent of GDP in the medium term, before balance is reestablished in the long run.<sup>20</sup> Due to expenditure restraint and higher GDP growth (see below), health spending rises only marginally, as a proportion of GDP, and the “pension shock” is reduced to 1½ percent of GDP, with a large saving (2 percent of GDP) resulting from the higher effective retirement age (Table 8). Consequently, social security funds—further strengthened by lower unemployment expenditures—reach a surplus of almost 4 percent of GDP over the medium term. In the long run, this is gradually transformed into a small deficit, offset by a surplus of the central government, without the need to raise taxes or social security contributions. In fact, by 2030, the pension funds assets are higher than in the current policy scenario, although net financial assets of the government are lower as a share of GDP, reflecting a higher level of GDP and smaller fiscal surpluses over the medium term.

36. *The key trade-offs between the two scenarios are apparent in their implied effects on growth and employment (Table 6 and Figure 6).* The high employment scenario implies average real GDP growth of 3¾ percent through 2004, and 3 percent in 2005–2010, compared with 3 percent and 1¾ percent in the current policy scenario. The higher growth in GDP is solely a reflection of the more buoyant employment generation, stimulated by both lower taxes and reforms to discourage early retirement—just in time to affect the retirement decisions of large parts of the “baby-boom” generation. As a consequence of these and other structural measures, the unemployment rate falls to a long-term equilibrium of 5½ percent, and the employment rate, after reaching the official target of 70 percent in 2004, climbs to almost 75 percent in the long run—8½ percentage points higher than in the current policy scenario (with almost 5 percentage points explained by the later retirement age, alone).<sup>21</sup> Moreover, while this is not explicitly modeled, the increased flexibility in the labor market strengthens the economy's resilience to shocks, and lowers the probability that cyclical unemployment in periods of economic downturn

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<sup>20</sup> In this connection, it is assumed that the central government exceeds current expenditure ceilings for 2002 and 2003, as a result of higher transfers to local governments, in order to help the latter absorb the effects of lower tax revenues. Alternatively, and with similar implications—but without the need to raise transfer beyond the levels underlying the current policy scenario—it could be assumed that tax cuts apply to central government taxes and social security contributions, only.

<sup>21</sup> The elasticity of the employment rate to changes in the tax ratio is one-third—at the conservative end of a 0.3–0.5 range, supported by cross-country empirical evidence (see International Monetary Fund (1998)).

Table 7. Finland: Public Finances, 1998-2030

## High Employment Scenario

(In percent of GDP, unless otherwise indicated)

	1998	1999	2000	2001	2002	2003	2004	2005	2010	2020	2030	Average		
												1999-2004	2005-2010	2011-2030
Revenue	51.0	50.7	50.5	48.8	47.4	46.3	45.1	44.1	41.0	40.9	40.1	48.1	42.4	40.8
Central government	25.9	25.8	25.7	24.9	24.3	23.6	22.7	22.4	21.4	21.2	21.1	24.5	21.8	21.2
Local government	15.2	14.9	14.6	14.1	13.7	13.5	13.2	13.1	12.8	12.9	13.0	14.0	12.9	12.9
Social security	20.6	20.0	19.6	18.9	18.6	18.4	18.3	17.7	15.8	15.7	14.7	19.0	16.7	15.5
Intergovernmental transfers	-10.7	-10.0	-9.5	-9.2	-9.2	-9.3	-9.1	-9.1	-9.1	-8.9	-8.8	-9.4	-9.1	-8.9
Tax ratio 1/	45.9	45.9	45.7	44.1	42.7	41.5	40.3	39.0	36.0	36.0	36.0	43.4	37.4	36.0
Interest receipts	3.0	2.9	2.9	2.8	2.9	2.9	3.0	3.2	3.1	3.0	2.3	2.9	3.2	2.9
Expenditure	49.5	47.7	46.3	44.8	43.5	42.4	41.3	40.4	37.8	39.6	40.1	44.3	39.0	39.4
Primary expenditure	44.6	43.3	42.3	41.2	40.4	39.7	39.0	38.4	36.3	38.8	39.8	41.0	37.3	38.6
Central government	22.8	21.9	21.3	20.8	20.6	20.5	20.2	20.0	19.5	19.8	19.7	20.9	19.8	19.7
Local government	14.9	14.6	14.3	14.0	13.8	13.6	13.4	13.2	12.6	12.8	12.9	13.9	12.9	12.8
Social security	17.5	16.8	16.2	15.7	15.2	14.9	14.6	14.2	13.3	15.1	15.9	15.6	13.8	14.9
Intergovernmental transfers	-10.7	-10.0	-9.5	-9.2	-9.2	-9.3	-9.1	-9.1	-9.1	-8.9	-8.8	-9.4	-9.1	-8.9
Interest payments	5.0	4.4	4.0	3.5	3.1	2.7	2.3	2.0	1.5	0.9	0.3	3.3	1.7	0.8
Balance	1.5	3.0	4.1	4.0	3.9	3.9	3.8	3.7	3.2	1.2	0.0	3.8	3.3	1.4
Central government	-1.6	-0.2	0.6	0.8	0.8	0.5	0.4	0.5	0.5	0.6	1.2	0.5	0.5	0.8
Local government	0.0	0.0	0.1	0.0	-0.2	-0.2	-0.3	-0.3	0.1	0.0	0.0	-0.1	-0.1	0.0
Social security	3.0	3.1	3.4	3.3	3.4	3.5	3.7	3.5	2.5	0.6	-1.2	3.4	2.9	0.6
<i>Memorandum items:</i>														
Primary balance 2/	3.4	4.5	5.2	4.7	4.1	3.7	3.1	2.5	1.5	-1.0	-1.9	4.2	1.9	-0.7
Structural balance	1.5	3.0	3.8	3.6	3.7	3.8	3.8	3.7	3.2	1.2	0.0	3.6	3.3	1.4
Structural primary balance 2/	3.4	4.4	4.9	4.3	3.9	3.5	3.1	2.5	1.5	-1.0	-1.9	4.0	1.9	-0.7
Output gap 3/	-0.1	0.1	0.4	0.6	0.4	0.2	0.0	0.0	0.0	0.0	0.0	0.3	0.0	0.0
Public debt (EMU definition)	48.4	45.8	42.6	39.5	36.6	34.3	32.2	30.3	22.3	12.8	3.8	38.5	26.2	12.4
Central government debt	62.2	58.9	54.9	50.8	47.1	44.0	41.3	38.9	28.6	15.9	3.7	49.5	33.5	15.3
Net financial assets of the public sector	18.6	20.6	23.6	26.2	28.6	31.0	33.1	35.3	42.8	51.2	44.4	27.2	39.3	49.0
	(Real growth rate, in percent)													
Total expenditure	-1.2	-0.2	0.9	0.5	0.8	0.9	0.8	0.8	1.6	0.9	1.2	0.6	1.5	1.3
Primary expenditure, incl. gross intergov. transfers	-1.7	-0.1	0.9	1.4	2.0	2.1	1.7	1.8	2.0	1.0	1.3	1.3	2.0	1.3
Central government	-2.1	-0.7	0.9	1.9	2.7	2.9	2.0	2.3	2.4	0.8	1.0	1.6	2.4	1.0
Local government	0.2	1.1	1.6	2.0	2.0	2.0	2.0	1.9	1.9	0.9	1.2	1.8	2.0	1.1
Social security	-2.6	-0.6	0.2	0.4	0.9	1.3	1.0	0.9	1.5	1.3	1.6	0.6	1.4	1.9
Primary expenditure, excl. gross intergov. transfers	-1.0	0.6	1.5	1.4	1.6	1.7	1.6	1.5	1.7	1.1	1.3	1.4	1.8	1.5
Central government	-0.2	0.3	2.7	1.9	1.9	1.9	1.8	1.8	1.7	0.9	1.1	1.8	1.9	1.2
Local government	0.4	0.9	1.6	2.0	2.1	2.0	2.0	2.0	2.0	1.0	1.2	1.8	2.1	1.1
Social security	-2.9	0.7	0.4	0.4	1.0	1.3	1.1	0.9	1.5	1.3	1.6	0.8	1.5	1.9

Source: Fund staff calculations.

1/ Includes taxes and social security contributions.

2/ Primary balance is defined as noninterest revenue minus noninterest expenditure.

3/ A positive output gap is defined as actual GDP in excess of potential output.

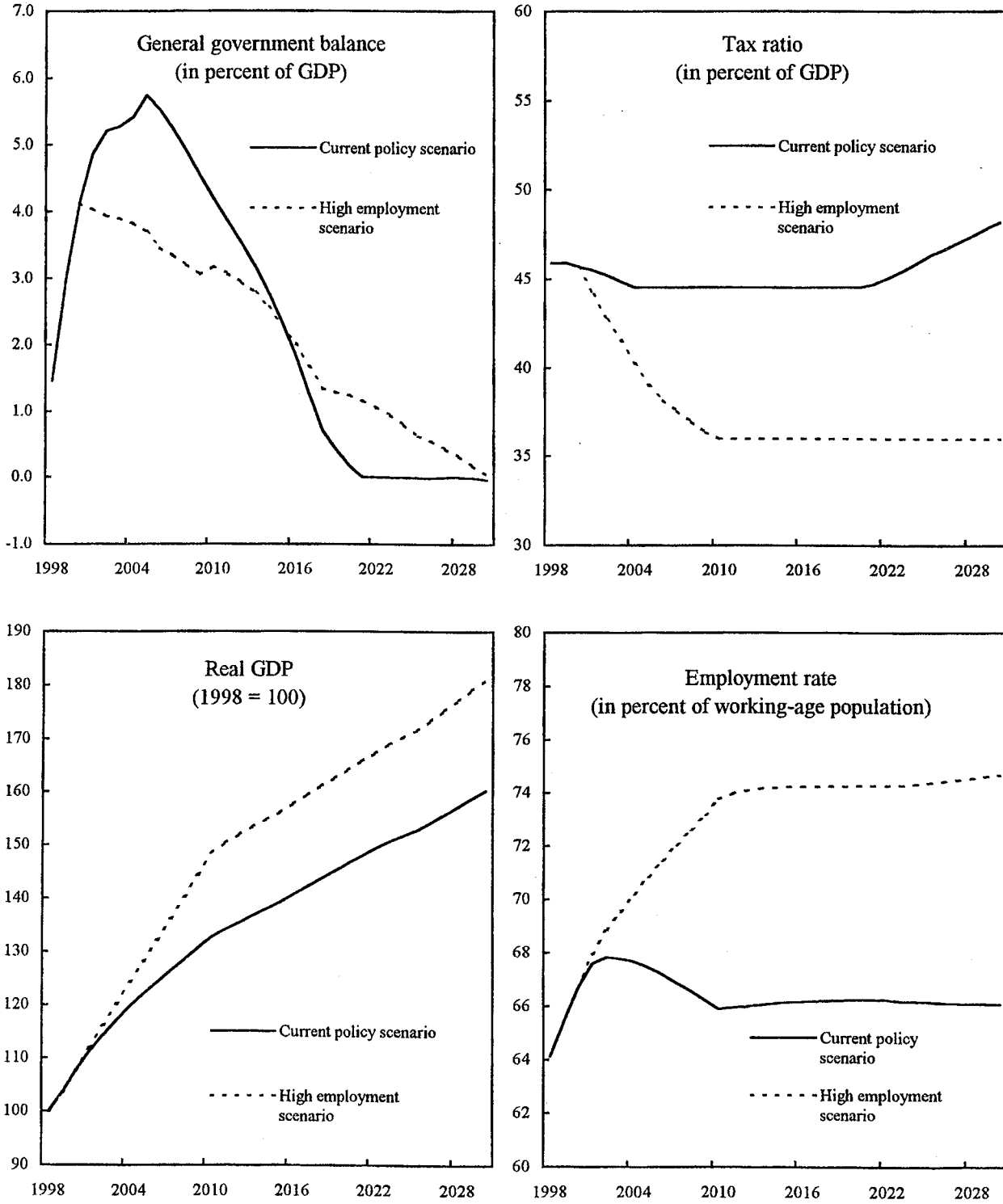
Table 8. Finland: Public Expenditure by Function, 1998-2030  
High Employment Scenario  
(In percent of GDP, unless otherwise indicated)

	1998	1999	2000	2001	2002	2003	2004	2005	2010	2020	2030
Central government	27.5	26.0	25.0	24.2	23.5	23.0	22.4	21.9	20.9	20.6	19.9
Consumption	6.6	6.5	6.3	6.2	6.0	6.0	5.9	5.8	5.4	5.4	5.3
Of which:											
Public order and safety 1/	2.6	2.6	2.5	2.4	2.4	2.3	2.3	2.3	2.2	2.2	2.1
Education	1.4	1.4	1.4	1.3	1.3	1.3	1.3	1.2	1.1	1.0	1.0
Other	2.6	2.5	2.5	2.4	2.4	2.3	2.3	2.3	2.1	2.2	2.1
Interest payments	4.7	4.1	3.8	3.4	2.9	2.5	2.2	1.8	1.4	0.8	0.2
Intragovernmental transfers	9.7	9.1	8.7	8.5	8.5	8.5	8.4	8.4	8.5	8.4	8.3
Other current expenditure	6.2	5.9	6.0	5.9	5.8	5.7	5.6	5.5	5.2	5.5	5.6
Of which:											
Subsidies	2.1	2.0	2.0	2.0	2.0	1.9	1.9	1.9	1.8	1.8	1.8
Transfers	2.0	2.0	2.0	2.0	2.0	1.9	1.9	1.9	1.8	1.8	1.7
Social security benefits	1.9	1.9	1.9	1.9	1.8	1.8	1.8	1.8	1.7	2.0	2.0
of which: pensions	1.5	1.4	1.4	1.3	1.3	1.3	1.3	1.2	1.2	1.5	1.6
Capital spending 2/	1.2	1.2	1.1	1.1	1.1	1.1	1.0	1.0	1.0	1.0	1.0
Local governments	15.2	14.8	14.5	14.2	13.9	13.7	13.5	13.3	12.7	12.9	13.0
Consumption	13.3	13.0	12.9	12.6	12.4	12.2	12.0	11.8	11.2	11.4	11.4
Of which:											
Health	4.1	4.1	4.0	4.0	3.9	3.9	3.9	3.8	3.8	4.1	4.3
Education	3.9	3.8	3.8	3.7	3.6	3.5	3.4	3.4	3.0	2.8	2.8
Social security and welfare services	2.6	2.6	2.5	2.5	2.4	2.4	2.4	2.3	2.2	2.2	2.2
Other consumption	2.6	2.6	2.5	2.5	2.4	2.4	2.4	2.3	2.2	2.2	2.2
Interest payments	0.3	0.3	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Intragovernmental transfers	0.4	0.4	0.4	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.2
Other current expenditure	1.1	1.0	0.9	0.9	0.9	0.8	0.8	0.8	0.8	0.8	0.8
Capital spending 2/	1.5	1.5	1.3	1.3	1.3	1.3	1.2	1.2	1.2	1.2	1.2
Social security funds	17.5	16.8	16.2	15.7	15.2	14.9	14.6	14.2	13.3	15.1	15.9
Consumption	1.4	1.4	1.3	1.3	1.3	1.3	1.2	1.2	1.2	1.2	1.1
Social security benefits and grants	15.4	14.9	14.4	13.9	13.5	13.2	12.9	12.6	11.7	13.5	14.4
Of which:											
Pensions	8.8	8.6	8.4	8.2	8.0	7.8	7.6	7.5	7.1	9.0	10.0
Unemployment	2.7	2.3	2.0	1.8	1.7	1.6	1.5	1.5	1.2	1.0	1.0
Other	3.9	4.0	4.0	3.9	3.9	3.8	3.7	3.7	3.5	3.5	3.4
Interest payments	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Intragovernmental transfers	0.7	0.4	0.4	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.2
Other current expenditure	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Capital spending 2/	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1

1/ Including national defense

2/ Gross fixed capital formation.

Figure 6. Finland: Long-Term Fiscal Scenarios, 1998-2030



Source: Staff estimates.

will become structural, as experienced by Finland and many other European countries in the past. In sum, by increasing the incentives to participate actively in a more flexible labor market, the fiscal constraints can be met with a significantly lower tax burden, generating strong benefits in terms of employment and growth, and pointing the way to an efficient fiscal strategy for the coming decades.

## V. ISSUES OF IMPLEMENTATION

37. *An important question for policy is how the current approach to public expenditure management might need to evolve, in order to achieve medium- and longer-term fiscal objectives in an efficient manner.* The centerpiece of the 1999–2003 Government Program remains the medium-term framework for the central government, which is designed to increase the general government surplus while reducing taxation. This framework continues to limit the expenditure of central government ministries and their transfers to other levels of government. In other words, the basic principles that have worked well in the past have prudently been retained. Given this broad framework, however, there are several specific aspects of implementation that could be adapted over time to enhance the sustainability of fiscal performance, and its support for activity and employment. These include the interaction of spending ceilings with stabilizers; possible adjustments in the composition of spending; the way in which restraint at the local level is achieved in practice; and the challenge of coordinating measures to improve incentives for private sector employment across the gamut of policy programs. More generically, it is important to review whether the very success of past control approaches may have allowed a build-up of tensions in the operation of public programs or the composition of expenditure.

38. *First, in terms of broad design of the public spending ceilings, there is an unresolved tension regarding the operation of fiscal stabilizers on the expenditure side.* The authorities have taken a number of steps in recent years to enhance the operation of stabilizers, the most prominent being the achievement of an overall fiscal position that limits risks of breaching the EMU Stability and Growth Pact, and the creation of EMU buffer funds in the social security system to avoid pro-cyclical fluctuations in unemployment insurance contributions. Currently, however, much public expenditure, including cyclically sensitive items such as basic unemployment benefits, is either contained by medium-term ceilings, which are intended to be fairly rigid, or delivered by local authorities that aim to follow a balanced budget rule. There is a case for reviewing whether cyclically sensitive spending—particularly, basic unemployment benefits—could be treated in a manner that would not trigger procyclical offsets in other spending. This could imply, for example, shifting closer to the approach followed in the United Kingdom, which essentially places many cyclically-sensitive expenditures under annual appropriations limits. This said, for a relatively small and open economy such as Finland, the case for removing a partial restraint on automatic fiscal stabilizers needs to be weighed carefully against the overriding priority of maintaining an effective medium-term expenditure control system.

39. *Second, there are clearly areas where additional savings could be found—freeing resources for deeper cuts in labor taxation or additional spending on high priority purposes.*

One option is a tighter targeting of transfers to households, which together with social security benefits amount to some 20 percent of GDP. Without vitiating the government's commitment to core social objectives, programs where savings could be found include family allowances, housing subsidies, and educational grants. A further area where spending could be reduced is agricultural and non-agricultural subsidies, with the scale of the former reflecting in part transition provisions following Finland's entry to the EU.<sup>22</sup> In addition, a review of areas in which public employment could be scaled back would indicate further savings possibilities or resources for any needed adjustments to wages in areas where the public sector may have difficulty in attracting specialized skills.<sup>23</sup>

40. ***Third, as medium-term ceilings on central government spending are maintained, it will be essential to ensure that the composition of expenditure is suitably supportive of growth.***

One area of potential concern in this regard is capital spending, which was reduced below 3 percent of GDP (from some 4 percent of GDP in the early 1990s and 3½ percent of GDP in the 1980s). As one possible route to maintain adequate infrastructure provision, the authorities are exploring the scope for private financing of capital projects. Experience in other countries (such as the United Kingdom) illustrates both the opportunities and the risks entailed in such approaches. On the one hand, the potential gains can be considerable where efficiency can be improved in major aspects of a project (including labor cost savings and innovative management, e.g., in hospitals or prisons). Such gains can potentially outweigh the higher funding costs normally incurred by private sector contractors. On the other hand, major transport projects are notoriously difficult to price (e.g., as regards viable tariff rates); and, more generally, it is crucial that legal or de facto contingent liabilities are tightly limited.

41. ***Another area where forward-looking and efficient approaches to restraint will be needed is in the social sector operations of local authorities.*** As noted above, these include health care, whose management is one key component in limiting the exposure of the public finances to demographic pressures: there have been already some encouraging signs of rationalization or merger of facilities across local authority lines. Relatively wide variations among municipalities in the cost of providing services, such as health care (see OECD (1998)), suggest

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<sup>22</sup> Cuts in agricultural subsidies could also have environmentally benign implications (for a detailed review of Finland's environmental policies—including tax and expenditure aspects—see the 1999 OECD Economic Survey). Non-agricultural subsidies have been a target for some studies, and the Ministry of Trade and Industry has begun exploring ways for reducing their cost and improving their effectiveness.

<sup>23</sup> On points of detailed implementation, there remains room for improvement with regard to setting spending priorities, measuring results, and creating appropriate incentives for civil servants. Also the positive experience with the devolution of spending authority (covering virtually all of the agencies' running costs, including personnel expenses) may call for a wider application to subsidies and transfers, further reducing the number of line-item appropriations voted upon by Parliament (which is still almost 500). Finally, if wage restraint were to weaken, the practice of adjusting real ceilings for wages awards might need to be reviewed.

that there is considerable room for further efficiency gains in some municipalities, while others may be reaching limits. Against this background, higher cost recovery in the provision of services and increased authority for local governments to set charges and fees independently, will be critical. Together with such improvements, facilitated by enhanced cooperation between municipalities, there is also a need for a gradual withdrawal from tasks that could be provided more efficiently by the private sector, fostering a more rapid growth of the personal services sector. Absent such reforms, there is a danger of growing bottlenecks in municipalities faced with heavy inward migration, with adverse effects on labor mobility and growth. Finally, municipalities, having the right to borrow without restriction, may be pressed to finance their expenditures increasingly by running deficits—a practice they have traditionally managed to avoid.<sup>24</sup>

42. ***Finally, there is a need for coordination across a range of government programs in order to foster broader and more rapid employment growth.*** There are three critical areas for action in this regard. The first is early retirement, which is influenced by a broad range of public programs, and where the reforms of 1993–97 need to be extended; and the second area comprises labor market programs (see Box 5). Finally, key aspects of product market reform—from competition enforcement to privatization—could be pressed further to increase the flexibility of the economy.

43. ***In sum, complementary measures along the lines discussed above would powerfully leverage the broad goals of the current government program, with mutually-reinforcing effects on the performance of the real economy and the public finances.*** In this connection, the main objective of this paper has been to illustrate how the successful public expenditure policies of recent years, if continued and coupled with wide-ranging structural reforms and tax cuts, could trigger a virtuous circle of strong employment creation, high economic growth, and fiscal savings. To achieve the desired effects, however, such reform measures would need to be implemented without delay, thus taking advantage of the demographic window of opportunity presented in the next few years. After that, rapid population aging will complicate the prospects for an alleviation of the heavy burden of taxes and social security contributions, and for a significant and lasting improvement in employment performance.

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<sup>24</sup> In this context it is also important that besides practical difficulties in raising revenue (including tax competition between municipalities), the incentives of municipalities for doing so are weakened by the state transfer system, which compensates for a large part of the revenue shortfall, with the cost shared by all municipalities together.

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