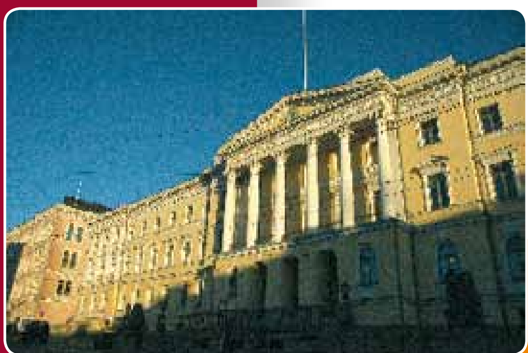
MINISTRY OF FINANCE

Stability programme for Finland 2012



15c/2012

Economic outlook and economic policy

MINISTRY OF FINANCE

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Ministry of Finance publications 15b/2012

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NORDIC ENVIRONMENTAL LABEL
441 002
Printed matter

MINISTRY OF FINANCE
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FINLAND
Tel. +358 295 5 30001
Internet: www.financeministry.fi
Layout: Anitta Heiskanen

Juvenes Print
Tampereen Yliopistopaino Oy, 2012

Description page

Publisher and date	Ministry of Finance, April 2012	
Author(s)	Ministry of Finance	
Title of publication	Stability programme for Finland 2012	
Parts of publication/ other versions released	The publication´s language versions: Finnish: Suomen vakausohjelma 2012 (15a/2012) Swedish: Finlands stabilitetsprogram 2012 (15b/2012)	
Publication series and number	Ministry of Finance publications15c/2012	
Distribution and sale	The publication can be accessed in pdf-format at www.financeministry.fi. There are also instructions for ordering a printed version of the publication.	
Printed by	Juvenes Print, Tampereen Yliopistopaino Oy 2012	
ISBN 978- 952-251-343-4 (print.) **ISSN** 1459-3394 (print.) **ISBN** 978-952-251-344-1 (PDF) **ISSN** 1797-9714 (PDF)	**No. of pages** 52	**Language** English

Abstract

The Stability Programme is based on Prime Minister Katainen's Government Programme, the Budget approved by Parliament on 21 December 2011 and the First Supplementary Budget issued in March 2012 as well as on the Central Government Decision on Spending Limits for 2013–2016 and the forecasts on which this was based.

Finland's GDP will grow by 0.8 per cent in 2012. Growth will be dependent to a large extent on private consumption. The outlook for exports remains poor and Finland will continue to lose market share in global trade. In 2013 exports will pick up and private investment will again begin to grow.

In the medium term, GDP growth will gradually subside. In 2013–2016 GDP is expected to grow on average by just under 2 per cent. The growth prospects for the economy will be adversely impacted by a reduction in labour supply resulting from rapid change in the population age structure.

The general government financial position will improve during the programme period, but there will be no return to the large surpluses that preceded the recession. According to the revised sustainability estimate, the surplus on general government finances ought to be around 4 per cent of GDP in 2016 for general government finances to be on a sustainable basis over the longer term.

In the 2009 Stability Programme, Finland's medium-term objective for general government finances was set at a structural surplus of 0.5 per cent of GDP. According to the forecast, immediate adjustment measures and other structural factors will improve the general government financial position such that the medium-term objective will be achieved during the programme period. At the same time, growth of general government debt will level off relative to GDP.

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Introduction and summary

According to preliminary data, Finland's GDP grew 2.9 per cent in 2011. Growth was driven by domestic demand. Exports, on the other hand, contracted. As a result of consumption- and investment-driven growth, the external financial position of the economy weakened. The current account slipped into deficit for the first time since 1993.

The forecast presented in this Stability Programme indicates that Finland's GDP will grow 0.8 per cent in 2012. Growth will be dependent to a large extent on private consumption. The outlook for exports remains poor and Finland will continue to lose market share in global trade. Subdued export prospects mean that private investment will contract. The current account will remain in deficit. In 2013 exports will pick up and private investment will again begin to grow. GDP will grow by 1.7 per cent. As growth will be strongly dependent on domestic demand, the current account will remain in deficit. In 2014 export growth will accelerate. Foreign trade will help boost GDP growth to just over 2 per cent and restore the current account to balance.

In the medium term, GDP growth will gradually subside. In 2013–2016 total output is expected to grow on average by just under 2 per cent. The growth prospects for the economy will be adversely impacted by a reduction in labour supply resulting from rapid change in the population age structure. Economic growth will be increasingly dependent on productivity growth. The threat exists, moreover, that conditions for productivity growth will be restricted by a structural change in which the proportion of GDP accounted for by lower productivity services will grow as the proportion of higher productivity industrial output declines.

In 2011 the employment rate was 68.6 per cent and the unemployment rate 7.8 per cent. According to the forecast, the employment rate will rise and the unemployment rate will fall slightly during the programme period. In its programme, the Government set as a target that the employment rate will rise to 72 per cent and the unemployment rate will fall to 5 per cent by 2015. These targets will not be achieved.

Finland's general government finances, which had long been in surplus, deteriorated sharply into deficit as a consequence of the recession in 2009, and in 2010 the deficit deepened further slightly. In 2011 the general government deficit reduced significantly as a result of two years of good growth, a tightening of indirect taxation and the ending of stimulus measures.

The forecast presented in this Stability Programme indicates that the general government financial position will improve in the programme period, but that there will be no return to large surpluses. Population ageing will exert upward pressure on public spending in the next few years at the same time as it increasingly slows growth of economic output and revenue, i.e. the financial base of public finances. According to the revised sustainability estimate of the Ministry of Finance, the general government financial surplus ought to be around 4 per cent of GDP in 2016 to enable the public authorities to handle their obligations over the longer term.

The Stability and Growth Pact requires that each Member State set an objective for the structural financial position of general government finances that it will strive to achieve in the medium term (medium-term objective, MTO). In the 2009 Stability Programme, Finland's medium-term objective for general government finances was set at a structural surplus of 0.5 per cent of GDP. According to the forecast, immediate adjustment measures and other structural factors will improve the general government financial position such that the medium-term objective will be achieved during the programme period. At the same time, growth of general government debt will level off relative to GDP.

Finland's general government finances consist of central government, local government and the social security funds, which are further divided into employment pension funds, which handle statutory employment pension insurance, and other social security funds.

Economic growth and immediate adjustment measures will reduce the central government deficit in the programme period. The deficit threatens, however, to remain larger than the target set in the Government Programme. The economic development of the municipalities is overshadowed by growing demand for social welfare and health services as a result of population ageing. The financial position of the municipalities will remain in deficit over the medium term. The employment pension sector's surplus will decline due to growth of pension expenditure. The financial position of other social security funds will be close to balance.

Challenges posed for economic growth conditions, for the wellbeing of citizens and for the sustainability of public finances as a result of the recession and population ageing will determine the basic tone of the Government's fiscal and economic policy.

In its programme, the Government has set a target of balancing central government finances and reducing the central government debt-to-GDP ratio significantly by the end of the parliamentary term. To achieve these targets, the Government is committed to implementing adjustment measures directed at central government revenue and expenditure as well as to reforming economic structures so that conditions for stronger-than-forecast economic growth are strengthened. The Government is also committed to implementing additional measures if there are no indications of a fall in the central government debt-to-GDP ratio and if the central government deficit shows signs of settling above 1 per cent of GDP. In addition, the Government has continued its spending limits procedure directed at central government appropriations.

To achieve its targets, the Government has decided in different contexts on immediate measures to reduce central government expenditure growth and boost revenue growth, which will improve the central government net financial position by a total of around EUR

4.7 billion by 2015[1]. Due to some temporary measures that will be implemented during the current electoral period, the permanent impact is somewhat larger from 2016 onwards. At the end of the electoral period the adjustment measures are evenly divided between those targeting central government expenditures and revenues.

Structural measures strengthening conditions for economic growth are an essential part of the package by which the Government will endeavour to improve the capacity of central government, local government and the social security funds to manage the statutory obligations prescribed for them over the longer term. One key target for the reforms is public services production. The structural reform of local government and services currently under way is also an essential part of this package. In connection with the Decision on Spending Limits for 2013–2016, the Government decided on measures by which it will strive to strengthen conditions for economic growth. At the same time, social partners presented their proposals for the extension of working careers. The measures were directed mainly at unemployment security, the early retirement pension system, education, and growth incentives in taxation for SMEs and R&D activity.

[1] The size of the adjustment has been assessed taking into account the net impact of the measures related to the Government programme in June 2011, spending limits decision in October 2011, the framework agreement of the labour market confederations in November 2011 and spending limits decision in April 2012.

1 Economic policy objectives and premises

1.1 General

Finland's economy recovered from the international economic crisis and recorded reasonably strong growth in 2010. Towards the end of last year, however, the economic outlook began to darken once again. As a result of the recession, a substantial deficit had quickly arisen in general government finances. This began to decline in 2011, due to the ending of stimulus measures and a strengthening of the economy. The Government has agreed corrective measures by which the balance of central government finances will be strengthened in the coming years. Even so, the state of public finances in the programme period will be significantly weaker than in the years preceding the recession.

The exceptionally deep recession accelerated a structural change in the economy whereby the proportion of total output accounted for by industrial production is contracting significantly. Finland's international competitiveness has also weakened in comparison with the earlier years of the millennium. In addition, the shift in the focus of global economic growth to developing countries has increased the transfer of manufacturing jobs outside of Finland. It is therefore important that economic policy supports the most favourable possible operating environment for the creation of new jobs and growth.

Population ageing will cast a shadow over the outlook for Finland's economy and public finances in the next few years. The working age population began to decline at the turn of the decade. According to a Statistics Finland population forecast, it will decline further in 2012–2016 by around 80.000 people. This will weaken the growth potential of the economy and adversely affect efforts to strengthen the fiscal position. Through population ageing, the role of productivity growth as a factor maintaining economic growth will be increasingly emphasised. Population ageing will also elevate public spending pressures by increasing, for example, pension and health care expenditure.

Corrective measures for the damage done by the recession to public finances as well as other post-crisis consolidation needs will be closely integrated with measures aimed at strengthening long-term sustainability. In terms of maintaining economic activity and growth, it is important to boost confidence in the stability of public finances not only in the short and medium term, but also in the long term. Direct measures to strengthen the fiscal position should be part of a package that credibly aims at closing the sustainability gap in the public finances. Structural reforms supporting growth and improving operating conditions for the welfare state form an essential part of this package.

In its Government Programme agreed on 22 June 2011, the Government committed to initiate the measures necessary to fully close the sustainability gap by 2015. To cover the sustainability gap, the Government aims to raise the employment rate, prolong working careers and improve the impact, effectiveness and productivity of public services and to strengthen the economy's growth potential by means of taxation and the allocation of central government expenditure. The aim is to raise the employment rate to 72 per cent and to reduce unemployment rate to 5 per cent by the end of this parliamentary term. The Government also aims to achieve a substantial reduction in the central government debt-to-GDP ratio by the end of this parliamentary term. The Government is committed to implementing new adjustment measures if there are signs that the central government debt-to-GDP ratio is not falling and indications that the central government deficit settles above 1 per cent of GDP. The Government will monitor on an annual basis the fulfilment of these central government finance targets.

1.2 Broad Economic Policy Guidelines

In June 2010 the European Council decided on a new economic and employment strategy. The strategy aims to strengthen employment, productivity and social cohesion and to create for the EU a smart, sustainable and inclusive economy. The strategy sets EU-wide targets for employment, research and development expenditure, climate policy, education and reducing poverty. The current broad economic policy guidelines and employment guidelines were approved in 2010 and they are valid until 2014. Based on these headline targets, Member States set their national targets and specify bottlenecks to economic growth. More detailed measures to achieve the targets and to remove bottlenecks to growth are presented in the Europe 2020 national reform programmes prepared by the Member States.

Finland's Europe 2020 Strategy National Programme was submitted in April 2011. The programme set as Finland's national targets the raising of the employment rate of 20–64 year-olds to 78 per cent, maintaining R&D spending at a minimum of 4 per cent of GDP, reaching the climate and energy targets agreed in the EU, raising the proportion of 30–34 year-olds with tertiary-level education to 42 per cent, reducing the proportion of early school leavers to 8 per cent and reducing the number of people living at risk of poverty and social exclusion. Finland's national targets exceed the headline targets set in the EU.

After assessing Finland's National Reform Programme for 2011 as well as Finland's Stability Programme Update for 2011–2014, the Council recommended for Finland in June 2011 the following measures for 2011–2012: 1) to continue the fiscal consolidation using any windfall revenue to reduce the deficit, while taking additional measures to maintain the fiscal position above the medium-term objective, in particular through compliance with the medium-term expenditure benchmark; 2) to take further measures to achieve productivity gains and cost savings in public service provision, including structural changes, in order to respond to the challenges arising from population ageing; 3) to target active labour market measures better on the long-term unemployed and young people; 4) to take measures to improve the employability of older workers and their participation in lifelong learning. To take further steps, in consultation with social partners and in accordance with national practices, to encourage older workers to stay in the labour market, by measures to reduce early exit and increase the effective retirement age. In view of the already existing system of linking pension benefits to life expectancy, to consider a link between the statutory retirement age and life expectancy; 5) to take further measures to open up further the service sector, by redesigning the regulatory framework and removing restrictions in order to facilitate new entry into service sector markets, especially in the retail sector.

Finland's Europe 2020 Strategy is being prepared simultaneously with the Stability Programme. The Stability Programme presented herein and the Finland's Europe 2020 National Reform Programme are consistent with each other.

1.3 Stability Programme for 2012 and its handling in Finland

This Stability Programme is based on the Budget approved by Parliament on 21 December 2011 and the First Supplementary Budget issued in March 2012 as well as on the Central Government Spending Limits Decision for 2013–2016 and the forecasts on which this was based. The expenditure estimates for 2012–2016 have taken into account the effects of decisions contained in the 2012 Budget.

The document will be delivered to the relevant EU bodies once it has been approved by the Government in plenary session. The contents of the Stability Programme have also been presented in writing and orally to the Grand Committee of Parliament. The Commission's assessment and the Council's statement on Finland's Stability Programme will be submitted to Parliament in connection with Ecofin preparations.

Stability Programme complies with the Code of Conduct endorsed by Ecofin in January 2012.

2 Economic situation and outlook

2.1 Recent developments and short-term outlook

Global economic growth slowed in late 2011, and this period of slow growth will continue at least through early 2012. World GDP adjusted for purchasing power will increase at just over 3% in 2012, but return to growth of 4% in 2013. Throughout the outlook period the main focus of growth will be in developing countries. At the same time many industrial countries will see growth slowing or turn into recession.

The US economy recovered quite robustly from the recession, among other things because of intensive stimulus and because the deep financial markets dampened the effects of the banking crisis on the real economy. However economic growth in the US is slow and will remain below 3% over the outlook period. Growth has stalled in the EU and in the euro area. In the EU, uncertainty caused by the sovereign debt crisis and the steps taken to consolidate public finances will slow growth especially in 2012 and 2013. Persistently high unemployment rates across the EU are also slowing growth.

Sluggish demand in industrial countries is holding back growth in developing countries, too, and in most cases growth rates will fall short of the recent trend. Growth in China, for instance, will slow to 8% in 2012, with internal stimulus accounting for part of that growth. Chinese exports are affected by dwindling international demand as well as by the sharp rise in recent years of income and wage levels, which has dented Chinese competitiveness. Russia is in the position to achieve growth of around 4% this year on the back of strong oil prices.

Preliminary figures show that Finnish economic growth in 2011 reached 2.9%. However this annual growth rate is significantly affected by the low base of comparison in the first quarter of 2010. The pace of growth varied widely within the year: Q2 seasonally adjusted GDP fell from the previous quarter, whereas Q3 saw the strongest growth. At the end of the year growth came to a virtual standstill. The demand side of the national economy in 2011 was driven mainly by private consumption, investment and the stocking up of inventories. Foreign trade saw some significant changes as the trade balance slipped into a large deficit. The balance of services and factor incomes and current transfers balance were both close to balance, and therefore the current account moved into negative territory for the first time since 1993. The current account still continued to deteriorate; this has been a persistent problem for the Finnish economy.

The economic outlook is somewhat brighter than it was at the end of 2011. The growth forecast for the current year is below one per cent, which will largely come from private consumption. Although slower than last year, the outlook predicts that world trade and the global economy will achieve reasonable growth. However Finnish exports will struggle to keep up with this pace and continue to lose market shares. There are indications that the economies of our key trading partners such as Germany and Sweden are also losing steam. The euro area is at risk of slipping into recession. Private investment will remain stagnant in 2012, partly because of the weak export outlook. The forecast for the unemployment rate is 8%. Two major factors behind the rising unemployment figure are the persistently subdued demand for labour and the ongoing restructuring of production. In 2012 inflation in Finland will continue to remain higher than the euro area average, but prices at least will not rise as sharply as during the past couple of years. It is forecast that consumer prices will increase by just below 3% from the year before.

In 2013 it is predicted that economic activity will pick up, and GDP growth is expected to come in at 1.5%. Growth will continue to rely largely on domestic demand. It is thought that exports will rebound to growth of almost 3%, at once pushing up private investment. Imports will nonetheless remain at a higher level than exports, and therefore the trade balance will remain in deficit. No major changes are expected in the labour market. The unemployment rate will edge down slightly from 2012, with the annual average forecast at 7.9%. Employment among older people (65–74 years) will continue to increase over the outlook period. Last year the number of older employed persons was around 45,000, and the employment rate in this age group climbed to 8.8%. The number of older people in the population is also rising: by 2014 the population aged 65–74 will number over 600,000, and the number of older employed persons will reach around 55,000. For the time being the greatest inflationary pressures have receded, but due inter alia to tax decisions the rate of inflation based on the national consumer price index will be above 2½%.

In 2014 economic growth will exceed 2%, but still remain slower than the long-term average. It is predicted that the current account will turn to balance, and unemployment will slowly edge down.

During the past few years import inflation and particularly the increase in raw materials prices have influenced domestic price trends. The euro price of crude oil will still head up during 2012, but over the next two years it is thought that this trend will level out. The forecast barrel price in 2014 is over 80 euros. For other raw materials the outlook is based on assumptions of moderate price increases. Monetary policy will remain easy throughout the outlook period. The 3-month Euribor rate is expected to average 1.2% in 2012, slightly down on the figure posted last year. In 2014 the rate will edge up to an average of around 2%. Interest on 10-year Finnish government bonds will follow the same path, reaching just over 3% towards the end of the forecast period.

The Finnish economy is currently faced with a whole host of challenges. Finnish exports continue to remain almost one-fifth below the record figures of 2008. The situation is largely the same both in traditional goods exports and in service exports. Some of these challenges, such as the long-standing deterioration of the terms of trade, are largely beyond the control and scope of government intervention. Since 2000, our terms of trade losses have amounted to around 10%. The adverse trends in export prices compared to import prices are ultimately due to fundamental changes in our country's production structure coupled with the competitive situation. The price competitiveness of the Finnish economy has declined in recent years. A comparison of the trends of unit labour costs in Finland with those in the euro area makes it clear that in a very short space of time from 2007 to 2010, we have lost the advantage in price competitiveness that we achieved in 2000–2006.

The outlook includes both upside and downside risks, although predominantly the latter. The situation in the financial market is highly volatile and conditional on a number of factors. If the crisis in the euro area is not contained and it spreads to bigger countries, then the already unstable financial markets will have to resort increasingly to public sources of assistance. This would act to undermine economic growth through various channels.

The downside risks in the global economy come first and foremost from public sector indebtedness and from the fragility of private demand and persistent high unemployment. In the short term a broad and concerted effort to consolidate public finances might reduce demand and exacerbate unemployment to a greater extent than forecast earlier, but in the medium term these measures might help to restore consumer and business confidence and so improve the prospects for private demand growth. Furthermore rising import and producer prices have in many countries created upward pressure on consumer prices and wages. If these pressures materialize, this could have the effect of slowing the growth of private demand.

2.2 Medium-term macroeconomic scenario

The Finnish economy recovered quite quickly from the exceptionally deep recession that started in 2008. Recently, however, this recovery has been fraught with uncertainty caused by the European sovereign debt crisis and risks surrounding the international economy. In the medium term it is estimated that output growth will be moderately strong again, but there are no signs of a return to the pre-crisis growth track. Even if the international economy and the Finnish export markets showed good improvement, the medium-term prospects of economic growth are hampered by population ageing and the consequent decline in the labour force. GDP growth in 2013–2016 is projected to average just under 2%, compared to over 4% during the cyclical peak in 2004–2007.

Assessments of medium-term economic growth are based on the projected development of the resources in the economy, i.e. labour, capital and overall productivity, which provide the foundation for potential output growth. Real GDP growth is forecast to outpace potential output growth in 2013–2016. In the wake of the recession productive resources remained underutilized, and it is assumed that over the next few years the use of resources will return to normal.

The exceptionally deep recession in 2008–2009 will have a long-standing impact on potential output development and influence the medium-term outlook of the national economy. Investment fell sharply during the recession, and some of the capital stock was permanently removed from production. The post-recession recovery of investment was rather short-lived, and in 2012 the decline in investment will again adversely affect the development of the capital stock.

Compared to the previous recession in the early 1990s, the labour market came through the economic crisis with considerably less damage. The rise in the unemployment rate was quite moderate in view of the depth of the crisis, nor did the number of people in the labour force decline very sharply. Because the population is ageing, the labour supply will begin to shrink in the medium term. The number of people of working age will be falling so sharply over the next few years that in order to offset this trend, labour participation rates should rise considerably. As a result of the shrinking labour force, it is projected that the number of employed persons will start falling towards the end of the medium-term outlook period. The decreasing labour supply will thus have the effect of undermining the economy's growth potential. Economic growth will depend increasingly on productivity growth.

The conditions for productivity growth are constrained by ongoing structural changes in which the economic focus is shifting towards service industries and high-productivity industrial production accounts for a smaller proportion of output. The recession accelerated this structural change. As the focus of global economic growth shifts to Asian markets, there will probably be increased pressure to relocate production outside of Finland. International competition for export markets and industrial production is intense, and over the past decade Finland has been losing ground in this competition.

Table 1a. Macroeconomic prospects

	2011 EUR bn	2011	2012	2013	2014	2015	2016
		change, %					
1. Real GDP	162.3	2.9	0.8	1.5	2.1	1.9	1.7
2. Nominal GDP	191.6	6.6	3.6	4.0	4.4	4.1	4.0
Components of real GDP							
3. Private consumption expenditure	105.3	3.3	1.0	1.1	1.8	2.0	2.0
4. Government consumption expenditure	45.7	0.8	1.1	0.8	0.9	1.0	1.0
5. Gross fixed capital formation	36.7	4.6	-1.0	2.2	2.4	1.9	1.6
6. Changes in inventories (% of GDP)	3.3	1.7	2.0	1.9	1.9	2.0	2.2
7. Exports of goods and services	74.9	-0.8	0.5	2.7	5.0	4.5	4.0
8. Imports of goods and services	75.9	0.1	0.7	2.2	3.5	3.4	3.2
Contributions to real GDP growth, % points							
9. Final domestic demand	187.7	2.9	0.6	1.2	1.6	1.7	1.6
10. Changes in inventories	3.3	0.3	0.2	0.0	-0.1	-0.1	-0.2
11. External balance of goods and services	-1.0	-0.3	-0.1	0.2	0.6	0.4	0.3

Table 1b. Price developments

	2011	2012	2013	2014	2015	2016
	change, %					
1. GDP deflator	3.6	2.8	2.5	2.3	2.1	2.1
2. Private consumption deflator	3.0	2.7	2.6	2.1	2.0	2.0
3. HICP	3.3	3.0	2.4	2.0	2.0	2.0
4. Public consumption deflator	2.6	3.1	2.1	2.6	2.7	2.7
5. Investment deflator	3.4	2.9	2.8	2.8	2.1	2.1
6. Export price deflator	4.7	1.2	1.3	0.5	1.0	1.0
7. Import price deflator	7.6	1.5	1.1	0.8	2.0	2.0

Table 1c. Labour market developments

	2011 level	2011	2012	2013	2014	2015	2016
		change, %					
1. Employment, 1.000 persons	2474	1.1	-0.3	0.1	0.4	0.1	-0.1
2. Employment, 1.000 hours worked	4182	1.2	-0.7	0.3	0.7	0.1	-0.1
3. Unemployment rate (%)	209	7.8	8.0	7.9	7.7	7.4	7.3
4. Labour productivity, persons	65.6	1.7	1.1	1.4	1.6	1.8	1.8
5. Labour productivity, hours worked	38.8	1.6	1.5	1.2	1.4	1.8	1.8
6. Compensation of employees	78.1	4.8	2.6	2.6	3.5	3.6	3.4
7. Compensation per employee	31.6	3.6	2.9	2.5	3.0	3.5	3.5

Table 1d. Sectoral balances

	2011	2012	2013	2014	2015	2016
	% of GDP					
1. Net lending/borrowing vis-à-vis the rest of the world	-0.3	-0.5	-0.2	0.2	0.2	0.1
of which:						
- Balance on goods and services	-0.5	-0.7	-0.4	0.0	0.0	0.0
- Balance of primary incomes and transfers	0.1	0.1	0.1	0.1	0.1	0.1
- Capital account	0.1	0.1	0.1	0.1	0.1	0.1
2. Net lending/borrowing of the private sector	1.3	1.8	1.5	1.4	1.3	0.9
3. Net lending/borrowing of general government	-0.5	-1.1	-0.5	-0.1	0.0	0.4
4. Statistical discrepancy	-1.2	-1.2	-1.2	-1.2	-1.2	-1.2

Table 1e. Basic assumptions*

	2011	2012	2013	2014
3-month EURIBOR	1.4	1.2	1.6	2.1
Long-term interest rate (10-year government bonds)	3.0	2.3	2.6	3.3
USD/EUR exchange rate	1.4	1.3	1.3	1.3
Nominal effective exchange rate	0.1	0.0	0.0	0.0
World GDP growth (excl. The EU)	4.2	4.1	4.3	4.5
EU-27 GDP growth	1.6	0.6	1.5	2.0
GDP growth of relevant foreign markets	7.7	4.8	5.8	6.0
World trade growth	6.0	4.0	8.0	7.0
Oil prices, (Brent, USD/barrel)	114.6	110.0	105.0	105.3

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

3 General government balance and debt

3.1 Fiscal policy strategy and medium-term objective

The recession weakened the funding basis of public finances substantially in a situation in which population ageing is beginning to burden public finances to an increasing degree. In contrast with most other developed industrialised countries, in Finland population ageing is already increasing public spending and cutting growth of the economy's production potential.

According to a number of independent assessments, the funding of Finland's public finances does not rest on a stable foundation over the longer term. According to a revised sustainability estimate of the Ministry of Finance, the general government financial surplus ought to be about 4 per cent of GDP in 2016 to enable the public authorities to handle their obligations also over the longer term.

In the Ecofin Council's statement (12 July 2011) on Finland's Stability Programme for 2011–14, Finland was urged to continue the fiscal consolidation using any windfall revenue to reduce the deficit, while taking additional measures to maintain the fiscal position above the medium-term objective. In addition, Finland was urged to take further measures to achieve productivity gains and cost savings in public service provision, including structural changes, in order to respond to the challenges arising from population ageing.

Challenges posed for economic growth conditions, for the wellbeing of citizens and for the sustainability of public finances as a result of the recession and population ageing will determine the basic tone of the Government's fiscal and economic policy.

In its programme, the Government has set a target of balancing central government finances and reducing central government debt-to-GDP ratio significantly by the end of the parliamentary term. To achieve these targets, the Government is committed to implementing adjustment measures directed at central government revenue and expenditure as well as to reforming economic structures so that conditions for stronger-than-forecast economic growth are strengthened. The Government is also committed to implementing additional measures if there are no indications of a fall in the central government debt-to-GDP ratio and if the central government deficit shows signs of settling above 1 per cent of GDP. In addition, the Government has continued its spending limits procedure directed at central government appropriations.

To achieve its targets, the Government has decided in different contexts on immediate measures to reduce central government expenditure growth and boost revenue growth, which will improve the central government net financial position by a total of around EUR 4.7 billion by 2015[1]. Due to some temporary measures that will be implemented during the current electoral period, the permanent impact is somewhat larger from 2016 onwards. At the end of the electoral period the adjustment measures are evenly divided between those targeting central government expenditures and revenues.

The Stability and Growth Pact requires that each Member State set an objective for the structural balance of general government finances that it will strive to achieve in the medium term (medium-term objective, MTO). In the 2009 Stability Programme, Finland's medium-term objective for general government finances was set at a structural surplus of 0.5 per cent of GDP.

According to the forecast presented in the Stability Programme, immediate adjustment measures and other structural factors will improve the general government financial position such that the medium-term objective will be achieved during the programme period. The deficit target set for central government finances will not be achieved, however.

Structural measures strengthening conditions for economic growth are an essential part of the package by which the Government will endeavour to improve the capacity of central government, local government and the social security funds to manage the statutory obligations prescribed for them over the longer term. Concrete decisions on a substantial reform of economic structures will reduce the need to adjust public finances through direct measures.

In connection with the Decision on Spending Limits for 2013–2016, the Government decided on measures by which it will strive to strengthen conditions for economic growth. At the same time, social partners presented their proposals for the extension of working careers. The measures were directed mainly at unemployment security, the early retirement pension system, education, and growth incentives in taxation for SMEs and R&D activity.

On the path towards a more efficient, more competitive and higher employment economy, there is much to be achieved. Reforms that improve the employment rate and productivity of the economy are particularly essential.

For example, there are many opportunities in respect of reforms increasing the supply of labour. Based on a comparison of Nordic countries, there is potential to be found particularly among young people and the elderly, but also within the core working-age groups.

Reforms supporting productivity growth, on the other hand, will produce favourable results most effectively when they create incentives to increase human capital, promote innovation activity and the allocation of investments in Finland, and increase competition in the market. One key target for the reforms is public services provision. The structural reform of local government and services currently under way is also an essential part of this package.

1 The size of the adjustment has been assessed taking into account the net impact of the measures related to the Government programme in June 2011, spending limits decision in October 2011, the framework agreement of the labour market confederations in November 2011 and spending limits decision in April 2012.

The favourable effects of fiscal consolidation will be based on how the measures are perceived to improve confidence in public authorities' capacity to maintain general government finances on a sustainable foundation. The significance of confidence, and of confidence-improving factors, has been highlighted in recent years. The financial crisis and the recession as well as the subsequent deterioration in public finances have increased the risk of a fiscally unsustainable rise in indebtedness. Accordingly, credible adjustment measures aimed at fiscal consolidation and reducing indebtedness may improve confidence in the fiscal sustainability and therefore support economic growth over the longer term.

3.2 General government balance and debt

Finland's public finances deteriorated sharply into deficit as a consequence of the recession in 2009, after a long period of surplus, and in 2010 the deficit deepened further slightly. Last year, the general government deficit reduced significantly as a result of two years of good growth, a tightening of indirect taxation and the ending of stimulus measures.

Although the financial position improved substantially last year, there will not be a return to the large surpluses of former years. In the next few years, population ageing will increasingly have the effect of slowing growth of economic output and revenue, i.e. the financial base of public finances.

Finland's general government finances consist of central government, local government and the social security funds, which are further divided into employment pension funds, which handle statutory employment pension insurance, and other social security funds. Cyclical fluctuations are reflected most clearly in the financial position of central government, particularly due to the high cyclical sensitivity of tax revenue.

Despite the substantial measures taken to improve the central government's financial position, with forecast growth central government finances threaten to remain in deficit in future. The deficit will likely decline to some extent in the medium term. Local government finances will also remain slightly in deficit. The economic development of the municipalities is overshadowed particularly by growing demand for social welfare and health services as a result of population ageing. The surplus of the employment pension sector will fall as a consequence of growing pension expenditure. The financial position of other social security funds will be close to balance.

General government debt grew last year by EUR 6 billion to EUR 93 billion, but the debt ratio, i.e. the ratio of public debt to GDP, remained roughly at the previous year's level. The levelling off of debt ratio growth is a temporary phenomenon, however, and in the medium term the general government debt-to-GDP ratio is expected to be somewhat higher than 50%. The debt ratio will not thus exceed the 60 per cent limit specified in the Stability and Growth Pact.

The general government primary balance returned to surplus last year, which slowed growth of debt. Of debt ratio growth, 1.4 percentage points arose from growth in debt interest expenditure. In terms of debt relative to GDP, an increase in GDP lowers the debt ratio. In 2011 growth of GDP volume and price lowered the debt ratio by a total of 3.2 percentage points.

The fact that in Finland general government includes the employment pension funds in addition to central government, local government and the social security funds has a significant impact on how the annual financial position of general government appears as a change of general government debt. As the employment pension institutions partially prefund their contribution revenue, their financial position is in surplus. In 2011 the surplus was 2.8 per cent of GDP.

The surplus of the employment pension institutions is included in the primary budgetary position of general government, but it is not used to pay off general government debt. On the other hand, last year the employment pension institutions increased their investments in bonds issued by the State of Finland. As general government internal borrowing is not included in general government debt, this slowed growth of the debt ratio. There are grounds for assuming that this trend will continue in the medium term.

The euro area debt crisis also affects the indebtedness of the central government and the entire public sector. Finland is providing capital to the European Stability Mechanism (ESM) of EUR 1.44 billion, which will increase the level of debt by a corresponding sum from this year. The capitalisation of the ESM has not yet been taken into account in this Stability Programme's baseline scenario, because it has not yet been taken into account in the Budget of the State of Finland.

By a decision of Eurostat, the debt taken by the European Financial Stability Facility (EFSF) will be treated in statistics as part of the public debt of the Member States which granted guarantees. In 2011 a total of EUR 312 million in loans, which the EFSF has granted, were recognised in Finland's public debt. The second rescue loan programme for Greece decided in February also increases Finland's state guarantees for the EFSF's acquisition of funds. In this forecast, these guarantees have not been taken into account as a factor increasing public debt, because the total sum and timing of the loans granted by the EFSF has not yet been decided upon.

3.3 Cyclically adjusted balance in general government finances

Targets determined with the aid of the structural balance have been set for general government finances at both the EU and the national level. The structural balance is obtained by removing from the fiscal position the impact of cyclical fluctuations in the economy and the one-off and other temporary measures. In this Stability Programme, as in previous years, Finland's medium-term objective is confirmed as being a general government structural surplus of 0.5 per cent of GDP.

The cyclically adjusted fiscal position describes what the fiscal position would be if the economy's production resources were in full use. The cyclical adjustment is based on an estimate of the development of potential output. Potential output describes the output capacity of the economy determined on the basis of different production factors such capital stock, productivity and labour input. Potential output has been estimated using the production function method agreed by the Ecofin Council.

Potential output grew by just over 3 per cent per annum in the early years of the millennium. The recession that began in 2008, however, weakened both labour and capital inputs and reduced the economy's growth potential. At the turn of the decade, population ageing and a reduction in the working-age population also began to restrict the economy's growth potential. In the coming years, potential output growth is expected to remain at just over 1 per cent.

The cyclical situation is described by the output gap, i.e. the difference between the potential output and actual output of the economy. In the middle of the last decade, the actual output of the economy was still clearly greater than the level of potential output, and the output gap was positive. During the recession, the output gap quickly changed to negative. The contraction of output was so sharp that the output gap was around 7 per cent of GDP in 2009. In 2010–2011 growth of total output recovered and the negative output gap was reduced. In medium-term growth estimates, the output gap is expected to close by 2017.

Changes in the cyclically adjusted balance are used to describe what the impact of fiscal policy on economic activity and the state of public finances has been in each year[2]. Another way to assess the fiscal policy impacts is to examine changes in the cyclically adjusted primary balance in general government finances[3].

Before the recession, the cyclically adjusted primary balance of the general government finances was strongly in surplus for many years. During the recession, the surplus contracted rapidly and almost completely disappeared. Fiscal policy was eased and support given to economic growth, while the consequences of the recession were alleviated through stimulus measures. In 2011 the cyclically adjusted primary balance strengthened, while fiscal policy changed from stimulus to tightening through tax increases, among other things. The adjustment measures directed at central government finances decided by the Government will strengthen the cyclically adjusted primary balance further so that the tuning of fiscal policy will be towards tightening during the programme period.

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2 When examining the cyclically adjusted balance and the primary balance as well as their changes, one should take into account uncertainty factors associated with the cyclical adjustment, which have been prominent after the sharp cyclical fluctuations caused by the deep crisis that began in 2008.

3 The primary balance is calculated here by deducting gross interest payments from general government net lending.

Table 2a. General government budgetary prospects

		2011	2011	2012	2013	2014	2015	2016
		EUR million	% of GDP					
Net lending by sub-sector (EDP B.9)								
1.	General government	-938	-0.5	-1.1	-0.5	-0.1	0.0	0.4
2.	Central government	-5406	-2.8	-3.4	-2.5	-2.0	-1.9	-1.4
3.	-							
4.	Local government	-833	-0.4	-0.5	-0.5	-0.5	-0.5	-0.6
5.	Social security funds	5301	2.8	2.8	2.5	2.4	2.4	2.4
General Government (S13)								
6.	Total revenue	101 994	53.2	53.3	53.9	54.1	54.2	54.4
7.	Total expenditure	102 932	53.7	54.4	54.4	54.2	54.2	54.0
8.	Net lending/borrowing	-938	-0.5	-1.1	-0.5	-0.1	0.0	0.4
9.	Interest expenditure	3457	1.1	1.3	1.3	1.4	1.6	1.7
10.	Primary balance	1920	0.6	0.2	0.8	1.3	1.6	2.0
11.	One-off and other temporary measures	0	0.0	0.0	0.0	0.0	0.0	0.0
	Selected components of revenue							
12.	Tax revenue (12=12a+12b+12c)	58 199	30.4	30.4	30.9	30.9	30.9	30.9
12a.	Taxes on production and imports	26 884	14.0	14.3	14.7	14.5	14.4	14.2
12b.	Taxes on income	30 920	16.1	16.0	16.0	16.2	16.2	16.4
12c.	Capital taxes	395	0.2	0.2	0.2	0.3	0.3	0.2
13.	Social security contributions	23 807	12.4	12.5	12.5	12.6	12.6	12.7
14.	Property income	7 284	3.8	4.0	4.1	4.2	4.4	4.5
15.	Other income (15=16-12-13-14)	12 704	6.6	6.3	6.3	6.3	6.4	6.3
16 = 6.	Total revenue	101 994	53.2	53.3	53.9	54.1	54.2	54.4
	of which: Tax burden (D2+D.5+D.61+D.91-D.995)	81 574	42.6	42.8	43.2	43.3	43.3	43.3
Selected components of expenditure								
17.	Compensation of employees + intermediate consumption	47 879	25.0	25.0	24.8	24.6	24.5	24.4
17a.	Compensation of employees	26 660	13.9	13.8	13.6	13.4	13.2	13.0
17b.	Intermediate consumption	21 219	11.1	11.2	11.3	11.3	11.3	11.4
18..	Social transfers (18=18a+18b)	38 944	20.3	20.8	20.9	21.0	21.0	21.1
	of which: Unemployment benefits	3 145	1.6	1.7	1.7	1.7	1.7	1.6
18a.	Social transfers in kind	5 179	2.7	2.8	2.8	2.9	2.9	3.0
18b.	Social transfers other than in kind	33 765	17.6	18.0	18.1	18.1	18.1	18.1
19 = 9.	Interest expenditure	3457	1.1	1.3	1.3	1.4	1.6	1.7
20.	Subsidies	2 712	1.4	1.4	1.3	1.3	1.3	1.2
21.	Gross fixed capital formation	4 003	2.5	2.5	2.5	2.4	2.4	2.3
22.	Capital transfers	672	0.4	0.3	0.3	0.3	0.3	0.2
21.	Other expenditure (23 = 24 -17-18-19-20-21)	5 265	3.0	3.0	3.2	3.2	3.1	3.1
24 = 7.	Total expenditure	102 932	53.7	54.4	54.4	54.2	54.2	54.0
	of which: Government consumption	45 719	23.9	24.0	23.8	23.6	23.5	23.5

Table 2b. Breakdown of revenue

	2011 EUR million	2011	2012	2013	2014	2015	2016
		% of GDP					
1. Total revenue at unchanged policies	100 953	52.7	52.5	52.1	52.0	52.2	52.3
2. Discretionary revenue measures	1 041	0.5	0.8	1.8	2.2	2.0	2.1

Table 2c. Expenditure to be excluded from the revenue benchmark

	2011 EUR million	2011	2012	2013	2014	2015	2016
		% of GDP					
1. Expenditure on EU programmes fully matched by EU funds revenue	1 136	0.6	0.6	0.5	0.5	0.5	0.4
2. Expenditure fully matched by mandated revenue increases	100	0.1	0.1	0.2	0.2	0.2	0.2
3. Non-discretionary changes in unemployment benefit expenditure	-210	-0.1	0.1	0.1	0.0	0.0	0.0

Table 3. General government debt developments

	2011	2012	2013	2014	2015	2016
	% of GDP					
1. Gross debt	48.6	50.7	51.8	51.9	51.6	50.9
2. Change in gross debt ratio	0.2	2.1	1.2	0.1	-0.3	-0.7
Contributions to changes in gross debt						
3. Primary balance	0.6	0.2	0.8	1.3	1.6	2.0
4. Interest expenditure	1.1	1.3	1.3	1.4	1.6	1.7
5. Stock-flow adjustment	-0.3	1.0	0.7	0.0	-0.3	-0.3
of which:						
- Differences between cash and accruals	0.0	0.0	0.0	0.0	0.0	0.0
- Net accumulation of financial assets	2.8	2.7	2.5	2.4	2.4	2.4
- of which: privatisation proceeds	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
- Valuation effects (incl. GDP growth contribution)	-3.1	-1.7	-1.9	-2.4	-2.7	-2.7
Implicit interest rate on debt	3.1	2.8	2.7	2.9	3.1	3.3
Other relevant variables						
6. Liquid financial assets	94.2	-	-	-	-	-
7. Net financial debt (7=1-6)	-45.6	-	-	-	-	-
8. Debt amortization (existing central government bonds)	14.3	-	-	-	-	-
9. Percentage of debt denominated in foreign currency	0	-	-	-	-	-
10. Average maturity of central government bonds (years)	5.3	-	-	-	-	-

Table 4. Contingent liabilities

	2011	2012
	% of GDP	
Central government guarantees	13.4	-
of which: linked to the financial sector	0.5	-

Table 5. Cyclical developments

	2011	2012	2013	2014	2015	2016
	% of GDP					
1. Real GDP growth (%)	2.9	0.8	1.5	2.1	1.9	1.7
2. Net lending of general government	-0.5	-1.1	-0.5	-0.1	0.0	0.4
3. Interest expenditure	1.1	1.3	1.3	1.4	1.6	1.7
4. One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	0.0
5. Potential GDP growth (%)	1.2	1.1	1.1	1.1	1.1	1.0
contributions:						
- labour	-0.2	-0.4	-0.4	-0.5	-0.5	-0.6
- capital	0.5	0.4	0.4	0.4	0.4	0.3
- total factor productivity	0.9	1.0	1.1	1.2	1.3	1.3
6. Output gap	-3.5	-3.8	-3.4	-2.5	-1.6	-0.9
7. Cyclical budgetary component	-1.4	-1.5	-1.4	-1.0	-0.7	-0.4
8. Cyclically-adjusted balance (2-7)	0.9	0.4	0.8	0.9	0.7	0.7
9. Cyclically-adjusted primary balance (8+3)	2.0	1.7	2.1	2.3	2.2	2.4
10. Structural balance (8-4)	0.9	0.4	0.8	0.9	0.7	0.7

4 Sensitivity analysis and comparison with previous programme

4.1 Economic development risks and their impact on public finances

The baseline scenario of the Stability Programme is based, in terms of 2012–2014, on the Ministry of Finance's March 2012 economic forecast. The years 2015 and 2016 have been taken into account in the scenario based on, among other things, the growth estimate for potential output. The baseline scenario's economic projection of the general government financial position is based on, in addition to the economic forecast, the Government Programme of Prime Minister Jyrki Katainen's Government, the 2012 Central Government Budget and the Decision on Spending Limits for 2013–2016, approved by the Government in March 2012. The baseline scenario is based on the assumption that the Finnish economy will grow by 0.4 per cent in 2012, and thereafter on average by just less than 2 per cent per year in the period 2013–2016.

Great uncertainties are associated with the development of the world economy, however, and Finland, due to its large export sector, is highly dependent on global economic performance. The situation in the financial markets is very sensitive and conditional on many factors. If the euro area crisis does not subside and it spreads to new countries, the already unbalanced financial markets will increasingly have to turn to the public authorities for assistance. This would undermine economic growth in a number of ways.

Finland's position in the global market depends on the price competitiveness of the export sector. Investment goods account for a large proportion of Finland's exports. As a result, the deterioration of the international economic climate was reflected more strongly in Finland's exports than in those of many other countries during the recent financial crisis. In addition to the structure of foreign trade, a faster rise in labour costs than in competitor countries has promoted the weakening of the competitiveness and external balance of the Finnish economy.

A faster rise in unit labour costs than competitor countries as well as the export structure represent a down-side risk for economic development also in the future. On the other hand, a broad-based, two-year labour market agreement was agreed in November 2011. This agreement will result in unit labour costs rising this year and next more slowly than the average for the last ten years.

Last year, the current account slipped into deficit for the first time since the recession of the 1990s. The current account is projected to remain slightly in deficit this year and next, but remain in balance thereafter. There is a risk, however, that the current account will remain permanently in deficit. Finland has lost global market share throughout nearly all of the 2000s, and since the financial crisis this trend has strengthened. As a consequence of the collapse of exports, exports have declined to less than 40 per cent of GDP, and Finland's exports are still nearly one fifth below the record levels of 2008. The proportion of total exports accounted for by high technology has declined to a record low, to less than 10 per cent.

Weaker than anticipated development of the export market would reduce domestic investment and would lead in the baseline scenario to a weaker than anticipated employment trend. This could, furthermore, compel households to consume more cautiously than expected. An export recovery slower than the baseline scenario might therefore lead to significantly weaker than projected growth in total output.

The general government balance will not be corrected in the programme period through economic growth alone to the level that preceded the 2009 recession. Should negative risks materialise, recovery from the recession would be prolonged and public finances would be significantly weaker than the baseline scenario at the end of the programme period. This would further increase the need to revitalise public finances and would make provisions for population ageing even more difficult than at present.

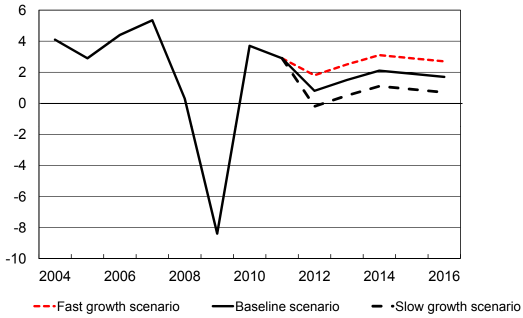
The euro area debt crisis is also increasing Finland's public debt. Bilateral loans, capitalisation of the ESM, and state guarantees for the EFSF's acquisition of funds are raising the level of Finland's public debt. In addition, the State of Finland has various commitments and liabilities relating to the debt crisis that do not have a direct impact on debt. It can be considered a risk that, if various liabilities are realised, Finland's public debt might rise to 60 per cent of GDP in the medium term.

The figures below present the impact of slower-than-baseline and faster-than-baseline economic growth on the financial balance and debt in general government. The calculations are based on the assumption that annual output growth deviates by one percentage point in either direction from the baseline scenario in period under examination.

In the slower growth scenario, growth of total output would remain on average below one per cent in 2013–2016 and the unemployment rate would rise to nearly 9 per cent. The general government deficit at the end of the programme period would be just under 3 per cent and the debt ratio would rise above 55 per cent. This would increase significantly the need to adjust public finances to secure their sustainability.

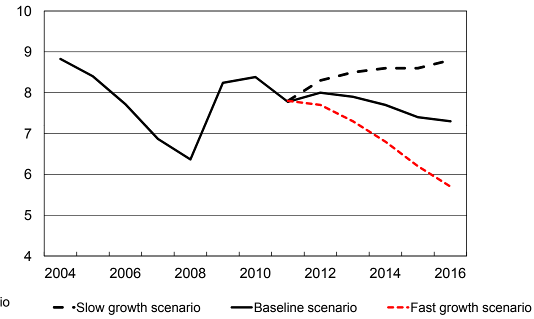
Faster growth than the baseline scenario of one percentage point would be sufficient for a clear decline in the general government debt ratio in the programme period. The general government financial position would change to surplus, even though central government finances would remain in deficit. The unemployment rate would fall fairly rapidly. The materialisation of economic growth more favourable than the baseline scenario will require a significant recovery of the international economy as well as higher demand than anticipated for Finnish export products.

GDP
change in volume, per cent



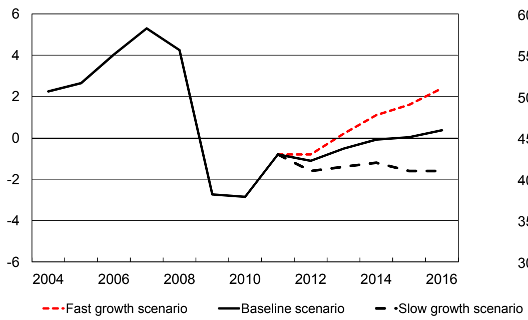
Source:Statistics Finland, MoF

Employment rate
per cent



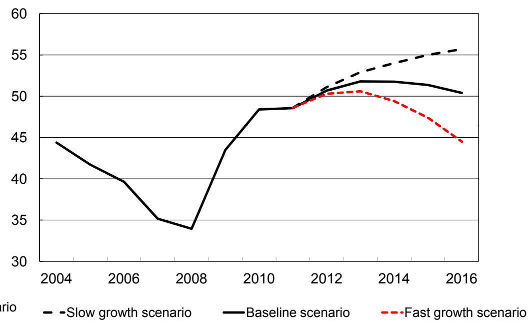
Source:Statistics Finland, MoF

General government net lending
in ratio to GDP, per cent



Source:Statistics Finland, MoF

General government gross debt
in ratio to GDP, per cent



Source:Statistics Finland, MoF

4.2 Comparison with last year's programme

The 2011 Stability Programme forecast that the Finnish economy would grow relatively strongly in 2011–2012. However, towards the end of 2011, uncertainty increased, particularly in relation to the development of the euro area, and this was transmitted into the real economy in Finland, too. Exports again weakened strongly and domestic demand subsided as uncertainty experienced by consumers increased. Economic growth therefore remained weaker than the previous year's estimate. Next year, economic activity is expected to pick up. Even so, growth in 2012–2013 will also remain more subdued than the estimate presented in the previous Stability Programme.

The slowing of economic growth has weakened the development of labour market demand. Last year, the increase in employment fell short of that projected in the previous Stability Programme and the unemployment rate fell less than forecast. Other than was forecast a year ago, the number of employed will decline in the current year and the unemployment rate will begin to rise. On the other hand, the number of temporary lay-offs is expected to increase, which will slow the rise in the unemployment rate. The projection for labour market development has also weakened in respect of 2013.

Inflation has picked up in comparison with last year's forecast. Subdued economic development will slow inflation, but increases in indirect taxes will raise consumer prices by just under one percentage point in the current year. Upward pressure on inflation will also come from higher prices. In addition, the comprehensive wage settlement agreed in November 2011 will increase cost pressures this year. The impact of the wage settlement on producer prices will decline next year. Oil prices are also projected to fall slightly. Next year, however, consumer prices will be increased by, among other things, a tightening of value-added tax.

The new Government began its term of office in June 2011 and agreed in its Government Programme a total of EUR 2.5 billion (around 1¼ per cent of GDP) in adjustment measures by 2015. In connection with the Decision on Spending Limits for 2013–2016, the Government agreed on new considerable adjustment measures. The adjustment has improved central government and general government net borrowing compared with last year's forecast. The deterioration of economic growth prospects after the preparation of the 2011 Stability Programme has weakened, however, the forecast for the development of the general government balance. The change compared with the 2011 Stability Programme will therefore remain smaller than the total level of adjustment measures.

General government gross debt has grown less than was estimated last year. In Finland, the general government includes the employment pension funds in addition to central government, local government and certain social security funds. Some issues related to cash management and to the new interpretation of the Parliament's Constitutional Committee on the budget balance rule lowered the debt ratio in 2011. Moreover, in 2011 employment pension funds invested significantly more of their assets than before in Finnish Government bonds. This reduced the general government consolidated debt ratio by just under one percentage point. It is assumed that the employment pension funds will increase their investments in government bonds also in the coming years. In addition, the adjustment measures agreed by the Government will reduce the growth of debt in the programme period.

Table 6. Divergence from previous programme

	2011	2012	2013	2014	2015	2016
Real GDP growth (%)						
SP-2011	3.6	2.7	2.4	2.1	1.9	-
SP-2012	2.9	0.8	1.5	2.1	1.9	1.7
Difference, %-points	-0.7	-2.0	-0.9	0.0	0.0	-
General government net lending (% of GDP)						
SP-2011	-0.9	-0.7	-0.9	-0.9	-0.9	-
SP-2012	-0.5	-1.1	-0.5	-0.1	0.0	0.4
Difference, %-points	0.4	-0.4	0.4	0.8	1.0	-
General government gross debt (% of GDP)						
SP-2011	50.1	51.3	53.0	54.6	56.2	-
SP-2012	48.6	50.7	51.8	51.9	51.6	50.9
Difference, %-points	-1.5	-0.7	-1.2	-2.6	-4.6	-

SP-2011: Stability programme update 2011, April 2011
SP-2012: Stability programme 2012, April 2012

5 Sustainability of public finances

5.1 Measures to enhance sustainability

Population ageing has started to increase public spending; the number of pensioners has grown by 100.000 during the last four years, as the baby boom generation retires. In 2010 Finland's old age dependency ratio, namely the ratio of those over 65 year-olds to the 15–64 year-old population, was 26.5 per cent, i.e. around four people of working age for each elderly person. This ratio is expected to weaken rapidly, so that in 2020 there will only be three working age people per elderly person and in 2030 only 2.3. In Finland the change in age structure will happen earlier than elsewhere in Europe, and the weakening of the dependency ratio will be among the fastest in EU Member States during the next 20 years.

Population ageing will increase age-related public expenditure significantly during the next decades. In addition, the simultaneous contraction of the working age population as well as the increasing service-orientation of production structure threaten to slow economic growth and thereby growth of tax revenue. These factors will adversely affect the long-term sustainability of public finances.

The recovery of the economy from the 2009 recession as well as general government adjustment measures have improved the sustainability outlook for public finances compared with last year's forecast. Despite this, the sustainability gap is still substantial. Closing the sustainability gap requires, in addition to spending cuts and tax tightening, structural reforms by which conditions for economic growth will be improved and growth of public spending controlled.

To curb expenditure growth, the Government has initiated a reform of local government, a central government impact and effectiveness programme, and an information systems standardisation project, which are steps in the right direction. The impact of these reforms on public spending is difficult to estimate, however, so they are not taken into account in the calculation.

Measures to increase the labour supply will improve conditions for economic growth. The Government's objective is to raise the employment rate to 72 per cent and reduce the unemployment rate to less than 5 per cent by 2015, and for the average retirement age to rise by three years by 2025.

To increase the labour supply, social partners proposed on 22 March 2012, in connection with the Government's Decision on Spending Limits for 2013–2016, that the minimum age of eligibility for the unemployment path to retirement be raised by one year, that the early old-age pension be abolished, and that the age limit for the part-time pension be raised from the present 60 years to 61 years. The aim of these reforms is to prolong working careers and thereby increase the labour supply.

Despite the substantial prefunding of pension contributions, it was decided to increase pension contributions by 0.4 percentage points in both 2015 and 2016 in order to safeguard the financing of the pension system. Employment pension contributions will rise in total by 2.4 percentage points in the period 2011–2016. In addition to these measures, it was agreed to implement a major pension reform by 2017, based on the proposals of a working group conducting a review of the pension system. Additional measures are needed, because the life expectancy of 60 year-olds is projected, according to a 2009 Statistics Finland forecast, to rise by just over seven years during the next 50 years. In terms of the sustainability of public finances, a key goal is that some of these extra years of life will be devoted to work.

A reduction of structural unemployment is one of the most effective measures for increasing labour input. Social partners proposed in connection with the Government's Decision on Spending Limits that the maximum amount of earnings-related unemployment allowance be limited and that incentives to accept work be increased. In addition, increased appropriations were allocated for the implementation of the social guarantee for young people.

According to Ministry of Finance estimates, the measures decided by the Government in connection with the Decision on Spending Limits for 2013–2016 and the measures proposed at the same time by social partners will extend working careers by 5 months and improve the sustainability of public finances by 0,3 percentage points. This estimate does not include all proposals of the working careers agreement or the Government´s position to increase supply of work, or any of the measures in the Government´s position aiming at strengthening growth and productivity.

The correction of the acute imbalance of central government finances and the pension system by increasing pension contributions and increasing taxation on income will increase the tax wedge, which will weaken incentives to accept work and continue in work. From the perspective of business, moreover, growth of the tax wedge will increase costs, which will weaken companies' price competitiveness and therefore demand for labour. This will put the spotlight on measures by which incentives to the supply and acceptance of work might be increased and working careers extended further in future in order to strengthen the financial foundation of public finances.

5.2 Sustainability scenario

The Ministry of Finance's estimate of the long-term sustainability of public finances has been prepared adhering to the EU's jointly agreed methodology and calculation principles. The assessment of age-related expenditure has used the social expenditure analysis model (SOME model), developed in the Ministry of Social Affairs and Health. The scenario's underlying assumptions (employment, productivity, inflation) are based on the assumptions of the 2012 Ageing Report of the EU Economic Policy Committee's Working

Group on Ageing. The population development assessment, which uses the 2009 population forecast of Statistics Finland, deviates from these assumptions. In the national forecast, both life expectancy and immigration rise slightly faster than in the latest Eurostat population forecast. The assessment of medium-term (2012–2016) economic development is based on the March 2012 economic forecast of the Ministry of Finance.

In the scenario, the employment rate is expected to rise to 71.9 per cent and the unemployment rate to fall to 6 per cent by 2022. Thereafter, no major changes are expected in these rates. Employment of the elderly is expected to continue to grow and working careers are assumed to extend by just over a year from the 2010 level during the next 10 years. As, in addition to the improvement of employment of the elderly, immigration will compensate for the reduction of the working age population caused by ageing, the number of employed is expected to remain quite stable throughout the projection period. Labour input will not grow, however, and therefore economic growth will be completely dependent on productivity growth. In addition, as a consequence of the structural change in the economy accelerated by the recession, the production structure will be increasingly weighted towards sectors marked by slower productivity growth. Total output is assumed to grow by an annual average of 1.7 per cent in the period 2010–2060.

Population ageing is expected to increase age-related expenditure by 3.5 percentage points of GDP in the period 2016–2060 (see table 7). Pension expenditure stood at 12.5 per cent of GDP in 2010. This is projected to grow by 1.4 percentage points during this decade and to continue growing to almost 15 per cent of GDP by 2030. Growth of pension expenditure will mainly burden the employment pension system, as the significance of national pensions declines. Growth of health care expenditure is projected to accelerate in the 2020s and during the entire projection period it is expected to grow by 1.2 percentage points of GDP. In addition to the change in population age structure, health care expenditure will be increased by other factors, such as the introduction of new, more expensive forms of care. Long-term care expenditure is forecast to double from its present level over the next 50 years, as the number of over-85 year-olds is expected to quadruple. The stage of fastest growth in long-term care expenditure will take place in the 2020s and 2030s, but expenditure is expected to continue to grow thereafter as the average lifespan rises.

Education expenditure is projected to remain roughly at its current level, as the size of new age groups is not expected to change. Unemployment expenditure is expected to fall during the next five years, as unemployment declines to the level of structural unemployment. Expenditure other than age-related expenditure and also general government revenue are expected in the scenario to grow at the same rate as GDP.

Due to public spending growth as a consequence of the change in population age structure and also to the simultaneous slowing of growth of total output, general government finances are projected to be on an unsustainable track over the longer term. The public finances sustainability gap is expected to be around 3.5 per cent of GDP in 2016. The sustainability gap indicates by how much the general government financial position should be improved by 2016 in order that public debt would not begin to grow uncontrollably as the costs arising from ageing begin to materialise.

The sustainability gap estimate is in nature a pressure calculation, by which an effort is made to assess how public finances will develop if measures are not initiated to adjust public finances. The estimates extend far into the future, which means that they are very sensitive to changes in the underlying assumptions. The sustainability gap estimate is just over one percentage point lower compared with last year's figure. Improvements in the sustainability gap come mainly from improving the primary balance of the starting year. This, in turn, has been improved by adjustment measures decided by the Government. The scenario's growth in age-related expenditure has remained nearly as before. The expected return of pension funds has declined from 4 per cent to 3.5 per cent, which reduces property income and accordingly increases the sustainability gap slightly.

5.3 Pension fund assets

Finland's earnings-related pension system is a partially prefunded, defined-benefit system in which the benefits are determined according to length of employment history and the level of earnings. The prefunding is collective and it does not affect the level of the pension, rather it is intended to even out the pension contributions between generations. Within the national accounting framework, the pension funds of the private sector, central government and local government are include in public social security funds.

The consolidated market value of the pension funds was EUR 136.3 billion at the end of 2011. The market value of pension fund assets fell sharply due to the financial and economic crisis. The strong recovery of share prices that began in spring 2009 together with the pension funds' substantial share purchases have restored the combined value of the pension assets to the pre-crisis level, around 71 per cent of GDP at the end of 2011.

Table 6: Long-term sustainability of public finances (2010-2060), % of GDP

	2010	2016	2020	2030	2060	2060-2016 change
	% av BNP					
Total expenditure	55.2	54.0	55.1	57.9	65.0	11.0
of which age-related and unemployment expenditure	28.0	29.0	29.4	31.7	32.4	3.5
Pensions	12.4	13.5	13.8	14.9	13.9	0.4
Old-age pensions	10.8	12.0	12.3	13.3	12.6	0.6
Other pensions	1.6	1.5	1.5	1.6	1.4	-0.1
Health care	5.7	5.7	5.9	6.3	6.9	1.2
Long-term care	2.1	2.2	2.3	3.0	4.4	2.2
Education	5.9	6.1	6.1	6.2	6.0	-0.2
Unemployment	1.8	1.5	1.3	1.3	1.3	-0.2
Interest expenditure	1.4	1.6	2.4	2.9	9.1	7.5
Total revenue	52.7	54.4	54.1	53.4	52.1	-2.3
of which: property income	3.7	4.6	4.3	3.6	2.3	-2.3
Net lending*)	-2.5	0.7	-1.9	-4.1	-12.9	-13.6
Gross debt	50.9	53.4	52.0	63.9	198.1	144.7
of which: consolidated debt	48.4	50.9	49.5	61.4	195.6	144.7
Pension funds' financial assets, gross	76.5	77.6	78.5	77.6	72.4	-5.2
of which: consolidated liquid assets	60.1	61.2	62.1	61.2	56.0	-5.2

*) Cyclically adjusted balance as of 2010

Source: Ministry of Social Affairs and Health, Ministry f Finance.

	Assumptions, %			
	2016	2020	2030	2060
Labour productivity growth	1.8	2.0	1.5	1.5
Real GDP growth	1.7	1.8	1.5	1.6
Participation rate				
males (20-64)	77.5	78.2	78.1	77.9
females (20-64)	73.9	74.9	74.9	75.3
total (20-64)	75.7	76.6	76.6	76.6
Unemployment rate	7.1	6.0	6.0	6.0
Population aged over 65 % of total population	20.9	22.7	25.9	28.7
Inflation	2.0	2.0	2.0	2.0
Real interest rate	3.0	3.0	3.0	3.0
Real return of pension funds, %	3.5	3.5	3.5	3.5
Net immigration, persons	15 000	15 000	15 000	15 000
Fertility	1.85	1.85	1.85	1.85

Source: Ministry of Social Affairs and Health, Statistics Finland, Ministry of Finance.

Table 7. Financial assets (market value) of the earnings-related pension institutions (sector 13141), EUR million

	2004	2005	2006	2007	2008	2009	2010
A. Non-consolidated assets							
AF21 Currency	0	0	0	0	13	12	12
AF22 Transferable deposits	417	530	968	1010	1100	1388	1891
AF29 Other deposits	377	246	199	78	175	438	198
AF331 Short-term bills	2819	2879	1746	4523	5076	4043	3356
AF332 Long-term bonds	39683	43084	42507	38255	38181	39824	34393
AF34 Derivatives, net	164	48	1264	1699	664	-90	349
AF511 Quoted shares	18648	21767	24773	26446	12300	21258	28263
AF52 Mutual fund shares	9677	16543	25195	32519	23436	31552	42027
Total	**71785**	**85097**	**96652**	**104530**	**80945**	**98425**	**110489**
% of GDP	47.1	54.1	58.3	58.1	43.6	57.1	61.5
B. Liabilities of general government (Sector 13) to pension funds							
AF331 Short-term bills	257	42	76	111	80	85	43
AF332 Long-term bonds	3992	3844	2996	3305	3030	2541	2367
Total	**4249**	**3886**	**3072**	**3416**	**3110**	**2626**	**2410**
% of GDP	2.8	2.5	1.9	1.9	1.7	1.5	1.3
C. Consolidated liquid assets (=A-B))							
AF21 Currency	0	0	0	0	13	12	12
AF22 Transferable deposits	417	530	968	1010	1100	1388	1891
AF29 Other deposits	377	246	199	78	175	438	198
AF331 Short-term bills	2562	2837	1670	4412	4996	3958	3313
AF332 Long-term bonds	35691	39240	39511	34950	35151	37283	32026
AF34 Derivatives, net	164	48	1264	1699	664	-90	349
AF511 Quoted shares	18648	21767	24773	26446	12300	21258	28263
AF52 Mutual fund shares	9677	16543	25195	32519	23436	31552	42027
Total	**67536**	**81211**	**93580**	**101114**	**77835**	**95799**	**108079**
% of GDP	44.4	51.6	56.5	56.2	41.9	55.5	60.1
D. Total assts of pension funds **							
Non-consolidated total assets	86329	99991	112697	122869	103840	122989	137565
% of GDP	56.7 %	63.5 %	68.0 %	68.3 %	55.9 %	71.3 %	76.5 %
Consolidated total assets	81325	95360	108890	118344	99380	119336	134192
% of GDP	53.4	60.6	65.7	65.8	53.5	69.2	74.7

* Derivatives, net

Source: Statistics Finland: Financial statistics.

In conjunction with a statistics reform in 2010, the State Pension Fund was transferred to the earnings-related pensions sector

6 Quality of public finances

6.1 Government policy

The Government's aim is to strengthen the financial basis for welfare society without undermining the sustainability of public finances. One means in covering the sustainability gap is strengthening the growth potential of the economy through taxation and by targeting central government expenditure.

To strengthen central government finances, the tax base will be expanded. Through taxation, economic growth and employment will be enhanced, social justice improved, and output and consumption steered in an environmentally more sustainable direction. The focus of taxation will move away from growth-hampering taxation of labour and entrepreneurship towards environmentally- and health-motivated taxation. As a contribution to covering the sustainability gap, the Government will act purposefully to combat the shadow economy.

The Government will implement throughout the country a comprehensive reform of local government and services based on economically robust municipalities. Within the framework of the reform, administrative structures as well as local government productivity and effectiveness will be improved.

The Government has replaced the former central government productivity programme with a new impact and effectiveness programme. The programme will comprise numerous projects aimed at developing, among other things, personnel skills, management and supervisor work, ICT utilisation, central government administrative structures, and customer service structures.

The Stability Programme is consistent with Finland's Europe 2020 Strategy, which is published at the same time. All of the reforms presented in the Europe 2020 Strategy are in accordance with the spending limits and have therefore been taken into account in the baseline scenario of the Stability Programme.

6.2 General government revenue and taxation

Central government tax revenue declined sharply during the recession, by more than 15 per cent in 2009. The decline in revenue was particularly evident in respect of the most cyclically sensitive taxes, such as corporate tax and capital income tax. Local government tax revenue also slowed, but it did not contract in the same way as central government tax revenue. Local government tax revenue consists of earned income tax, a share of corporate tax, and real-estate tax. The municipalities' corporate tax share was temporarily increased as a stimulus measure for 2009–2011. The Government has decided to distribute to municipalities an increased share of corporate tax revenue also in 2012–2015. The increase has been reduced to half of its previous level, however.

The tax rate, i.e. the share relative to total output of taxes and social insurance contributions collected by general government, has remained quite stable in recent years. In 2011 the tax rate rose as indirect taxation in particular was increased. The most significant change was an increase in energy taxes. Taxes of different energy sources were increased on environmental grounds on average by 150 per cent. Earned income taxation was changed such that a rise in earnings level and employee contributions does not increase taxation on work. In addition, taxation of those on low incomes was lightened. Taxation of pension income was also lightened so that the tax rate is no higher than the tax rate of corresponding earned income. Furthermore, the average municipal tax rate rose and social insurance contributions included in the tax rate were increased.

In the current year, the tax rate is expected to remain at nearly last year's level. The implemented discretionary tax measures will shift, in accordance with the Government Programme, the focus of taxation towards indirect taxation. The tax measures will increase central government tax revenue only slightly, however, when adjustments made to earned income taxation criteria in accordance with the Index of Wage and Salary Earnings are taken into account. At the beginning of the year, excise duties on alcohol, tobacco, sweets, soft drinks and energy were increased. Central government tax revenue was also boosted by a tightening of capital income taxation and by a curtailment of the domestic work deduction and the right to deduct interest on home loans. Reducing the corporate tax rate from 26 per cent to 24.5 per cent, on the other hand, will cut central government tax revenue in the current year. The municipalities' tax revenue loss was compensated by increasing the municipalities' share of corporate tax revenue and by lowering the central government's share correspondingly. At the same time, a number of municipalities increased their taxation, such that the average municipal tax rate rose. Social insurance contributions were also increased further.

The substantial sustainability gap in general government finances will increase pressure to increase taxation in the programme period. The average municipal tax rate will rise and social insurance contributions will be increased. On the other hand, the slow growth of the excise duty tax bases will moderate the rise in the tax rate. The Finnish Broadcasting Company tax (replacing the current TV licences) to be introduced in 2013 will, as a pass-though item, raise the tax rate and expenditure ratio by around 0.2 percentage points relative to GDP. In accordance with the Government Programme, fuel taxes will be increased in 2014. In addition, during the programme period a bank tax and a windfall tax will be introduced, which will increase central government tax revenue.

The Government agreed on new immediate adjustment measures in connection with the Decision on Spending Limits for 2013–2016. The agreed tax measures will increase general government revenue in net terms (increases and cuts combined) by a total of around ¾ per cent of GDP at the 2016 level. The most significant single measure is the raising of all value-added tax rates from the beginning of 2013. The general value-added tax rate will rise to 24 per cent. In addition, adjustments to the income tax scale in accordance with the Index of Wage and Salary Earnings will not be made in 2013–2014. Cuts directed at central government transfers to local government will also increase pressure on municipalities to raise their tax rates. In addition, taxation on large inheritances, gifts and earned income will be temporarily increased in the period 2013–2015. Revenue from corporate tax, on the other hand, will be reduced in the period 2013–2015 by fixed-term tax reliefs. In the medium-term revenue estimate, it is assumed that adjustments to earned income taxation in accordance with the Index of Wage and Salary Earnings will be made in 2015 and that an inflation adjustment will be made in 2016.

6.3 Central government expenditure

The expenditure ratio, i.e. the ratio of general government expenditure to total output, rose during the recession in 2009 to over 50 per cent. Finland's expenditure ratio last year was 4 percentage points higher than the euro area average. Last year the expenditure ratio declined by 1½ percentage points, as expenditure growth was slower than the rise in GDP. In the medium term, public spending is projected to grow at most at the same rate as total output, as adjustment measures directed at expenditure curb growth in spending. The expenditure ratio will remain at a higher level than in the last decade.

Of general government expenditure, 45 per cent is consumption expenditure and 40 per cent income transfers, particularly social welfare benefits. Examined by general government function (COFOG I), more than 40 per cent of general government total consolidated expenditure is directed at social expenditure, while over 10 per cent is directed at health care, education and general public services. Population ageing will determine to a large extent the development of expenditure structure in the coming years. The proportion of total expenditure accounted for by social welfare expenditure and health care expenditure will rise, and that of other expenditure, excluding debt interest payments, will fall. The portion of total expenditure accounted for by debt interest payments was last year 2.6 per cent, from where it is expected to rise to 3.2 per cent by 2016 due to the growing indebtedness of central and local government.

Central government adjustment measures and the municipalities' tight financial situation will restrict growth of public spending in the programme period. The general government expenditure trend has been estimated on the basis of prevailing policy guidelines. Growth of central government budget expenditure will be based almost exclusively on growth of debt interest payments. The Government is committed to achieve a substantial reduction in the central government debt-to-GDP ratio by 2015 as well as to balancing central government finances, which will also require significant adjustment measures targeted at expenditure. Local government finances are expected to remain tight in the next few years. The spending estimate for the municipal sector is based on the present level of obligations. The estimate includes annual volume growth of around one per cent, which corresponds to growth of demand for services arising from ageing. Uncertainties associated with the general economic situation as well as central government adjustment measures will compel municipalities to continue a prudent expenditure policy. Nominal consumption expenditure is expected to increase on average by 3½ per cent annually.

Table 9. General government expenditure by function

	COFOG-	2010	2016
	code	% of GDP	
1. General public services	1	6.9	6.5
2. Defence	2	1.6	1.5
3. Public order and safety	3	1.5	1.5
4. Economic affairs	4	4.9	4.7
5. Environmental protection	5	0.3	0.3
6. Housing and community amenities	6	0.5	0.5
7. Health	7	7.9	7.8
8. Recreation, culture and religion	8	1.2	1.2
9. Education	9	6,5	6,3
10. Social protection	10	23,9	23,8
11. Total expenditure (=item 7=24 in Table 2)	TE	55,2	54,0

7 National fiscal procedures and institutions

The central government spending limits are the most important fiscal policy steering instrument in Finland. The Government, which took office in June 2011, made the commitment in its Government Programme to follow the spending rule it sets as well as the first decision on spending limits based on it, which was issued on 5 October 2011.

In the first decision on spending limits of the parliamentary term, decisions were made in respect of additional expenditure and expenditure cuts for spending included within the spending limits, such that the level of spending limits expenditure will fall in real terms by EUR 1.2 billion in 2015 compared with the technical spending limits of March 2011. The Government's second decision on spending limits on 22 March 2012 includes new substantial adjustment measures to revitalise central government finances.

The spending rules set a maximum level for most, around four fifths, of budget expenditure. Central government budget expenditure outside the spending rule consists mainly of expenditure items that vary according to the economic cycle and automatic stabilisers, which are included, however, within the spending limits in terms of the expenditure effects of changes made to their criteria. In addition, interest payable on central government debt, value-added tax expenditure, financial investment expenditure and expenditure corresponding to technically transmitted payments, for example, also remain outside the spending limits.

Expenditure items outside the spending limits comprise:

- unemployment security expenditure, the central government contribution to social assistance expenditure, pay security and housing allowance (these expenditure items are included, however, within the spending limits in terms of the expenditure effects of changes made to their criteria)
- debt interest payments
- possible compensation payable to other tax recipients for tax changes decided by central government (including social insurance contributions)
- expenditure corresponding to technically transmitted payments and external funding contributions

- expenditure corresponding to the revenue from betting and lotteries, revenue from totalisator betting and transferred earnings from the Slot Machine Association
- financial investment expenditure
- appropriations for value-added tax expenditure

In accordance with the Government Programme, if annual proceeds from the sale of shares exceed EUR 400 million, a maximum of EUR 150 million of the excess can be used for one-off infrastructure and skills investments to support sustainable growth. Proceeds accruing to central government from the auction of emissions rights can be used without reference to the spending limits for one-off expenditure on climate measures and development cooperation.

If the level of expenditure falls below that specified in the spending limits after supplementary budgets, the difference, to a maximum of EUR 200 million, may be used for one-off expenditure in the following year without reference to the spending limits.

If economic growth proves to be faster than forecast, the increased revenue and lower expenditure as a result of growth will be used primarily to reduce central government indebtedness. If, before 2015, central government debt as a proportion of GDP begins to fall significantly, a maximum of 30 per cent of the improved fiscal position can be used for expenditure increases in line with the Government's strategic goals.

The spending limits procedure has remained broadly the same since 2003. It has proved in practice to be a very effective system. Revenue accrued in good times has not caused permanent increases in expenditure and, moreover, in bad times the spending limits have not prevented growth of expenditure related to unemployment.

In the parliamentary term, the spending limits system was developed such that elements that increase flexibility were added to it. These elements included a fixed annual supplementary budget provision and a special undistributed provision for future Government decisions. Moreover, the rescheduling of expenditure over different years has also been made more flexible.

The Government Programme states that the Government will not use tax subsidies to circumvent the spending limits in any way that clashes with the purpose of the spending rule. The spending limits are neutral with regard to changes between tax subsidies and expenditure of equal magnitude. The spending limits do not restrict re-budgeting of expenditure, changes to the timing of expenditure items nor, during the parliamentary term, refunds or compensation of revenue that have proved to be unjustifiably large.

In addition to the central government spending limits, the Government Programme states that the Government is committed to implementing further adjustment measures if there are signs that the central government debt-to-GDP ratio is not falling and indications that the central government deficit has settled above 1% of GDP. Adjustment measures decided by the Government directed at central government revenue and expenditure will be sufficient to reduce the central government debt ratio given the forecast level of economic growth.

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15c/2012
Ministry of Finance publications
April 2012

ISSN 1459-3394 (print)
ISBN 978-952-251-343-4 (print)
ISSN 1797-9714 (pdf)
ISBN 978-952-251-344-1 (pdf)