MINISTRY OF FINANCE

Stability programme update for Finland 2011

16c/2011

Economic outlook and economic policy

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Ministry of Finance publications

16c/2011

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Internet: www.financeministry.fi
Layout: Anitta Türkkan

Juvenes Print
Tampereen Yliopistopaino Oy, 2011

Description page

Publisher and date	Ministry of Finance, April 2011	
Author(s)	Ministry of Finance	
Title of publication	Stability programme update for Finland 2011	
Parts of publication/ other versions released	The publication´s language versions: Finnish: Suomen vakausohjelman tarkistus 2011 (16a/2011) Swedish: Uppdatering av Finlands stabilitetsprogram 2011 (16b/2011)	
Publication series and number	Ministry of Finance publications 16c/2011	
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 2011	
ISBN 978- 952-251-183-6 (print.) **ISSN** 1459-3394 (print.) **ISBN** 978- 952-251-184-3 (PDF) **ISSN** 1797-9714 (PDF)	**No. of pages** 50	**Language** English

Abstract

This Stability Programme update is based on the short-term forecast published in the Ministry of Finance Economic Bulletin of March 2011, on the decision on the 2012-2015 spending limits for central government finances endorsed by Prime Minister Kiviniemi's Government on 18 March 2011, and on the 2011 Budget approved by Parliament on 20 December 2010.

The new Government that takes office following the general election in April will set the economic and fiscal policies for the next government term. The European Commission will be informed of these decisions as soon as possible.

In the course of 2010 the Finnish economy saw growth across a wide range of industries. Economic growth is expected to reach 3.6% in 2011. Strong external demand is fuelling growth in exports, and other demand items will also contribute positively to growth. Annual economic growth is estimated to average around 2½% between 2011 and 2015.

Following the economic crisis, Finland's public finances went into deficit in 2009 and, unless new measures to strengthen the financial stance are introduced, are expected to remain in a slight deficit in the medium term too. The projected economic growth in itself is not sufficient to stabilize general government finances. In the wake of the economic crisis, being able to safeguard the sustainability of public has become a greater challenge than before. Indeed, fiscal policy calls for strategies and measures that will bolster long-term sustainability in general government finances.

In the Stability Programme update of 2009, the medium-term objective for Finland's general government finances was set at a structural surplus of 0.5% of GDP. Based on developments according to the baseline scenario in this update, without new additional measures, the medium-term objective will not be achieved over the programme period. The general government structural deficit is estimated to be around 1% of GDP in 2015.

Contens

Introduction and summary 9

1 Economic policy objectives and premises 11
- 1.1 General 11
- 1.2 Broad Economic Policy Guidelines 12
- 1.3 Stability Programme update for 2011 and its handling in Finland 13

2 Economic situation and outlook 15
- 2.1 Recent developments and short-term outlook 15
- 2.2 Medium-term macroeconomic scenario 19

3 General government balance and debt 23
- 3.1 Fiscal policy strategy and medium-term budget objective 23
- 3.2 General government balance and debt 24
- 3.3 Cyclically adjusted balance in general government finances 26

4 Sensitivity analysis and comparison with previous programme 29
- 4.1 Economic development risks and their impact on public finances 29
- 4.2 Comparison with last year's Stability Programme update 31

5 Sustainability of public finances 33
- 5.1 Measures to enhance sustainability 33
- 5.2 Sustainability scenario 34
- 5.3 Pension fund assets 38

6 Quality of public finances 41
- 6.1 Government policy 41
- 6.2 General government revenue and taxation 41
- 6.3 Central government expenditure 43
- 6.4 Productivity in general government 44

7 National fiscal procedures and institutions 47

Introduction and summary

As a consequence of the international economic crisis, the Finnish economy contracted exceptionally strongly in 2009. The balance of general government finances has weakened sharply due to a fall in tax revenue, growth in cyclical expenditure and central government stimulus measures. The deep recession faced by Finland has been managed systematically. During the economic crisis, concern for employment and economic activity has been emphasised in the setting of fiscal policy. The Government has responded quickly to the weakened economic situation with stimulus measures that have maintained consumer confidence. As a result of the chosen economic policy line, unemployment has remained clearly lower than during the 1990s' recession. In this way, the conditions were created for the recovery of economic growth that began last year.

The recession has left a deep and enduring mark on the position of general government finances and the debt ratio. Increases of value-added tax, energy taxes, excise duties on sweets and soft drinks, and the waste tax are among the first steps towards balancing public finances. At the same time, the effect on spending of fixed-term stimulus measures is gradually receding. Fiscal policy has changed from stimulus to tightening.

Changes in economic activity are reflected with a delay in the position of public finances. The positive impact on public finances of the improvement in economic activity was therefore not yet evident in full during 2010. The general government deficit, however, was smaller than the 3%-of-GDP deficit limit set in the Stability and Growth Pact. The central government's financial position, on the other hand, continued to weaken last year. The central government deficit deepened to 5.1% of GDP. The state of local government finances clearly improved in 2010, as tax revenue grew significantly faster than projected and development of personnel expenses was moderate. Pressures to tighten municipal taxation and to increase strongly the level of local government debt remain high. To improve the financial position of local government finances and curb indebtedness, it is necessary to maintain a moderate development of expenditure. Growth of general government debt continued rapidly in 2010, with the combined EMU debt of central government and the municipalities rising to 48% of GDP.

As the world economy recovered, Finland's GDP also returned to growth last year. Output has not, however, returned to the growth track that preceded the economic crisis in the same way as after the recession of the early 1990s in Finland. In 2009 the level of GDP collapsed by 8%, whereas in 1991–1993 the total contraction was 10%. During the next five years, GDP is projected to grow by just over 12 %. The recovery will therefore be significantly slower than in the years after the previous recession, 1994–1998, when GDP grew by a total of 22%. Even if the level of output of the previous peak year of 2008 were to be achieved in the next few years, growth in the coming years will remain for a number of reasons slower than after the early 1990s' recession. At that time, a devaluation of the Finnish mark improved competitiveness substantially, whereas in recent years Finland's price competitiveness has, if anything, weakened. The current economic crisis has probably permanently lowered the level of potential output corresponding to the full use of resources. The recession, moreover, has probably accelerated retirement related to the change in population age structure. The size of working age population is contracting due to demographic change.

Member States must set a medium-term objective for the structural financial position of public finances. In the 2009 Stability Programme update, Finland's medium-term objective for general government finances was set at a structural surplus of 0.5% of GDP. The state of public finances will improve this year due to economic recovery, tax increases and the withdrawal of fixed-term stimulus spending. Although the economic recovery will also strengthen public finances in the coming years, without new measures to support growth or strengthen public finances, general government finances overall are expected to still be in deficit in 2015. Based on development according to the baseline scenario presented in this Stability Programme, the medium-term objective will therefore not be achieved in the programme period without additional measures.

General government finances are in a more vulnerable position from which to meet expenditure pressures and the narrowing of the tax base arising from population ageing. Ensuring the sustainability of public finances now presents a greater challenge than before. The economic policy to be implemented after the economic crisis must take these altered conditions into consideration.

In fiscal policy, a strategy and measures to strengthen the long-term sustainability of public finances are required. Sustainability can be improved, in principle, in three ways: through structural reforms, increasing taxes or cutting spending. The longer the restoration of public finances is delayed, the greater the costs will be. The Government that takes office after the parliamentary elections to be held in April 2011 will determine the economic and fiscal policies for the next parliamentary term.

1 Economic policy objectives and premises

1.1 General

As a consequence of the international financial crisis, the Finnish economy contracted exceptionally strongly in 2009. A substantial deficit arose in general government finances as tax revenue declined and public expenditure grew as a result, among other things, of rising unemployment. Improving confidence among economic actors together with an expansive economic policy created conditions for a recovery of economic growth in 2010.

In the next few years, it will be a characteristic of general government finances that although revenue will grow slightly faster than expenditure, this will be insufficient to balance the financial position of general government finances. Without new decisions strengthening the financial position, general government finances will therefore remain in deficit and public debt will continue to grow relatively strongly. As a consequence of the economic crisis, monetary policy has been exceptionally relaxed. Normalisation will inevitably see a rise in interest rates which, together with the public finances deficit, threatens to lead to situation in which interest expenditure will become a more rapidly growing expenditure item.

In Finland's case, the coming demographic change will be stronger and will happen more quickly than in other developed industrialised countries. The change in population structure facing the Finnish economy will also inevitably test the capacity of the public sector to respond to the obligations set for it. Despite the recovery of the general economic situation after the exceptionally deep crisis, Finland's general government finances are in a weaker position compared with the situation that preceded the financial crisis to face the change in population age structure.

The key challenges of economic policy in the next few years are managing the change in population structure and resolving the related sustainability problem in general government finances, boosting economic growth and identifying new, innovation-based growth factors, and managing the effects of the financial crisis in general government finances. Although in recession conditions it has been necessary to address short-term concerns, the above-mentioned major economic problems are the key challenges of economic policy.

The Government that takes office after the parliamentary elections to be held in April 2011 will determine the economic and fiscal policies for the next parliamentary term. It has become an established practice in Finland that the Government Programme includes the economic and fiscal policy outlines for the coming parliamentary term and specifies the Government's central government spending rules for the entire parliamentary term. In addition, they create a stable, long-term framework for tax and spending policy as well as the management of public debt.

1.2 Broad Economic Policy Guidelines

The international economic and financial crisis as well as the debt crisis affecting the euro area have highlighted Europe's economic problems. To rectify these problems, the EU has initiated numerous reforms in current operating systems and has created new procedures. The objective of these measures is to promote employment and smart, sustainable and inclusive growth. The Stability and Growth Pact will also be revised in certain respects so that stable development of the economy can be safeguarded.

The economic and employment guidelines give consistent directions both for the EU and for all of its Member States. They assist in steering Member States' economic policy. The guidelines are decided on in the Council, based on a proposal of the Commission. The present ten guidelines were approved in 2010 and they are valid until 2014.

The EU's goal is for the development of economic policy coordination to focus on key areas where action is required to improve growth and competitiveness. On this basis, the Member States prepare national Europe 2020 reform programmes, which propose in detail the measures they intend to implement within the framework of the new strategy. There is particular emphasis on achieving national objectives and removing bottlenecks to growth.

The guidelines set shared objectives guiding the actions of the Member States. The guidelines are 1) Ensuring the quality and the sustainability of public finances, 2) Addressing macroeconomic imbalances, 3) Reducing imbalances in the euro area, 4) Optimising support for R&D and innovation, strengthening the knowledge triangle and unleashing the potential for the digital economy, 5) Improving resource efficiency and reducing greenhouse gas emissions, 6) To strengthen the single market, improving the business and consumer environment and modernising the industrial base. The following objectives have been set for employment: 1) Increasing labour market participation of women and men, reducing structural unemployment and improving the quality of jobs, 2) Developing a skilled workforce responding to labour market needs, promoting job quality and lifelong learning, 3) Improving the performance of education

and training systems at all levels and increasing participation in tertiary education and 4) Promoting social inclusion and combating poverty.

The economic policy practised in Finland since the turn of the millennium has been in accord with the broad guidelines of the European Union's Stability and Growth Pact. The Stability Programme update presented herein and the Finnish Europe 2020 National Reform Programme are consistent with each other.

1.3 Stability Programme update for 2011 and its handling in Finland

This Stability Programme update is based on the 2012–2015 technical spending limits for central government finances, the 2011 Budget approved by Parliament on 20 December 2010 and the forecasts on which these were based. The expenditure estimates for 2012–2015 have taken into account the effects of decisions contained in the 2011 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 to the Grand Committee of Parliament. The Commission's assessment and the Council's statement on Finland's Stability Programme will be submitted to the new Parliament for consideration in connection with Ecofin preparations.

The Stability Programme complies with the Code of Conduct endorsed by the EU Council on 7 September 2010.

2 Economic situation and outlook

2.1 Recent developments and short-term outlook

During 2010 the Finnish economy made a broad-based recovery. Preliminary data from Statistics Finland indicate that the change of GDP in 2010 was 3.1%. An improvement in exports by 5.1% played a significant role in boosting demand. In terms of investment, house building investment increased strongly and private consumption grew at a respectable rate of 2.6%. Last year, growth of household consumption was again lower than growth of disposable income, so the savings ratio rose further. Business operations were more profitable last year than the previous year; profits increased by around a third and taxes paid by companies therefore increased significantly. Despite the pick-up in economic activity, central government finances remained in deficit to the tune of around EUR 10 billion.

In the world economy the period of rapid growth will continue. The world's ppp-adjusted GDP will grow during the next two years at a rate of more than 4%. The focus of growth will be in the developing countries, which will grow on average by around 6%. Correspondingly, traditional industrialised countries will grow on average by around 2%. The United States' economy has recovered quite quickly because, among other things, the activity of the financial markets has dampened the effects of the banking crisis on the activity of the real economy. Economic growth will be just over 3% this year and a little under 3% next year. Medium-term growth will be slowed not only by a lacklustre job market and negative wealth effects arising from the housing market, but also by the need for a substantial adjustment of general government finances and the external imbalance. In the euro area and in the EU as a whole, growth will be just under 2% this year and next. The growth rate in the euro area will vary greatly: this year, Germany will achieve a rate of around 3%, while countries struggling with the economic and financial crisis will remain under 1% or their economies will contract.

China's growth will slow to around 9%. Growth will be slowed by subdued growth in demand in industrialised countries and by a weakening of China's price competitiveness. Russia has the potential this year and next for strong growth of around 5%. Russian growth will be supported by a continuing high

price of oil and, to date, a low capacity utilisation rate. Rigidities in the economy, government steering and protectionist measures, on the other hand, will slow growth in the medium term. The Swedish economy will also continue to grow quickly; this year growth will exceed 4% and in the following two years will be around 3%. Sweden's rapid growth will be supported by export and domestic demand.

In Finland's main export countries, Germany, Sweden and Russia, economic growth has strengthened, which will increase these countries' import demand. Industrial export expectations were fairly positive at the beginning of the year. Export growth is focused mainly on the traditional metal industry, because export orders for machines and metal products increased rapidly during last year. Export expectations in the chemical industry were also increasingly positive at the turn of the year. In export demand for electronics industry products, on the other hand, uncertainty will continue, and exports of wood and paper industry products will not continue to grow as fast as last year. This year, goods exports will grow at nearly last year's rate. Growth of service exports may be more subdued than growth of goods exports, so exports overall will grow by 8%. Higher prices of metals and chemical products will increase export prices by 5½%. During the next couple of years, the focus of export growth will remain on the metal industry, which experienced the deepest downturn in 2009. Export growth will gradually slow in line with a slowing of growth in world trade.

A strengthening of growth in industrial output will sustain growth of raw material imports this year, while the start-up of new investments will increase the need for imports of investment goods. On the other hand, last year's rapid growth of consumer goods exports will slow, as the real income of households will not increase this year. Service imports will rise from last year's low level. Imports will grow this year by 6½% and the import price level will rise by 8½%. The increase in prices will be fastest in energy and raw materials, which together account for more than half of goods imports.

In the next couple of years, imports will continue to grow briskly, but at a slower rate. The high import susceptibility associated with metal industry production sectors and the faster than average growth of the metal industry will maintain production imports, which will continue to grow faster than imports of consumer goods.

In Finland, private consumption expenditure increased last year by 2.6%, whereas in the euro area it grew by just under 1%. The rate of growth of nominal household income picked up in Finland as unemployment moderated by one percentage point, even though the rise in earnings and pensions slowed. Inflation picked up only slightly, so purchasing power, i.e. households' real disposable income, showed modest growth. As consumption grew more slowly than income, the savings ratio rose further. Household debt levels once more increased faster than income, and the debt ratio again reached a new record at around 115% of disposable income.

Household consumption has not yet fully reached the level from which it began to contract in mid-2008, so postponed consumption needs are still fuelling household purchases to some extent. This is evident most clearly in purchases of durables, such as cars. Housing investment also increases purchases of semi-durables. Private consumption is projected to rise in the current year by 2% and next year by 1.8%. As real earnings turn to growth at the end of the projection period, private consumption will increase by just over 2% from the previous year. Household consumption intentions may exceed income growth, so the savings ratio may start to decline this year, and as consumption growth picks up towards the end of the projection period, the trend will also be maintained next year and the following year.

Growth conditions for domestic output are fairly positive. Demand in Finland's main markets and commodity groups is strong. Companies still have free capacity available and the cost of financing and its availability may not be a barrier to investment in future. There is also good availability of labour, so output may, in the short term, continue the strong growth that began last year. Growth may be supported this year and next by secondary production, i.e. industrial output and construction activity. Service output will be supported by increasing business and household demand, so it appears that growth of output demand overall will be broad-based. Projections indicate that economic growth will reach its peak level of late-2008 in the latter part of next year, so it would appear that the downturn will have been deep but short-lived. Growth is expected to be broad-based, because both service output and secondary production may make an equally large contribution to total output in the projection period.

The employment situation improved during 2010. Measured as an annual average, however, the number of employed still fell slightly and the unemployment rate rose. The number of employed fell further in manufacturing, but in the service sector the number of jobs grew. In the commercial sector, there was growth in the wholesale trade and in warehousing. The number of hours worked also grew and the average working time in 2010 lengthened by 1.4%. One reason for the increase in working hours was a reduction in temporary lay-offs, but the working hours of those in work and of the under-employed also grew.

Employment will improve further in 2011. Work input will grow to roughly the same extent both in hours and in the number of employed, so in this respect the labour market situation would appear to be normalising. The unemployment rate will fall to 7.6%, and 69.1% of 15–64 year-olds will be employed. The rise in the employment rate will be boosted by the fact that the number of 15–64 year-olds is projected to decline from this point forward. As the working age population declines, a decisive position will be held by those who are outside the workforce (i.e. the workforce as recorded by statistics). In the current situation, they form a reserve of labour for which there will be much demand in the labour market.

Measured by the national consumer price index, prices rose on average by 1.2% in 2010. Inflation is forecast to pick up to 3.3% this year, due in particular to an increase in food and energy raw material prices on the international commodity markets. Towards the end of 2013, inflation will gradually slow to around 2%, as the increase in raw material prices slows and a tightening of monetary policy reduces total demand in the economy. Rising interest rates on home loans will keep inflation high, however, and in 2012 it is forecast to be 2.7%.

In early 2011, inflation has accelerated to over 3%, mainly due to an increase in energy raw material prices, which has raised fuel prices, and to an increase in energy taxation, which has raised the price of household electricity. More expensive energy and high energy taxation has exerted upward pressure on consumer prices indirectly, as producers of goods and services try to raise their product prices to cover higher production costs. The projected trend in world market prices, combined with tax changes, will lead to a situation in which energy commodities will contribute significantly to the increase in consumer prices this year. In 2012–2013 it is expected that pressures in the international energy market, and thereby the increase in energy prices, will subside.

The index of wage and salary earnings rose last year by 2.6%. Collective agreements were signed in a number of sectors in spring 2010. Most of the agreements were multi-year agreements, but pay rises were, as a rule, only agreed for one year ahead. During 2010 negotiated agreements increased earnings by only 0.7%. Factors other than agreement pay rises increased the earnings level by 0.5%, i.e. by less than in previous years. Most of the increase in earnings is explained by the fact that the 2009 increase in earnings did not impact earnings in full until 2010.

Wage settlements for 2011 concluded by the beginning of March have yielded increases of around 1½-2%. These include private and public sector agreements. General wage increases have been at a higher level than the year before, but the effects of the previous year's increases on the current year will be less compared with the situation in 2010. The forecast is based on the assumption that new wage settlements will be broadly in line with those concluded during the spring, which means that earnings levels in 2011 will rise quite moderately from the year before. As economic output recovers, factors other than agreement pay rises are expected to increase earnings in the next few years by an amount closer to the long-term average. In addition, agreement pay rises are expected to increase as a result, among other things, of growth in labour productivity. The index of wage and salary earnings is therefore expected to continue to accelerate in 2012 and 2013.

The forecast for 2011 predicts annual growth of 3.6%, much of which will come from a carry-over effect. Strong external demand is accelerating the growth of exports, which will drive up capacity utilisation. As a result it is expected that investment will gather momentum and that economic growth will continue to expand. All demand items are forecast to have a positive impact on growth,

with the role of exports becoming more significant. Output growth in 2012 is expected to average 2.7%. Growth will remain export-driven, but not to the same extent as in the current year. Investment through building construction is set to slow somewhat, as is the growth of private consumption. In 2013 it is projected that total output will increase by 2.4%.

2.2 Medium-term macroeconomic scenario

As the world economy recovered, Finland's GDP also returned to growth last year and growth accelerated this year. Output, however, has not returned to the growth track that preceded the economic crisis in the same way as after the recession of the early 1990s in Finland. In 2009 the level of GDP collapsed by 8%, whereas in 1991–1993 the total contraction was 10%. During the next five years, GDP is projected to grow on average by 2½% per year. The recovery will therefore be slower than in the years after the previous recession, 1994–1998, when GDP grew on average by 4% per year.

Even if the level of output of the peak year of 2008 were to be achieved next year, growth in the next few years will remain for a number of reasons slower than after the early 1990s' recession. At that time, a devaluation of the Finnish mark improved competitiveness substantially, whereas in recent years Finland's price competitiveness has, if anything, weakened. The current economic crisis has probably permanently lowered the level of potential output corresponding to the full use of resources. The size of working age population is contracting due to demographic change.

Economic growth potential is examined by estimating the development of the economy's production resources, i.e. labour and capital, as well as productivity. During the recent economic crisis, Finland's total output contracted exceptionally steeply, as export demand in particular fell sharply. This has been evident in, among other things, increasing unemployment and a lowering of companies' utilisation of capacity. The economy's production resources are therefore being used less as a result of the crisis. Using the production function method jointly developed by the EU Commission and Member States, it is estimated that Finland's output gap, i.e. the difference between actual output and potential output, was around 5% in 2010.

In the medium term, total output is expected to grow faster than potential output. This is possible because after the crisis the economy has unused resources necessary for production, such as labour. It is assumed, therefore, that the output gap will be closed, i.e. total output is expected to correspond to potential output, at the end of the period under review. In the next few years, potential output is expected to grow by around 1.5% per year.

The most significant single factor explaining Finland's economic growth after the recession of the early 1990s has been a rapid improvement in productivity, which in turn is explained by the higher profile of the electronics industry. Although technological development and new innovations are difficult to forecast, the potential for productivity growth in Finland would appear to be weaker than before; there is currently no Nokia-like phenomenon in prospect. The economic crisis might have permanent or long-term effects on the economy. The changing population age structure will probably increase the weighting of the service sector in the economy. Service output productivity has generally grown more slowly than that of traditional manufacturing industry. Productivity growth is also expected to remain quite slow in the next few years.

Based on a Statistics Finland population forecast, the size of the working age population will fall by just over 85,000 during the next five years. Labour supply will therefore contract. Owing to the contraction of labour resources, growth in the number of those in employment will gradually begin to slow. The employment rate (15–64 year-olds) is expected, however, to return to 71% by 2015. In addition to the size of the working age population, labour supply will be affected by the willingness of those of working age to offer their labour to the labour market.

Labour participation rates vary between age groups. As the economic situation improves, part of those who are currently outside work will return to job market. Due to the economic crisis, the rise in the labour participation rate was interrupted and a temporary decline resulted. As the labour market recovers from the recession, it is assumed that the labour participation rate of 15–64 year-olds will rise in the medium term to a higher level than before, to just over 76%.

Table 1a. Macroeconomic prospects

	2010 EUR bn	2010	2011	2012	2013	2014	2015
		change, %					
1. Real GDP	158.0	3.1	3.6	2.7	2.4	2.1	1.9
2. Nominal GDP	180.3	5.3	6.4	5.2	4.5	4.3	4.0
Components of real GDP							
3. Private consumption expenditure	97.3	2.6	2.1	1.8	2.3	2.3	2.2
4. Government consumption expenditure	44.2	0.4	1.2	0.6	0.9	0.4	0.4
5. Gross fixed capital formation	33.4	0.8	7.2	4.7	2.9	2.6	2.2
6. Changes in inventories (% of GDP)	0.8	0.4	1.1	1.5	1.8	1.9	1.8
7. Exports of goods and services	70.2	5.1	7.8	5.5	4.3	4.5	4.5
8. Imports of goods and services	65.2	2.6	6.7	4.7	3.9	3.5	3.5
Contributions to real GDP growth, % points							
9. Final domestic demand	175.0	1.7	2.7	2.0	2.0	1.8	1.7
10. Changes in inventories	0.8	0.5	0.3	0.3	0.1	-0.3	-0.4
11. External balance of goods and services	5.0	1.0	0.6	0.5	0.3	0.6	0.6

Table 1b. Price developments

	2010	2011	2012	2013	2014	2015
	change, %					
1. GDP deflator	2.1	2.7	2.4	2.1	2.1	2.1
2. Private consumption deflator	1.0	3.3	2.7	2.2	2.0	2.0
3. HICP	1.7	3.0	2.4	2.0	2.0	2.0
4. Public consumption deflator	1.8	2.6	2.7	2.7	3.0	3.0
5. Investment deflator	-0.9	1.8	2.1	1.8	2.0	2.0
6. Export price deflator	4.1	5.5	3.3	2.4	1.0	1.0
7. Import price deflator	5.6	7.0	4.2	3.6	2.0	2.0

Table 1c. Labour market developments

	2010 level	2010	2011	2012	2013	2014	2015
		change, %					
1. Employment, 1,000 persons	2 447	-0.4	1.7	0.9	0.6	0.1	0.0
2. Employment, 1,000 hours worked	41 539	1.1	1.8	0.7	0.4	0.1	0.0
3. Unemployment rate (%)	224	8.4	7.6	7.2	6.9	6.5	6.3
4. Labour productivity, persons	64.6	3.5	1.8	1.8	1.8	2.0	1.9
5. Labour productivity, hours worked	3.8	2.0	1.7	1.8	1.8	2.0	1.9
6. Compensation of employees	73.5	1.9	4.5	4.1	4.0	3.8	3.7
7. Compensation per employee	30.0	2.3	2.7	3.2	3.4	3.7	3.7

Table 1d. Sectoral balances

	2010	2011	2012	2013	2014	2015
	% of GDP					
1. Net lending/borrowing vis-à-vis the rest of the world	3.2	2.3	2.2	2.0	2.0	2.0
of which:						
- Balance of goods and services	2.8	2.8	2.9	2.6	2.7	2.7
- Balance of primary incomes and transfers	0.3	-0.6	-0.7	-0.7	-0.7	-0.7
- Capital account	0.1	0.1	0.1	0.1	0.0	0.0
2. Net lending/borrowing of the private sector	5.6	3.8	2.9	2.7	2.7	2.8
3. Net lending/borrowing of general government	-2.5	-1.8	-1.0	-1.0	-1.0	-1.0
4. Statistical discrepancy	0.0	0.3	0.3	0.3	0.3	0.3

Table 1 e. Basic assumptions

	2010	2011	2012	2013
3-month Euribor	0.8	1.4	2.1	2.5
Long-term interest rate (10-year government bonds)	3.0	3.5	4.0	4.3
USD/EUR exchange rate	1.3	1.4	1.4	1.4
Nominal effective exchange rate	-3.7	0.0	0.0	0.0
World GDP growth (excl. the EU)	4.8	4.2	4.5	4.6
EU-27 GDP growth	1.8	1.7	2.0	2.0
GDP growth of relevant foreign markets	11.6	7.0	6.8	6.0
World trade growth	15.1	10.0	7.5	7.0
Oil prices (Brent, USD/barrel)	79.8	101.3	108.0	114.8

* 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 budget objective

The deep recession faced by Finland has been managed systematically. During the economic crisis, concern for employment and economic activity has been emphasised in the setting of fiscal policy. The Government has responded quickly to the weakened economic situation with stimulus measures that have maintained consumer confidence. Due to the economic policy pursued, the level of unemployment is significantly lower than could have been anticipated based on the strong reduction of GDP.

In the Ecofin Council's statement (26 April 2010) on Finland's updated Stability Programme for 2009–2013 Finland was urged to:

i) implement the 2010 fiscal policy as planned in line with the EERP, while ensuring that the planned breach of the 3%-of-GDP reference value would remain contained and temporary;

ii) take timely action to define a comprehensive and concrete medium-term fiscal strategy to consolidate from 2011 onwards, also with a view to achieve the MTO and to restore the long-term sustainability of public finances

The Government is committed to pursuing a responsible and consistent fiscal policy. The Government has continued to apply the system of spending limits, which has achieved good results and also proved its effectiveness during the recession. The spending limits system has accommodated the application of automatic stabilisers and has not prevented considered increases in spending aimed at maintaining economic activity.

The impact and cost of fixed-term or one-off stimulus measures will fall mainly in 2009–2011. No separate exit decisions are required with respect to these measures. In 2010 and 2011 the first steps towards the balancing of public finances will be taken. Through increases of value-added tax, energy taxes, excise duties on sweets and soft drinks, and the waste tax, fiscal policy has changed from stimulus to tightening.

Member States must set a medium-term objective for the structural financial position of public finances. In the 2009 Stability Programme update, Finland's medium-term objective for general government finances was set at a structural surplus of 0.5% of GDP. Based on development according to the baseline scenario presented in this Stability Programme, the medium-term objective will not be achieved in the programme period without additional measures.

The economic crisis has changed the priorities and basis of fiscal policy. As a result of the crisis, the balance of general government finances has weakened sharply owing to a fall in tax revenue, growth in cyclical expenditure, and central government stimulus measures. General government finances are therefore in a more vulnerable position from which to meet expenditure pressures arising from both population ageing and a narrowing of the tax base. Ensuring the sustainability of public finances now presents a greater challenge. The economic policy to be implemented after the economic crisis must take these altered conditions into consideration.

In fiscal policy, a strategy and measures to strengthen the long-term sustainability of public finances are required. Sustainability can be improved in principle in three ways: through structural reforms, increasing taxes or cutting spending. The longer the restoration of public finances is delayed, the greater the costs will be.

The Government that takes office after the parliamentary elections to be held in April 2011 will determine the economic and fiscal policies for the next parliamentary term. The European Commission will be notified of these policies as soon as this is possible.

3.2 General government balance and debt

Finland's general government finances were quite strong and in surplus for the whole of the past decade right up to 2008. Due to the economic crisis, the general government financial position weakened in 2009 by around 7 percentage points and was at that time nearly 3% of GDP in deficit. In 2010, too, the deficit remained below the 3%-of-GDP reference value set in the Stability and Growth Pact, even though forecasts generally projected that the limit would be exceeded.

The 2011 general government deficit is expected to fall significantly due to relatively strong economic growth and tax increases. General government finances will nevertheless remain in deficit in the medium term without new measures to strengthen the financial position. The forecast economic growth is insufficient alone to stabilise public finances. Although indebtedness will rise quickly in the next few years, public debt as a proportion of GDP will not exceed in the programme period the 60% reference value set for EU countries in the Stability and Growth Pact.

As a result of the economic crisis, central government finances in particular have deteriorated significantly. This has been accentuated above all by the cyclical sensitivity of central government tax revenue and by stimulus measures. This year, the central government deficit is forecast to be 4% of GDP, and in the next few years it will fall relatively slowly. According to national accounting, central government revenue will increase on average by 5% per year in the period 2011–2015. At the same time, expenditure growth will remain at just under 4% per year. Central government revenue will grow fastest this year, with revenue increasing by up to 10% due to higher economic activity and a tightening of indirect taxation.

The local government sector appears to be have come through the recession relatively unscathed. During the economic crisis, the financial position of municipalities was consciously supported, for example by temporarily increasing their share of corporate tax revenue. In the next few years, growth of local government tax revenue will pick up, although the average 3½% growth in the period 2011–2015 will be clearly slower than in the years preceding the recession. Although the outlook for local government finances is now better than expected, correcting the impact of the recession, uncertainties relating to future revenue development, and pressures associated with rising cost levels will compel municipalities to continue a cautious spending policy. Local government finances in the next few years will remain close to balance.

The social security sector is projected to be in surplus in the medium term. Employment pension institutions are clearly in surplus, but the surplus is forecast to decline slowly as pension expenditure increases rapidly in the coming decade. Employment pension contributions are expected to grow in accordance with the tripartite agreement of January 2009 by a total of 1.6 percentage points of the wage bill by 2014. The substantial employment pension assets will generate significant asset income for the employment pension institutions in the medium term. The other social security funds, i.e. the Social Insurance Institution of Finland and the Unemployment Insurance Fund, are close to balance.

In the medium term, the fastest growing expenditure item will be central government and local government interest expenditure. The level of interest rates is currently very low and, despite the growth of the loan portfolio, interest expenditure remains relatively modest. The effective interest rate on combined central government and local government debt will be at its lowest this year, i.e. at around 3%. Towards the end of projection period, the cost of borrowing will grow as the general level of interest rates rises. The rise in level of interest rates will be transmitted with a delay to interest expenditure insofar as existing debt will have to be refinanced at a higher interest rate. General government interest expenditure will reach EUR 4.3 billion in 2015, whereas last year the cost was only EUR 2.5 billion.

3.3 Cyclically adjusted balance in general government finances

The potential output of the Finnish economy grew by just over 3% per annum in the early years of the millennium. The deep recession, however, slowed growth of potential output significantly. The impact of the recession was transmitted to growth potential via both labour and capital inputs. As the labour market situation deteriorated, labour supply also declined sharply. All of those who have left the labour market will not necessarily by available to the labour market once again when economic conditions improve. Potential output has been estimated using the production function method agreed by the Ecofin Council. Potential output describes the output capacity of the economy as well as the productivity, capital stock and employment resources that determine it.

The revival of growth that began last year has to some extent temporarily accelerated growth of potential output growth, as investment has recovered and unemployment has fallen. Even so, population ageing and a decline in the size of the working age population are already beginning to restrict the economy's growth potential. Due to the decline in size of the labour force, potential output growth will in future by mainly dependent on a favourable productivity trend.

The output gap describing the cyclical position, i.e. the difference between total output and projected potential output, grew sharply during the recent recession. Total output was still clearly higher than potential output in 2008 and the output gap was therefore positive. Through the contraction of the economy in 2009, the output gap in 2009 quickly changed to negative, however. The difference between total output and potential output began to contract last year. The negative output gap caused by the depth of the recession is expected to close around the middle of the decade.

The impact of fiscal policy can be estimated by assessing the changes in the cyclically adjusted balance. The cyclically adjusted balance describes what the general government financial position would be if the economy's output resources were in full use. However, one must take into account uncertainties connected with the calculation of potential output and cyclical adjustment, which are highlighted during large cyclical fluctuations like those recently encountered.

Before the recession that began in 2008, the cyclically adjusted balance remained for years nearly unchanged at an average of just under 3% of GDP. Fiscal policy can therefore be characterised to have been quite neutral. In 2009–2010 the cyclically adjusted balance weakened. The backdrop to this was formed by the stimulus measures implemented to alleviate the consequences of the recession. In 2011 the structural balance will again improve slightly. Owing to tax increases implemented this year and last, fiscal policy is therefore changing from stimulus to tightening. The development of the cyclically adjusted balance in 2012–2015 as well as fiscal policy tuning will be decisively dependent on the fiscal policy line of the new Government.

Table 2. General government budgetary prospects

		2010 EUR milli-on	2010	2011	2012	2013	2014	2015
			% of GDP					
Net lending by sub-sector (EDP B.9)								
1.	General government	-4 427	-2.5	-0.9	-0.7	-0.9	-0.9	-0.9
2.	Central government	-9 195	-5.1	-3.9	-3.7	-3.9	-3.8	-3.7
3.	-							
4.	Local government	-500	-0.3	-0.1	-0.1	-0.2	-0.2	-0.2
5.	Social security funds	5 268	2.9	3.1	3.1	3.1	3.1	3.0
General government (S13)								
6.	Total revenue	94 355	52.3	52.9	52.8	52.6	52.5	52.4
7.	Total expenditure	98 782	54.8	53.8	53.5	53.6	53.4	53.4
8.	Net lending/borrowing	-4 427	-2.5	-0.9	-0.7	-0.9	-0.9	-0.9
9.	Interest expenditure	3 183	1.1	1.4	1.5	1.7	1.8	1.9
10.	Primary surplus	-1 800	-1.4	0.5	0.8	0.8	0.9	1.0
11.	Non-recurring measures	-378	-0.2	0.0	0.0	0.0	0.0	0.0
Selected components of revenue								
12.	Tax revenue (12=12a+12b+12c)	53 163	29.5	30.2	29.9	29.6	29.5	29.3
12a.	Taxes on production and imports	24 146	13.4	13.7	13.6	13.4	13.3	13.2
12b.	Taxes on income	28 630	15.9	16.2	16.1	16.0	16.0	16.0
12c.	Capital taxes	387	0.2	0.2	0.2	0.2	0.2	0.2
13.	Social security contributions	22 692	12.6	12.4	12.5	12.6	12.7	12.7
14.	Property income	7 063	3.9	4.3	4.4	4.4	4.5	4.5
15.	Other income (15=16-12-13-14)	11 437	6.3	6.1	5.9	5.9	5.9	5.9
16.=6	Total revenue	94 355	52.3	52.9	52.8	52.6	52.5	52.5
	of which: Tax burden (D2+D.5+D.61+D.91-D.995)	75 470	41.9	42.4	42.2	42.1	42.0	41.8
Selected components of expenditure								
17.	Compensation of employees + intermediate consumption	45 736	25.4	24.7	24.3	24.1	24.0	23.9
17a.	Compensation of employees (wages + employer social security contributions)	25 988	14.4	13.8	13.5	13.3	13.2	13.1
17b.	Intermediate consumption	19 748	11.0	10.9	10.8	10.8	10.8	10.9
18.	Social transfers (18=18a+18b)	37 447	20.8	20.2	20.3	20.3	20.3	20.3
18a.	Social transfers in kind	4 956	2.7	2.7	2.7	2.7	2.7	2.7
18b.	Social transfers other than in kind	32 491	18.0	17.5	17.6	17.6	17.5	17.6
19.=9	Interest expenditure	3 183	1.1	1.4	1.5	1.7	1.8	1.9
20.	Subsidies	2 691	1.5	1.5	1.5	1.4	1.4	1.4
21.	Gross fixed capital formation	4 000	2.7	2.6	2.5	2.5	2.4	2.4
22.	Other expenditure (22 = 23 -17-18-19-19-20)	5 725	3.4	3.4	3.5	3.5	3.5	3.4
23.=7	Total expenditure	98 782	54.8	53.8	53.5	53.6	53.4	53.4
	of which: Government consumption	44 242	24.5	23.9	23.5	23.3	23.2	23.2

Table 3. General government debt developments

	2010	2011	2012	2013	2014	2015
	% of GDP					
1. Gross debt, % of GDP	48.4	50.1	51.3	53..0	54.6	56.2
2. Change in gross debt ratio, % points	4.6	1.7	1.2	1.7	1.6	1.7
Contributions to change in gross debt, % points						
3. Primary balance	-1.4	0.5	0.8	0.8	0.9	1.0
4. Interest expenditure	1.1	1.4	1.5	1.7	1.8	1.9
5. Stock-flow adjustment	2.1	0.8	0.5	0.8	0.7	0.7
of which:						
- Net acquisition of financial assets	2.9	3.0	3.1	3.0	3.0	2.9
- of which: privatisation proceeds	0.0	-0.2	-0.2	-0.2	-0.2	-0.2
- Valuation effects (incl. GDP growth contribution)	-0.6	-2.2	-2.6	-2.3	-2.3	-2.2
Implicit interest rate on debt (= consolidated interest expenses divided by the previous year's debt level multiplied by 100)	3.3	3.1	3.2	3.5	3.6	3.6
Other variables						
6. Liquid financial assets	101.7	-	-	-	-	-
7. Net financial liabilities (7=1-6)	-53.3	-	-	-	-	-

Table 4. Cyclical developments, % of GDP

	2010	2011	2012	2013	2014	2015
	% of GDP					
1. Real GDP growth (%)	3.1	3.6	2.7	2.4	2.1	1.9
2. Net lending of general government	-2.5	-0.9	-0.7	-0.9	-0.9	-0.9
3. Interest expenditure	1.1	1.4	1.5	1.7	1.8	1.9
4. Potential GDP growth (%)	1.8	1.8	1.7	1.5	1.3	1.2
contributions:						
- labour	0.4	0.2	0.0	-0.3	-0.5	-0.6
- capital	0.1	0.3	0.4	0.4	0.4	0.3
- total factor productivity	1.2	1.3	1.3	1.4	1.4	1.5
5. Output gap	-5.0	-3.3	-2.3	-1.5	-0.7	0.0
6. Cyclical budgetary component	-2.5	-1.6	-1.2	-0.7	-0.4	0.0
7. Cyclically adjusted budgetary balance (2-6)	0.0	0.7	0.5	-0.2	-0.5	-0.9
8. Cyclically adjusted primary balance (7+3)	1.1	2.1	2.0	1.5	1.3	1.0

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 2011–2013, on the Ministry of Finance's March 2011 economic forecast. The years 2014 and 2015 have been taken into account in the scenario based on, among other things, the growth estimate for potential output and the expenditure development of the technical spending limits approved by the Government in March 2011.

The baseline scenario is based on the assumption that the Finnish economy would grow in line with the economic forecast quite rapidly in 2010–2012, after which total output is expected grow faster than potential output, although at a clearly declining rate. The development of the world economy is overshadowed, however, by great uncertainty and Finland, due to its large export sector, is highly dependent on global economic performance. Recent events in the euro area serve as a reminder of the sensitivity of the situation. Although the problems of Greece, Ireland and Portugal do not directly affect the Finnish economy significantly, for example in terms of trade flows, indirect effects may become significant. As was evident a couple of years ago, a small, open economy such as Finland's has no possibility of protecting itself against a decline in international demand. This would also be reflected in the central government balance and would substantially weaken Finland's capacity to prepare for the challenges brought by population ageing.

Finland's position in a recovering global market depends on the price competitiveness of the export sector. Concern about the development of competitiveness has grown, because growth of nominal wages in the collective bargaining agreement period extending to the start of 2010 was clearly faster than in competitor countries. At the same time, labour productivity developed poorly. Future wage settlements, moreover, will have a big impact on the kind of posi-

tion from which Finland competes for market shares after the recession. A pick-up in inflation in the short term and wage competition between different groups of workers will weaken conditions for the agreement of moderate wage settlements that support employment. Earlier, responsible wage settlements in terms of competitiveness and employment have been supported with the aid of tax cuts. In the coming years, public finances will be subjected to great adjustment pressures, which will restrict room for manoeuvre in tax policy. Price competitiveness will also be affected by the development of the common euro currency.

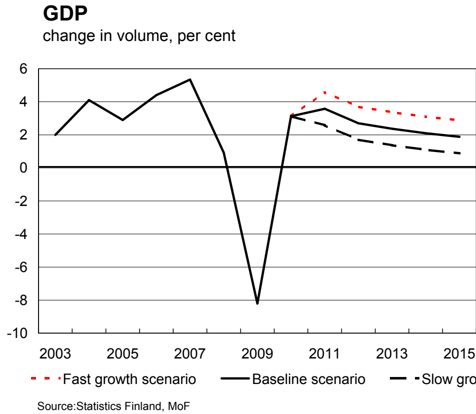
Weaker than anticipated development of the export market would reduce domestic investment and would lead in the baseline scenario to a weaker than anticipated employment trend. This could, furthermore, compel households to adopt more cautious than expected consumption habits. An export recovery slower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

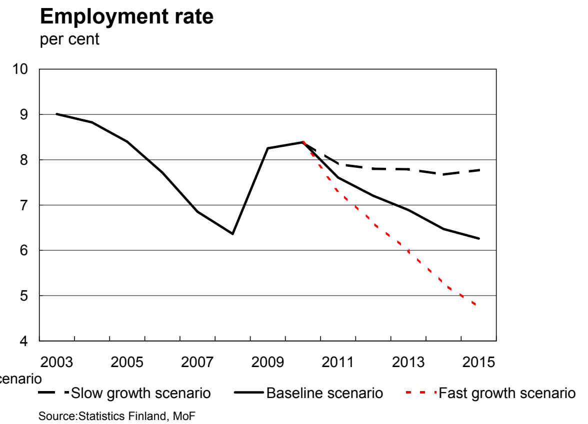
The regional distribution of labour and its mobility will also affect the efficient allocation of employment resources and the lowering of unemployment. Conditions for different types of business activity vary in different parts of the country and consequently the need for labour also varies. For example, deficiencies and problems related to the housing market may contribute adversely to the utilisation of the economy's employment resources. Shortcomings evident in the labour and commodity markets may therefore result in clearly weaker development than that assumed in the baseline scenario.

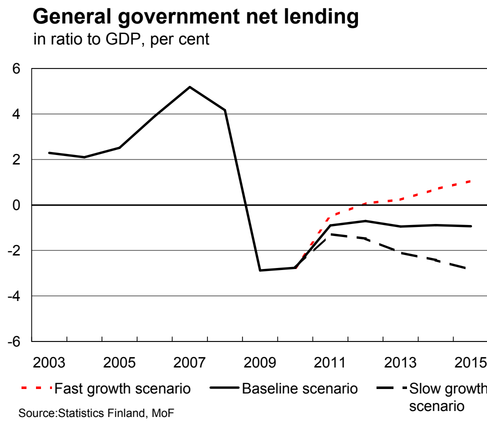
The general government balance will not be corrected in the programme period through economic growth alone to the level that preceded the recession. Should negative risks be realised, recovery from the recession would be prolonged and public finances would be significantly weaker than the baseline scenario 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.

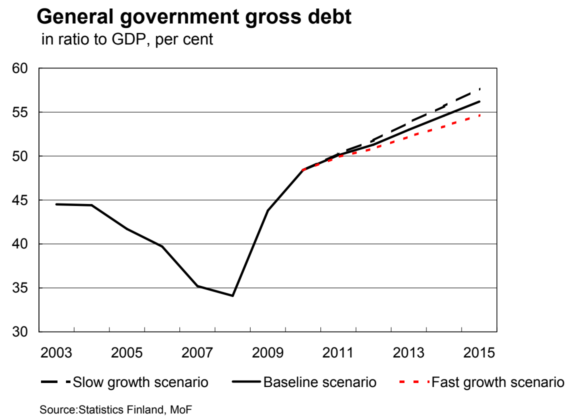
The figures below present the impact of slower-than-baseline and faster-than-baseline economic growth on the financial balance and debt in general government. The calculations are based on the assumption that output growth deviates by one percentage point in either direction from the baseline scenario.

In the slower growth scenario, the post-recession growth spurt will be more subdued than that anticipated in the baseline scenario. Total output growth will be a little under 1½% on average in 2011–2015. The unemployment rate would rise to nearly 8% in 2011 and would remain at that level until the end of the programme period. The general government deficit at the end of the programme period would be around 3% and the debt ratio would rise to 58%. This would significantly increase the need to adjust public finances.









4.2 Comparison with last year's Stability Programme update

The 2009 Stability Programme update forecast that growth of the Finnish economy would not recover from the deep recession of 2009 until 2011. The recovery began last year, however, and this year strong growth will continue. This is perhaps the most significant difference compared with the previous programme update. Even so, the crisis will leave its mark on the situation of public finances throughout the programme period, as was stated in the previous update.

In the previous Stability Programme update, GDP was still projected to grow in 2010 by only 0.7% and in 2011 by 2.4%. These estimates have since been adjusted upwards. The Finnish economy has returned quickly to a growth track from the recession that followed the financial crisis. The basis for growth has been provided by a recovery of export demand as well as of domestic consumption and trade.

Last year, consumer prices rose by just over 1%, i.e. approximately as estimated in the previous Stability Programme update. On the other hand, inflation will be significantly higher in 2011 than was forecast in the previous update. A number of tax changes came into force at the beginning of the year, which will increase prices at the same time as higher world market prices for raw materials are transmitted into consumer prices. The employment situation has developed significantly better than expected. The labour force grew throughout the whole of last year.

The position of general government finances is also better than was forecast in the 2009 Stability Programme update, when it seemed that the deficit would be higher than 3%, but only in 2010. The current outlook suggests that general government finances will be stronger and only slightly in deficit in the programme period.

Table 5. Divergence from previous update

	2010	2011	2012	2013	2014	2015
Real GDP growth (%)						
SP-2009	0.7	2.4	3.5	3.0	-	-
SP-2011	3.1	3.6	2.7	2.4	2.1	1.9
Difference, % points	2.4	1.2	-0.8	-0.6	-	-
General government net lending, % of GDP						
SP-2009	-3.6	-3.0	-2.3	-1.9	-	-
SP-2011	-2.5	-0.9	-0.7	-0.9	-0.9	-0.9
Difference, % points	1.2	2.1	1.6	1.0	-	-
General government gross debt, % of GDP						
SP-2009	48.3	52.2	54.4	56.4	-	-
SP-2011	48.4	50.1	51.3	53.0	54.6	56.2
Difference, % points	0.1	-2.1	-3.0	-3.3	-	-

Previous update: Stability Programme update (SP-2009), February 2010

Current update: Stability Programme update (SP-2011), April 2011

5 Sustainability of public finances

5.1 Measures to enhance sustainability

The changing of Finland's population age structure will also be reflected in the long-term outlook for public finances. The ageing of the population is a consequence of two developments: the baby boom generation, born in the late 1940s, is reaching retirement age, and the life expectancy of Finns is continually rising. A population forecast published by Statistics Finland in 2009 assumes that the life expectancy of Finns will rise by 9½ years by 2060, i.e. by roughly two years per each coming decade. The fastest stage of population ageing will take place in Finland in the 2010s and 2020s, when the ageing trend in Finland will be strongest among EU countries. According to the forecast, the size of Finland's working age population (15–64 year-olds) will fall in the period 2009–2030 by around 170,000. The number of those 65 years old and over is expected to double from the present level by 2060.

Population ageing and the related decline in the working age population will contribute to a weakening of long-term growth prospects for the economy. The reduction in labour supply will undermine the financial base of public finances just as the expansion of the elderly population group increases public age-related expenditure, of which the most important elements are for pensions, long-term care and health care. Population ageing will therefore adversely affect the long-term sustainability of public finances in two ways: through a weakening of output potential and through growing public age-related expenditure.

The international financial and economic crisis that began in 2008 has also been strongly reflected in the Finnish economy, weakening further the public finances sustainability outlook. In the sustainability scenario, the starting situation for public finances is now substantially weaker than before the crisis. In the years preceding the economic crisis, public finances were robustly in surplus and the debt ratio had been reduced to 34% of GDP in 2008. In 2010 public finances were 2½% in deficit and the debt ratio has grown to 48½%. The effects of the economic crisis on public finances are partly temporary, and the state of public finances is expected to improve from the current year, according to a Ministry of Finance forecast extending to 2015, through a strengthening of economic growth and a tightening of taxation. Upward pressures on ageing-

related costs, on the other hand, will last for decades, and responding to them will remain the most significant challenge for public finances.

In Finland an effort has been made to provide for population ageing through responsible economic policy. Before the economic crisis, debt was reduced by means of a disciplined fiscal policy. By reducing debt and interest outlays, room for manoeuvre was created to cope with expenditure growth caused by population ageing. Through the pension system, a significant portion of accumulated pension contributions are invested in funds, which balances the financial burden of pensions between the generations. Due to prefunding, it will not be necessary to increase pension contributions to the same extent, as pension expenditure will grow in the coming decades. The last time the pension system was reformed was in 2005 when, among other things, a life expectancy factor, adjusting pensions to changes in life expectancy, was agreed. In addition, accelerated accruals are offered to those close to retirement age in an effort to boost incentives to remain in work. Supported by the 2005 reform, the retirement age expectancy has increased slightly more than the target set in connection with the reform, i.e. 1.6 years in the period 2002-2010. In 2009 the Government and social partners further agreed a new target of delaying retirement by at least three years by 2025, but the measures by which this target will be achieved have not been agreed.

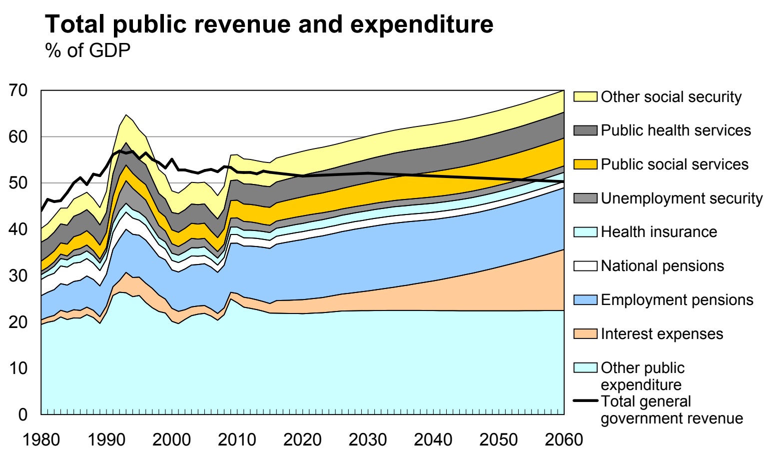
An effort has been made to broaden the financial base of public finances through an economic policy supporting economic growth and employment. In spring 2010 the Government and key social partners launched a Programme for Sustainable Economic Growth and Employment, whose aim is to find means to strengthen the sustainability of public finances by improving conditions for sustainable economic growth and high employment. This resulted in many tripartite measure proposals whose time span extends into future parliamentary terms. The Programme for Sustainable Economic Growth and Employment will improve the opportunities for future governments to agree measures to improve the sustainability of public finances.

5.2 Sustainability scenario

The sustainability scenario has been prepared adhering to the EU's jointly agreed methodology. There is some divergence, however, in terms of the use of some national forecasts and background factors insofar as this has been considered justified. The scenario is based on the National Population Forecast (Statistics Finland 2009), which differs slightly from Eurostat's latest population forecast. In the national forecast, life expectancy rises more strongly and the immigration assumption is greater than in the Eurostat forecast. When estimating age-related expenditure, the national calculation model for social expenditure has been used. The scenario draws on a Ministry of Finance projection for economic development up to 2015.

The macro-economic assumptions (employment, productivity and interest rate level) are consistent with the baseline scenario jointly agreed upon in the EU Economic Policy Committee's working group on ageing. The development of employment presented in the scenario is slightly weaker than that forecast in the working group on ageing in 2009, which takes into account the longer term spill-over effects on employment of the 2008–2009 economic crisis. In the scenario, the employment rate is expected to settle after 2025 at around 74% and the level of structural unemployment to be close to unemployment rate, at around 6½%. Labour productivity growth is assumed to slow significantly in the long term from its present level to around 1¾% owing to, among other things, the increasing service-orientation of output. The average GDP growth rate in the projection period is around 1.8%, based almost exclusively on growth of productivity.

In the scenario, age-related public expenditure is expected to rise in the period 2010–2060 by around 4½ percentage points of GDP. Most of the projected expenditure growth up to 2060 will come from an increase in long-term care expenditure, but pension and health care spending will also grow significantly. In terms of age-related public expenditure, the fastest growth in pensions will take place in the current decade; in the 2030s, pension expenditure as a share of GDP is expected start to fall. Pension expenditure growth will be based on growth of earnings-related pensions as the significance of national pensions gradually declines. The fastest growth of health care and long-term care expenditure will take place in the 2020s and 2030s, but growth is also projected to continue thereafter, especially with respect to long-term care expenditure. Unemployment expenditure will remain roughly at the level of the starting year and education expenditure will fall slightly due to a decline in younger age groups. Expenditure other than age-related expenditure is assumed in the sustainability scenario to remain stable as a proportion of GDP.



Historical data from National Institute for Health and Welfare's social expenditure statistics; future development from the Ministry of Social Affairs and Health's SOME model.
There may be minor differences in the expenditure classification between historical development and future development.

Due to the projected population development described above and the growth of age-related expenditure growth associated with it, general government finances are on an unsustainable long-term trend. Without new measures to strengthen the financial position, general government finances are headed for a situation in which continually growing deficits will lead to an unmanageable development of indebtedness. In the scenario, pension assets relative to GDP are kept roughly stable by permitting an increase in pension contributions. The total tax rate has been fixed at the level of the starting year (2015), which means a reduction of central government and local government taxation as pension contributions rise. In the scenario, the sustainability problem is channelled in practice through growth of central government and local government indebtedness.

According to the scenario, the public finances sustainability gap will be around 5% of GDP in 2015. This figure shows by how much the general government balance should be immediately improved either by increasing taxes and/or cutting spending in order that general government finances would not begin to grow unmanageably through population ageing-related public spending growth. The sustainability gap is sensitive to the scenario's basic assumptions and to the estimate of the structural balance of general government finances in the starting year. Another indicator that illustrates the problem is the surplus ensuring sustainability, the size of which is not influenced by the starting situation balance. In the baseline scenario, the surplus ensuring sustainability is estimated to be around 4% of GDP in 2015. This estimate has remained relatively stable in sustainability evaluations made in recent years.

The sustainability gap is of such magnitude that it is not sensible to close the gap solely through spending cuts and tax increases; economic growth and strong structural reforms aimed at strengthening the sustainability of public finances are needed as part of the solution to the problem. The most effective reforms are expected to include the lengthening of working careers and the curbing of public spending by improving the productivity of public welfare services.

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

	2010	2015	2020	2030	2060	2060-2015 change
Total expenditure	55.1	53.4	57.2	59.0	69.0	15.6
of which age-related and unemployment expenditure	27.6	28.0	29.3	31.2	32.0	4.0
Pensions	12.5	13.3	14.2	15.0	14.0	0.7
Old-age pensions	9.1	10.9	12.0	13.1	12.4	1.5
Other pensions	3.4	2.5	2.2	1.8	1.6	-0.9
Health care	5.3	5.5	5.7	6.1	6.7	1.2
Long-term care	2.0	2.2	2.4	3.1	4.5	2.3
Education	5.9	5.6	5.6	5.6	5.4	-0.2
Unemployment	1.9	1.4	1.4	1.4	1.4	0.0
Interest expenditure	1.4	1.9	4.4	4.3	13.5	11.6
Total revenue	52.3	52.4	53.6	51.4	50.1	-2.3
of which: property income	3.9	4.5	4.5	3.6	2.4	-2.1
Net lending*)	-2.8	-0.9	-3.6	-7.6	-18.9	-18.0
Gross debt	50.9	59.2	68.4	97.3	292.8	233.6
of which: consolidated debt	48.4	56.2	65.4	94.3	289.8	233.6
Pension funds' financial assets, gross	77.0	79.0	81.1	80.5	79.8	0.8
of which: consolidated liquid assets	63.3	65.3	67.4	66.8	66.1	0.8

*) Cyclically adjusted balance as of 2015.

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

	Assumptions, %			
	2015	2020	2030	2060
Labour productivity growth	2.1	1.7	1.7	1.7
Real GDP growth	1.9	1.8	1.8	1.7
Participation rate				
males (20-64)	82.2	83.3	84.9	85.3
females (20-64)	78.5	79.6	81.3	81.8
total (20-64)	80.3	81.5	83.1	83.6
Unemployment rate	6.3	6.3	6.3	6.3
Population aged over 65 % of total population	16.9	22.6	26.1	27.0
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, %	4	4	4	4
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.

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 in the private and municipal sector are included in social security funds. In a reform implemented in the early part of the year 2010, the State Pension Fund was also incorporated within the social security funds, whereas previously it was counted as part of the central administration. Pension funds are therefore now counted in their entirety as belonging to the social security funds.

The consolidated market value of the pension funds was EUR 138.8 billion at the end of 2010. 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 funds to the pre-crisis level, around 77% of GDP at the end of 2010.

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

	2003	2004	2005	2006	2007	2008	2009
A. Non-consolidated assets							
AF21 Currency	0	0	0	0	0	13	13
AF22 Transferable deposits	264	417	530	968	1010	1100	1388
AF29 Other deposits	309	377	246	199	78	175	438
AF331 Short-term bills	2413	2819	2879	1746	4523	5076	4043
AF332 Long-term bonds	35450	39683	43084	42507	38255	38181	39824
AF34 Derivatives, net	90	164	48	1264	1699	664	-90
AF511 Quoted shares	14768	18648	21767	24773	26446	12300	21258
AF52 Mutual fund shares	6201	9677	16543	25195	32519	23436	31552
Total	**59495**	**71785**	**85097**	**96652**	**104530**	**80945**	**98426**
% of GDP	40.9	47.2	54.1	58.3	58.2	43.8	57.5
B. Liabilities of general government (Sector 13) to pension funds							
AF331 Short-term bills	26	257	42	76	111	80	85
AF332 Long-term bonds	5460	3992	3844	2996	3305	3030	2541
Total	**5486**	**4249**	**3886**	**3072**	**3416**	**3110**	**2626**
% of GDP	3.8	2.8	2.5	1.9	1.9	1.7	1.5
C. Consolidated liquid assets (=A-B)							
AF21 Currency	0	0	0	0	0	13	13
AF22 Transferable deposits	264	417	530	968	1010	1100	1388
AF29 Other deposits	309	377	246	199	78	175	438
AF331 Short-term bills	2387	2562	2837	1670	4412	4996	3958
AF332 Long-term bonds	29990	35691	39240	39511	34950	35151	37283
AF34 Derivatives, net	90	164	48	1264	1699	664	-90
AF511 Quoted shares	14768	18648	21767	24773	26446	12300	21258
AF52 Mutual fund shares	6201	9677	16543	25195	32519	23436	31552
Total	**54009**	**67536**	**81211**	**93580**	**101114**	**77835**	**95800**
% of GDP	37.1	44.4	51.6	56.5	56.3	42.2	56.0
D. Total assts of pension funds *							
Non-consolidated total assets	74327	86329	99991	112697	122869	103840	122990
% of GDP	51.1	56.7	63.6	68.0	68.4	56.2	71.8
Consolidated total assets	67534	81325	95360	108890	118344	99380	119337
% of GDP	46.4	53.5	60.6	65.7	65.9	53.8	69.7

* 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

According to Prime Minister Kiviniemi's Government Programme, the Government is committed to a responsible, long-term fiscal policy. The Government is continuing the spending limits procedure in line with that agreed by the Vanhanen II Government and is adhering to the spending limits of the now-ending parliamentary term. The goal is to curb growth of public spending by improving public sector productivity, with the key instruments for doing so being the structural reform of the municipalities and the central government productivity programme.

6.2 General government revenue and taxation

As the general economic situation improved, the national economy's total output resumed growth last year. The strengthening of economic activity will be evident with a delay in general government tax revenue. Last year, tax revenue grew by 3%. In addition to a broadening of tax bases, tax revenue was boosted by increases in indirect taxation. From July 2010, all value-added tax rates were increased by one percentage point and at the same time the value-added tax on restaurant food was reduced to the level of the value-added tax percentage for food, i.e. 13%. The impact of changes in taxation made during the calendar year will only become evident, however, this year. The increase in tax percentages will boost tax revenue by around EUR 470 million in 2011 and the impact on an annual basis will be around EUR 690 million. The reduction of tax on restaurant food will reduce tax revenue by around EUR 170 million in 2011 and on an annual basis by around EUR 260 million.

Tax revenue will be increased by tax changes relating to excise duties, which came into force at the beginning of the current year. The most significant of these with respect to revenue is an increase in energy taxes, which compensates for the earlier abolition of the employer's national pension contribution. The increase is directed at all energy products, excluding transport fuels. This is expected to boost central government tax revenues by around EUR 700 million. The excise duty on soft drinks was also increased and an excise duty on

sweets was introduced from the beginning of 2011, which will increase tax revenue on an annual basis by EUR 100 million.

In the medium-term baseline scenario, it has been assumed in terms of tax rate changes that taxation on work will not be allowed to increase via progression. The changes in taxation necessary to offset the tax-increasing effects of higher earnings would reduce tax revenue in 2012–2015 by a total of EUR 1,860 million, depending on the earnings trend. This takes into account adjustment to income tax scales for inflation. Making the inflation adjustments alone would reduce revenue by EUR 700 million.

As a result of the recession, a substantial deficit has arisen in central government finances. The coming change in population age structure threatens to weaken further the position of public finances. These factors are exerting pressure to increase taxation. After the parliamentary elections of spring 2011, the Government will have to take a view on the development of taxation and on the degree to which tax increases are required to strengthen public finances.

Tax revenue relative to GDP will rise in the early years of the period under review. In addition to changes to indirect taxation, contributions to this will be made by the return of revenue from the most cyclically sensitive taxes, such as corporate tax, capital income and car tax, closer to normal levels after the exceptionally deep recession. The recovery of corporate tax revenue will be slowed by the fact that companies can deduct in taxation losses that arose during the recession. Similarly, with respect to capital taxes, losses on the disposal of assets will reduce the taxable capital income arising from gains on the disposal of assets.

Towards the end of the period under review, the level of tax revenue on production and imports relative to GDP will fall slightly, even though it has been assumed in the scenario that no significant changes in tax criteria will be made. The fact that certain excise duties, such as taxes on alcohol and tobacco, as well as demand for energy products are expected to develop more moderately than growth of total output will contribute to this. Growth of energy demand will be curbed by an improvement in the average energy efficiency of vehicles as the vehicle stock is renewed.

In connection with the social agreement of January 2009, a raising of employment pension contributions in the period 2011–2014 was agreed. As a result, the proportion of social insurance contributions relative to GDP will rise in the medium term. In contrast, both the employer's and the employee's unemployment insurance contributions are assumed to remain unchanged in the next few years.

Most of the public sector asset income will arise in the employment pension funds. At the end of 2010, the total market value of the employment pension funds was EUR 138,8 billion (77% of GDP). In the medium term, the employment pension funds will remain in surplus, which will increase the level of investment assets further. A rise in the level of interest rates will increase the interest income received by the employment pension funds. Property income will also be increased by a rise in dividend income. The financial performance

of companies and thereby their dividend distribution is expected to develop favourably in the next few years. The proportion of property income relative to GDP will rise slightly in the medium term.

6.3 Central government expenditure

In the early 1990s, general government expenditure grew very rapidly in Finland, primarily as a result of the recession. Aggregate general government spending peaked at 65% of GDP in 1993, from which it declined significantly to less than 50% in 2007. In 2009 general government expenditure rose to an estimated 56% of GDP; total output declined sharply as public spending grew by more than 5%, as a result, among other things, of stimulus measures and the operation of automatic stabilisers. In the medium term, the expenditure ratio will gradually fall, but it will remain at a significantly higher level throughout the programme period than the level that preceded the economic crisis in 2008.

In 2010, public spending increased by just over 3%, i.e. around 2 percentage points less than the value of total output. Up to 2015, spending is expected to grow every year slightly less than GDP and therefore the ratio of spending to GDP will fall from 2009 to 2015 by a total of 3 percentage points.

The development of general government spending has been estimated based on prevailing policy guidelines, which the new Government will naturally adjust. The Stability Programme's central government spending estimates do not include any increase in the level of discretionary spending, so the spending estimate is based on a very moderate development of spending. Growth of central government budget expenditure is based almost exclusively on growth of interest expenditure and changes in price criteria of index-linked expenditure. The spending estimate does not include one-off expenditure increases of the present Government or any made in the now-ending parliamentary term. Such expenditure includes, for example, stimulus measures, capital investment and certain fixed-term employment increases. Cyclical spending is expected to fall significantly by 2015. Absent from the spending estimates, on the other hand, are future discretionary, but probable, expenditure items to be decided by the new Parliament.

The spending estimate for the municipal sector is based in the present level of obligations. The estimate includes annual growth of around 1%, which corresponds to growth of demand for services arising from ageing. The cost level is expected to grow by around 3% per year, which results to a large extent from the projected increase in earnings.

In terms of the medium-term development of municipalities, no view is taken on how the local government structural reforms now under way will affect the development of local government expenditure. Local government productivity is assumed to remain unchanged. It is uncertain whether the structural reforms will cause further growth in expenditure or whether it will be possible to realise the benefits made possible by them in the next parliamentary term.

Table 10. General government expenditure by function, % of GDP

	COFOG-division	2009	2015
		% of GDP	
1. General public services	1	7.2	6.4
2. Defence	2	1.7	1.5
3. Public order and safety	3	1.5	1.5
4. Economic affairs	4	5.1	4.4
5. Environmental protection	5	0.4	0.4
6. Housing and community amenities	6	0.5	0.4
7. Health	7	8.0	8.3
8. Recreation, culture and religion	8	1.2	1.1
9. Education	9	6.6	6.8
10. Social protection	10	23.9	22.5
11. Total expenditure (=item 7 = item 22 in Table 2)	Total	56.0	53.4

6.4 Productivity in general government

Population ageing and the consequent reduction in labour supply as well as the sustainability gap in public finances arising from the economic crisis require a substantial improvement of public sector productivity. A particularly demanding task is improving the productivity of the municipal sector. In the next few years, the structure and level of both central government and, more widely, general government expenditure cannot remain as before; they must be adjusted to the demands of new circumstances.

Productivity in central government

A central government productivity programme was initiated in 2003 and it has been implemented by several governments. Targets have been set for the programme up to 2015. The basis of the programme has not changed; since the programme began, the goal has been to reduce the number of central government personnel through restructuring, improving operating processes and utilising information technology.

The justifications of the programme were the demographic trend foreseeable in the early 2000s, a reduction of the working age population and a "window of change" made possible by large-scale retirement of central government employees. There was no foreseeable need to expand central government tasks, and information technology development offered new opportunities to extend electronic services and make use of automation, which, in the light of experiences elsewhere, meant a reduced need for labour.

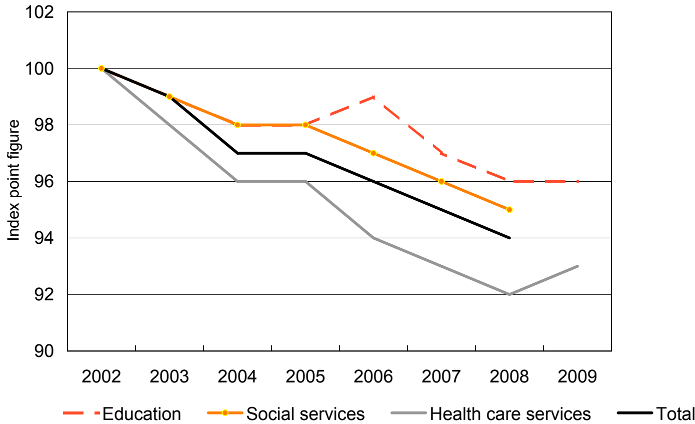
In the 2011 Budget, the Government has undertaken to reduce the central government's overall labour requirement in 2011 by the equivalent of 9,645 person-years (c. 8%) compared with in 2005. In November 2010, the Government decided to continue the productivity programme in the period 2012–2015. The objective is to reduce the central government labour requirement by 4,800 person-years.

Measuring public administration productivity has proved to be difficult and it has not been possible to develop a standard method of measurement despite numerous attempts to do so. The indicator used in the productivity programme to monitor targets is person-years. Although it does not cover all of the subareas of productivity, it is clear with respect to the monitoring of set targets. A fundamental aspect of the productivity programme has always been the concrete nature of measures and the verifiability of their personnel-reducing effects; in this, the said indicator has been effective.

Based on the central government's productivity statistics, central government productivity fell in 2009. Currently, due to shortcomings in central government productivity statistics, it has not been possible to assess precisely the effects of the productivity programme or the development of agencies' productivity. Making conclusions based on annual results alone is problematic, because the 2009 result, for example, would appear to have been distorted by factors unrelated to productivity, such as changes in non-recurring depreciations of infrastructure investments, a reduction in the level of central government services during the recession, and ensuring the provision of development input and resources in connection with the university reform, for example. There are grounds for continuing the development of central government productivity statistics to improve their reliability.

Productivity in local government

A key challenge of improving public sector productivity is to improve the productivity of the municipal sector, which is much more extensive than central government. Although there are measurement and statistical problems connected with measuring the productivity of public services, statistics and research indicate unambiguously that the overall productivity of education, health care and social services provided by municipalities and joint municipal authorities has declined on average since the turn of the millennium. The figure below shows the development of productivity in local government in the 2000s.



The sustainability gap in public finances presents a significant challenge. Around half of the growth pressure in long-term age-related expenditure is directed at local government finances. Raising the productivity of municipal services will therefore play a key role on closing the public finances sustainability gap and consolidating public finances. It is estimated that 0.25% annual productivity growth in welfare services would reduce the sustainability gap by one percentage point of GDP. Although the problem cannot be solved merely by raising productivity, it is a key means of doing so.

The impact to date of the structural reform of municipalities and services, initiated in 2007, is evident particularly in the development of the municipal structure. During the last five years, 2007–2011, 57 municipal mergers have been implemented in Finland. During this period, the number of municipalities has fallen by 105, i.e. by around one quarter. In 2006 Finland had a total of 431 municipalities and now, five years later, there are 336. Service structures will be strengthened by consolidating services that require a broader population base of more than one municipality and by increasing cooperation between municipalities. Municipalities have formed partnership areas for basic health care and closely related social welfare tasks. A total of 66 partnership areas will be founded by 2013. By amending the framework act, the Government has acquired the power to require municipalities to fulfil the population-base obligations prescribed in the act for social welfare and health care cooperation.

Central government and the municipalities are cooperating in implementing a Government-initiated productivity programme in the 20 largest municipalities. Development is directed at the following areas: personnel, skills and wellbeing in work, the service system, processes and electronic services, service networks and facilities, organisation and structures, procurement, management systems and productivity indicators.

7 National fiscal procedures and institutions

The annual central government spending limits decisions are revised only for changes in price and cost level and for adjustments in the budget structure. Thus they do not involve changes in the underlying spending rules adopted in the Government Programme. The central government spending limits endorsed by the Government form the guideline for the following year's budget proposal in the administrative branches of the government. In Finland, the Government is committed to adhering to the spending rules it sets. Measures entered in the Government Programme are implemented insofar as this is possible within the framework of the spending limits decision.

The parliamentary term spending limits set a ceiling of around 3/4 of the total budgetary expenditure. Outside the scope of the spending limits are expenditures affected by cyclical fluctuations and automatic stabilisers, such as unemployment security expenditure, central government contributions under the National Pensions Act to the Social Insurance Institution, and the central government contribution to social assistance. Interest payable on central government debt, value-added tax expenditure, financial investment expenditure and expenditure corresponding to technically transmitted payments are also outside the scope of the spending limits.

Parliamentary elections will be held in Finland in April 2011. In Finland, a practice has been established in which experiences of the spending limits system acquired in previous parliamentary terms are evaluated in connection with elections. The two previous parliamentary terms (2003–2007 and 2007–2011) have shown the multi-year spending limits procedure based on spending rules to be an effective system. Governments have committed themselves to adhering to the spending limits procedure, thereby keeping spending within the set spending limits. In connection with the 2011 elections, a working group evaluation of the effectiveness of the spending limits procedure has again been prepared. The evaluation has also been supported by development work undertaken within the EU and recommendations given on the development of the national fiscal policy system.

Political commitment to spending limits has become a generally accepted policy in Finland across party lines. It has strengthened the credibility of fiscal policy. Even so, there are grounds for developing fiscal policy procedures in order to increase clarity and transparency as well as in the light of experiences gained from the economic crisis.

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16c/2011
Ministry of Finance publications
April 2011

ISSN 1459-3394 (print)
ISBN 978-952-251-183-6 (print)
ISSN 1797-9714 (pdf)
ISBN 978-952-251-184-3 (pdf)