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Economic outlook and economic policy



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Abstract	<p>This Stability Programme update draws on the central government spending limits for 2008 – 2011, the budget proposal submitted in September, the amendment to the budget proposal for 2009 submitted on 20 November 2008, and on the related assessments on economic developments.</p> <p>The problems in the financial markets, which have exacerbated in the course of the autumn and spread into the real economy, are causing a great deal of uncertainty in economic prospects and could further aggravate economic developments in the next few years. The decrease in labour supply caused by the ageing of the population will start to hamper production potential in the medium term.</p> <p>Finland's general government finances will weaken considerably but will remain in surplus over the review period. The general government surplus will hinge entirely on the employment pension funds from next year onwards.</p> <p>Finland will meet the objectives of the Stability and Growth Pact for the EU countries. However, the structural surplus in general government will not reach its medium-term budgetary objective of a 2% structural surplus relative to GDP at the end of the programme period. Owing to the ageing of the population, it would appear that public finances are not on a sustainable basis in the long term either. A structural surplus-to-GDP ratio of 4% is estimated to be required to safeguard sustainability. The Stability Programme indicated that the surplus-to-GDP ratio would be about 1% in 2012.</p>	

Contents

Introduction and summary	5
1 Economic policy objectives and premises	11
1.1 General.....	11
1.2 Broad Economic Policy Guidelines.....	12
1.3 Stability Programme update for 2008 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.....	20
3 General government balance and debt	23
3.1 Fiscal policy strategy and medium-term budgetary objective	23
3.2 General government financial position and public debt.....	25
3.3 Cyclically adjusted balance in general government finances	26
4 Sensitivity analysis and comparison with previous programme	29
4.1 Risks in economic developments and risk impact on public finances	29
4.2 Comparison with last year's Stability Programme update.....	32
5 Quality of public finances	35
5.1 Government policy	35
5.2 General government revenue and taxation	35
5.3 General government expenditure	38
5.4 Productivity in general government	40
6 Sustainability of general government finances	43
6.1 Measures to enhance sustainability	43
6.2 Sustainability scenario.....	45
6.3 Pension fund assets.....	48
7 National fiscal procedures and institutions	49

Introduction and summary

The biggest challenges facing the Finnish economy in the years and decades ahead come from population ageing. The baby boomers are now reaching retirement age, and neither younger age groups nor immigration will be able to replenish the dwindling labour supply. The latest population projections by Statistics Finland indicate that by 2050, the working-age population (ages 15–64) will decline by more than 250,000, and at the same time the population aged 65 or over will grow by more than 700,000. This will bring a dramatic increase in the old-age dependency ratio.

Under these pressures of demographic change, public finances will have to adjust to a situation in which pension expenditure and the need for social care and nursing services are soaring, but at the same time the declining labour supply is effectively curbing the growth of output and tax revenue. Public pension expenditure will start to grow sharply by the 2010s, whereas expenditure on care and nursing services will gather more impetus in the 2020s. To cushion the impacts of population ageing, steps have been undertaken to enhance the sustainability of public finances: these include the government productivity programme and other measures to improve public sector efficiency, reforms of municipal and service structures, as well as social security, labour policy and education reforms aimed at raising the employment rate. Moreover, it is important to maintain discipline in spending so that provision can be made for the forthcoming expenditure pressure. The spending limits for central government finances that were set for the government term constitute a key instrument in this context.

During the upswing in recent years, the surplus in general government has remained strong and employment has increased. However the cyclical upswing has now peaked and economic growth is rapidly decelerating. Over the programme period economic growth will average 1.9%. The attainment of even this figure requires that the international downturn remains short-lived and that economic growth in Finland rebounds with the rest of the global economy in 2010. Indeed, the economic performance projected in the baseline scenario involves certain risks which, if they were to materialise, would result in considerably slower economic growth. For example, if the average growth rate during the programme period remains one percentage point below projections, public finances would swing into a deficit as early as 2011 and the public sector

debt to GDP ratio would climb to around 39% by 2012. This would seriously undermine the sustainability of general government finances as the population continues to age.

The biggest threat to global economic development comes from the problems in the world financial markets, their failure to shrug of these problems, and the knock-on effects of these problems on other areas of the economy. Furthermore, the slowdown of domestic productivity growth coupled with higher labour cost pressures may significantly erode price competitiveness. Indeed, the Government deems it important to curb the rise in labour costs to safeguard competitiveness and employment. The relatively large wage increases agreed last year for the local government sector, some of which extend to early 2010, are bound to have an adverse impact on local government finances, particularly if there is a sharp slowdown in economic growth and tax revenue.

As a result of population ageing and the economic downturn, the numbers in employment will start falling as soon as next year. Unless efforts to extend labour market careers and to increase occupational and regional mobility are successful, the demographic change will permanently reduce the economy's growth potential. Many branches have already been struggling to fill labour shortages, even though the employment rate has remained at over 6%.

Finland's general government balance is projected to deteriorate sharply, but to remain in surplus throughout the programme period. Both central and local government will slip into deficit in 2009. Indeed, from next year the surplus in central government finances will come exclusively from employment pension funds, although in contrast to many other EU countries in Finland these funds are, according to the national accounting, classified under general government. It is expected that general government gross debt (EMU debt) will begin to rise next year and reach around 34½% by 2012.

Under the 2005 revision of the Stability and Growth Pact, each Member State shall have a differentiated medium-term objective for general government. In the Finnish Stability Programme update for 2006, the medium-term objective for general government was set at a structural surplus of 2% of GDP. In the absence of new measures, the projections here indicate that by the end of the programme period, the general government structural surplus will fall short of this target and stand at just one per cent of GDP in 2012. The Government is prepared to take corrective action if the attainment of this surplus target is jeopardised. It will be meeting in early 2009, midway through its term, to review the economic situation and the outlook for public finances and to take decisions on any further action required.

The target set for the general government surplus in the Government Programme is even more challenging. It is the Government's view that over the next few years, the main consideration in assessing the state of public finances should be to prepare for the impending demographic change. The objective set out in the Government Programme is by means of employment-enhancing

reforms to secure a structural surplus in central government finances equivalent to 1% of GDP by the end of the government term, i.e. 2011. Taking account of the projected developments in local government finances and social security funds, this is equivalent to a structural surplus of around 3½% at the level of general government. In line with this, the Government is aiming at structural surplus of 3½% of GDP by the end of the electoral term in 2011.

Current projections are that the structural deficit in central government finances in 2011 will be around one per cent of GDP. In other words, in the absence of any new measures, the target announced in the Government Programme of a one per cent structural surplus will not be reached. The baseline scenario of general government balance outlined in this Stability Programme update is also insufficient to ensure the long-term sustainability of public finances. It is estimated that for purposes of ensuring long-term sustainability, a general government surplus of around 4% of GDP is required in the medium-term. The Government will be seeking to assess whether sufficient provision has been made for the ageing of the population so that any necessary reforms can be launched while it is still in office, i.e. by 2011.

1 Economic policy objectives and premises

1.1 General

Finland has just come out of a sustained period of strong economic growth. During this period the numbers in employment have risen substantially, unemployment has come down – and this applies particularly to the high levels of structural unemployment that has been a persistent problem after the 1990s recession – and general government has remained in surplus. The global economic situation, on the other hand, has deteriorated very rapidly. The economic outlook in Finland, too, has changed and the phase of exceptionally rapid growth is now over. In the years ahead, population ageing and the resulting contraction in labour supply will begin to constrain the potential output and make it harder to reach the kind of growth figures posted in recent years.

The Government is seeking to achieve stronger economic growth by creating the conditions for a substantial increase in employment and for higher output growth. According to the Government Programme it is possible to create 80,000 to 100,000 new jobs by the end of the current parliamentary term. Under conditions of an economic downturn, this will be a formidable challenge indeed. In fact, the achievement of this target will require not only measures to increase the supply of labour and to bolster productivity, but also a speedy recovery of the global economy and a quick return to economic growth in Finland. Furthermore, pay rises must be kept in line with productivity growth so that domestic competitiveness and labour demand can be safeguarded. Measures to encourage greater regional and occupational labour mobility are needed to ease the problem of labour market mismatches.

Increasing employment is also essential for the sustainability of public finances. Population ageing is hurting central and local government tax revenue, driving up local government expenditure through increased social care and nursing provision, and it presents a huge challenge to the sustainable financing of the pension system. In anticipation of the fiscal pressures associated with population ageing, the Government is committed to undertake structural

reforms that will increase the capacity of the economy and to pursue responsible spending and tax policies.

Growth in public spending will be curbed by the spending limits adopted on 13 March 2008 for the 2009–2012 period. In addition, work will be continued through the restructuring of municipalities and services and the Government productivity programme to increase productivity. The restructuring project is aimed at streamlining the delivery and organisation of municipal services and at strengthening the economic foundations of service provision, while the Government productivity programme is intended to improve the overall efficiency of the public sector and to reallocate labour resources. Ultimately the aim is to prevent the growing demand for labour in the public sector from hampering the growth potential in the private sector and the rest of the national economy. Social security will be reformed in order to lower structural unemployment and to extend labour market careers. The match between labour demand and labour supply will be improved through labour policy changes and educational reforms.

1.2 Broad Economic Policy Guidelines

On the launch of the second three-year cycle of the renewed Lisbon Strategy for Growth and Jobs in spring 2008, the European Council decided that the current Integrated Guidelines are still valid and applicable for the period 2008–2010. In line with these guidelines and to achieve the Lisbon strategy objectives, economic growth potential should be promoted across the European Union hand in hand with robust public finances. The aim should be to promote knowledge work, to boost labour supply and to create new jobs.

In March 2008, the European Council observed that although the renewed Lisbon strategy was delivering results, Member States should not rest on their laurels but continue on the path of reform. At the same time, the Council issued specific recommendations to euro area economies: these recommendations had to do with strengthening the sustainability of public finances and their ability to promote economic growth, financial integration and the promotion of competition especially in services, adequate wage developments in line with productivity development in order to ensure competitiveness, and increasing labour mobility.

There were no country-specific recommendations for Finland, but certain areas were singled out that require special focus. These have to do with increasing competition and productivity in some services, steps to achieve the Kyoto climate objectives, the removal of bottlenecks in the labour market and the lowering of structural unemployment. Finland was also urged to take advantage of the opportunities created by inward economic migration.

The Government's economic policy is consistent with the Broad Economic Policy Guidelines and with the Integrated Guidelines for 2008–2010. The economic policy measures taken by the Government relating to the recommendations on general government finances and structural policy are described in more detail later in this Stability Programme update and in the Finnish National Reform Programme adopted by the Government in October 2008. The Stability Programme update and the Finnish National Reform Programme are consistent with each other. The NRP only incorporates reforms included in the Government Programme or which the government has decided to implement during its term in office. All the significant structural reforms set out in the NRP are contained within the Government Programme and the Government spending limits and have thus been taken into account in the baseline scenario presented in the Stability Programme.

1.3 Stability Programme update for 2008 and its handling in Finland

This Stability Programme update is based on the Government's decision on the 2009–2012 spending limits for central government finances, the 2009 budget proposal submitted in September, the amendment to the budget proposal submitted on 20 November 2008 and the short-term forecast underlying that amendment. The expenditure estimates for 2009–2012 include additional expenditure generated by the decisions taken in the context of the 2009 budget proposal and the main foreseeable on-budget spending pressure.

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 update have been presented to Parliament during the drafting stage. The Commission's assessment and the Council's statement on Finland's Stability Programme will be submitted to Parliament in connection with Ecofin preparations. The Stability Programme update complies with the Code of Conduct endorsed by the EU Council in October 2005.

2 Economic situation and outlook

2.1 Recent developments and short-term outlook

The global economic outlook has deteriorated sharply during the past autumn in the wake of the bursting of the housing bubble and the severe disruption in the world financial markets. The sudden turnaround is also reflected in prices of production supplies. Crude oil prices have dropped by more than 50% from the peak last summer, reflecting both the dampening of demand and the strengthening of the dollar. Metal and food prices have also started to come down. Slower demand and falling prices of production supplies have combined to ease inflation pressures, and next year the inflation rate in advanced economies is expected to drop back to around 1½%.

Output has declined in the euro area and it is expected that the US will soon be in the same situation. As the crisis wears on, the state of emerging economies is becoming more precarious than previously thought. Monetary policy, however, has been eased worldwide. The outlook is expected to begin to improve from late 2009 as the problems in the financial markets and inflation begin to ease. However, the forecasts are that growth will be rather slow to pick up.

In Finland the economic downturn set in early in the summer. However the overall picture for the current year is divided in that the employment situation has remained favourable through to the latter end of the year, whereas total output growth in 2008 will struggle to reach 2½%, considerably lower than last year. In 2009 output growth will slow further to around ½% as the global economic crisis cuts demand for exports and slows down investment. The risk is that the international financial crisis, which deepened further early in the autumn, will hamper growth even more severely than projected. It is thought that the disruption in the financial market will have the most profound impact in investment, where yield requirements have risen substantially since late summer following the sharp increase in the costs of financing. Problems with the availability of funding will also hamper investment projects where yield expectations otherwise would be adequate. The decline in housing prices and other asset values has in turn had the effect of holding back household consumption. On the other hand, the prospects of a relatively swift rebound are enhanced by decisions already taken on growth supportive fiscal policy measures that will

be put into place in 2009, by a more relaxed monetary policy, the expected easing of the crisis in the financial markets as well as by the slowdown of inflation and the weakening of the euro.

Industry was still in a relatively strong cyclical position early in the year and exports were high, but in the autumn both the export outlook and orders slowed sharply. The situation is most difficult in the forest industry and particularly in the wood products industry. The slowdown in world trade growth and the special challenges faced by the forest sector will cause export growth to slow this year and take a downturn in 2009.

In the early part of the year household consumption increased more rapidly than last year, but recently has shown signs of slowing down in the wake of a year-long slump in consumer confidence. Consumption growth will be bolstered not only by rising earnings levels and slowing inflation, but also by cuts in income taxes, which especially in 2009 will provide a major boost to household purchasing power. However the growth of purchasing power is being eroded by rising unemployment. As households remain uncertain about the future and have relatively high debts, a growing share of their increased purchasing power will be saved rather than spent. Therefore it is expected that household consumption expenditure will rise much more slowly than in previous years, which saw vigorous growth. Furthermore, as they continue to repay their loans and prepare for slower economic growth, consumers in general are increasingly cautious with their money.

Investment will continue to grow this year, but in 2009 will be down by a few per cent from its current high level. Investment in residential construction is set to decrease both this year and next, even though housing demand will remain substantial in centres of population growth and plans are in place to generate new starts of moderately-priced owner-occupied and rented housing with state subsidies. Investment in machinery and equipment and civil engineering investment will continue to grow this year, but will slow in 2009. The volume of public investment will increase in 2008 by virtue of major infrastructure projects. Moreover, the improved financial position of the local government sector will facilitate implementation of infrastructure obligations in urban planning. It is expected that public sector investment will slow down somewhat in 2009, but still remain at a fairly high level.

Despite the cyclical slowdown, the number of employed people will still rise by more than 35,000 this year. Many sectors are struggling with problems of labour availability, even though the supply of labour has in fact grown rapidly, particularly in age groups approaching retirement age and among those under 25. Work-related immigration is increasing, too. The numbers employed are rising primarily in business services, in wholesale and retail trade, accommodation and catering services as well as in construction, but decreasing somewhat in industry. Structural unemployment will decrease thanks to more efficient public employment services and reforms in the labour market subsidy system

in 2006, but still remains high. In 2009, however, demand for labour will begin quickly to fall, even though the number of part-time jobs as a proportion of total employment will increase to some extent. It is expected that the numbers employed will only rise in public services, whereas building construction and industry in particular will see job numbers go down. The supply of labour will decline both as a result of the economic downturn and because baby boomer retirement has now begun. If the slowdown of economic growth is sharper than anticipated because of the crisis in the financial markets, employment trends may remain weaker than projected.

Inflation has accelerated appreciably during 2008. World market prices of crude oil rose sharply in the first half of the year, and pent-up pressures on food prices were released in January. The rise in labour costs has clearly accelerated, and inflation has also been pushed up by increased excise duties and health care charges. Rents have also been rising more steeply. Although inflationary pressures have eased considerably towards the end of the year, the harmonized index for consumer prices will increase by an average of 4% in 2008. The rise in labour costs will remain more or less unchanged throughout 2009. If the reduction in the VAT rate on food is carried over into consumer prices as anticipated, then the rise in the consumer price index may slow to around 2% at the end of the year. In 2009 the index will go up by an average of around 2½%.

With the rise in labour costs and slowing productivity trends, competitiveness in manufacturing will continue to decline in most branches during 2008. The outlook for 2009 is much the same: in sectors other than the electrotechnical industry, competitiveness may already drop below the long-term average.

The estimates on economic growth and associated factors for 2008–2009 presented in Table 1 are based on the amended budget proposal published by the Ministry of Finance in November this year. The basic assumptions in the forecasts are in line with the Commission's estimates. The impact of the risks related to economic developments on actual performance in general government is discussed under section 4.1 below.

Table 1a. Macroeconomic prospects

	2007	2007	2008	2009	2010	2011	2012
	EUR bn	change, %					
1. Real GDP		4.5	2.6	0.6	1.8	2.4	2.2
2. Nominal GDP	179.7	7.6	6.3	2.5	3.9	4.5	4.2
Components of real GDP							
3. Private consumption expenditure	90.6	3.2	3.0	1.8	2.3	2.2	2.0
4. Government consumption expenditure	38.2	1.3	1.6	1.8	1.4	1.5	1.5
5. Gross fixed capital formation	32.2	8.5	2.1	-2.7	-1.5	2.6	2.1
6. Changes in inventories (% of GDP)	3.6	2.0	2.8	2.5	2.5	2.5	2.5
7. Exports of goods and services	82.2	8.2	3.4	-0.4	4.0	5.0	4.5
8. Imports of goods and services	73.1	6.6	3.0	0.0	3.4	4.0	3.5
Contributions to real GDP growth, % points							
9. Final domestic demand	165.3	3.6	2.3	0.8	1.2	2.0	1.8
10. Changes in inventories	3.6	-0.1	0.0	0.0	0.2	-0.1	-0.2
11. External balance of goods and services	9.1	1.1	0.3	-0.2	0.4	0.6	0.6

Table 1b. Price developments

	2007	2008	2009	2010	2011	2012
	change, %					
1. GDP deflator	2.9	3.6	1.8	2.1	2.0	2.0
2. Private consumption deflator	2.2	4.2	2.2	1.9	2.0	2.0
3. HICP	1.6	4.0	2.3	1.9	2.0	2.0
4. Public consumption deflator	3.4	4.6	3.7	3.5	3.0	3.0
5. Investointien hinta	4.5	3.7	-0.9	2.0	2.0	2.0
6. Export price deflator	0.7	1.2	-1.2	1.5	0.5	0.0
7. Import price deflator	2.1	4.1	-2.0	1.8	1.0	1.0

Table 1c. Labour market developments

	2007	2007	2008	2009	2010	2011	2012
	level	change, %					
1. Employment, 1 000 persons	2492	2.0	1.5	-1.1	-0.2	0.2	0.1
2. Employment, 1 000 hours worked	4262	1.9	1.2	-1.1	-0.4	0.0	-0.1
3. Unemployment rate		6.9	6.3	7.1	7.2	6.8	6.6
4. Labour productivity, persons		2.5	1.2	1.8	2.0	2.2	2.1
5. Labour productivity, hours worked		2.5	1.4	1.7	2.2	2.4	2.3
6. Compensation of employees	68.4	5.9	7.2	4.0	4.8	4.2	4.1
7. Compensation per employee		3.8	5.7	5.1	5.0	4.0	4.0

Table 1d. Sectoral balances

	2007	2008	2009	2010	2011	2012
	% of GDP					
1. Net lending/borrowing vis-à-vis the rest of the world	5.4	4.0	3.6	3.7	3.9	3.9
of which:						
- Balance on goods and services	5.1	4.0	4.0	4.2	4.4	4.4
- Balance of primary incomes and transfers	0.3	-0.1	-0.5	-0.6	-0.6	-0.6
- Capital account	0.1	0.1	0.1	0.1	0.1	0.1
2. Net lending/borrowing of the private sector	1.2	0.8	2.6	3.7	4.0	4.1
3. Net lending/borrowing of general government	5.3	4.4	2.1	1.1	1.0	0.9
4. Statistical discrepancy	-1.1	-	-	-	-	-

Table 1e. Basic assumptions*

	2007	2008	2009	2010
Short-term interest rate (3 month money market)	4.3	4.6	3.5	4.1
Long-term interest rate (10 year government bonds)	4.3	4.1	4.0	4.1
USD/EUR exchange rate	1.4	1.5	1.4	1.4
Nominal effective exchange rate	2.1	3.9	-0.5	-0.1
World GDP growth	4.9	4.3	2.9	3.8
EU-27 GDP growth	2.9	1.4	0.2	1.1
GDP growth of relevant foreign markets	8.7	6.4	4.0	5.1
World trade growth	7.1	5.3	2.4	4.0
Oil prices (Brent, USD/barrel)	70.9	104.0	85.7	90.4

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

2.2 Medium-term macroeconomic scenario

The basic factors driving economic growth in Finland are set to change around the turn of the decade. Although the cyclical situation can be expected to normalise, population ageing will begin to constrain economic growth as early as the beginning of the next decade. Statistics Finland population projections indicate that the working-age population (ages 15–64) will start to decline from 2010. Various structural reforms have been undertaken to prepare for the challenges of population ageing: one example is the 2005 pension reform, which indeed has greatly increased the labour participation rate in older age groups. Nevertheless the changes in the population age structure are so profound that the numbers in employment are expected to begin to decrease as early as 2009 and to continue steadily to decline thereafter. The economic downturn will also constrain the supply of labour over the next few years and may persuade people to retire early.

Medium-term growth prospects are here reviewed using the production function method adopted by the EU Commission and Member States. The method illustrates economic growth potential by forecasting the development of various supply factors, such as labour and capital, and exploring productivity projections. The baseline scenario produced by the method involves a number of uncertainties, not least in the current economic situation where growth is sharply decelerating before supply constraints set in. This is why it is necessary to consider not only the baseline scenario, but alternative growth prospects, too. Chapter 4.1 describes both the baseline scenario as well as slower and faster growth scenarios.

In the medium term it is projected that economic growth in Finland will begin gradually to accelerate after a very slow start to 2009. This, however, will only be possible if the global economy rebounds and if Finland's major export markets return to a growth track. Due to the declining labour supply and other structural factors, it is projected that by 2012, GDP growth in Finland will slip back to around two per cent again. Supply constraints are threatening to permanently damage the growth potential of the economy unless labour input can be increased by extending labour market careers or through immigration, for instance.

Annual exports growth is projected to accelerate to around 4–5% from 2010, as demand in the global economy picks up again. It is also expected that private consumption will rebound after a period of slower growth next year. In the medium term, however, the growth of private consumption will be dampened by household indebtedness. On the other hand consumer purchasing power will be boosted in the years ahead by the rise in earnings levels and income tax cuts.

Despite the loss of industrial jobs, the numbers in employment have grown sharply in recent years. With the structural changes of the economy, new jobs

have been created especially in the service sector. However, medium-term growth projections will not create opportunities for employment to improve at the same rate over the next few years. The labour market situation is exacerbated by the economic downturn, which is why the numbers employed are expected to increase by no more than just over 10,000 during the Government's term in office. Following the dip in 2009–2010, it is expected that the numbers employed will begin to rise again, but because of the shrinking size of the labour force this increase will remain moderate. The projected unemployment rate for 2012 is 6½%, and the employment rate is expected to stand at 70%.

3 General government balance and debt

3.1 Fiscal policy strategy and medium-term budgetary objective

Finland's medium-term budgetary objective set out in this Stability Programme update is a general government structural surplus of 2% of GDP. As in recent years, Finland will reach this objective during the early stages of the programme period. Nevertheless the general government structural surplus is fast disappearing, and by the end of the programme period it will fall short of the target unless new measures are introduced. The Government is prepared to take corrective action if this surplus target is jeopardised.

The deeper and the more prolonged the slowdown in the global economy, the more important it is that the domestic economy sits on solid pillars, i.e. that public finances and competitiveness are strong. The objective set out in the Government Programme is by means of employment-enhancing reforms to secure a structural surplus in central government finances equivalent to 1% of GDP by the end of the government term, i.e. 2011. Taking account of the projected developments in local government finances and social security funds, this is equivalent to a structural surplus of around 3½% at the level of general government. In line with this, the Government is aiming at structural surplus of 3½% of GDP by the end of the electoral term in 2011.

It is the Government's intention to schedule its expenditure increases and tax cuts in such a way that the cyclical stability of the economy is not jeopardised and that the surplus target will be reached. Tax policy measures will be gauged so that neither the long-term sustainability of public finances nor the commitments included in Finland's Stability Programme are put at risk. Moreover, the Government Programme states that central government finances must never show a deficit of more than 2½% of GDP even in an exceptionally weak economy. Bearing in mind the surplus in social security funds, this means that overall general government finances have to be kept more or less in balance.

The baseline scenario presented in the Stability Programme takes account of the 2009 budget proposal, the additional expenditure stemming from the decisions made in the context of the amendment to the budget proposal on 20 November 2008, and the main foreseeable on-budget spending pressures and tax decisions. The projected general government surplus for 2012 is estimated at 0.9% of GDP, leaving the central government deficit at 1.2% of GDP. In the light of this scenario, then, the target of a one per cent structural surplus set out in the Government Programme will not be reached.

Even the achievement of the baseline scenario of general government balance outlined in this Stability Programme is not yet enough to ensure the long-term sustainability of public finances. In the medium term, sustainability would require an estimated surplus ratio of around 4% of GDP. There are various economic policy options and combinations that can be used to bridge the sustainability gap. Besides prudent budget policy, sustainability in public finances can be strengthened by implementing structural reforms that boost productivity in the public sector, improve the sustainability of the pension scheme or perk employment.

During the Government's term in office an assessment will be conducted to determine whether sustainable provision has been made for population ageing. Any necessary action will be undertaken while the present Government is still in office. Sustainability calculations are presented in chapter 6 of this update.

In view of the pressures that are anticipated on public finances, the Government is committed to undertake structural reforms that will bolster general government sustainability and to pursue responsible spending and tax policies. For reasons of general government sustainability it is crucial that the employment rate is improved. Greater occupational and regional labour mobility is necessary to ease the problem of labour market mismatches. Social security and education reforms are also needed to lower structural unemployment.

The Government is committed to staying within the multi-annual spending limits adopted on 25 May 2007 and revised in March 2008. Projects and measures set out in the Government Programme will only be implemented so far as is possible within the spending limits. Efforts will be continued to improve public sector productivity through the restructuring of municipalities and services and the Government productivity programme. This will create a more efficient public sector, and labour resources in the public sector will be allocated to better respond to the needs arising from population ageing.

Next year's tax cuts on labour that are aimed at fostering job creation, as set out in the Government Programme, fit in well with the weakening cyclical outlook. Overall, with the tax reforms that are incorporated in the draft budget, fiscal policy in 2009 clearly supports aggregate demand and growth. The tax cuts will have the effect of increasing household purchasing power and reducing the tax wedge and thus of improving incentives for work and for commissioning work and encouraging moderate wage settlements.

3.2 General government financial position and public debt

In 2008–2012 the surplus in general government is estimated to average 2% of GDP. It is projected that by the end of the period under review, the EMU debt ratio in public finances will climb to around 34½%. Finland meets the objectives of the Stability and Growth Pact both in terms of the general government surplus ratio and the debt ratio.

Output growth is set to slow considerably in 2009. The bleaker cyclical outlook will also be reflected in the development of tax revenue. Apart from the cyclical downturn, the impending demographic change will also be driving up public expenditure during the period under review. Indeed the surplus in public finances will be shrinking from its current high level during this period. Central government will bear most of the brunt, with its fiscal position weakening by almost 2½ percentage points during the programme period.

However, the Government has decided in its programme to increase the supply of labour and to take other measures in a bid to bolster economic growth. This would strengthen the fiscal position of central government and improve the sustainability of general government. In Finland the surplus in general government will continue to depend mainly on employment pension funds. With the acceleration of pension expenditure, however, the surplus in employment pension funds will begin to shrink even in the medium term. During the current year the surplus in social security funds will amount to 3% of GDP, and is expected to drop to around 2½% by 2012. With the exception of the current year, aggregate central and local government finances will show a deficit throughout the programme period.

Local government finances have shown a slight deficit throughout the 2000s, and total local government debt has doubled since the turn of the decade. However, robust economic growth in recent years has brought a marked increase in tax revenue, although at the same time local government spending has spiralled. The fiscal position in local government will improve and reach balance during 2008, and the growth of the debt stock will slow. Despite the overall improvement in local government finances, there remain marked differences in the financial position of individual municipalities.

In 2009 municipal finances will decline but still remain close to balance. The impacts of the ongoing downturn will be more acutely felt in municipal finances in 2010, especially as local government expenditure will continue to rise sharply on the back of large pay rises. However it is expected that the number of poorly performing municipalities will start to rise as early as 2009. In the medium term the stability of municipal finances is also under threat from weakening longer-term growth prospects coupled with growing service needs. Implementation of the municipal and service structure reforms, the labour shortage and

high investment pressures may drive up local government expenditure even more than projected. Unless local government expenditure is curtailed and investment is revised with a view to sustainability and timeliness, municipal finances will be at real risk of slipping into permanent deficit and a continued cycle of indebtedness.

3.3 Cyclically adjusted balance in general government finances

Based on the production function method used by the EU Commission and Member States, the potential output of the Finnish economy has grown at just over 3% per annum. However it is forecast that growth in potential output will slow to around 1½% by 2012. This is mainly due to the fact that the working-age population is beginning to decline. Therefore, in the future, output growth potential will rely primarily on improving productivity.

During the upswing in recent years, the Finnish economy has grown much faster than its output potential. However, following the recent economic turnaround, it is projected that growth will remain considerably slower than potential output growth, both this year and next. The difference between actual and potential output, or the output gap, will consequently turn negative. The output gap will begin to shrink again after 2010, but it is not believed it will have closed completely by 2012. In other words, the projection is that actual output in 2012 will still be lower than the level of potential output. It is important to bear in mind, though, that calculations of potential output and the output gap involve uncertainty, which is mainly attributable to the uncertainty surrounding economic and labour market trends over the next few years as well as the impending structural changes associated with population ageing.

The slowdown in output growth will also be reflected in general government and central government balances, which will be down both this year and next. The impact of discretionary fiscal policy on general government balance can be assessed by taking out the cyclical influences from the general government surplus. Over the past few years of strong growth, the cyclically adjusted balance has improved, but projections are that in 2008 the cyclically adjusted surplus will take a downward turn and that next year it will decrease by an amount equivalent to more than one per cent of GDP.¹ This will be primarily as a result of cuts in income taxes and a lower VAT rate on food. In the weak economic conditions that lie ahead, therefore, the fiscal policy pursued can be described as clearly expansionary.

¹ The cyclically adjusted balance is computed by using estimates of the output gap and OECD income and expenditure elasticity estimates. However there is always an element of uncertainty in elasticity estimates, particularly at times of cyclical change. For instance, it is difficult to take account of all timing-related factors of tax accruals.

Table 2. General government budgetary prospects

	2007 EUR million	2007	2008	2009	2010	2011	2012	
		% of GDP						
Net lending by sub-sector								
1..	General government	9 584	5.3	4.4	2.1	1.1	1.0	0.9
2.	Central government	3810	2.1	1.2	-0.4	-1.3	-1.2	-1.2
3.	-							
4.	Local government	-137	-0.1	0.1	-0.1	-0.2	-0.2	-0.3
5.	Social security funds	5911	3.3	3.1	2.6	2.6	2.5	2.5
General government								
6.	Total revenue	94539	52.6	51.4	50.3	49.7	49.4	49.4
7.	Total expenditure	84955	47.3	47.0	48.2	48.6	48.4	48.5
8.	Net lending/borrowing	9584	5.3	4.4	2.1	1.1	1.0	0.9
9.	Interest expenditure	2605	1.4	1.5	1.3	1.3	1.2	1.3
10.	Primary surplus	12189	6.8	5.8	3.4	2.4	2.2	2.3
Selected components of revenue								
11.	Total taxes (11=11a+11b+11c)	55 829	30.8	30.0	29.3	28.7	28.4	28.3
11a.	Taxes on production and imports	23 836	13.0	12.7	12.7	12.2	12.0	11.9
11b.	Taxes on income	31 534	17.5	17.1	16.4	16.3	16.1	16.1
11c.	Capital taxes	459	0.3	0.3	0.2	0.2	0.2	0.2
12.	Social security contributions	21624	12.0	11.7	11.8	12.1	12.1	12.2
13.	Property income	7 788	4.3	4.3	3.8	3.8	3.7	3.7
14.	Other income (14=15-11-12-13)	9 298	5.4	5.3	5.4	5.2	5.2	5.2
15. = 6.	Total revenue	94539	52.6	51.4	50.3	49.7	49.4	49.4
	p.m.: Tax burden	76 992	42.6	41.5	40.9	40.5	40.3	40.3
Selected components of expenditure								
16.	Collective consumption	12 797	7.1	7.1	7.4	7.4	7.3	7.3
17.	Total social transfers (17=17a+17b)	52 491	29.2	29.1	30.1	30.6	30.7	30.8
17a.	Social transfers in kind	25 357	14.1	14.1	14.5	14.7	14.8	14.9
17b.	Social transfers other than in kind	27 134	15.1	15.0	15.6	15.9	15.9	15.9
18. = 9.	Interest expenditure	2605	1.4	1.5	1.3	1.3	1.2	1.3
19.	Subsidies	2 197	1.2	1.2	1.2	1.2	1.2	1.2
20.	Gross fixed capital formation	4 647	2.6	2.6	2.5	2.5	2.4	2.3
21.	Other expenditure (21 = 22 -16-17-18-19-20)	10218.0	5.7	5.5	5.7	5.6	5.6	5.5
22.	23. = 7. Total expenditure	84955	47.3	47.0	48.2	48.6	48.4	48.5
	of which: Government consumption	38154	21.2	21.2	21.9	22.1	22.1	22.2

Table 3. General government debt developments

	2007	2008	2009	2010	2011
	% of GDP				
1. Gross debt, % of GDP	35.1	32.4	33.0	33.7	34.1
2. Change in gross debt, % points	-4.1	-2.7	0.6	0.7	0.4
Contributions to changes in gross debt, % points					
3. Primary balance	6.8	5.8	3.4	2.4	2.2
4. Interest expenditure	1.4	1.5	1.3	1.3	1.2
5. Stock-flow adjustment	1.2	1.7	2.7	1.8	1.4
of which:					
- Net acquisition of financial assets	3.9	3.2	2.9	2.9	2.8
- of which: privatisation proceeds	-0.2	-0.2	-0.2	-0.2	-0.2
- Valuation effects (incl. impact of GDP growth)	-2.7	-1.6	-0.3	-1.1	-1.4
Implicit interest rate on debt (= consolidated interest expenses divided by the previous year's debt level multiplied by 100)	4.0	4.2	4.0	4.2	3.7
Other variables					
6. Liquid financial assets	91.1	-	-	-	-
7. Net financial liabilities (7=1-6)	-56.0	-	-	-	-

Table 4. Cyclical developments

	2007	2008	2009	2010	2011	2012
	% of GDP					
1. Real GDP growth (%)	4.5	2.6	0.6	1.8	2.4	2.2
2. Net lending of general government	5.3	4.4	2.1	1.1	1.0	0.9
3. Interest expenditure	1.4	1.5	1.3	1.3	1.2	1.3
4. Potential GDP growth (%)	3.1	3.3	2.7	2.3	1.8	1.5
contributions:						
- labour	0.4	0.6	0.2	0.0	-0.3	-0.5
- capital	0.7	0.7	0.6	0.4	0.2	0.1
- total factor productivity	2.0	1.9	1.9	1.9	1.9	1.9
5. Output gap	1.5	0.9	-1.1	-1.7	-1.1	-0.4
6. Cyclical budgetary component	0.7	0.4	-0.6	-0.8	-0.5	-0.2
7. Structural financial balance (2-6)	4.6	3.9	2.7	2.0	1.6	1.1
8. Structural primary balance (7+3)	6.0	5.4	4.0	3.3	2.8	2.4

4 Sensitivity analysis and comparison with previous programme

4.1 Risks in economic developments and risk impact on public finances

There is considerable uncertainty in the economic outlook right now, chiefly as a result of the problems in the world's financial markets that escalated during the course of this autumn and spilled over into the real economy. However the Finnish economy is relatively well placed to face the downturn. Its price competitiveness is strong, as are business balance sheets. The banking sector is also in a healthy shape. Employment has improved at an exceptional rate in recent years, and the improved labour market situation has also helped to reduce structural unemployment. With the public finances in surplus, there is enough room for automatic fiscal stabilizers to operate. Overall then, the economy has a reasonably good chance of withstanding the volatility in the financial markets and the problems in the real economy.

The medium-term outlook, however, is susceptible to certain risks. For the Stability Programme's baseline scenario to materialise, the international downturn must remain short-lived and the global economy must rebound in 2010. If, on the other hand, the problems in the financial markets continue to spread and if the uncertainty persists, that could well have a greater than anticipated impact on the growth prospects for the immediate future. If the international downturn is protracted or if it becomes deeper and more severe than expected, this is bound to affect the Finnish economy as well, primarily through impacts on export prospects, business investment and household consumption behaviour.

The deterioration of the labour market situation and the fall in asset prices may persuade households to be even more cautious in their spending. In recent years households have been spending their disposable income more liberally,

and the savings rate has dropped to an exceptionally low level. Already the average household debt ratio is over 100% of disposable income – although this is no more than the European average. However, household assets and debts are very unevenly distributed. Some households have accumulated so much debt that the burden of repayment is beginning to limit their consumption.

Apart from the risks associated with the global economy, Finland's economic outlook for the next few years is overshadowed by concerns of its industry's price competitiveness, particularly in sectors with weaker productivity. In recent years nominal wage increases in Finland have been higher than in the EU on average, but this has not had any dramatic effect on competitiveness since the rise in costs has been offset by robust economic growth twice the European average. However during this year and next, productivity growth is set to drop below the customary rate, at the same time as nominal wages will be rising at an exceptional rate. Earnings will continue to rise quickly in the medium term, too. Although it is projected that inflation will slow next year, there is the risk that the next round of wage negotiations will seek to achieve wage increases sufficient to offset this year's exceptionally sharp rises in price levels, and food prices in particular. Another potential source of pressure during the next round of negotiations comes from the differences between the pay rises prescribed in the current wage settlements for the open and closed sector.

The nominal wage increases agreed upon in recent years are set to drive up public consumption expenditure and pose a risk to the stability of municipal finances in particular. The loss of economic momentum is reflected in local government revenue almost immediately, whereas the pay rises mean that expenditure growth in local government will remain high over the next few years. In the future, the increasing shortage of labour may lead to higher-than-anticipated wage and outsourcing expenditure. Furthermore, implementation of the municipal and service structure reforms may have an even greater impact on local government expenditure than projected.

Combating and adjusting to climate change poses a huge challenge to the national economy. In the long term these commitments detract from the economy's growth potential and undermine competitiveness, even though in the short term they may increase investment in renewable energy and energy-saving measures. In the process of drafting the government's climate and energy strategy, it has been estimated that full implementation of the EU's climate and energy package will reduce Finnish GDP in 2020 by almost one per cent as compared to the baseline scenario. Beyond 2012, the financial implications of the Convention on Climate Change pose a further challenge for Finland. Preliminary estimates are that the total costs of the new agreement may amount to 0.3–0.5% of global GDP.

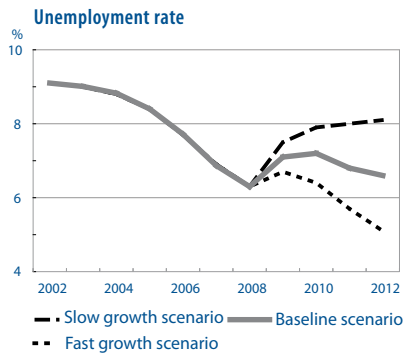
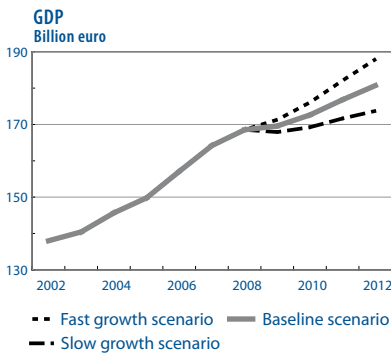
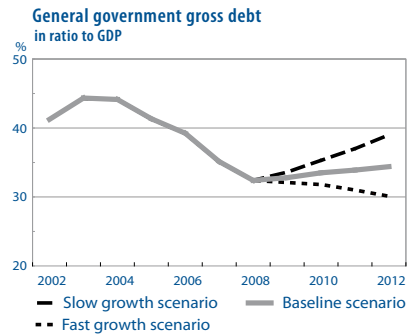
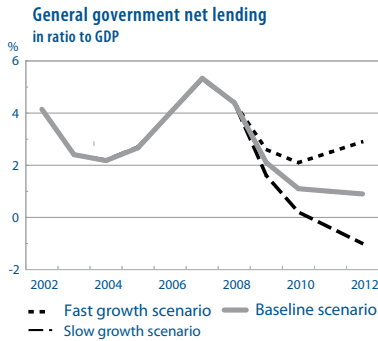
Projections of the medium-term outlook are based on the production function method as used by the EU Commission and EU Member States, with a view to evaluating potential output growth. The method involves a number of uncer-

tainties that are further accentuated by the impending structural changes associated with population ageing. Indeed the biggest risks related to medium-term projections are related to employment and productivity trends. If the downturn is protracted, that may adversely impact demand for labour and have a greater than anticipated effect on the supply of labour, bringing forward the drop in labour supply triggered by population ageing.

The figures below illustrate the impacts 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, output growth would increase by just over 1% at the end of the review period. The unemployment rate would climb to over 8% by 2012. General government would go substantially into deficit, and the debt ratio would go up to around 39%. This would seriously undermine the sustainability of general government finances as the population continues to age. The impacts of economic growth on general government finances are gauged by using OECD elasticity estimates.

If economic growth were faster than the baseline scenario throughout the period under review, the unemployment rate would drop to around 5% and the general government surplus would rise to almost 3%. The debt ratio would fall to around 30% by 2012. However, this faster growth scenario can only be achieved if the labour supply increases and if structural unemployment is reduced over the longer term. Additionally, labour market careers should be further extended, immigration and labour mobility should increase and labour market mismatch problems should be eased. In the absence of structural reforms to increase the supply of labour and to improve the efficiency of labour markets, supply constraints will hinder faster than baseline growth.



4.2 Comparison with last year's Stability Programme update

Last year's Stability Programme update predicted GDP growth for 2007 at 4.4%, which is very close to current preliminary figures for actual growth (4.5%). As in previous years, economic growth was robust and broad-based. Exports and investment growth actually exceeded last year's forecasts, whereas it looks like private consumption growth will come in slightly below estimate.

At the time that the previous Stability Programme update was being drafted, the picture of the problems that were brewing in the financial market and their impact on the real economy was still fragmented and incomplete. For this reason the forecasts put forward last year for GDP growth in 2008–2010, in the light of what we know today, seem overly optimistic. The upswing in the global economy has peaked and the world economy and trade are growing more slowly than projected last year. The deteriorating global economic outlook is also

reflected in the outlook for the Finnish national economy, which has become more depressed since last year's update. In particular, exports and investment growth will slow more sharply than projected in the previous Stability Programme update.

Employment has improved at an exceptional rate during the upswing in recent years, and it is expected that the number of employed people will still rise by more than 35,000 this year. On the other hand as the downturn gathers pace both at home and in Finland's major export markets, employment will inevitably decrease next year. For the same reason the unemployment rate will be much higher over the next years than previously forecast.

Inflation has accelerated significantly compared to last year's forecast. Together with the rise in labour costs and other factors, pent-up pressures on food prices resulting from the long-term contracts in industry and trade caused an exceptionally sharp rise in inflation during 2008. Cost pressures deriving from labour costs will remain intense in 2009 as well. By contrast the increase in consumer prices will slow in 2009–2010, assuming that the reduction in the VAT rate on food in October 2009 is carried over into consumer prices as anticipated.

Estimates for general government surplus in 2007–2008 are stronger than the forecasts made in the previous Stability Programme. Part of the change, some 0.3 percentage points in 2007, is due to a technical change in national accounting whereby the distinction between capitalised property income from investment funds and changes in appreciation of assets is redefined. Another underlying factor is central government property income, which has almost doubled since 2005. The figure for 2008 will still reach record levels, partly due to certain non-recurring factors. However, because of the current cyclical situation, tax decisions adopted earlier and other reasons, the central government surplus will shrink rapidly and from 2009 will remain weaker than predicted last year.

The gloomier economic outlook is also reflected in local government finances, which are weaker than the forecast last year. In line with the adjustments made to the surplus estimates for general government, the estimated debt ratio has been lowered for 2007–2008 and increased for later years.

Table 5. Divergence from previous update

	2007	2008	2009	2010	2011	2012
Real GDP growth (%)						
SP-2007	4.4	3.3	3.0	2.5	2.1	-
SP-2008	4.5	2.6	0.6	1.8	2.4	2.2
Difference, % points	0.1	-0.7	-2.4	-0.7	0.3	-
General government net lending (% of GDP)						
SP-2007	4.5	3.7	3.6	2.8	2.4	-
SP-2008	5.3	4.4	2.1	1.1	1.0	0.9
Difference, % points	0.8	0.7	-1.5	-1.7	-1.4	-
General government gross debt (% of GDP)						
SP-2007	35.3	32.8	30.4	29.0	27.9	-
SP-2008	35.1	32.4	33.0	33.7	34.1	34.6
Difference, % points	-0.2	-0.4	2.6	4.7	6.2	-

Previous update: Stability Programme update, November 2007

Current update: Stability Programme update, November 2008

5 Quality of public finances

5.1 Government policy

To ease the pressure on public finances caused by population ageing, the Government aims to improve the capacity of the economy by pursuing sound spending and tax policies. The Government plans to foster labour supply, improve the efficiency of the labour market and reduce structural unemployment by means of targeted increases in appropriations, tax cuts and structural reforms. Growth in public spending will be curbed by enhancing public sector efficiency and by boosting productivity. The main instruments in this context are the restructuring of municipalities and services and the Government productivity programme.

This Stability Programme update is in line with National Reform Programme for Finland published in October 2008. The NRP only incorporates reforms included in the Government Programme or which the Government has decided to implement during its term in office. All the reforms listed in the NRP are contained within the Government spending limits and have thus been taken into account in the baseline scenario presented in the Stability Programme.

5.2 General government revenue and taxation

As outlined in the Government Programme of spring 2007, the Government is committed to promoting employment and productivity by means of tax policy, chiefly by cutting taxes on labour. According to the Government Programme overall taxes on labour should be reduced by a total of EUR 1.1 billion during the current electoral term. The aim is to carry out the tax cuts recorded in the Government Programme in such a way that taxation truly does ease by EUR 1.1 billion. The bulk of this, i.e. EUR 870 million, is scheduled for 2009. If tax rates were not adjusted at all, taxation would increase as a result of rising earnings levels and the progressive tax system. The changes in tax rates necessary to offset the tax-raising effects of higher earnings levels would reduce tax revenue in 2009–2010 by around EUR 500 million per annum. The impacts on tax revenue of the corresponding tax base changes necessary in 2011–2012

would be somewhat lower at EUR 400 million, as the rise in earnings levels is expected to slow down.

The 2009 budget proposal cuts taxes on labour by a total of EUR 1.37 billion. Income taxes will be cut in all income brackets. When the tax-raising effects of higher earnings levels and the progressive tax system are taken into account, the net effect of the tax cuts in 2009 is estimated at EUR 870 million. Furthermore, the calculation is performed with the assumption that in addition to the tax cuts for 2010–2011 derived from higher earnings levels, the tax rates will be adjusted by EUR 100 million per annum: this would bring the total amount of the genuine tax cut to the figure of EUR 1.1 billion specified in the Government Programme.

If the tax-raising effects of higher earnings levels and progressive taxation are eliminated, this together with the tax cuts set out in the Government Programme would have the effect of reducing revenue from labour taxation by a total of EUR 2,870 million in 2009–2012. The Government will decide on the magnitude of its tax cuts for the remainder of the electoral term in connection with its mid-term review at the beginning of 2009.

In certain income bands taxes on pensions have so far been higher than taxes on earned income. In 2008 the taxation of pensioners was eased so that in all income bands tax rates for pension income will be no higher than the corresponding tax rate for earned income. The reduction of taxes on pensions next year will reduce tax receipts by over EUR 200 million.

In the calculation here, the tax revenue base for earned income consists of wage, pension and capital income. In 2008–2012, wage and capital income will increase on average by 4½% per annum. However in the medium term the increase in the volume of taxable income will slow. The growth of wage income will slow down towards the end of the programme period as the rise in earnings levels slows and the numbers employed take a slight downward turn. The growth of pension earnings will continue at a relatively high pace in the medium term as the number of pensioners continues to rise with population ageing.

On the back of a sustained period of economic upswing, capital income growth has been exceptionally strong in recent years. As a result of the cyclical downturn, capital income will decrease both this year and next. The decline in capital income will be intensified by the sharp fall in prices of securities, which will also be reflected in capital gains development. Furthermore, it is projected that general government dividend income will shrink next year as businesses will be generating lower profits than earlier. The medium-term projection for capital gains is based on a straightforward assumption of 2½% growth. In other words it is expected that in the medium term capital income will continue to increase, although much more moderately than earlier.

Under the Government Programme, the tax base for corporate taxation will remain contained and any changes that might jeopardise the competitiveness of Finnish businesses will be avoided. In recent years revenue from corporate

taxation has developed favourably. The economic slowdown will be reflected in corporate tax revenue with some delay. It is projected that corporate tax revenue will drop by around 5% next year. Towards the end of the programme period tax revenue will increase by an annual average of 4%. This, however, requires that productivity will continue to remain reasonably strong.

Private consumption has grown rapidly in the past few years. Household indebtedness has reached a record high. Coupled with these high debt levels, lowered household confidence in the future is undermining medium-term growth prospects in private consumption. As a result, the growth of VAT and other indirect tax revenue will also slow appreciably in the medium term. Annual VAT revenue will also be dented by the 5% reduction in the VAT rate on food as of October 2009, which will reduce tax receipts by EUR 500 million. Furthermore, the proposed introduction of a tax account system from the beginning of 2010 would reduce VAT receipts. This system is intended to facilitate the reporting and payment of taxes, the monitoring of tax payments and at a later stage the collection of overdues. If the system is put into place, its introduction will cause a one-off loss in tax receipts of around EUR 400 million.

Taxes on all alcoholic beverages will be increased by 10% from the beginning of 2009, increasing central government tax revenue by an estimated EUR 65 million a year. In the medium term revenue growth from energy taxes will remain somewhat slower than total output growth. As a result the ratio of taxes on production and imports to GDP will continue to fall somewhat in 2010–2012. Together, the slowdown of domestic demand and the tax cuts will have the effect of depressing the growth of central government tax revenue to around 2% in 2008–2012.

Local government tax receipts increased on average by 6½% in 2005–2007. This growth will still be robust during the current year, but then grind to a virtual halt in 2009 as corporate tax revenue begins to fall, lowered employment reduces the tax base and income tax cuts are partly implemented through municipal taxation. In 2010–2012, it is projected that tax revenue will increase by around 4% a year. However, the growth of local government tax revenue could fall significantly short of this if employment trends are weaker than expected. Furthermore, the risk of a weaker economic development has increased most particularly in municipalities that rely heavily on corporate tax revenue.

Over half of all basic municipal services are financed through local government tax receipts. In 2007, total local government tax revenue amounted to EUR 16.4 billion. The bulk or 85% came from municipal taxes. Corporate taxes accounted for just under 10% of total tax revenue and real estate tax receipts for 5%. In 2008 the average municipal income tax rate is 18.55%. Over the past 10 years this rate has gone up on average by around one percentage point, with around 100 local municipalities increasing their tax rates each year. Preliminary figures for 2009 indicate that the tax rate will increase by 0.04 percentage points. In the wake of the economic downturn it is likely that local government tax rates will widely increase after 2009 as well.

Central government transfers to local government increased considerably in 2008 among other things as a result of the revision of the distribution of costs between central and local government and a substantial index adjustment. In 2009, too, central government transfers will rise considerably as local authorities are fully compensated for the loss of tax revenue from tax cuts and as support for municipal amalgamations is significantly stepped up.

The development of social security funds is determined by macroeconomic trends on the basis of current legislation and known forthcoming changes in that legislation. The unemployment insurance contributions of both employers and employees will decrease in 2009. It is expected that the employment pension contribution rate will be raised with a view to population ageing and the acceleration of employment pension expenditure. Consequently, in the medium term, social security contributions as a percentage of GDP are set to increase somewhat.

5.3 General government expenditure

In the early 1990s general government expenditure increased 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 then edged down to 50% in 2005. Measures to restore general government finances and the onset of rapid economic growth changed the course of developments in the mid-1990s.

General government expenditure to GDP has continued to fall in 2006–2008. Since 2005, public expenditure has gone up by 13%, which is markedly less than total output growth, which is up by more than one-fifth. Nevertheless the ratio of public expenditure to GDP remains high in Finland when compared to many other EU countries. In 2009, under conditions of economic downturn, the ratio will start to increase again. Public spending will increase mainly in 2008; in 2009–2012 the growth will slow down again. Overall general government expenditure to GDP is expected to remain fairly stable through the planning period.

It is projected that aggregate central government expenditure will increase by about 7% in 2008, which would be the highest figure in 15 years. The reason for this lies in the large number of ongoing transport infrastructure projects, relatively high pay rises and the general acceleration of prices. As a result of the revised distribution of costs between central and local government, indexations and other factors, central government transfers to local government will increase by one-tenth. In 2009 the growth of central government expenditure is expected to slow, but still remain faster than in 2003–2007.

Most of the spending increases earmarked in the Government Programme for this electoral period will be allocated to health care and welfare services,

current transfers and to promoting knowledge and skills. In particular, funds will be made available to strengthen primary health care, increase staffing levels in home care and institutional care for the elderly, increase and develop the coverage and support available to family carers, and to support R&D. In addition, appropriations will be allocated to renovation, business ventures and to financing exports. Personnel in central government will be reduced during the planning period as outlined in the Government productivity programme, which will slow the growth of consumption expenditure.

All told, on-budget expenditure in 2009–2012 is projected to rise by just over 3% and in real terms by around ½% per annum.

Local government consumption expenditure is expected to grow by 1½% in real terms both this year and next. In nominal terms consumption expenditure is expected to rise by 6½% and 5%, respectively. The growth of nominal consumption expenditure is accelerated particularly by the rise in earnings levels, which will impact local government finances not only through higher expenditure on personnel wages but also through higher costs on purchased services. In addition, the general rise in price levels is driving up the costs of acquisitions in local government.

In the medium term, too, local government expenditure growth will remain strong as population ageing begins to increase the demand for services and as the rise in earnings levels in the local government sector is projected to remain high. Furthermore, the large number of municipal amalgamations and the increase in central government transfers to support these amalgamations will drive up local municipalities' expenditure in the transitional stage. On the other hand the expenditure pressures in local government will be eased from 2009 by the reduction of pension insurance contributions and the transfer of certain local government functions to central government.

In 2010–2012, local government consumption expenditure is expected to increase nominally by just over 5% per annum. Because of the changing population age structure, expenditure on health care and services for the elderly will increase by around one per cent per annum, assuming that the use of health care services in different age groups remains unchanged from 2008. The situation is quite the opposite in education expenditure, which will decrease in real terms by an annual average of 0.7% up to 2012.

When the growth of service needs is coupled with the simultaneous ageing of personnel in the local government sector, labour shortages and the consequent wage pressures, the costs of services may rise much more sharply than indicated by the changing population structure alone. Along with the growth of expenditure in operating finances, investment pressure in local government is also set to remain high because of the need for infrastructure investment in centres of growth, the investments required by implementation of structural reforms, and the high need for renovations and repairs throughout the local government sector.

The proportion of social security expenditure is expected to start rising around the turn of the decade. Population ageing and the related increase in pension and care and nursing expenditure means that the proportion of health care and social welfare expenditure is likely to increase in the longer term, too.

Table 6. General government expenditure by function

	COFOG-division	2006	2011
		% of GDP	
1. General public services	1	6.5	6.1
2. Defence	2	1.5	1.3
3. Public order and safety	3	1.5	1.3
4. Economic affairs	4	4.5	4.2
5. Environmental protection	5	0.3	0.3
6. Housing and community amenities	6	0.3	0.3
7. Health	7	6.8	7.1
8. Recreation, culture and religion	8	1.1	1.1
9. Education	9	5.8	5.8
10. Social protection	10	20.4	20.8
11. Total expenditure (=item 7=22 in Table 2)	TE	48.9	48.4

5.4 Productivity in general government

The standard of service provision in Finland is highly rated according to international comparisons and poll results among end-users, both in terms of quality and effectiveness. Although there are problems related to the gauging of productivity in public services, both statistical data and research results show that productivity in public sector service provision has in some cases fallen and in others remained unchanged in recent years. In the coming years, labour productivity will need to improve both the public and private sector because the Finnish population is ageing fast, leading to a fall in labour supply.

Productivity in central government

Preliminary figures for 2007 indicate a decrease in central government total productivity in spite of a slight improvement in labour productivity. Measures adopted earlier and currently ongoing under the Government productivity programme will reduce staff numbers in central government by the equivalent of some 9,600 person-years by 2011 compared to 2005. In addition, in keeping with the Government Programme and decisions on this year's spending limits,

new productivity enhancing actions will be launched with a view to cutting back a further 4,800 person-years mainly during 2012–2015. As a result of the productivity programme, staff numbers in central government will drop by about 12% between 2005-2015. Part of the savings achieved can be re-allocated by the respective administrative branches, the rest will be entered as savings to total central government expenditures.

In 2009 it is estimated that measures introduced under the productivity programme will reduce staff needs by the equivalent of 2,000 person-years. At the aggregate level, the necessary reductions can be achieved through natural attrition, since in 2009 it is estimated that some 5,600 people will be leaving their jobs in central government, 2,800 of who will be retiring on old-age pension.

The Government's aim is to increase productivity along with the quality of services and life in the workplace. The improvement of productivity depends on skilled leadership, good management and fruitful collaboration. Central government has moved towards a more consolidated approach in the development of information management. The aim is to improve the quality of services provided, to promote the coherence of the activities of different authorities, and to enhance IT compatibility and e-Services throughout central government. Further steps will be taken to improve procurement efficiency in central government. The Budget sets aside a total of around EUR 30 million for productivity-enhancing IT projects and certain key IT system development projects in different administrative branches.

Reform in restructuring municipalities and services

Municipalities and services will be reformed as stipulated in the Act on Restructuring Municipalities and Services (framework law), which entered into force on 23 February 2007 and is effective until the end of 2012 and as specified in the decrees issued by virtue of the act. The purpose of the new legislation is to bolster both municipal and service structures, enhance the ways in which services are produced and provided, revamp the municipal financial structures and the system of central government transfers to local government and review the division of duties between central and local government with a view to ensuring a solid structural foundation and a sound financial basis in the municipalities. The purpose is to boost productivity and curb growth in expenditure in the municipalities and to enhance the steering systems used in providing municipal services.

The structure of local government can be bolstered by regrouping and amalgamating municipalities. The aim is to create a municipal structure that is viable, robust and coherent. All mergers will be made on a voluntary basis. Altogether 32 mergers will take place at the beginning of 2009 involving 99 municipali-

ties. There will be 67 less municipalities, so that their total number will be 348 at the beginning of next year. Some municipalities are also planning possible mergers. The provisions governing subsidies for municipal amalgamations were amended at the beginning of 2007 so that where a merger creates a municipality with a total population of over 20,000 inhabitants, the amalgamation subsidy is larger.

Service structures will be strengthened by consolidating individual services that require a population base of more than one municipality to be viable, and closer cooperation between municipalities will be promoted. Municipalities and partnership areas responsible for providing basic health care services and related social services must have a minimum population base of around 20,000 inhabitants. Where municipalities and partnership areas offer basic vocational training, the minimum population base must be in the range of 50,000 inhabitants. To secure the provision of services requiring a large population base, the country is divided into municipal alliances as stipulated in the Act on Specialized Medical Care. Data for summer 2008 show that nearly 80% of the whole population lives in municipalities equipped to meet the criterion of 20,000 inhabitants for basic health care services and related social welfare services.

Functions will be made more effective by boosting efficiency in municipal service provision and production and by improving the operating conditions in the Helsinki metropolitan area and other urban areas suffering from problems in the community structure. Large urban areas are obligated to take part in joint implementation.

6 Sustainability of general government finances

6.1 Measures to enhance sustainability

The long-term outlook for general government finances in Finland is overshadowed by the impending rise in costs due to population ageing and by the shrinking of the revenue base resulting from less labour supply. With the baby boom generation retiring soon and causing a rise in pension expenditure and a fall in labour supply towards the end of this decade, the effects of the ageing population will actually become manifest in economic developments quite soon. The sharpest increase in the costs of health and long-term care provision for the elderly will take place in the 2020s. Finland's old-age dependency ratio in 2020 will be the highest in the EU.

The following measures have been taken to make provision for the financial and expenditure pressure created by the ageing of the population:

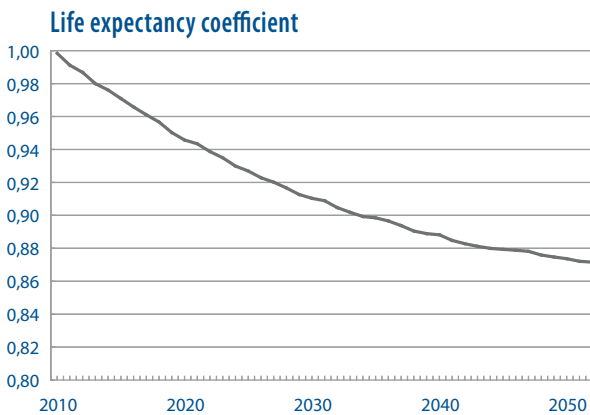
- pursuing disciplined fiscal policy to reduce levels of public debt;
- prefunding for future pensions;
- reforming pension schemes for greater financial sustainability;
- strengthening the financial basis of general government by means of economic policies that promote growth and improve the employment rate; and
- boost public service provision by means of the productivity programme and reforms in municipalities and services described above.

The structural surpluses in central government finances and reduction in government debt and interest outlays have created room for manoeuvre so that the impending growth in expenditure and fall in the revenue base caused by the ageing of the population will not lead to a new increase in the central government debt ratio. The prefunding of earnings-related pensions has helped

considerably to ease the pressures to raise pension contributions in the future. Thanks to prefunding, long-term increases in pension contributions will be no more than one-half of the rise in pension expenditure. The market value of the assets in the pension funds amounted to roughly 59½% of GDP in September 2008. The market value of the assets has dropped considerably in the course of the year as a result of the turbulence in the international financial markets.

Finland's pension system has been reformed on several occasions since the early 1990s. The most recent comprehensive reform took effect at the beginning of 2005. The aim is to strengthen the sustainability of the pension system by adjusting pensions to changes in life expectancy and to encourage older workers (from the age of 63 onwards) to stay longer in employment by introducing an accelerated pension accrual. The aim is to postpone retirement by at least three years. Indeed, the employment rate among older workers has been rising considerably, indicating that the pension reforms have been able to serve their purpose. The employment rate in the age group 55-64 has risen from 36.4% in 1997 to 55% in 2007.

To strengthen the sustainability of the pension system, a new life expectancy coefficient (see below diagram) introduced in the 2005 pension reform will be put into practice for those retiring on old-age pension in 2010 onwards. The life expectancy coefficient is used to adjust new pensions to higher life expectancies. The coefficient will first be used in computations in 2009 but will not impact pensions until the following year. The impact of the coefficient can be compensated by staying longer in employment. Based on the EU's population projections of 2004, the coefficient will reduce pensions upon retirement by a little less than 1% in 2011 and can be offset by working for one month longer. Similarly, the coefficient will cut pensions for those retiring in 2020 and born in 1958 by 5.5%, which can be offset by working for 8 months longer.



Source: Finnish Centre for Pensions, according to the Eurostat 2004 population projection.

To boost employment, a number of incentive traps have been removed by reforming the tax and social security schemes with a view to encouraging individual initiative and job creation. The Government set up a social protection committee in 2007 to overhaul the social protection system. The aim is to create more incentives for people to work, to reduce poverty and to ensure an adequate level of social protection in all life situations. The Government has stipulated that the proposals made by the committee must be such that they do not pose a risk to sustainable public finances in the long term. The committee's mandate is to draw up overall guidelines for the reform by the end of 2008 and to formulate specific guidelines on the economic and employment impacts of the reform by February 2009. The Government expects the committee to deliver the government bills by the end of April 2009 so that they can be brought into force at the beginning of 2010.

6.2 Sustainability scenario

In the following technical sustainability scenario the computations start in 2012 and extend through to 2050. The scenario is based on Eurostat's population forecast for Finland (2004). The macro-economic assumptions used in the scenario, i.e. employment, unemployment, productivity and interest rate, are consistent with the baseline scenario jointly agreed upon in the working group dealing with the economic impacts of population ageing (AWG) under the EU Economic Policy Committee.

In the scenario, the employment rate is expected to rise to over 74% by 2030 and the unemployment rate to settle at around 6.5% by 2013. Labour productivity is assumed to increase on average by 2% annually during the early part of the review period and by an average of 1.8% a year from 2030 onwards. The assumption is that changes in the structure of the labour force have no bearing on labour productivity and that the number of hours worked is constant. The average rate of GDP growth for the whole period is 1.9% per annum. The real interest rate is assumed at 3% in the baseline scenario, both for public debt and for investments by earnings-related pension funds.

Table 7: Long-term sustainability of public finances (2005-2050), % of GDP

	2005	2010	2020	2030	2050	2050-2010 change, %
	Total expenditure	50.1	48.6	50.4	54.1	59.9
Of which: age-related and unemployment expenditures	25.0	25.6	27.6	30.2	30.7	5.1
Pension expenditure	10.4	11.2	12.9	14.0	13.7	2.5
Old-age and early pensions	8.0	8.8	10.7	12.0	12.1	3.3
Other pensions (disability and family pensions)	2.4	2.4	2.2	2.0	1.7	-0.7
Health care	5.5	5.8	6.2	6.6	7.0	1.2
Long-term care	1.8	1.9	2.1	3.0	3.5	1.6
Education	5.9	5.5	5.3	5.4	5.3	-0.2
Unemployment	1.4	1.2	1.1	1.1	1.1	-0.1
Interest expenditure	1.7	1.3	1.9	3.1	8.4	7.1
Total revenue *)	52.6	49.7	50.4	49.9	48.9	-0.8
Of which: property income *)	3.2	3.8	4.7	4.2	3.3	-0.5
pension contributions	9.1	9.8	10.7	11.6	11.7	1.9
Net lending *) **)	2.5	1.1	-0.1	-4.2	-11.0	-12.1
Gross debt	43.7	35.0	38.5	62.2	166.8	131.8
Of which: consolidated debt	41.3	33.5	37.0	60.7	165.3	131.8
Pension funds' financial assets, gross	62.7	68.4	75.5	71.8	59.2	-9.2
Of which: consolidated liquid assets	51.7	57.5	63.6	60.5	49.9	-7.6

*) As of 2012, property income and net lending include changes in valuation of equity investments.

***) Cyclically adjusted balance as of 2020.

	Assumptions, %			
	2010	2020	2030	2050
Labour productivity growth	2.2	2.1	1.7	1.7
Real GDP growth	1.8	1.7	1.4	1.4
Participation rate males (20-64)	83.3	85.7	86.4	86.5
females (20-64)	76.6	80.3	81.5	81.9
total (20-64)	79.8	82.9	84.0	84.2
Unemployment rate	7.2	6.5	6.5	6.5
Population aged over 65 % of total population	16.9	22.6	26.1	27
Inflation	1.9	2.0	2.0	2.0
Real interest rate	3.0	3.0	3.0	3.0

In the sustainability scenario the total tax rate is kept constant at the level forecast for 2012. The increased pressure in pension expenditure is released into the pension contributions, which are assumed to rise by about 2 percentage points of GDP by 2030. Keeping the total tax rate constant, taxation in other areas eases.

Age-related expenditure (pensions, health care, long-term care, education and unemployment) is expected to increase by 5.1 percentage points of GDP by 2050. Pension expenditure will be up by 2.5 percentage points and spending on health care and long-term care together by 2.8 percentage points of GDP. With unemployment decreasing, unemployment expenses relative to GDP will drop slightly and the ratio of education expenditure to GDP will decrease because younger cohorts are smaller (cf. Table 7).

Calculated on the basis of these assumptions, overall public finances do not seem to be on a sustainable foundation. Public finances would slip into deficit in 2020, with the deficit exacerbating so that by 2050 it would reach 11% of GDP. If changes in the valuation of assets were not taken into account, the deficit-to-GDP ratio would be just less than one percentage point higher by the end of the review period.

On closer examination of the different sectors in general government, it can be seen that the situation is dualistic. The pension funds will stay in surplus throughout the projection period and the market value of their assets will amount to 55% of GDP in 2050. The rest of general government (central and local government) is calculated to stay in deficit throughout the period, and the deficit will climb to about 12½% by 2050. The public debt-to-GDP ratio will therefore exceed the 60% mark by 2030, escalating to 165% of GDP by the end of the review period.

In the baseline scenario, computed using the S2 indicator applied by the working group dealing with the economic impacts of population ageing (AWG) under the EU Economic Policy Committee, the sustainability gap in general government (S2) is about 3% of GDP. With the structural surplus in general government being forecast at 1.1% of GDP in 2012, the sustainability criterion calls for a surplus of around 4%. This means that either spending must be reduced or revenue increased by the amount shown by the indicator if general government finances are to be kept sustainable in the long term. The sustainability gap could also be bridged by means of structural reforms, which impact sustainability in public finances in the longer term.

If the computations were to be made using the most recent national population projections (Statistics Finland, 2007), the outlook for general government sustainability would be slightly more pessimistic than in the scenario above. The surge in the number of people needing care and nursing compared to the earlier projections means that expenditure in health care and nursing services will increase. Assessments based on the latest population projection suggest that a general government surplus ratio of 4½% would in this case be necessary to secure sustainability in general government in the medium term, which means the sustainability gap would be even wider than the one presented above.

scenario was that the rate of return in the pension funds is 0% in 2008 and that the nominal rate of return would reach 5% annually after that. However, if we assume that the fall in asset values caused by the financial crisis were to lead to a nominal rate of return of -15% in the pension funds in 2008 and to rise to the same level as the baseline scenario after that, this would mean that pension contributions would have to be raised on a permanent basis. To keep the ratio of pension fund assets to GDP at the same level in 2050 as in the baseline scenario, pension contributions would have to be raised immediately and on a permanent basis by 0.3 percentage point of GDP and by 0.8 percentage point of wages. This would increase the sustainability gap by 0.3 percentage point relative to the baseline scenario. This sort of result is naturally too bleak, if it turns out that the markets have overreacted in 2008 and the share market recovers from the slump caused by the financial crisis.

6.3 Pension fund assets

Finland's earnings-related pension system is a partially pre-funded, defined benefit system in which the benefits are determined according to the length of employment history and the level of earnings. The pre-funding is collective and it does not affect the level of the pension; rather, it is intended to even out the pension contribution rate over time. Within the national accounts framework, the pension funds in the private and municipal sector are counted as social security funds. By contrast, the State Pension Fund is part of central administration. Tables 8 to 10 show the non-consolidated and consolidated market value of the pension funds in 2001-2007.

The revenue from the investment proceeds of consolidated liquid assets – interest and dividends – amounted to EUR 3.5 billion in 2007. Interest and dividends, however, represent only part of the revenue generated by the pensions funds; under normal circumstances, much of the revenue derives from the sales profits and appreciation of shares and bonds. When these items are included, revenue from proceeds of non-consolidated pension fund assets amounted to EUR 5.0 billion in 2007.

Table 8. Financial assets (market value) of the earnings-related pension institutions, EUR million

	2001	2002	2003	2004	2005	2007
A. Non-consolidated assets						
AF21 Currency	0	2	0	0	0	0
AF22 Transferable deposits	241	256	257	376	510	937
AF29 Other deposits	228	880	379	377	246	78
AF331 Short term bills	2125	1838	2320	2624	2666	3438
AF332 Long term bonds	30202	32312	32821	36355	38965	33233
AF34 Derivatives, net	2	67	88	164	48	1699
AF511 Quoted shares	13016	10518	13807	17225	20355	24556
AF52 Mutual fund shares	3093	3399	5209	7794	14420	28396
Total	48907	49272	54881	64915	77210	92337
% of GDP	35.0	34.2	37.6	42.6	49.1	51.4
B. Liabilities of general government (sector 13) to pension funds						
AF331 Short term bills	5	29	26	257	42	111
AF332 Long term bonds	6887	4786	4666	3512	3606	3062
Total	6892	4815	4692	3769	3648	3173
% of GDP	4.9	3.3	3.2	2.5	2.3	1.8
C. Consolidated liquid assets (=A-B)						
AF21 Currency	0	2	0	0	0	0
AF22 Transferable deposits	241	256	257	376	510	937
AF29 Other deposits	228	880	379	377	246	78
AF331 Short term bills	2120	1809	2294	2367	2624	3327
AF332 Long term bonds	23315	27526	28155	32843	35359	30171
AF34 Derivatives, net	2	67	88	164	48	1699
AF511 Quoted shares	13016	10518	13807	17225	20355	24556
AF52 Mutual fund shares	3093	3399	5209	7794	14420	28396
Total	42015	44457	50189	61146	73562	89164
% of GDP	30.0	30.9	34.4	40.1	46.8	49.6
D. Total assets of pension funds*						
Non-consolidated total assets	62462	63557	69267	78340	90509	107871
% of GDP	44.7	44.1	47.5	51.4	57.5	60.0
Consolidated total assets	54649	57812	63714	73817	86116	103589
% of GDP	39.1	40.2	43.7	48.5	54.7	57.6

* Derivatives, net

Source: Statistics Finland, Financial statistics

Table 9. Financial assets (market value) of the State Pension Fund

	2001	2002	2003	2004	2005	2006*	2007*
	EUR million						
Non-consolidated assets	4427	4484	5795	6867	8201	10305	12051
Consolidated assets	1686	3099	4549	6339	7963	10127	11813
	% of GDP						
Non-consolidated assets	3.2	3.1	4.0	4.5	5.2	6.2	6.7
Consolidated assets	1.2	2.2	3.1	4.2	5.1	6.1	6.6

Source: State Pension Fund

Table 10. Financial assets (market value) of the earnings-related pension institutions, total

	2001	2002	2003	2004	2005	2006*	2007*
	EUR million						
Non-consolidated assets	66889	68041	75062	85207	98710	110016	119922
Consolidated assets	56335	60911	68263	80156	94079	106210	115402
Consolidated liquid assets	43701	47556	54738	67485	81525	93029	100977
	% of GDP						
Non-consolidated assets	47.8	47.3	51.4	55.9	62.7	65.9	66.7
Consolidated assets	40.3	42.3	46.8	52.6	59.8	63.6	64.2
Consolidated liquid assets	31.2	33.0	37.5	44.3	51.8	55.7	56.2

Sources: Statistics Finland and State Pension Fund

7 National fiscal procedures and institutions

The new Government, which took office in April 2007, is committed to following the spending rules it has set and the first spending limits decision of 25 May 2007 based on them. Measures entered in the Government Programme will be implemented insofar as it is possible within the framework of the spending limits decision.

The annual central government spending limit decisions are revised only for changes in the price and cost level and for adjustments in the budget structure. Thus they do not involve changes in the underlying spending rule adopted in the Government Programme. The Government published its spending limits decision for 2009-2012 on 13 March 2008. The central government spending limits endorsed by Government form the guideline for the following year's draft budget in the administrative branches of government. The Government will review annually the need for changing focus in expenditure, for example through structural reform or inter-administrative transfers, on the basis of submissions from the leaders of government party groups.

Roughly three-quarters of all central government budget appropriations are binding for the whole electoral period through the spending limits. Expenditures affected by cyclical fluctuations and automatic stabilizers, such as unemployment security expenditure, housing allowances, the central government contribution to the Social Insurance Institution and the central government's contribution to social assistance are all excluded from the scope of the spending rule. However, expenditure caused by any changes in the basis of these items will be included in the spending limits. Debt interest payments, appropriations for VAT expenditure, financial investment expenditure and expenditure corresponding to technically transmitted payments are also excluded from the spending limits.

This government's first spending limits for the parliamentary term decided in May 2007 were set in such a way that it is possible to observe the EUR 1.3 billion increase in spending at the expenditure level for 2011, as agreed in the government programme. At the time, the spending limit for 2009 was set at EUR 34.0 billion.

Because the spending limits are technically revised and adjusted annually to the existing spending limits for the parliamentary term according to changes in cost and price levels and in the structure of the Budget, the spending limits was increased by a total of EUR 1.9 billion in connection with the formulation of the 2008 budget proposal, of the March 2008 spending limits decision and of the 2009 budget proposal. This means the revised spending limit for 2009 is EUR 35.9 billion. Altogether EUR 10.3 billion in appropriations will be excluded from the spending limits for 2009.

If such adjustments were not to be made, the level of the spending limits would not correspond to changes in caused by factors other than the spending limits decisions, and would effectively toughen or ease depending on the direction of the changes. An annual reserve of EUR 300 million in the supplementary budgets is used as a tool to bring greater flexibility to the current system of spending limits.

The aim is to keep transport route construction and its funding stable every year. If costs for civil engineering works are anticipated to increase substantially because of a high capacity utilisation rate, project starts and other transport route construction will be postponed.

If the annual revenue from the sales of shares exceeds EUR 400 million, a maximum of 25% but no more than EUR 150 million of the excess can be used for one-off expenditure without reference to the spending limits to boost expertise, innovation and economic growth.

If total annual expenditure falls below that specified in the spending limits even after supplementary budgets, the surplus, to a maximum of EUR 100 million, may be used for one-off expenditure in the following year without reference to the spending limits.

The Government Programme allows for adjustments to the level of spending limits to adapt to rescheduling and re-budgeting expenditure. Where expenditure is rescheduled, it is possible to increase the overall spending limit in one budget year by the amount required, provided that in a later year in the same spending limits period a corresponding decrease is made. If the expenditure for a project or other equivalent entity needs to be re-budgeted and earlier appropriations have not been cancelled, the spending limit will be increased by the re-budgeted amount.

The previous government term (2003-2007) demonstrated that a multiannual system of spending limits based on a spending rule is functional. The Government committed itself to adhere to the system of spending limits and expenditure was kept within the limits decided on throughout the electoral period. The economy developed much more briskly than expected over the past electoral period. Partly thanks to the spending rules, there was less scope for pro-cyclical fiscal policy, and the surplus generated in central government finances was used to debt reduction and to augment the State Pension Fund. It can also be

noted that excluding the automatic fiscal stabilizers from the spending rules was a good idea.

This Government made a commitment in its Government Programme to adhere to a spending rule covering the whole of the election period. Based on experience to date, the system of spending limits has been improved for the current government term. To increase the flexibility of the system, a fixed annual provision for supplementary budgets and an unallocated provision for recognition of new government expenditure were added. Additionally, there is now the option of allocating unbudgeted funds within the spending limits to the next budget year and re-budgeting has been made more flexible overall.

In practical terms, it is important to have the Government annually review the needs and potential for the re-allocation of expenditure within the set overall spending limits. What this means is that new items could be introduced by transferring funds from other items that are to be reduced or discontinued.

Generally, the problem with the spending rules is that in practice they dictate the actual level of expenditure and spending does not go below that level. This means the chosen spending limit level thus becomes a crucial factor. An error of judgment in scaling may lead to indispensable measures being left untaken because of the strict spending limits set. On the other hand, a ceiling on spending loses its fiscal policy meaning if it is set too high. Another problem is that the spending limits system can be circumvented through tax subsidies and by using various funding schemes such as public-private-partnership for projects.

Systems like the Finnish spending limits system are not statutory but are agreed on by coalition partners. However, experience from the past and present government terms show that this has not eroded the importance of the spending limits system or lessened the Government's commitment to observing it.



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