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Stability programme update for Finland 2009

6c/2010

Economic outlook and economic policy

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Abstract

This Stability Programme update is based on the Government's 26 March 2009 decision on the 2010-2013 spending limits for central government finances, the 2010 Budget approved by Parliament on 18 December 2009 and the short-term forecast published in the Ministry of Finance Economic Bulletin of December 2009.

The global economic crisis plunged Finland into an exceptionally deep recession at the end of 2008. The recession will leave a deep, long-lasting mark on the balance of general government finances and the debt ratio. As a result of the recession, the previously strong public finances have turned into deficit within a year.

The aggregate general government deficit will deepen in 2010 to 3½% of GDP. This will breach the 3% limit for the public finances deficit of EU countries outlined in the Stability and Growth Pact.

In the next few years, a great challenge of economic policy is to implement a post-recession exit strategy in which measures supporting growth will be combined with general government adjustment measures. The recession has also exacerbated the challenges arising to public finances from population ageing. Provision must now be made for the spending pressures resulting from population ageing with much weaker general government finances than before.

The medium-term objective for Finland's general government finances is set at a structural surplus of 0.5% of GDP. Based on developments according to the baseline scenario, the medium-term objective will not be achieved in the programme period without new, significant additional measures. The general government structural deficit is expected to be 1.3% of GDP in 2013.

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Introduction and summary

Compared with many other countries, the Finnish economy was in a good position when the economic crisis began, because it faced the recession with its general government finances in surplus. Moreover, companies' balance sheets have been strong and the banking sector has been on a solid footing. The financial sector has also withstood the upheaval caused by the global financial crisis well. However, as an economy dependent on exports, Finland sank into an exceptionally steep recession. In 2009 the economy is expected to have contracted by 7.6%, which is significantly more than the average for EU countries. GDP contracted even more quickly than in the recession experienced in Finland in the early 1990s.

The Government has responded quickly to the weakened economic situation with stimulus measures. These, however, can only alleviate the effects of the crisis on the domestic market; they cannot compensate for the contraction of exports due to the collapse of international trade. The stimulus measures, moreover, cannot be endlessly increased, because even during a recession the sustainability of general government finances must be maintained. Public finances remaining deeply in deficit for an extended period would increase the general government interest burden and undermine sustainability. This would also weaken the credibility of economic policy and thus the effectiveness of stimulus measures over time.

The decline in the economy seems to have levelled off and a gradual growth in GDP is expected in 2010. After the recession, a similar rapid economic recovery to that experienced in Finland after the 1990s' recession is not expected, however. At that time, there was strong expansion of Finland's electrotechnical industry based on a global breakthrough of new information and communications technology, which increased productivity and generated a growth surge that raised Finland to be one of Europe's fastest growing national economies by the turn of the millennium. In addition, a devaluation at the beginning of the 1990s had improved the price competitiveness of export products. In the next few years, a corresponding expansion based on information and communications technology is not expected. New fields of strong growth have not appeared. Furthermore, the export sector's price competitiveness can no longer be maintained with the help of exchange rate policy; it must be maintained through productivity growth and a competitive cost structure.

Unemployment is growing sharply as a consequence of the recession. The longer the downturn and the later the subsequent recovery, the greater the proportion of unemployment growth that will become structural. The situation is complicated by structural change in the economy. It has tested the forest industry in particular, but is also strongly felt in other important sectors for Finnish exports, such as the mechanical engineering industry and the electrotechnical industry. After the recession, the capacity of Finnish industry threatens to remain on a lower level than before. Replacement jobs will not necessarily arise in the same occupations and localities where jobs were lost in the years of crisis. The challenge is therefore to improve the operation of the labour market, to retrain the labour force and to increase mobility.

The recession will leave a deep, long-lasting mark on the balance of general government finances and the debt ratio. As a result of the recession, the previously strong public finances have turned into deficit already within one year. The general government deficit will deepen in 2010 to 3½% and general government finances projected in the baseline scenario will remain in deficit throughout the programme period. Only employment pension funds, which in contrast with other EU countries are classified under general government in Finland according to national accounting, will remain in surplus. The debt ratio will grow to more than 56% by 2013. Restoring general government finances in Finland will be a particularly challenging task, because the baby boomers are now reaching retirement age. The dwindling labour supply as a result of population ageing will restrict economic growth and soon lead to labour shortages.

In the next few years a great challenge of economic policy is to implement a post-recession exit strategy in which measures supporting growth will be combined with general government adjustment measures. The Government has already agreed individual tightening measures, but for the most part the Government will decide on the exit strategy later. As already agreed, both the general and reduced value-added tax rates will be raised by one percentage point at the beginning of July 2010. In addition, energy taxes will be increased from the beginning of 2011. These measures have already been taken in account in the baseline scenario of the Stability Programme.

Post-recession after-care will take several years. Structures facilitating long-term management of public finances such as medium-term budget planning and, based on this, spending limits extending beyond the parliamentary term are therefore an important tool in implementing the strategy. Experiences already acquired before the crisis have demonstrated the effectiveness of a multi-year spending limits procedure based on spending rules. Expenditure has also remained within the spending limits during the recession and stimulus measures. Remaining within the spending limits has been influenced by the fact that cyclical expenditure items such as unemployment security spending are outside the spending limits procedure and cyclic automatic stabilisers have therefore operated to their full extent.

In addition to measures aimed at strengthening the position of general government finances, structural reforms supporting growth and the sustainability of general government finances will form an integral part of the exit strategy. The Government has set as a target the implementation of measures aimed at extending working careers by three years by 2025. Moreover, projects initiated earlier can be used to support the productivity of the public administration and public service provision, which is important in terms of sustainability. Through the structural reform of municipalities and services, the production practices and organisation of services offered by municipalities will be developed and an effort made to strengthen the financial basis of the arrangement and provision of services. A productivity project will enhance public sector activity and reallocate labour. In future, particular attention will be paid to developing the productivity of municipal services.

Under the 2005 revision of the Stability and Growth Pact, each Member State shall have a differentiated medium-term objective for the structural financial position of general government. In this Stability Programme update for 2009, the medium-term target for general government is set at a structural surplus of 0.5% of GDP. The baseline scenario presented in the Stability Programme projects a general government structural deficit of 1.3% of GDP in 2013. Based on development according to the baseline scenario, the medium-term target will therefore not be achieved in the programme period without new, significant additional measures. Achieving the target will require the structural financial position of general government to be strengthened annually on average by slightly more than one half of a percentage point of GDP in the period 2011–2013.

Achieving the medium-term surplus target will not be sufficient alone to safeguard the long-term sustainability of general government finances, because the surplus required to safeguard sustainability is expected to be around 4% of GDP. Owing to the large sustainability gap, general government finances must be supported by measures to strengthen the budget balance in the programme period and by structural reforms to boost growth and mitigate the spending pressures resulting from population ageing.

1 Economic policy objectives and premises

1.1 General

When the Government began its work and set its targets according to the Government Programme in spring 2007, Finland had behind it a long period of rapid economic growth. General government finances were strongly in surplus and, based on projected economic growth, they were forecast to remain relatively strong throughout the parliamentary term. Due to government debt reduction and a low level of interest rates, central government interest outlays had long been reduced, which had in turn improved the central government's financial position.

In its programme, the Government aimed to achieve significantly stronger economic growth than that presented in expert estimates. It was estimated that 80,000–100,000 new jobs could be created during the parliamentary term if international economic development continued to be favourable and wages developed at a rate that supported employment. At the start of the parliamentary term, before the global recession began, economic growth continued to be strong and around half of the job creation target had been achieved by summer 2008. The deep recession has completely changed the situation, however. The targets set in the Government Programme for employment and public finances will not be achieved.

Population ageing has long been viewed as a major challenge to which the Government is striving to respond in different ways. Later, alongside population ageing, a further challenge has been presented by the need to alleviate the effects of a rapidly deepening recession and to strengthen public finances and economic growth after the recession. Although the recession has focused attention on short-term issues, the problems associated with population ageing have not disappeared. The starting situation, moreover, has become significantly more difficult. The Government must now prepare for the spending pressures arising from population ageing with much weaker general government finances than before.

The Government has responded quickly to the weakened economic situation with stimulus measures in accordance with the principles agreed in the European Economic Recovery Plan. The effects of the crisis have been dampened, for example, by bringing forward public investment, cutting taxation and facilitating funding opportunities for businesses.

The post-recession economic policy must combine a policy that supports growth with confidence-boosting measures that strengthen general government finances and their sustainability. The need to adjust general government finances is considerable and the timing of the adjustments must be considered with care. The financial position of Finland's general government will weaken in 2009–2010 significantly more than for EU countries on average. In Finland growth in age-linked expenditure caused by population ageing will additionally begin to burden general government finances before the recession has been properly overcome. Finland, therefore, must engage the challenges caused by population ageing more quickly than in EU countries on average.

1.2 Broad Economic Policy Guidelines

When introducing the second three-year period of the revised Lisbon Strategy for Growth and Jobs in spring 2008, the European Council confirmed that the present Integrated Guidelines (Broad Economic Policy Guidelines and Employment Guidelines) were to remain valid and were also applicable in 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, boost labour supply and create new jobs.

The European Council stated at its spring 2009 summit meeting that the revised Lisbon Strategy and the Integrated Guidelines currently being applied will continue to direct effectively the promotion of sustainable growth and employment. The European Council emphasised that in the context of the crisis there is a greater need to continue and accelerate structural reforms. At the same time, it issued recommendations to euro area countries. It urged Member States to, among other things, accelerate the implementation of structural reforms, safeguard the sustainability of public finances, improve the quality of public finances, increase flexibility and competitiveness in markets for goods and services, and to ensure that all EU legislation relating to financial services is implemented. No country-specific recommendations were given to Finland. The European Council did, however, single out for special attention the challenges arising to Finland from population ageing.

The Government's economic policy is consistent with the Broad Economic Policy Guidelines and with the Integrated Guidelines for 2008–2010. A more detailed description of the Government's economic policy measures is presented in later sections of this Stability Programme update and in the Finnish National Reform Programme adopted by the Government in October 2009. 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 2009 and its handling in Finland

This Stability Programme update is based on the Government's 26 March 2009 decision on the 2010–2013 spending limits for central government finances, the 2010 Budget approved by Parliament on 18 December 2009 and the short-term forecast published in the Ministry of Finance Economic Bulletin of December 2009. The expenditure estimates for 2010–2013 have taken into account the effects of decisions contained in the 2010 Budget Proposal.

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 also 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 trough of the recession in the international economy has passed and the recovery has started. This improvement is partly thanks to the massive stimulus measures adopted in both fiscal and monetary policy to maintain growth and bring stability to the markets. Growing demand is partly explained by the replenishment of stocks closer to normal levels. When the effect of these measures gradually starts to wear off and as fiscal and monetary policy slowly starts being focused more on longer term sustainability, the budding recovery cannot be expected to accelerate to a rate similar to that normally witnessed in cyclical upswings.

There are also other factors slowing down growth. Low capacity utilisation rates, higher unemployment, a fall in house prices and other asset prices and higher household indebtedness are all hampering growth in investment and consumption. Global imbalances, i.e. surpluses and deficits in current accounts, call for corrective measures and structural reforms, namely higher growth in domestic demand in surplus economies and lower domestic demand and more exports in those with current account deficits.

Emerging economies are in the forefront of the recovery. Growth in the advanced economies is likely to remain sluggish well into late 2010 and to start accelerating in 2011. The world economy is forecast to contract by a little over 1% in 2009 and to increase by over 3% in 2010–2011. The euro area economy, following a 4% contraction in 2009, may grow by around 1% in 2010–2011.

The Finnish economy's nosedive at the end of 2008 and in the first half of 2009 was very fast and sharp. GDP declined to the same level as it was around three years ago. Based on this forecast, the current economic cycle has bottomed out and the Finnish economy will slowly start to recover. GDP in 2009 is expected to decrease by 7.6%, in other words more than in any of the recession years of the early 1990s. With investment continuing to fall, the Finnish economy will grow only by a little under 1% in 2010, while in 2011, with all demand items expected to increase, it will grow by an estimated 2.4%. Following the sharp fall, economic growth will thus be sluggish.

Owing to the global recession, Finland's exports declined by around a quarter in 2009, a record fall. The decline in exports has been much sharper than in the early 1990s, when exports fell by 7% at most in any single year. Nevertheless, Finland's export markets have already started expanding. In addition, recent statistics show that production of intermediate products and investment goods has increased. Exports are expected to grow by 5% in 2010. Growth in Finnish exports will be supported in particular by demand for intermediate products and services in Finland's export markets. Demand for investment goods, however, is expected to remain modest in 2010. Investment in the Finnish export markets will accelerate in 2011, perking up demand in investment goods. Export growth is forecast to climb to 5½% in 2011. Import growth will also accelerate, rising to 4%, as domestic demand is expected to strengthen.

The fall in private consumption expenditure came to an end between July and September 2009, when consumption grew by 0.3% on the previous quarter. The increase has covered a broad base, because, with the exception of semi-durables, consumption of all goods and services grew. The consumption of consumer durables increased the most. Consumer confidence has continued to improve. Indeed, the 2009 decline in private consumption remained at around 2% while it already seems that 2010 will be a year of growth. This is the case even though consumers are saving more now as a precaution against the risk of unemployment, for example. In short, household purchasing power will increase faster than consumption expenditure. Cuts in income taxation and particularly the offsetting of higher social security contributions are boosting income to some extent. However, the average local tax rate will be significantly higher. It is anticipated that households will spend slightly more on both goods and services in 2010 than in 2009, with only spending on semi-durables expected to be less active. In 2011 household income is expected to increase once unemployment starts to ease. Should confidence in the future continue to improve, consumption may increase in 2011 faster than income for the first time in five years, meaning that the savings ratio would fall slightly.

Investment decreased by an estimated 12% in 2009. House building investments bottomed out in autumn 2009 and began to grow slightly at the end of the year or at the latest in early 2010. Civil engineering investment will also increase in 2010. Investment in other construction as well as in machinery and equipment will likely not pick up until 2011, at which time overall investment is also expected to return to a growth track. The business cycle in construction remains weak. New construction in 2009 was around one quarter lower than the previous year, but renovation construction increased to some extent, partly due to implemented stimulus measures. Housing starts, on the other hand, are growing slightly from the record low levels, mainly owing to an increase in state-subsidised housing production. In 2010 construction investments will contract further to some extent, because industrial and office construction in particular will remain low. In 2011 construction is forecast to increase slightly both in buildings construction and in civil engineering.

The number of employed declined by an estimated 80,000 people in 2009. To date, fixed-term lay-offs, which are classified in the Labour Force Survey as unemployed, have not led to permanent redundancies to the extent feared. Most job losses took place in industry and in private services. Public services, by contrast, saw a slight increase in labour demand. The number of hours worked fell by 7%, i.e. over twice as much as the number of job losses. The employment rate fell to just over 68% and the unemployment rate rose to an average 8½%, despite a decrease of 25,000 people in the labour supply. Youth unemployment is three times as high as that for those aged between 25 and 64.

In 2010 labour demand will continue to deteriorate in both industry and in private services, and the number of employed will be an estimated 75,000 lower than in 2009. The risk that temporary lay-offs may become permanent redundancies is higher in 2010 than in 2009 and the number of vacancies will also be half that of 2008. Although labour supply will contract especially in the older age groups owing to more people retiring, as was the case in 2009, the unemployment rate will nonetheless rise to an average of 10½%. Since the labour market is stimulated by an improvement in production with a lag of about half a year, labour demand is likely to start rising only in late winter/early spring 2011. In this case, unemployment may decrease to a seasonally adjusted 9% in late 2011. Mismatches between labour supply and demand might become a significant problem at the time, too.

Consumer prices did not increase on average in 2009. This was due to the fact that, besides a fall in world market prices, house prices and loan expenses fell. Moreover, the cut in VAT on foodstuff introduced in October 2009 was fully translated, at least in the short term, into food prices. In 2010 consumer prices will edge up slightly, but there is no significant pressure for price rises unless caused by new pay settlements. The annual rate of change in the harmonised consumer price index in 2009–2010 will still be higher that in EU countries on average.

Table 1a. Macroeconomic prospects

	2008 EUR bn	2008	2009	2010	2011	2012	2013
		change, %					
1. Real GDP	165.3	1.0	-7.6	0.7	2.4	3.5	3.0
2. Nominal GDP	184.7	2.8	-6.5	1.9	4.0	5.7	5.2
Components of real GDP							
3. Private consumption expenditure	95.6	1.9	-2.2	1.2	2.5	3.0	2.5
4. Government consumption expenditure	41.3	2.0	1.2	0.2	0.5	0.5	0.5
5. Gross fixed capital formation	38.1	0.3	-11.6	-4.5	1.8	3.4	3.4
6. Changes in inventories (% of GDP)	2.0	1.1	-1.3	-0.9	-0.6	-0.1	0.4
7. Exports of goods and services	86.8	7.3	-25.7	5.0	5.6	6.5	5.5
8. Imports of goods and services	79.6	7.0	-22.5	3.7	4.4	4.5	4.0
Contributions to real GDP growth, % points							
9. Final domestic demand	174.9	1.5	-3.3	-0.2	1.8	2.4	2.1
10. Changes in inventories	2.0	-0.9	-1.9	0.3	0.0	0.2	0.2
11. External balance of goods and services	7.2	0.5	-2.4	0.5	0.5	0.9	0.7

Table 1b. Price developments

	2008	2009	2010	2011	2012	2013
	change, %					
1. GDP deflator	1.8	1.1	1.2	1.5	2.2	2.1
2. Private consumption deflator	3.4	1.0	1.5	1.7	2.0	2.0
3. HICP	3.9	1.7	1.8	1.7	2.0	2.0
4. Public consumption deflator	5.3	3.2	2.6	2.8	3.0	3.0
5. Investment deflator	3.9	-1.5	-1.3	-0.6	2.0	2.0
6. Export price deflator	-1.6	-5.1	1.5	1.6	0.5	0.0
7. Import price deflator	1.8	-6.6	2.0	2.4	1.5	1.0

Table 1c. Labour market developments

	2008 level	2008	2009	2010	2011	2012	2013
		change, %					
1. Employment, 1.000 persons	2531	1.6	-3.2	-3.1	0.6	1.2	0.9
2. Employment, 1.000 hours worked	4321	1.3	-6.6	-2.0	0.3	1.0	0.7
3. Unemployment rate (%)	172	6.4	8.5	10.5	9.6	8.7	8.1
4. Labour productivity, persons	65.3	-0.5	-4.5	3.8	1.8	2.3	2.1
5. Labour productivity, hours worked	38.3	-0.3	-1.1	2.7	2.1	2.5	2.3
6. Compensation of employees	73.1	6.8	-1.0	1.0	2.5	4.2	4.6
7. Compensation per employee	28.9	5.2	2.3	4.2	1.9	3.0	3.7

Table 1d. Sectoral balances

	2008	2009	2010	2011	2012	2013
	% of GDP					
1. Net lending/borrowing vis-à-vis the rest of the world	2.7	0.8	1.2	1.5	1.8	2.0
of which:						
- Balance of goods and services	3.9	2.1	2.5	2.7	3.1	3.3
- Balance of primary incomes and transfers	-1.3	-1.4	-1.4	-1.3	-1.4	-1.4
- Capital account	0.1	0.1	0.1	0.1	0.1	0.1
2. Net lending/borrowing of the private sector	-1.2	3.5	5.4	5.0	4.6	4.4
3. Net lending/borrowing of general government	4.4	-2.2	-3.6	-3.0	-2.3	-1.9
4. Statistical discrepancy	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5

Table 1 e. Basic assumptions*

	2008	2009	2010	2011
Short-term interest rate (3-month money market)	4.6	1.3	1.5	2.5
Long-term interest rate (10-year government bonds)	4.3	3.7	3.7	4.0
USD/EUR exchange rate	1.5	1.4	1.5	1.5
Nominal effective exchange rate	2.1	1.6	0.5	0.0
World GDP growth (excl. the EU)	3.8	-0.4	3.8	4.1
EU-27 GDP growth	0.8	-4.1	0.7	1.6
GDP growth of relevant foreign markets	3.6	-13.8	2.2	4.4
World trade growth	4.6	-12.6	4.6	5.0
Oil prices (Brent, USD/barrel)	98.5	61.3	76.5	80.5

* 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

Along with the rest of Europe, the Finnish economy is expected to recover from the deep economic crisis in the next few years. The recovery will be slow, however. Finland's export industry produces many investment goods whose sales will adjust more slowly than demand for consumer goods. Furthermore, recovery of demand for investment products will be slowed by the fact that companies still have much unused capacity as a consequence of the economic crisis.

Annual growth of total output is estimated to remain at 0.9% on average during the programme period. In the post-recession years, growth is expected to be clearly slower than was the case in the middle of the decade before the crisis arose. The recovery, moreover, will not be comparable with the growth witnessed after the recession of the early 1990s, which was in many ways exceptional. At that time, growth of total output was supported by a spread in the use of information and communications technology, explosive growth in demand for that sector's products, and expanding production in Finland. Now no corresponding growth surge is expected from the same sector. In contrast, production will be transferred to countries where production costs are lower. Export growth is also limited by structural change in the forest industry, which is expected to continue in the new decade. The post-recession recovery will, however, lead to a temporary acceleration of export growth to a relatively high level. Investment, too, will recover in the wake of exports. Nevertheless, annual economic growth is expected to slow soon after the programme period to around 2%.

The mark of the recession will be evident on the labour market for a long time. However, the risk of substantial structural unemployment, which arose in the early 1990s recession, is smaller in the current recession. The unemployment rate is expected to fall from its 2010 peak to around 8% by 2013. Growth of structural unemployment has been slowed by companies' active use of temporary lay-offs instead of direct redundancies as well as by public authority stimulus measures aimed at preventing an increase in long-term unemployment. On the other hand, problems in matching labour demand and supply will return quite quickly after the recession. Matching problems will be exacerbated by structural change in the economy; during the recession, jobs will decline in industry, but as the upswing begins many of the new jobs will arise in the service sector, for example. The challenge is therefore to increase labour mobility and to retrain those who have lost their jobs.

The retirement of the baby boomers will begin to be evident in the labour market in the next few years. According to a Statistics Finland population forecast, the size of the working-age population will start to decline in 2010 and will fall by more than 50,000 by 2013. Labour supply will therefore inevitably contract in the coming decade. The recession will probably accelerate the contraction of labour supply caused by population ageing, because many of those workers approaching retirement age who become unemployed during the crisis will remain permanently outside the labour force. Owing to the contraction of labour resources, growth in the number of those in employment will begin to slow at the end of the programme period. The employment rate is expected to recover, however, to nearly 69% by 2013. The impact of population ageing can be reduced by measures to support labour supply, such as extending working careers. Lowering structural unemployment and boosting labour market efficiency are also important in efforts to ensure that a limited labour supply is matched with demand for labour.

Medium-term growth prospects are here estimated using the production function method adopted by the EU Commission and Member States. The method examines economic growth potential by forecasting the development of various supply factors, such as labour and capital, and exploring productivity projections. The growth track produced by the method involves a number of uncertainties, whose significance is highlighted during times of large economic fluctuations. The global market situation after the deep recession and the effects of the structural changes under way will also incorporate a considerable number of risk factors. This is why it is necessary to consider not only the baseline scenario, but alternative growth prospects, too. Section 4.1 examines both the baseline scenario as well as slower and faster growth scenarios.

3 General government balance and debt

3.1 Fiscal policy strategy, medium-term objective and exit measures

During the economic crisis, concern for employment and economic activity has been emphasised in setting and measuring the fiscal policy objective. The fiscal policy stimulus has been substantial in Finland and in other countries. The stimulus measures in the European Economic Recovery Plan (EERP), endorsed by the European Council in December 2008, have been dimensioned so that they would rise in total to 1.5% of Europe's GDP. Most of the funding would come from national budgets. Finland's stimulus measures are in line with EERP targets.

As a result of the international economic crisis, the financial position of Finland's general government has deteriorated sharply, in 2009 by around 6½% of GDP. Automatic stabilisers have been allowed to operate freely, in addition to which discretionary stimulus measures have also weakened the general government financial position.

Stimulus measures agreed by the Government can be divided roughly into two groups: safeguarding the availability of finance and actual stimulus measures. A requirement of stimulus measures is that they can be implemented quickly and that they are as effective as possible in terms of their impact on employment. For example, in terms of investment the objective has been to bring forward as many projects as possible that would in any case have been implemented. The availability of finance has been safeguarded by, for example, export credits and guarantees, Finnvera cyclical loans and bank funding guarantees. There has been no need for actual support measures for banks.

Efforts have been made to boost economic activity through public authority measures while at the same time having to address heightened concern for the sustainability of the longer-term financial position of public finances. The effects of the economic and financial crisis on the sustainability of public finances are due to a deterioration of the starting situation and a slowing of growth in the medium term. It is still too early to say, how long the effects of the deep recession will be apparent in the economy and to what extent they will burden public finances. The longer the effects are apparent, the more public finances and their long-term sustainability will impose restrictions on the implementation of other sociopolitical objectives. This will inevitably be reflected in the emphases of fiscal policy decision-making.

The objective set out in the Government Programme has been to secure by means of employment-enhancing reforms a structural surplus in central government finances equivalent to 1% of GDP by the end of the parliamentary term. The Government Programme also 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 Government declared in a statement issued in February 2009 in connection with the mid-term review of its programme that temporary flexibility may be shown in terms of the Government Programme's deficit restriction on central government finances and in terms of the target for the structural surplus, if decisions are simultaneously made to strengthen public finances structurally. There is good reason to assess how it will be possible to return to the above-mentioned minimum target for the deficit set out in Government Programme as quickly as possible through recovery.

The Government seeks at the same time to ensure the continuation of a responsible, long-term spending policy. To curb growth in public spending, the Government is committed to public spending limits to contain expenditure. Productivity will be improved by restructuring municipalities and services and through the Government productivity programme. This means boosting the efficiency of public activity and reallocating public sector personnel to answer better the needs arising from population ageing.

In this Finnish Stability Programme update, the medium-term target for general government finances is set at a structural surplus of 0.5% of GDP, which would mean in practice a deficit of around 2% of GDP in general government finances. The baseline scenario presented in the Stability Programme has taken into account additional expenditure in the spending limits period arising from decisions contained in the 2010 Budget. The projected general government deficit for 2013 is estimated at 1.9% of GDP, leaving the central government deficit at 4.5% of GDP. Based on development according to the Stability Programme's baseline scenario, the medium-term target will therefore not be achieved in the programme period without new, significant measures.

The general government balance according to the baseline scenario presented in this programme is not sufficient to safeguard the long-term sustainability of public finances. An estimate of the general government surplus ensuring the sustainability of general government finances in the medium term is around 4%. A sustainability scenario is presented in Section 6 of this Stability Programme.

Alongside stimulus, fiscal policy must look further into the future. The situation is exacerbated by the fact that, as a consequence of population ageing, pension expenditure will grow strongly in the next decade and, later, the growth of the health care and long-term care expenditure will also start to burden public finances. In fiscal policy, a strategy and measures are required that can strengthen the long-term sustainability of public finances. Sustainability can be improved in principle in three ways: through structural reforms, increasing taxes and cutting spending.

The Government will decide on actual exit measures later and will specify its strategy in the 2011 Budget and in the 2010 Stability Programme update when the dimensions of the sustainability challenge become clearer as the recession abates. Some decisions have already been made, however. The employment pension (TyEL) contribution paid by employees and employers as an indirect cost on salaries will both be raised by 0.2 percentage points annually in the period 2011–2014. Raising the employment pension contribution is part of an overall labour market package that promotes the sustainability of public finances by boosting the funding of pensions.

The Government has also decided on certain tightening tax policy measures. As of 1 July 2010, all value-added tax rates will be increased by one percentage point. In addition, energy taxes will be increased from the beginning of 2011. The impact of these decisions has been taken into account in the baseline scenario of the Stability Programme as well as in the sustainability scenario presented later.

Structural reforms boosting long-term sustainability will have an important role in post-recession after-care. In a statement made in February 2009, the Government outlined its aim of extending working careers by shortening study times and raising the retirement age. A target has been set of raising the average retirement age gradually by at least three years by 2025. This will be pursued by various means. In addition to raising the retirement age for early old-age pensions, special attention will be paid to measures that promote, among other things, wellbeing in work, working capacity and expertise.

During its parliamentary term, the Government has also initiated projects in the form of working groups examining social security reform, overall reform of taxation and the prerequisites for economic growth, the results of which can be utilised in future in preparing structural reforms and an exit strategy.

3.2 General government financial position and public debt

Finland's general government finances have been quite strong for the whole of the past decade right up to 2008. As a consequence of the economic crisis, the financial position of general government weakened in 2009 by around 6½ percentage points, i.e. significantly more than in EU countries on average. Public finances have weakened even more quickly than during the recession of the early 1990s. Contraction of tax bases, cutting of taxes, reduction of property income from an exceptionally high level, growth of unemployment-linked expenditure and the Government's stimulus measures all contribute to explaining the weakening of the financial position. At the same time, public debt has begun to grow sharply.

In 2010 the deficit in general government is estimated to already be greater than 3% of GDP. The general government deficit will also remain large in future years, unless corrective measures are instigated. In 2008 public debt was still rather low by international comparisons. Although indebtedness will rise quickly in the next few years, public debt as a proportion of total output will not exceed 60% in the programme period.

The economic crisis has been reflected most strongly in central government finances due, for example, to automatic stabilisers. The central government will also remain in deficit throughout the programme period, although the state of central government finances will gradually improve with economic growth.[1]Social security funds will remain in surplus throughout the programme period. The financial position of employment pension funds will gradually begin to deteriorate as pension expenditure grows.

Local government net borrowing weakened in 2009 to an estimated –½ per cent of total output. Despite the recession, municipal income tax revenue increased further and central government transfers to local government also grew significantly. The weakening was due mainly to a decline in corporate tax revenue and to the fact that the municipalities have maintained their planned investments with the assistance of debt funding. As a consequence of this, the local government's rapid increase in indebtedness in recent years will continue. Increasing unemployment will keep the municipal income tax base weak.

The imbalance arising between revenue and anticipated spending in local government finances as a result of the economic crisis will radiate to municipalities for a number of years despite the fact that the economic situation will gradually begin to improve. The local government sector with therefore remain in deficit in future unless there are clear measures to balance the development of revenue and expenditure. In the medium term, the implementation of the reform of the municipalities and services structures, labour shortages and large investment pressures might increase local government expenditure even more than anticipated.

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[1] To date, the State Pension Fund has been entered in the central government sector in national economic accounting. Statistics Finland has decided to change the sector classification such that the State Pension fund will be included in social security funds from February 2010. A correction will be made to time series. The change will weaken the financial position of the central government and improve that of the social security funds correspondingly. The change has no impact on the financial position of the general government. In the Stability Programme scenario the change has not been taken into account.

The annual state of local government finances will centrally depend, among other things, on future pay settlements and on decisions relating to municipal tax percentages and curbing expenditure growth. It is probable that the increases in municipal income tax and property tax percentages agreed for 2010 will also be continued later.

3.3 Cyclically adjusted balance in general government finances

The potential output[2] of the Finnish economy grew by just over 3% per annum in the early years of the millennium. The deep recession under way is, however, slowing potential growth significantly. The impact of the recession will be transmitted to growth potential via both labour and capital inputs. Firstly, increasing unemployment will lead to growth in structural unemployment. Moreover, participation in the labour force will decline as employment opportunities deteriorate. Secondly, lower investment will reduce the capital stock and, simultaneously, growth potential. The recession might also change economic structures permanently or accelerate the structural change that is under way. Part of the capital stock will therefore remain unused. When investment again grows and unemployment starts to fall, growth in potential output is expected to recover. Nevertheless it seems that the recession will cause a long-lasting fall in output level with compared with output prospects projected before the crisis.

Population ageing and a decline in the size of the working age population will begin to restrict economic growth potential in the next few years. The baby boomers born after the Second World War will reach retirement age just as the economy is recovering from the global crisis. Before the recession, the annual growth of potential output was already projected because of this to remain just under 2% in the coming decade. Due to the decline in size of the labour force, potential output growth will in future be mainly dependent on a favourable productivity trend.

The output gap describing the cyclical position, i.e. the difference between total actual output and projected potential output, will grow sharply during the recession. Total output was still clearly higher than potential output in 2008 and the output gap was therefore positive. Through the contraction of the economy in 2009, the output gap in 2009 quickly changed to negative, however. The difference between total output and potential production may grow further in 2010.

[2] The level of potential output has been estimated using the production function method agreed by the ECOFIN Council. Potential output describes the output capacity of the economy as well as the productivity, capital stock and employment that determine it.

Owing to the depth of the recession, the negative output gap is not expected to close until the middle of the decade.

The impact of fiscal policy can be estimated by assessing the changes in the cyclically adjusted balance. However, one must take into account uncertainties connected with the calculation of potential output and cyclical adjustment, which are highlighted during large cyclical fluctuations[3]. Before the recession, the cyclically adjusted balance remained for years nearly unchanged at an average of around 3% of GDP. Fiscal policy can therefore be characterised to have been quite neutral. In 2009–2010, on the other hand, the cyclically adjusted balance will contract strongly and will be a deficit of around 1% in 2010. The backdrop to this is formed by stimulus measures implemented to alleviate the consequences of the recession. Excluding corrective measures, general government finances threaten to remain chronically in deficit also after the recession. If potential growth cannot be boosted by measures supporting employment and productivity, general government finances must be adjusted in the coming decade to conditions of clearly slowing economic growth.

[3] The cyclically adjusted balance has been calculated utilising estimates of the output gap as well as the elasticity of public finances, which describes their cyclical sensitivity, estimated by the OECD. Elasticity estimates are averages calculated from historical data. By using them it is difficult to take into account, for example, all the factors relating to the timing of tax revenue.

Table 2. General government budgetary prospects

		2008 EUR million	2008	2009	2010	2011	2012	2013
			% of GDP					
	Net lending by sub-sector							
1.	General government	8 145	4.4	-2.2	-3.6	-3.0	-2.3	-1.9
2.	Central government	1635	0.9	-4.5	-5.8	-5.2	-4.7	-4.5
3.	-							
4.	Local government	-351	-0.2	-0.5	-0.4	-0.3	-0.4	-0.3
5.	Social security funds	6861	3.7	2.7	2.5	2.6	2.8	2.8
	General government							
6.	Total revenue	98576	53.4	53.1	52.6	53.4	53.2	52.8
7.	Total expenditure	90431	49.0	55.3	56.2	56.4	55.5	54.7
8.	Net lending/borrowing	8145	4.4	-2.2	-3.6	-3.0	-2.3	-1.9
9.	Interest expenditure	2719	1.5	1.4	1.4	1.7	2.1	2.3
10.	Primary surplus	10864	5.9	-0.8	-2.3	-1.2	-0.2	0.4
11.	Non-recurring measures	0	0.0	0.0	-0.2	0.0	0.0	0.0
	Selected components of revenue							
12.	Tax revenue (12=12a+12b+12c)	57 336	30.8	29.9	29.3	30.2	30.0	29.9
12a.	Taxes on production and imports	24 364	12.9	13.4	13.3	14.1	13.8	13.6
12b.	Taxes on income	32 321	17.5	16.2	15.8	15.9	16.0	16.1
12c.	Capital taxes	651	0.4	0.2	0.2	0.2	0.2	0.2
13.	Social security contributions	22527	12.2	12.8	12.9	12.9	13.0	13.1
14.	Property income	9 338	5.1	4.3	4.1	4.2	4.2	4.3
15.	Other income (15=16-12-13-14)	9 375	5.3	6.0	6.2	6.1	5.9	5.5
16.=6.	Total revenue	98576	53.4	53.1	52.6	53.4	53.2	52.8
	of which: Tax burden	79 410	42.7	42.5	42.0	42.8	42.9	42.8
	Selected components of expenditure							
17.	Compensation of employees + intermediate consumption	42187	22.8	25.6	25.9	25.8	25.2	24.5
17a.	Compensation of employees (wages + employer social security contributions)	24698	13.4	14.7	14.7	14.5	14.1	13.8
17b.	Intermediate consumption	17489	9.5	10.9	11.2	11.4	11.1	10.7
18.	Social transfers (18=18a+18b)	32 665	17.7	20.5	21.3	21.3	20.8	20.6
18.a.	Social transfers in kind	4 233	2.3	2.6	2.6	2.7	2.6	2.6
18b.	Social transfers other than in kind	28 432	15.4	17.9	18.6	18.6	18.2	18.0
19.=9.	Interest expenditure	2719	1.5	1.4	1.4	1.7	2.1	2.3
20.	Subsidies	2 451	1.3	1.5	1.5	1.5	1.5	1.5
21.	Gross fixed capital formation	4 771	2.6	2.8	2.7	2.7	2.6	2.5
22.	Other expenditure (22 = 23 -17-18-19-20-21)	5638	3.1	3.5	3.4	3.3	3.3	3.3
23.=7.	Total expenditure	90431	49.0	55.3	56.2	56.4	55.5	54.7
	of which: Government consumption	41273	22.3	25.0	25.2	25.1	24.6	24.2

Table 3. General government debt developments

	2008	2009	2010	2011	2012	2013
	% of GDP					
1. Gross debt, % of GDP	34.2	41.8	48.3	52.2	54.4	56.4
2. Change in gross debt ratio, % points	-1.0	7.6	6.5	3.9	2.2	2.0
Contributions to change in gross debt, % points						
3. Primary balance	5.9	-0.8	-2.3	-1.2	-0.2	0.4
4. Interest expenditure	1.5	1.4	1.4	1.7	2.1	2.3
5. Stock-flow adjustment	3.4	5.4	2.9	0.9	-0.1	0.1
of which:						
- Net acquisition of financial assets	3.9	3.3	3.0	2.9	3.0	3.0
- of which: privatisation proceeds	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
- Valuation effects (incl. GDP growth contribution)	-0.5	2.1	-0.2	-2.0	-3.1	-2.9
Implicit interest rate on debt (= consolidated interest expenses divided by the previous year's debt level multiplied by 100)	4.1	3.8	3.9	3.8	4.2	4.4
Other variables						
6. Liquid financial assets	69.7	-	-	-	-	-
7. Net financial liabilities (7=1-6)	-35.5	-	-	-	-	-

Table 4. Cyclical developments, % of GDP

	2008	2009	2010	2011	2012	2013
	% of GDP					
1. Real GDP growth (%)	1.0	-7.6	0.7	2.4	3.5	3.0
2. Net lending of general government	4.4	-2.2	-3.6	-3.0	-2.3	-1.9
3. Interest expenditure	1.5	1.4	1.4	1.7	2.1	2.3
4. Potential GDP growth (%)	2.0	0.9	0.8	1.6	1.5	1.7
contributions:						
- labour	0.2	-0.5	-0.4	0.2	0.0	0.1
- capital	0.7	0.3	0.2	0.2	0.2	0.2
- total factor productivity	1.1	1.1	1.1	1.2	1.2	1.3
5. Output gap	3.6	-5.0	-5.2	-4.3	-2.5	-1.2
6. Cyclical budgetary component	1.8	-2.5	-2.6	-2.2	-1.2	-0.6
7. Cyclically adjusted balance (2-6)	2.6	0.3	-1.1	-0.8	-1.0	-1.3
8. Cyclically adjusted primary balance (7+3)	4.1	1.7	0.3	0.9	1.0	1.0

4 Sensitivity analysis and comparison with previous programme

4.1 Risks in economic developments and their impact on public finances

The baseline scenario of the Stability Programme is based on the assumption that the global economy will gradually recover. Major uncertainties are still connected with the development of the global economy, however. Finland, due to its large export sector, is highly dependent on whether a robust, self-sustaining growth arises in the global economy. The realisation of negative risks and a slower than assumed recovery of the international economy might lead to a global investment recession, which would be very damaging for the recovery of Finland's export sector.

A return to a sustainable growth track requires that both fiscal and monetary policy stimulus measures are removed in a timely and orderly manner. Too fast a tightening worldwide may lead to a new recession. On the other hand, efforts must be made to restore strongly indebted public finances so that confidence in sustainable economic growth can be re-established. An evident risk is also the rise of protectionism, which if realised would lead inevitably to clearly slower growth of the global economy. Among the biggest losers would be small national economies dependent on foreign trade, like Finland.

Finland's position in a recovering global market depends on the price competitiveness of the export sector. Concern about the development of competitiveness has grown, because growth of nominal wages in the collective bargaining agreement period extending to the start of 2010 has been clearly faster than in competitor countries. At the same time, work productivity has deteriorated. Future pay settlements, moreover, will have a big impact on the kind of position from which Finland competes for market shares after the recession. Earlier, responsible pay settlements in terms of competitiveness and employment have been supported with the aid of tax cuts. In the coming years, public finances will be subjected to great adjustment pressures, which will restrict room for manoeuvre in tax policy. Price competitiveness will also be affected by the development of the common currency. A significant strengthening of the euro would require the internal market to exhibit flexibility in order to maintain competitiveness.

The recession may further accelerate the structural change in which industrial production is transferred to emerging economies where production costs are lower. Mature markets such as Finland must find products and services to replace lost production. But it is difficult to anticipate in advance, when, in which sectors and on what scale these will be created. This will increase uncertainty in the medium-term outlook.

Climate change, its prevention and adjustment to it represent a huge international challenge. Finland is more industrialised and energy-intensive that other EU countries and because of this the impact of climate and energy measures is greater in Finland than elsewhere. In the emissions trading sector, climate and energy policy costs will be to a large extent determined on the basis of the price of a tonne of carbon, which is expected to rise to EUR 30–40 by 2015. Outside emissions trading, the cost of policy measures may rise to significantly higher than this. The cost-effectiveness of climate measures can be improved by participating in international emissions trading and by utilising the Kyoto mechanisms. A rise in the price of a tonne of carbon will increase the costs of industry and favour carbon leakage, i.e. encourage energy-intensive industry to transfer outside the EU.

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

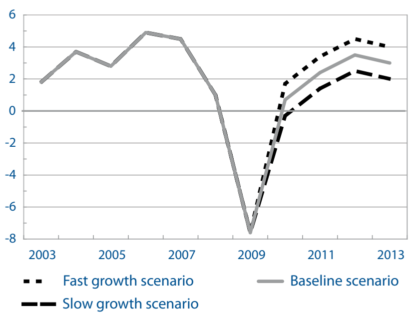
The general government balance will not be corrected in the programme period through economic growth alone to the level that preceded the recession. Should negative risks be realised, recovery from the recession would be prolonged and public finances would be significantly weaker than the baseline scenario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

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

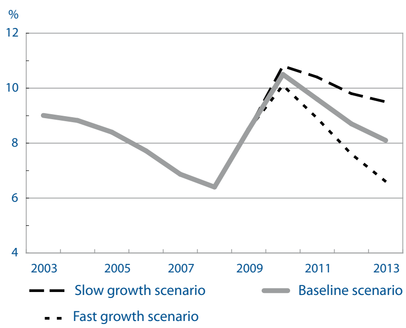
In the slower growth scenario, the post-recession growth spurt will be smaller than that anticipated in the baseline scenario. Total output growth will be a little under 1½% on average in 2010–2013. The unemployment rate would rise to nearly 11 per cent in 2010 and would be nearly 10% at the end of the programme period. The general government deficit at the end of the programme period would be around 4% and the debt ratio would rise to nearly 60%. This would significantly increase the need to adjust public finances. The impact of economic growth on public finances has been estimated by using OECD elasticity estimates.

Even annual growth faster than the baseline scenario would not halt growth of the debt ratio in the programme period. The general government financial position would be clearly strengthened, however, and would be in balance at the end of the programme period. Even so, central government finances would still be clearly in deficit. The unemployment rate would fall fairly rapidly and would be around 6½% in 2013. The realisation of economic growth more favourable than the baseline scenario will require a fast and strong recovery of the international economy as well as significantly higher demand than anticipated for Finnish export products.

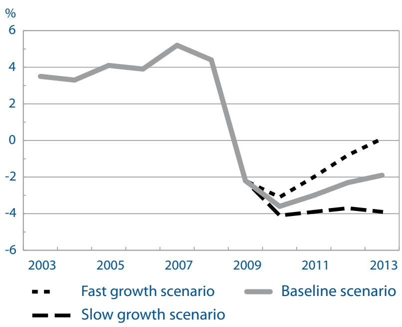
GDP
change in volume, %



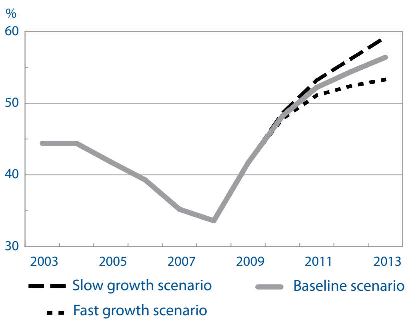
EMPLOYMENT RATE



GENERAL GOVERNEMNT NET LENDING
in ratio to GDP



GENERAL GOVERNMENT GROSS DEBT
in ratio to GDP



Source: Statistics Finland, Ministry of Finance.

4.2 Comparison with last year's Stability Programme update

The 2008 Stability Programme update predicted that the Finnish economy would slide into recession, but the recession proved to be significantly deeper than anticipated. According to the current view, the recovery from the recession will be relatively slow and the crisis will leave its mark on the state of public finances throughout the programme period. That's why differences compared with last year's programme are considerable.

In the previous Stability Programme update GDP was still projected to grow in 2008 by 2.6%. This projection later had to be adjusted downward. Due to a strong first half of the year, annual growth in exports still remained good in 2008. The recession was already clearly evident elsewhere in the economy, however. Investment growth came to a halt and growth in public consumption slowed clearly more than expected.

A little over a year ago it was expected that Finland would survive the recession without a contraction in total output. The collapse of world trade, however, lead to a steep fall in Finnish exports in 2009. This was accompanied by a sharp cutback in investment. The estimate of total output development in 2009 therefore had to be adjusted downward by an exceptionally large amount. Moreover, the outlook for 2010 is gloomier than projected only one year ago.

The inflation trend markedly changed around the middle of 2008. The rise in the price of many raw materials came to a halt and prices fell sharply in the latter part of the year. Nevertheless, consumer prices rose in Finland clearly more than the euro area average. This was partly due to higher prices for food and housing. In 2009–2010 prices are also expected to rise less than projected in the last Stability Programme update.

The economic crisis halted the long-continued favourable trend in employment. The number of employed increased further during 2008 in line with the forecast in the last Stability Programme update. In 2009–2010 employment will fall substantially, however. Unemployment is expected to increase in the programme period significantly more than that forecast only just over a year ago.

Owing to the economic crisis that began at the end of 2008, the financial balances of central and local government have been adjusted downward for the whole programme period. The view on the 2008 surplus of the social security funds, on the other hand, is now more favourable than that estimated a little over a year ago. This is due to the fact that the property income of employment pension funds grew very strongly in 2008. In 2009–2010, however, the financial position of the entire public sector (including social security funds) is expected to weaken clearly more than the previous Stability Programme estimate. In addition to automatic stabilisers, stimulus measures aimed at maintaining economic activity will also be evident in the development of the general government net lending. Through the improved economic outlook, general government finances will strengthen to some extent from 2011, but will still remain weaker than estimated in the 2008 Stability Programme update. Due to changes made in the estimates for general government net lending, estimates of the debt ratio have been raised significantly. In addition, some of the stimulus measures are financial investments, which do not appear in the deficit, but raise the debt ratio.

Table 5. Divergence from previous update

	2008	2009	2010	2011	2012	2013
Real GDP growth (%)						
SP-2008	2.6	0.6	1.8	2.4	2.2	-
SP-2009	1.0	-7.6	0.7	2.4	3.5	3.0
Difference, % points	-1.6	-8.2	-1.1	0.0	1.3	-
General government net lending, % of GDP						
SP-2008	4.4	2.1	1.1	1.0	0.9	-
SP-2009	4.4	-2.2	-3.6	-3.0	-2.3	-1.9
Difference, % points	0.0	-4.3	-4.7	-4.0	-3.2	-
General government gross debt, % of GDP						
SP-2008	32.4	33.0	33.7	34.1	34.6	-
SP-2009	34.2	41.8	48.3	52.2	54.4	56.4
Difference, % points	1.8	8.8	14.6	18.1	19.8	-

Previous update: Stability Programme update (SP-2008), December 2008
Current update: Stability Programme update (SP-2009), February 2010

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 structures and the Government productivity programme.

5.2 General government revenue and taxation

The financial position of central government has worsened very sharply as a result of the steep fall in total output. The erosion of the tax base, with business profits, private consumption, capital gains and labour income all declining, is reflected in decreasing tax revenue. Central government tax revenue has fallen more quickly than that of other tax recipients, because for central government the significance of cyclically sensitive tax revenue is greater.

The Government Programme prepared in spring 2007 set as an objective the reduction of taxation on work by EUR 1.1 billion in the current parliamentary term. If tax rates were not adjusted at all, taxation would increase as a result of rising earnings and the progressive nature of the tax system. In the medium-term basic scenario, in terms of tax rate changes it has been assumed that taxation on work will not be allowed to increase via progression. The changes in tax rates necessary to offset the tax-raising effects of higher earnings would reduce tax revenue in 2009–2013 by slightly more than EUR 300 million per annum, depending on the earnings trend. In 2010 the tax-raising effect of an increase in social security contributions will also be compensated by a change in tax rates, which will reduce tax revenue by EUR 470 million. In addition to this, in the basic scenario taxes from earned income will be reduced in accordance with a tax cut in accordance with the Government Programme, of which for cyclical reasons most, i.e. EUR 970 million, took place in 2009. Moreover, a technical assumption has been made that the rest of the Government Programme's tax cuts, i.e. EUR 140 million, would be implemented in 2011.

Despite the substantial deterioration of the financial position of general government and the rapid growth of indebtedness, central government taxation has not yet been increased to any significant extent. It has, however, been decided to increase indirect taxation. In July 2010 value-added tax rates will be raised by one percentage point. This is expected to boost central government tax revenues by around EUR 700 million per annum. The simultaneous lowering of value-added tax on restaurant food to the value-added tax level on food in general will reduce tax revenue on an annual basis by EUR 260 million. In 2010 value-added tax revenue will be reduced by the introduction of the tax account system, intended to facilitate the reporting and payment of taxes, which is expected to cause a one-off loss in tax receipts of around EUR 380 million. In accordance with the policy outlines of the summer 2009 budget review, the tax on soft drinks will be increased and a tax on sweets introduced at the end of 2010, which will increase tax revenue on an annual basis by around EUR 100 million.

As part of measures to stimulate the economy and boost employment, the Government decided to lower the employer's national pension contribution as of April 2009. The employer's national pension contribution was completely abolished on 1 January 2010. The central government will compensate for the impact of the abolition by increasing income transfers made to social security funds. In connection with the abolition of the national pension contribution, it was decided that replacement revenue would be found by raising energy taxation by around EUR 750 million in 2011. To date, the Government has not through its own measures weakened economic activity during the economic crisis; the aim is to implement balancing measures at a later date, at which time the recovery of economic conditions is expected to be on a stronger foundation.

As the economic situation improves, the financial position of general government will strengthen in 2011–2013. The improved economic activity on the horizon will not be sufficient to balance public finances in the medium term. The revenue items that have declined most strongly in the economic crisis, such as corporate tax and tax on capital income, will return to clear growth, but the high level of economic activity that preceded the crisis will not be reached in the period under review. Growth of corporate tax revenue will be dampened by companies' opportunities to offset in taxation losses incurred earlier. The most significant capital revenue item comes from capital gains. Growth of tax on capital income will be slowed by the opportunity to offset capital losses incurred earlier from future capital gains.

The financial situation of municipalities has deteriorated as a result of the economic crisis and at the same time differences between municipalities have grown. The financial position of municipalities will be improved by temporarily increasing in 2009–2011 the municipalities' share of corporate tax. The annual impact of this is around EUR 400 million. Furthermore, the lowering of the employer's national pension contribution as of 1 April 2009 and its abolition in 2010 will ease the municipalities' financial situation (in 2009 by around EUR 80 million and in 2010 by around EUR 200 million). In 2010 municipal income tax rate will rise on average by 0.4 percentage points, which will increase municipal revenue by around EUR 320 million. An increase in real-estate tax rates will increase municipality revenue by nearly EUR 200 million. Even after this there will be pressure to increase municipal taxes. There is still scope within the upper limit set by the Government to increase the real-estate tax decided by municipalities. Increasing the real-estate tax to the upper limit in all municipalities would increase municipal revenue by around EUR 900 million.

Social security funds will remain in surplus during the period under review. As unemployment expenditure rises and the number of pensioners increases as a result of demographic change, the financial position of social security funds will be strengthened by raising social security contributions.

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 under 50% in 2007. Measures to restore general government finances and the onset of rapid economic growth changed the course of developments in the mid-1990s.

Public expenditure growth accelerated already in 2008 due to, for example, rather high pay rises and numerous infrastructure projects. In 2009 general government expenditure rose to an estimated 55%; the value of total output declined sharply as public expenditure grew by more than 5%, due to, among other things, the operation of automatic stabilisers. In the next few years, the ratio of expenditure to GDP will also remain high.

All of the rise in stimulus-related expenditure is not seen in aggregate spending according to national accounts. Financial investments, for example, increase central government budget expenditure, but in national accounts they are entered as financial transactions. Financial investments, moreover, are not included in the central government spending limits. Nominal growth of central government on-budget expenditure in 2009 was more than 10%, while according to national accounts total central government expenditure growth was around 5%.

In the medium term, population ageing will already be evident in the structure of public expenditure, when the proportion of pension spending but also of health care and long-term care expenditure will grow.

The Government has reacted to weakening economic development by launching an extensive package of measures in several stages, starting with the August 2008 budget review. The 2010 Budget contains proposals for bringing forward investments and for other measures aimed at achieving rapid employment impacts cost-effectively. The emphasis is on measures that support longer term economic growth while also promoting innovations, exploiting information technology and taking environmental and climate aspects into account. There will be investment in employment and training policy measures and the number of places in vocational education will be increased. The objective is to mitigate long-term unemployment and social exclusion among young people in particular. In accordance with the central government productivity programme, the number of central government personnel will fall during the programme period, which will reduce growth of household consumption expenditure.

The 2010 Budget re-allocated around EUR 230 million in appropriations from, for example, government agencies' operating expenditure to maintaining employment, tackling unemployment and alleviating the financial situation of local government.

Expenditure of the various administrative branches will not grow in real terms by the end of the programme period. Central government interest outlays will double from 2010 to 2013 due to a rise in interest rates and growth of total debt.

Municipalities provide for their inhabitants basic public services, of which the most important relate to education as well as social services and health care. Services are funded mainly with municipal tax revenue, which is estimated to be around EUR 17.6 billion in 2010. Central government aid to municipalities to finance basic services will total EUR 9.6 billion in 2010. The system of central government transfers to local government will be reformed in 2010, when the present sector-specific central government transfers will be combined into a single central government transfer intended for the arrangement of basic public services.

The state of local government finances will remain difficult throughout the programme period. The recession has weakened municipalities' capacity to prepare for growth in services needs caused by changes in age structure. Local government finances are threatened by a more permanent state of deficit and a continuation of the debt spiral, unless their activities can be made more efficient and expenditure growth curtailed.

Table 6. General government expenditure by function, % of GDP

		COFOG-division	2007	2012
			% of GDP	
1.	General public services	1	6.2	6.8
2.	Defence	2	1.4	1.7
3.	Public order and safety	3	1.2	1.3
4.	Economic affairs	4	4.4	4.7
5.	Environmental protection	5	0.3	0.6
6.	Housing and community amenities	6	0.4	0.4
7.	Health	7	6.6	7.8
8.	Recreation. culture and religion	8	1.1	1.6
9.	Education	9	5.8	6.7
10.	Social protection	10	19.9	23.9
11.	Total expenditure (=item 7 = item 23 in Table 2)	Total	47.3	55.5

5.4 Productivity in general government

Population ageing and the consequent reduction in labour supply as well as the economic crisis will require labour productivity to improve substantially in the coming years, particularly in the public sector but also in the private sector. The standard of service provision in Finland is highly rated according to international comparisons and opinion surveys among end-users, both in terms of quality and effectiveness. Examined over the long term, it has not been possible to set the productivity of public service provision on a growth track that answering the challenges that lie ahead would require. A particularly demanding task is improving the productivity of the municipal sector.

Productivity in central government

Total productivity in central government has risen on average since 2005. Labour productivity has risen by nearly 2% and total productivity by 1% since 2007. Growth of labour productivity is explained by labour input falling more than output. The result is a consequence of the Government's goal-directed, multi-year central government productivity programme. By 2011 measures adopted earlier and currently ongoing under the programme will reduce staff numbers in central government by the equivalent of some 9,600 person-years compared with 2005. The latest Government assessment indicates the target will be achieved. In addition, in keeping with the Government Programme and the decision on the 2008 spending limits, new productivity-enhancing measures 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 fall by around 12% between 2005 and 2015. If by reforming service processes and use of ICT it is possible at the same time to safeguard the level and standard of output, as has happened to date, the outcome will be growth of labour productivity and total productivity of a corresponding magnitude.

Overall, the productivity programme can be implemented at central government level by utilising natural attrition of staff. For the whole of central government, the annual reductions required by the productivity programme are in 2010–2011 on average around 60% and in 2012–2015 around 30% of the expected attrition caused by retiring. Productivity enhancing measures will reduce the need for staff, but the natural attrition of current staff is so great that the central government's recruitment need in the next few years will be 3,000–4,000 people.

In recent years, the Government has prioritised structural reforms promoting more consolidation within central government. One such project is the establishment of a financial and human resources service centre providing financial and human resources management support and expert services for the whole of central government. The joint financial and human resources management information systems provided by the service centre as well as the automation of processes will reduce government agencies' own tasks, increase the productivity of the whole system and improve quality. The Government has created corporate steering structures for information management by establishing ValtIT and KuntaIT units in the Ministry of Finance and a central government IT service centre in the Treasury. The aim of the reforms is to improve the quality of services provided, to promote the coherence of different authorities' activities and new joint IT solutions, and to introduce e-Services throughout central government. Common information system architectures will be defined for key public service entities in cooperation with the ministries and municipalities by the end of 2010. The objective is for central government IT acquisitions to be implemented centrally in future. The centralisation of central government procurement to date has generated significant savings and improved procurement efficiency. In October 2009, the Ministry of Finance published the central government's new procurement strategy, which increases use of joint procurement in the spirit of corporate steering.

Structural reform and productivity of municipalities and services

A key challenge of improving public sector productivity is to improve the productivity of the municipal sector, which is much more extensive than central government. Although there are measurement and statistical problems connected with measuring the productivity of public services, statistics and research indicate unambiguously that overall productivity of education, health care and social services provided by municipalities and joint municipal authorities has declined on average since the turn of the millennium. From 2007 to 2008 the decline was 0.5%.

The Government's main instrument in improving municipal sector productivity is the structural reform of municipalities and services. Municipality and service structures were reformed as stipulated in the Act on Restructuring Municipalities and Services (framework law), which entered into force on 23 February 2007 and which is effective until the end of 2012. The purpose of the reform 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 intention is therefore to improve productivity and curb growth of expenditure in the municipalities and to enhance the steering systems used in providing municipal services.

The impact of the reform to date is evident particularly in the development of the municipal structure. In 2007, 14 municipal mergers were implemented, in 2008 one merger, and in 2009 32 mergers. These mergers involved a total of 99 municipalities. Mergers are also planned for 2010–2013. The number of municipalities has fallen by 67 since the beginning of 2009. Currently there are 348 municipalities in total, and there will be 337 in 2013.

Service structures will be strengthened by consolidating services that require a broader population base of more than one municipality and by increasing cooperation between municipalities. Municipalities or partnership areas responsible for providing basic health care and closely related social welfare services must have a minimum population base of around 20,000 inhabitants. As a result of the reform, the population bases for social services and health care are growing, but structures are still to some extent disconnected. The formation of partnership areas for basic vocational training has gone fairly well, because after 2010 only 3–4 municipalities and 1–2 joint municipal authorities will remain below the target.

The reform is still incomplete, because the municipal structure is not yet coherent enough. Revamping services and raising productivity is the next challenge of the reform. To date, productivity improvements have been slowed by, for example, long transition times to changes in the tasks and number of staff as well as merger agreements that prevent the direct cutting of inefficient activities. Only when restrictions relating to transition times have been removed and the reform progresses will it be possible to assess its effects on improving productivity and curbing longer term expenditure growth.

6 Sustainability of general government finances

6.1 Measures to enhance sustainability

The outlook for Finnish public finances is overshadowed by the rapid population ageing that will take place over the next two decades; the baby boom generation, born after the Second World War, will retire from working life. Ageing will also be affected by the continual lengthening of life expectancy. According to the national population forecast (2009), the life expectancy of Finns is expected to grow by 9½ years by 2060, i.e. by around two years for every coming decade. Men are expected to live 11 years longer and women 8 years longer.

Up to 2030 Finland's population will age more quickly than any other EU Member State. Population ageing will already begin to be apparent in economic development in 2010, when the first large age group – those born in 1945 – reaches the age of 65. At the same time, the working age population will start to decline. In the economic history of independent Finland the working age population has declined only in time of war and in a couple of years at the end of the 1960s when emigration to Sweden was at its strongest.

The most rapid growth of pensions will take place in the 2010s and of health care and long-term care services in the 2020s. In the 2010s growth of costs arising from ageing will be faster in Finland as a proportion of GDP than in any other EU country. At the same time as public expenditure is growing strongly, growth of the financial base of general government finances will slow significantly as the labour force declines. The sustainability challenge will therefore arise from expenditure growth and slowing tax revenues.

Due to the financial and economic crisis, general government finances have deteriorated sharply, which has further increased the sustainability challenge. Without underestimating the effects of the economic crisis, the challenge to the sustainability of general government finances caused by ageing is many times the challenge arising to the public sector caused by the economic crisis. The costs of ageing are permanent, extending over many decades, in contrast with the costs of the recession, which are mainly temporary. It is estimated that the costs of the economic crisis to the public sector are a little under one tenth of the costs caused by ageing.

The following measures, among others, have been taken to make provision for the challenges to general government finances created by population ageing:

- pursuing a disciplined fiscal policy in good times 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.

Before the economic crisis, in 2000–2008, central government finances were kept in surplus through disciplined fiscal policy. By reducing debt and interest outlays, room for manoeuvre was created to cope with expenditure growth caused by population ageing. Action to balance the financial burden of pension between generations has been taken through partial prefunding of pensions. Thanks to prefunding, long-term increases in pension contributions will be no more than one half of the rise in pension expenditure. Just over a quarter of pensions have been prefunded and the market value of assets in pension funds is around 60% of GDP. Assets in pension funds amount to more than public debt.

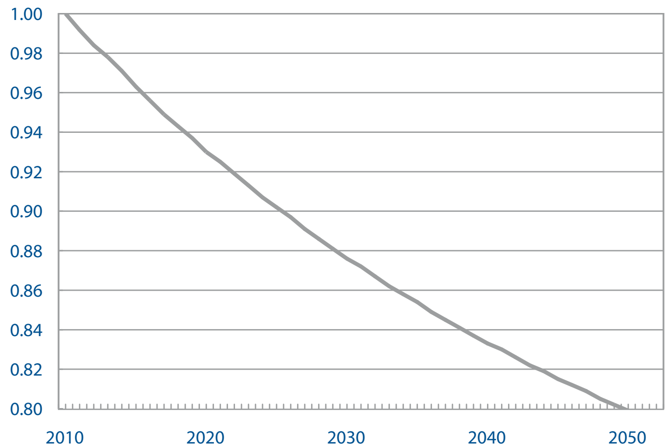
Finland's pension system has been reformed on several occasions since the early 1990s. The most recent comprehensive reform took effect at the beginning of 2005. The aim is to strengthen the sustainability of the pension system by adjusting pensions to changes in life expectancy and encouraging older workers to stay longer in employment by introducing an accelerated pension accrual.

In March 2009 the Government and social partners agreed that retirement will be postponed by at least three years by 2025. In this context, the Government established two working groups in spring 2009 to consider means by which the effective retirement age might be raised. The working groups' proposals will be ready by the end of January 2010. It is estimated that pension reforms already implemented will raise the retirement age by 1½ years by 2025, so the Government's goal by means of new measures is to postpone retirement by a further 1½ years on top of this by 2025.

The employment rate among older workers has been rising considerably, indicating that the pension reforms have served their purpose. The employment rate in the age group 55–64 has risen from 36.4% in 1997 to 55.5% in 2008. For the Government target of extending working careers by three years to be fulfilled, it will not be sufficient solely to postpone retirement on the old-age pension. The risk of retiring on disability pension must also be reduced. In Finland around 9% of the labour force is on disability pension.

To strengthen the sustainability of the pension system, a new life expectancy coefficient (see diagram below) has been put into practice for those retiring on old-age pension from 2010 onwards, and this will adjust new pensions to higher life expectancy. The lowering impact of the coefficient can be compensated by staying longer in work. In 2010 the life expectancy coefficient will reduce pensions on retirement by 0.8% and this can be offset by working for one month longer. In old-age pensions, the first age group to be affected by the coefficient will be those born in 1948, who will reach 62 years of age and will therefore by entitled to early old-age pension. The coefficient will not be applied to age groups born before them. The coefficient for those born in 1947 is 1.00. In disability pensions the coefficient will be applied to all new disability pensions in terms of earned pension entitlement. The coefficient will not, on the other hand, be applied to the projected pensionable service of disability pensions. The term projected pensionable service refers to the time from the beginning of pension contingency year to the old-age pension retirement age.

Life expectancy coefficient



Source: Finnish Centre for Pensions, according to the Eurostat 2005 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 (SATA) 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 committee's proposals must be such that they do not pose a risk to the sustainability of the public finances in the long term. The committee completed its work at the beginning of December 2009.

The minimum age of eligibility for a part-time pension will rise by two years to 60 from the beginning of 2011. In March 2011 a guaranteed pension, which will increase the lowest pensions of all, will be introduced.

Alongside pension reform, the unemployment security system has also been reformed in a direction that strengthens employment the sustainability of public finances. The minimum age of eligibility for the unemployment path to retirement (extended earnings-related unemployment security for elderly workers), by which the transition to retirement has quite commonly taken place in Finland, will rise by one year to 58 from the beginning of 2011. It is possible to transfer to old–age pension from the unemployment path to retirement flexibly between 62 and 65 years of age.

6.2. Sustainability scenario

In the following sustainability scenario, the projections start in 2015 and extend through to 2060. Due to the economic and financial crisis, the outlook for economic growth and the sustainability of general government finances has changed substantially over a short period and the criteria for the projections have had to be updated. The scenario is based on the national population forecast (Statistics Finland 2009), which differs to some extent for Eurostat's population forecast.[4] The scenario was produced using a national calculation model for social expenditure. The macro-economic assumptions used in the scenario (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.

The baseline scenario assumes a decline in potential output of just over 4% due to the financial and economic crisis. In the scenario, the employment rate is expected to settle at just over 74% by 2025 and the unemployment rate at 6½ %. Of the expected 4% contraction in potential output in relation to the baseline scenario of the Economic Policy Committee, a little under half is expected to take place through a deterioration of employment and just over a half through a slowing of productivity growth. Labour productivity is assumed to increase by 1.9% per annum in the period 2010–2019 and thereafter at an annual rate of 1.7%. In addition, the scenario assumes that annual working time (working hours/year) per employed person will remain stable. The average rate of GDP growth for the projection period is around 1.8% per annum. Calculated with the above assumptions, age-related expenditure (pensions, health care, long-term

[4] In the national population forecast, life expectancy increases to 2060 by just over 2 years more than in the population forecast made by Eurostat in 2008. Net immigration, moreover, is to some extent greater.

care, education and unemployment) will grow in 2008–2060 by 7 percentage points of GDP. By 2015 already 1.9 percentage points of this growth will be realised and by 2030 5.7 percentage points. The fastest growth of pension expenditure will take place in the 2010s and the expenditure peak will be reached after two decades, after which pension expenditure as a proportion of GDP will fall slightly. Long-term care expenditure on the elderly will increase most quickly by far, from 1.9% in 2008 to 4.9% per cent of GDP in 2060. Unemployment expenditure will remain roughly at the level of the starting year and education expenditure will fall slightly due to a decline in younger age groups (Table 7). Expenditure other than age-related expenses is assumed in the sustainability scenario to remain stable as a proportion of GDP.

In the sustainability scenario the total tax rate is kept constant at the level forecast for 2015. The increased pressure in pension expenditure is released into the pension contributions. When the total tax rate is kept constant, other taxation is correspondingly eased. The primary balance of general government finances was determined by the net principle, i.e. it does not include interest outlays nor interest and other property income. The real interest rate for general government finances is assumed to be 3% and the interest rate assumption for employment pension funds and other public finance investments is 4%.

Calculated on the basis of these assumptions, overall public finances are not on a sustainable foundation. 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 pension assets relative to GDP will remain quite stable at just over 60%. The rest of general government (central and local government) is calculated to stay in deficit throughout the period under review, and both their deficit and debt will grow throughout the projection period.

In the baseline scenario there is a sustainability gap[5], which is roughly estimated to be around 5½% of GDP. This figure shows by how much the balance of general government should be immediately improved either by increasing taxes and/or cutting spending in order to place general government finances on a sustainable foundation. Making an exact estimate of the gap is exacerbated by uncertainty about the length and depth of the current economic crisis. The sustainability gap indicator is rather sensitive to the assumption of the structural balance of general government in the starting year. Due to the economic crisis, the structural balance is now significantly weaker than in the projections presented in earlier years.

A more stable and less economically sensitive indicator is the target surplus which if realised would remove the sustainability gap. In the baseline scenario, the surplus ensuring sustainability would be around 4% of total output in 2015.

5 The EU Commission has developed two indicators describing sustainability : S1 and S2. In the former, the level of debt at the end of the review period (2060) is 60% / GDP. According to the S2 indicator, indebtedness remains steady at the present level.

Rapidly closing the sustainability gap during the recession is not sensible, because it would slow economic recovery and could further exacerbate the stabilisation of general government finances. The situation is exceptionally challenging, because the deep recession and a sharp onset of population ageing will take place at the same time. Alongside spending curbs and tax increases, structural reforms that impact on general government finances in the long term are required to enhance sustainability. Structural reforms should aim, for example, at extending working careers, i.e. at strengthening the financial foundation of general government, and at curbing public spending by improving the productivity of welfare services.

Table 7: Long-term sustainability of public finances (2008-2060), % of GDP

	2008	2015	2020	2030	2060	2060-2015 change
Total expenditure	49.0	51.4	54.0	58.2	71.4	20.0
of which age-related and unemployment expenditure	24.6	26.4	28.0	30.2	31.5	5.1
Pensions	10.7	12.1	13.2	14.3	13.7	1.6
Earnings-related pensions	9.3	10.7	11.9	13.2	12.9	2.2
National pensions	1.4	1.3	1.3	1.1	0.8	-0.5
Health care	5.1	5.3	5.5	5.8	6.3	1.0
Long-term care	1.9	2.2	2.5	3.3	4.9	2.7
Education	5.6	5.5	5.5	5.6	5.4	-0.1
Unemployment	1.3	1.3	1.3	1.3	1.3	0.0
Interest expenditure	1.8	2.5	3.5	5.4	17.4	14.9
Total revenue *)	53.4	49.9	51.3	50.7	49.5	-0.4
of which: property income *)	5.1	4.3	5.7	5.1	3.9	-0.4
pension contributions	8.1	8.8	9.1	9.7	9.7	0.9
Net lending*))**	4.4	-1.5	-2.7	-7.5	-21.9	-20.4
Gross debt	37.2	60.0	68.3	106.8	344.2	284.2
of which: consolidated debt	34.2	57.0	65.3	103.8	341.2	284.2
Pension funds' financial assets, gross	54.8	63.1	67.5	67.8	63.2	0.1
of which: consolidated liquid assets	42.4	50.7	55.1	55.4	50.8	0.1

*) As of 2020, property income and net lending will include changes in valuation of equity investments.
**) Cyclically adjusted balance as of 2020.

	Assumptions, %			
	2015	2020	2030	2060
Labour productivity growth	1.8	1.7	1.7	1.7
Real GDP growth	2.0	1.6	1.7	1.7
Participation rate				
males (20-64)	82.9	83.9	85.2	85.4
females (20-64)	79.3	80.3	81.6	81.9
total (20-64)	81.1	82.1	83.5	83.7
Unemployment rate	7.0	6.4	6.4	6.5
Population aged over 65 % of total population	17.3	22.7	26.8	28.7
Inflation	2.0	2.0	2.0	2.0
Real interest rate	3.0	3.0	3.0	3.0

6.3. Pension fund assets

Finland's earnings-related pension system is a partially prefunded, defined-benefit system in which the benefits are determined according to length of employment history and the level of earnings. The prefunding is collective and it does not affect the level of the pension; rather it is intended to even out the pension 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. The consolidated market value of the pension funds was EUR 96.9 billion (52.4% of GDP) at the end of 2008. Tables 8–10 show the consolidated and non-consolidated market value of the pension funds in 2002–2008.

The revenue from the investment proceeds of consolidated liquid assets – interest and dividends – amounted to around EUR 4.5 billion in 2008. The market value of pension fund assets fell sharply due to the financial and economic crisis. When these changes in the value of pension fund assets, which amounted to minus EUR 19.5 billion, are taken into account, revenue from proceeds of fund assets was EUR 15 billion in the red.

Table 8. Financial assets (market value) of the earnings-related pension institutions (sector 13141), EUR million

	2002	2003	2004	2005	2006	2007	2008
A. Non-consolidated assets							
AF21 Currency	2	0	0	0	0	0	13
AF22 Transferable deposits	256	257	376	510	903	937	1026
AF29 Other deposits	880	379	377	246	199	78	175
AF331 Short-term bills	1838	2320	2624	2666	1537	3438	4315
AF332 Long-term bonds	32312	32821	36355	38965	37507	33233	33429
AF34 Derivatives, net	67	88	164	48	1264	1699	1139
AF511 Quoted shares	10518	13807	17225	20355	23052	24556	11185
AF52 Mutual fund shares	3399	5209	7794	14420	21886	28396	19779
Total	**49272**	**54881**	**64915**	**77210**	**86348**	**92337**	**71061**
% of GDP	34,3	37,6	42,7	49,2	51,7	51,4	38,5
B. Liabilities of general government (Sector 13) to pension funds							
AF331 Short-term bills	29	26	257	42	76	111	80
AF332 Long-term bonds	4786	4666	3512	3606	2817	3062	2923
Total	**4815**	**4692**	**3769**	**3648**	**2893**	**3173**	**3003**
% of GDP	3,3	3,2	2,5	2,3	1,7	1,8	1,6
C. Consolidated liquid assets (=A-B)							
AF21 Currency	2	0	0	0	0	0	13
AF22 Transferable deposits	256	257	376	510	903	937	1026
AF29 Other deposits	880	379	377	246	199	78	175
AF331 Short-term bills	1809	2294	2367	2624	1461	3327	4235
AF332 Long-term bonds	27526	28155	32843	35359	34690	30171	30506
AF34 Derivatives, net	67	88	164	48	1264	1699	1139
AF511 Quoted shares	10518	13807	17225	20355	23052	24556	11185
AF52 Mutual fund shares	3399	5209	7794	14420	21886	28396	19779
Total	**44457**	**50189**	**61146**	**73562**	**83455**	**89164**	**68058**
% of GDP	30,9	34,4	40,2	46,8	50,0	49,6	36,8
D. Total assts of pension funds *							
Non-consolidated total assets	63557	69267	78340	90509	100264	107871	90968
% of GDP	44,2	47,5	51,5	57,6	60,0	60,0	49,2
Consolidated total assets	57812	63714	73817	86116	96636	103589	86615
% of GDP	40,2	43,7	48,5	54,8	57,9	57,7	46,9

* Derivatives, net

Source: Statistics Finland: Financial statistics

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

	2002	2003	2004	2005	2006	2007	2008*
	EUR million						
Non-consolidated assets	4484	5795	6867	8201	10305	12051	10355
Consolidated assets	3099	4549	6339	7963	10127	11813	10254
	% of GDP						
Non-consolidated assets	3.1	4.0	4.5	5.2	6.2	6.7	5.6
Consolidated assets	2.2	3.1	4.2	5.1	6.1	6.6	5.6

Source: State Pension Fund

10. Financial assets (market value) of the earnings-related pension institutions, total (Tables 8 and 9)

	2002	2003	2004	2005	2006	2007	2008*
	EUR million						
Non-consolidated assets	68041	75062	85207	98710	110569	119922	101323
Consolidated assets	60911	68263	80156	94079	106763	115402	96869
Consolidated liquid assets	47556	54738	67485	81525	93029	100977	78312
	% of GDP						
Non-consolidated assets	47.3	51.5	56.0	62.8	66.2	66.7	54.8
Consolidated assets	42.4	46.8	52.7	59.9	63.9	64.2	52.4
Consolidated liquid assets	33.1	37.5	44.4	51.9	55.7	56.2	42.4

Sources: Statistics Finland and State Pension Fund

7 National fiscal procedures and institutions

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

The annual central government spending limits 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 central government spending limits endorsed by the Government form the guideline for the following year's budget proposal in the administrative branches of the government.

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

Based on experience gained in the previous parliamentary term, the spending limits system was developed and a revised spending limits system was introduced in this parliamentary term. Elements that increased flexibility, such as a fixed annual supplementary budget provision and a special undistributed provision for future Government decisions, were added to the system. Additionally, there is now the option of allocating unbudgeted funds within the spending limits to the next budget year. Moreover, the rescheduling of expenditure over different years has also been made more flexible. The Government Programme has, for example, permitted adjustments to the level of spending limits to adapt to rescheduling and rebudgeting expenditure, provided that in a later year a corresponding decrease is made in the same year's spending limits. If the expenditure for a project or other equivalent entity needs to be rebudgeted and earlier appropriations have not been cancelled, the spending limit will be increased by the rebudgeted amount.

In addition to the central government spending limits, two targets relating to the central government balance are entered in the Government Programme. According to the Government Programme, the Government is aiming for a structural surplus in central government finances of 1% of GDP at the end the parliamentary term. The Government Programme also states that central government finances must never show a deficit of more than 2½ per cent of GDP even in an exceptionally weak economy.

In its first spending limits decision, this Government set the spending limits for the parliamentary term so that it adheres to the EUR 1.3 billion increase in spending at the level for 2011 that was agreed in the Government Programme. The 2010 spending limits level, after changes in cost and price levels and in the structure of the Budget, is EUR 37.0 billion.

Due to the economic crisis, room for manoeuvre in the spending limits has been particularly constrained in the preparation of the 2010 Budget. Owing to this, the Government prepared re-allocations of around EUR 230 million, directed at all administrative branches, in which the operating expenditures of agencies, for example, were reduced by a total of EUR 56 million. Through the re-allocation, appropriations have been increased particularly to promote employment and tackle unemployment. There is a supplementary budget provision of EUR 300 million for unexpected appropriation needs in 2010.

The previous government term (2003–2007) demonstrated that a multi-annual system of spending limits based on a spending rule is effective. The previous Government committed itself to adhere to the system of spending limits, and expenditure was kept within the set limits throughout the parliamentary term. The economy developed better than expected during the previous parliamentary term. Partly thanks to the spending rules, there was less scope for procyclical fiscal policy, and the surplus generated in central government finances was used for debt reduction and to augment the State Pension Fund. It can also be noted that excluding the automatic fiscal stabilisers from the spending rules has been a good decision.

A regulatory framework based on spending rules has also proved to be effective to some extent during the economic crisis. To date, a spending limits round realised via tax subsidies has not arisen to any appreciable extent. The spending limits have allowed full room for manoeuvre for automatic stabilisers that balance the fluctuations in fiscal policy. There is no evidence that the spending limits have prevented the practice of an active cyclical policy. Political commitment to spending limits has remained strong. Even so there are grounds for developing fiscal policy procedures in order to increase clarity and transparency as well as in the light of experiences gained from the economic crisis.

Despite adhering to the spending limits, a key goal of fiscal policy, safeguarding the sustainability of general government finances, has slipped further away.

The targets set in the Government Programme for the financial position of central government are not being fulfilled even though the spending limits have been adhered to. The Government declared in a statement issued in connection with the mid-term review of its programme that temporary flexibility may be shown in terms of the balance targets set in the Government Programme, if decisions are simultaneously made to strengthen public finances structurally.

Alongside economic stimulus measures, the focus will increasingly fall in the near future on the post-crisis period. An essential near-term task of fiscal policy is preparing a credible post-crisis exit strategy. Practically speaking, a key element of the exit strategy recommendations of international organisations is strengthening fiscal policy regulatory frameworks to improve the credibility of fiscal policy. Greater emphasis than at present should be given to the sustainability of public finances in future development work on fiscal policy rules and in the setting of targets for the next parliamentary term.

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