



MINISTRY OF FINANCE

Economic Survey

Spring 2010

Economic outlook
and fiscal policy
for 2010-2014



17b/2010

Economic outlook and economic policy



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| <p>Abstract</p> <p>In the medium term it is expected that the Finnish economy will recover from the deep economic crisis along with the rest of Europe. As recovery gathers momentum, economic growth will accelerate to over 3% in 2012. It is projected that exports will again begin to grow rapidly with the revival of world trade and the export markets. Domestic demand growth will also accelerate with the improving labour market situation and the unleashing of pent-up investment needs.</p> <p>As we approach the middle of the decade, however, economic growth will begin to slow as a result of structural changes in the economy, population ageing and the relocation of production to cheaper labour economies.</p> <p>The labour market situation also looks set to improve over the medium term, and it is expected that the number of job vacancies will begin to rise sharply. At the same time the mismatch between labour supply and labour demand will get worse. The new jobs that are being created after the recession are not located in the same places and in the same branches where jobs were lost during the recession. This is slowing the growth of employment. Population ageing will also begin to constrain the labour market during the present decade. The unemployment rate is expected to fall from its 2010 peak to just over 7% by 2014. The employment rate in 2014 is projected to stand at close to 70%.</p> <p>The legacy of the recession will continue to impact public finances for years to come. In 2010 it is forecast that the deficit will deepen further to about 4% of GDP and therefore clearly exceed the 3% deficit threshold of the Stability and Growth Pact. However this will only be a temporary breach because in 2011 the deficit will narrow to close to 2% of GDP. Although general government finances will continue to improve over the years ahead on the back of economic recovery, it is expected that without new measures to stimulate growth and consolidate public finances, they will remain firmly in deficit in 2014. Only social security funds will retain a surplus. The general government debt ratio began to rise last year, and by 2014 it is projected to climb to 56.5%.</p> | | |

Preface

This, the March 2010 Economic Survey, is the third one to be published as an annex to the Government's decision on spending limits. It considers Finland's economic forecasts for 2010 and 2011. Besides short-term prospects, the publication also includes estimates for medium-term projections up to 2014 and background material related to the Government spending limits decision reached in March.

The forecasts are based on provisional national accounts data for 2009 published by Statistics Finland in March 2010 and other public statistical sources.

This Survey is the 63rd in its series.

Helsinki, March 2010

Ministry of Finance
Economics Department

A handwritten signature in blue ink, consisting of a stylized 'J' followed by a series of loops and a long horizontal stroke.

Jukka Pekkarinen

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The source for all data on materialised developments is Statistics Finland unless otherwise indicated.

SYMBOLS AND CONVENTIONS USED

- nil
- 0 less than half the final digit shown
- . not available
- not pertinent
- * provisional
- ** forecast

Each of the figures presented in the tables has been rounded separately, and therefore the items may not always add to the totals.

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Summary

Cyclical outlook

The industrial countries have been very severely hit by the recession. In 2009 the global economy suffered its deepest downturn since the Second World War. In the United States GDP dropped by 2.6% and in the European Union by over 4% from 2008. China experienced a less dramatic downswing, and already Chinese economic growth has returned to pre-crisis levels. As a result of the crisis many major structural problems have taken a back seat. The US current account deficit continues to remain a matter of serious concern, and Europe is set to undergo significant structural changes to reignite economic growth. Indeed it seems that in the near future, economic policy makers in different countries are going to have to tackle the same imbalances and structural problems coupled with massively indebted economies. Furthermore, economic growth in industrial countries is being held back by the following factors. The situation in the financial sector has not yet returned to normal, and therefore access to credit sources may be problematic. In addition, capacity utilization rates are still low and unemployment rates high. It is also clear that expansionary monetary and fiscal policy cannot be continued indefinitely.

The United States is thought to have come out of recession in Q3 2009, when its annualized quarterly output growth was just over 2%, accelerating further to 5.7% in the last quarter of 2009. However the average growth rate for 2010 is forecast to slow to 2.5%. In 2011 the figure will likely remain slightly lower as a result of tightening economic policy and the need to rein in the budget deficit.

In the euro area, recovery has been sluggish and driven primarily by temporary factors such as inventory adjustments and stimulus measures. Furthermore, the latest statistics are not entirely unambiguous in that figures for retail trade, for instance, do not support assumptions of a rapid recovery, but on the other hand growing international demand has helped to boost exports from the euro area. It is projected that output growth in the euro area will remain moderate, i.e. at less than one per cent in 2010, edging up to around 1.5% in 2011.

The Finnish economy had an exceptionally bad year in 2009. According to preliminary figures from Statistics Finland, GDP plunged by 7.8%. In 1991 GDP fell by 6.0%, but the last time GDP figures dropped as sharply was more

than 90 years ago. Demand was primarily affected by the decrease in exports and investment. The volume of exports fell by 24% and investment was down by more than 13%. Private consumption dropped by more than 2%, and the savings rate turned positive.

It is forecast that output in the Finnish economy will start rising this year. Driven by the recovery of private consumption and exports, GDP is expected to grow by 1.1% from the previous year. In 2011 private investment will also turn up, and at the same time exports and consumption will continue to rise, albeit at a slower pace than this year. Output growth in 2011 is expected to average just over two per cent.

Foreign trade has already turned the corner. Demand has picked up in the cyclically sensitive wood products industry and paper industry. Demand for metals in the global market is also on the up. Export prospects are limited by the fact that the bulk of Finnish exports go to the EU area, where the outlook for growth is weaker than average. The forecast for 2010 projects a 5.5% increase in exports. In 2011 exports are expected to slow somewhat despite the accelerating global economy. This is due to non-recurring factors, such as the timing of ship deliveries. The recovery of domestic manufacturing will reinforce demand for imports of raw materials and intermediate products. Imports of consumer products will also begin to recover. Overall imports growth in 2010 will climb to around 3.5%. It is projected that both this year and next, exports will grow slightly faster than imports, which will help to restore the current account from its rock-bottom level in 2009.

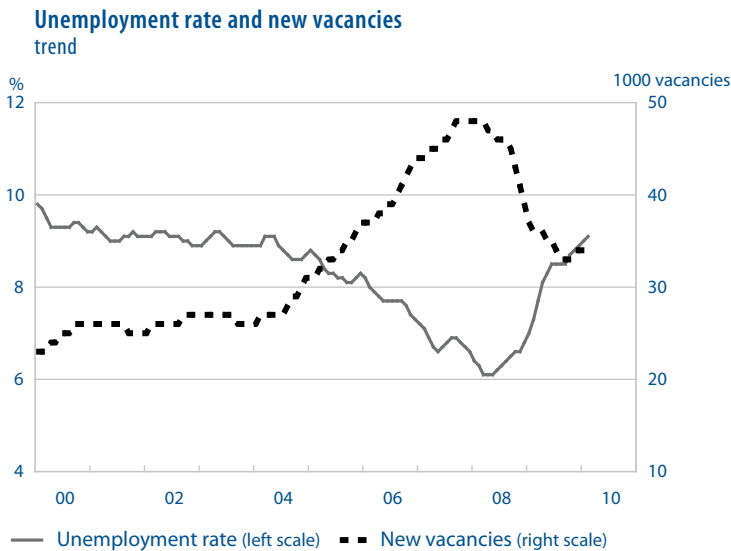
Private consumption is expected to show a favourable trend over the next two years: the growth forecast for this year is 2% and for next year 1.7%. During 2010 consumption growth is sustained by consumer confidence, which in view of the unemployment situation is running at high level, and by rising wages and property income. Furthermore the rate of price increases over the current forecast horizon will remain restrained. Households' real disposable income will increase more rapidly this year than last, but pressures to raise taxes may act to curb the growth of purchasing power next year. If, contrary to expectations, households continue to save at the same rate as last year, consumption will slow more than forecast. In the baseline scenario, the savings rate is no longer expected to rise this year, and next year it will start falling. Household indebtedness will continue to increase, and by the end of the forecast period household debts will exceed 110% of annual disposable income.

The fall in private investment last year at 15.7% was not quite as sharp as during the recession in the early 1990s: in 1991 and 1992 investment declined even more, and private investment furthermore dropped for a number of years in succession. This is not expected to be repeated this time: it is forecast that investment will contract by around 3 ½% in 2010, but by 2011 it will show a slight upward trend. Fiscal stimulus packages have already pushed dwelling investment onto a growth track. Manufacturing industry investment in machinery

and equipment is still confined to replacements since there is only limited need for additional production capacity. In 2011, with the improving outlook, investment in machinery and equipment will start growing again.

For Finland, 2008 was a very good year from an employment point of view, despite the sharp economic downturn. However the situation changed during 2009 and demand for labour declined particularly at the younger end of the labour force. Overall the rise in the unemployment rate has been quite modest in view of the weak cyclical environment, chiefly because of layoffs and the commitment of businesses to retain their competent staff. In 2009 the number of employees classified as temporarily laid off and therefore entered in the statistics as people in employment was around 60,000. Nevertheless the number of people in employment was down by 74,000. It is also noteworthy that the number of hours worked fell by more than 6%. During 2010 the number of people out of work is set to rise despite the trend of output growth, and the unemployment rate is expected to climb to 10.2%. The highest monthly unemployment rates will probably be recorded late in the spring. The situation will improve in 2011 when the employment rate is expected to edge up to 67% and the unemployment rate to fall back to 9.6%.

The fall in output last year was unprecedented in the country's economic history. Growth was not recorded in a single branch, and secondary production in particular fell very sharply and exacerbated the economic contraction. Output expectations have recovered and the export industry is driving Finn-



Source: Statistics Finland

ish economy back onto a moderate growth track. The recovery of world trade and the inventory cycle are helping to pull manufacturing back to growth, but even so it is projected that manufacturing output in 2011 will be more than 10% down on 2008 figures.

Consumer prices did not rise at all in 2009 as measured by the national consumer price index. However the harmonized consumer price index, which excludes the effect of interest rates and housing prices, went up by 1.6%, well above the average for the whole euro area. In 2010 inflation will accelerate to 1.5% because of rising energy and other raw material prices. Housing prices and interest rates will also stop falling. In 2011 import and production prices will continue to rise, which together with the hike in the energy tax at the start of the year means that consumer prices are expected to increase by about 2.5%.

Earnings increased very rapidly in 2009 in view of the cyclical environment. Following the 2007 round of collective bargaining, negotiated wage rates increased by 3.7% and the earnings level by 3.9%. However because of the lower level of labour input, the wage bill actually decreased. It is projected that in 2010, earnings will rise by 2.8%, over half of which is attributable to the transfer effect of the high pay rises late in 2009. Finnish price competitiveness has deteriorated significantly compared to euro area in the past years. In 2008 and 2009 unit labour costs rose at twice the average rate for the euro area, with wages continuing to grow in line with agreed pay rises despite the fall in output.

In 2010 the state of public finances will continue to deteriorate as a result of stimulus measures and escalating unemployment. It will take some time for the effects of the economic upturn to show up in the budgetary position of general government. The 3% of GDP deficit criterion in the Stability and Growth Pact will be breached in 2010 as the general government deficit widens to 4%. Next year the financial position of general government will be strengthened by accelerating growth and rising taxes. The growth of public debt will slow somewhat but nonetheless continue apace.

Key forecast figures

| | 2009* EUR bn | 2007* | 2008* | 2009* | 2010** | 2011** |
|---|-----------------|---------------------|-------|-------|--------|--------|
| | | change in volume, % | | | | |
| GDP at market prices | 171 | 4.9 | 1.2 | -7.8 | 1.1 | 2.1 |
| Imports | 57 | 6.0 | 6.6 | -22.3 | 3.7 | 4.0 |
| Total supply | 228 | 5.2 | 2.8 | -12.1 | 1.8 | 2.6 |
| Exports | 62 | 7.9 | 6.5 | -24.3 | 5.5 | 4.6 |
| Consumption | 137 | 2.7 | 2.0 | -1.3 | 1.3 | 1.1 |
| private | 94 | 3.4 | 1.7 | -2.1 | 2.0 | 1.7 |
| public | 43 | 1.1 | 2.7 | 0.7 | -0.1 | 0.0 |
| Investment | 34 | 10.6 | -0.2 | -13.4 | -3.4 | 3.6 |
| private | 29 | 11.0 | -0.2 | -15.7 | -4.2 | 4.8 |
| public | 5 | 7.9 | -0.7 | 4.0 | 1.4 | -3.4 |
| Total demand | 228 | 5.2 | 2.8 | -12.1 | 1.8 | 2.6 |
| domestic demand | 166 | 3.9 | 1.0 | -6.2 | 0.4 | 1.8 |
| | | 2007* | 2008* | 2009* | 2010** | 2011** |
| Services, change in volume, % | | 3.8 | 1.5 | -3.7 | 0.5 | 1.7 |
| Industry, change in volume, % | | 8.6 | 0.1 | -20.0 | 4.6 | 4.9 |
| Labour productivity, change, % | | 3.3 | -0.3 | -2.8 | 3.4 | 1.1 |
| Employment rate, % | | 69.9 | 70.6 | 68.3 | 66.4 | 67.1 |
| Unemployment rate, % | | 6.9 | 6.4 | 8.2 | 10.2 | 9.6 |
| Consumer price index, change, % | | 2.5 | 4.1 | 0.0 | 1.5 | 2.5 |
| Index of wage and salary earnings, change, % | | 3.4 | 5.5 | 3.9 | 2.8 | 2.5 |
| Current account, EUR bn | | 7.7 | 6.4 | 2.5 | 3.3 | 3.1 |
| Current account, % of GDP | | 4.3 | 3.5 | 1.5 | 1.9 | 1.7 |
| Short-term interest rates (3-month Euribor), % | | 4.3 | 4.8 | 1.2 | 1.3 | 2.5 |
| Long-term interest rates (10-year Govt. bonds), % | | 4.3 | 4.3 | 3.7 | 3.7 | 4.5 |
| General government expenditure, % of GDP | | 47.3 | 49.5 | 55.6 | 56.7 | 56.1 |
| Tax ratio, % of GDP | | 42.9 | 43.1 | 42.9 | 42.4 | 43.6 |
| General government net lending, % of GDP | | 5.2 | 4.1 | -2.4 | -4.1 | -2.2 |
| Central government net lending, % of GDP | | 1.0 | 0.5 | -5.1 | -6.3 | -4.7 |
| General government gross debt (EMU), % of GDP | | 35.2 | 34.2 | 44.0 | 49.9 | 51.7 |
| Central government debt, % of GDP | | 31.2 | 29.5 | 37.6 | 43.5 | 46.3 |

Medium-term outlook

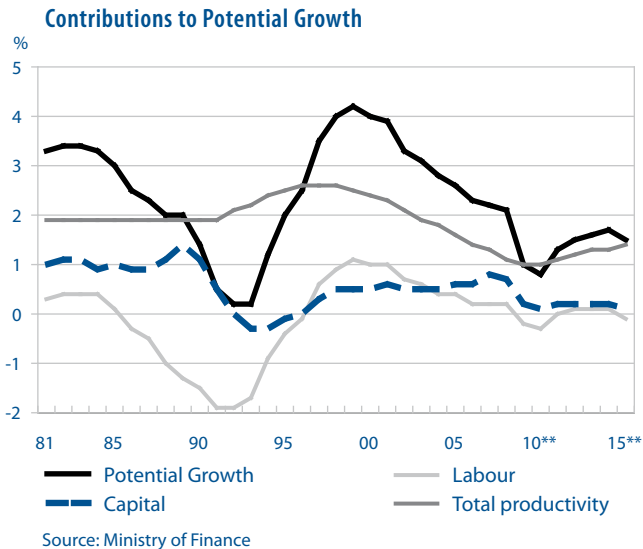
In the medium term it is expected that the Finnish economy will recover from the deep economic crisis along with the rest of Europe. As recovery gathers momentum, economic growth will accelerate to over 3% in 2012. It is projected that exports will again grow rapidly with the revival of world trade and the export markets. Domestic demand growth will also accelerate with the improving labour market situation and the unleashing of pent-up investment needs.

As we approach the middle of the decade, however, economic growth will begin to slow as a result of structural changes in the economy, population ageing and the relocation of production to cheaper labour economies. Post-recession recovery, therefore, is unlikely to match the rapid economic revival that was seen following the recession in the early 1990s. The economic operating environment has changed and there is no such growth impetus in sight that in the 1990s was provided by the expanding use of ICTs and the exceptionally strong growth of demand for ICT products.

The labour market situation also looks set to improve over the medium term, and it is expected that the number of job vacancies will begin to rise sharply. At the same time the mismatch between labour supply and labour demand will get worse. The new jobs that are being created after the recession are not located in the same places and in the same branches where jobs were lost during the recession. This is slowing the growth of employment. Population ageing will also begin to constrain the labour market during the present decade. Statistics Finland population projections indicate that the working-age population will begin to decline during the current year and that by 2015, their number will be down by around 90,000. For this reason it is expected that the growth of the labour force will begin to stall in the medium term, even though the labour participation rate will continue to rise. The unemployment rate is expected to fall from its 2010 peak to just over 7% by 2014. The employment rate in 2014 is projected to stand at close to 70%.

The legacy of the recession will continue to impact public finances for years to come. In 2009 the strong balance of general government finances swung into a deficit of almost 2½%. In 2010 it is forecast that the deficit will deepen further to 4.1% of GDP and therefore clearly exceed the 3% deficit threshold of the Stability and Growth Pact. However this will only be a temporary breach because in 2011 the deficit will narrow to 2.2% of GDP. Although general government finances will continue to improve over the years ahead on the back of economic recovery, it is expected that without new measures to stimulate growth and consolidate public finances, they will remain firmly in deficit in 2014. Only social security funds will retain a surplus. The general government debt ratio began to rise last year, and by 2014 it is projected to climb to 56.5%.

The budgetary position of central government deteriorated sharply in 2009, and it is forecast that in 2010 the deficit will climb to 6.3% of GDP. The central government's financial balance was also negatively impacted by the technical



accounting change whereby the State Pension Fund was reassigned from the central government to the pension funds sector. This reclassification will impact the financial balance of central government and employment pensions funds from 1990 onwards, but it has no bearing on the aggregate financial position of general government. In 2014 central government debt will stand at around EUR 109 billion, almost 55 billion more than at year-end 2008.

The sustainability gap in public finances has increased very rapidly as a result of the recession. The sharp deterioration in the budgetary position of general government is severely hampering efforts to prepare for the expenditure pressures arising from population ageing, underlining the need for reforms to strengthen the sustainability of public finances.

Key forecast figures for the medium term

| | 2008* | 2009* | 2010** | 2011** | 2012** | 2013** | 2014** |
|--|-------|-------|--------|--------|--------|--------|--------|
| GDP at market prices, change in volume, % | 1.2 | -7.8 | 1.1 | 2.1 | 3.3 | 2.8 | 2.3 |
| Consumer price index, change, % | 4.1 | 0.0 | 1.5 | 2.5 | 2.0 | 2.0 | 2.0 |
| Unemployment, % | 6.4 | 8.2 | 10.2 | 9.6 | 8.8 | 8.0 | 7.3 |
| Employment rate, % | 70.6 | 68.3 | 66.4 | 67.1 | 68.2 | 69.1 | 69.7 |
| General government net lending,% of GDP | 4.1 | -2.4 | -4.1 | -2.2 | -1.6 | -1.5 | -1.3 |
| Central government | 0.5 | -5.1 | -6.3 | -4.7 | -4.4 | -4.2 | -4.0 |
| Local government | -0.4 | -0.4 | -0.5 | -0.3 | -0.5 | -0.4 | -0.4 |
| Social security funds | 4.0 | 3.1 | 2.6 | 2.8 | 3.3 | 3.2 | 3.1 |
| General government gross debt(EMU), % of GDP | 34.2 | 44.0 | 49.9 | 51.7 | 53.4 | 55.0 | 56.5 |
| Central government debt, % of GDP | 29.5 | 37.6 | 43.5 | 46.3 | 48.1 | 49.7 | 51.3 |

Fiscal Policy

When the Government took office and set out its objectives in the Government Programme in spring 2007, Finland had been enjoying a period of sustained and rapid economic growth. General government finances were in healthy surplus, and projections of continued economic growth gave reason to expect that they would remain reasonably strong throughout the parliamentary term. Government debt reductions and low interest rates meant that central government interest outlays had long been falling, which had further contributed to improving the central government's financial position.

The world economic crisis arrived in Finland surprisingly fast, impacting its exports. As a result of the crisis Finland's strong public finances have deteriorated very sharply, in 2009 by around 6½ percentage points relative to GDP. Automatic stabilizers have been allowed to operate freely, and in addition discretionary stimulus measures have adversely affected the financial position of general government.

During the economic crisis, fiscal policy-making has largely been driven by employment and economic activity concerns. The Government has responded swiftly to the economic downturn with fiscal stimulus measures, which can be roughly divided into two categories: firstly, those aimed at securing access to finance and secondly, actual stimulus measures aimed at maintaining economic activity and preventing marginalization. A fundamental requirement for stimulus measures has been that they can be implemented quickly and that they have maximum employment impact.

Fiscal expansion cannot be continued indefinitely, however, because even under conditions of recession it is necessary to ensure the sustainability of public finances. If public finances were to remain deeply in deficit for an extended period of time, that would undermine the credibility of economic policy and therefore, over time, the effectiveness of stimulus measures.

The Government Programme was much more ambitious in its economic growth targets than the expert projections. It was estimated that if the international economy continued to grow and if wage developments supported employment, it would be possible to create 80,000–100,000 new jobs during the parliamentary term. Indeed at the start of the parliamentary term, before the onset of global recession, economic growth continued apace and by the summer of 2008 roughly half of the job creation target had been reached. The target announced for central government finances was a one per cent structural surplus ratio by the end of the parliamentary term.

However the situation has changed completely with the deep recession. The employment and public finances targets outlined in the Government Programme will not be achieved. Indeed the economic crisis is fundamentally changing the underlying orientation of fiscal policy. Public finances are increasingly vulnerable to the rising cost pressures associated with population ageing and to the

narrowing tax base. It is an ever greater challenge to ensure the sustainability of public finances.

It will take years to repair the damage caused by the recession. For this reason structures designed to facilitate the long-term management of public finances, such as medium-term budget planning and the system of multi-year spending limits, are important tools of fiscal policy strategy implementation.

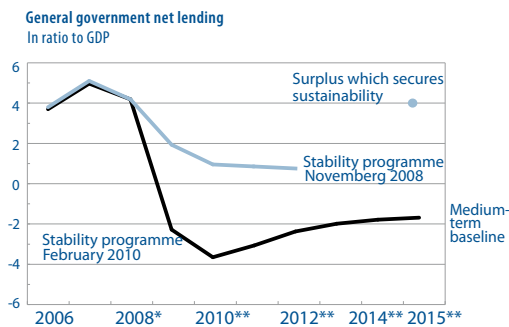
A major challenge for economic policy over the next few years ahead is to develop a viable post-recession exit strategy in which growth-supporting measures are coupled with general government adjustment measures. It is clear then that there is a need for a fiscal policy strategy and fiscal policy measures that can enhance the long-term sustainability of public finances. There are in principle three ways in which sustainability can be enhanced: by means of structural reforms, by increasing taxes or by cutting spending. The Government's main focus so far has been on structural reform, most particularly on extending labour market careers. Its target is to increase the average expected retirement age by at least three years by 2025. The Government and social partners have agreed on further preparations with a view to drafting a programme for sustainable economic growth and employment. The aim of the tripartite process is to decide upon steps for securing employment, economic growth and the sustainability of public finances.

Public finances at a crossroads

The ongoing economic crisis is profoundly reshaping the mandate and mission of fiscal policy. In the wake of the crisis it is expected that potential output will drop back, employment has already declined substantially and the general government balance has deteriorated sharply. All this means that public finances are increasingly vulnerable to the rising costs associated with population ageing and to the narrowing tax base. These changed conditions must be taken into account in post-crisis fiscal policy.

It was against this backdrop that the Ministry of Finance launched a fiscal policy project and in this context set out to identify factors impacting future fiscal policy guidelines. Its report on this work is intended to serve as a discussion paper for fiscal policy decisions during the next parliament and beyond. The main conclusions of the report are as follows:

- To meet the sustainability challenge, general government finances must reach a structural (or cyclically adjusted) surplus equivalent to 4% of GDP (approx. EUR 8 billion). This would allow the ratio of public debt to GDP to stabilize at a level of 60% under roughly the current tax rate.
- It is estimated that the post-crisis general government structural deficit in 2015 will be around 1.5% of GDP. This means that the sustainability gap, i.e. the difference between a surplus level that guarantees sustainability and the general government structural balance, would be around 5½% of GDP.
- Such is the scale of the sustainability problem that adjustment measures will have to continue throughout this decade, i.e. over two parliamentary terms, with front-loaded implementation. Solving the sustainability problem will require not only structural measures but also a critical review of all expenditure items as well as spending cuts and reallocations. Moderate tax increases will also be needed.
- In the first phase, structural measures should focus on improving productivity primarily in public sector services run by local government, and on the other hand on extending labour market careers. Towards the end of the decade structural measures could play a more prominent role in the adjustment programme.
- Containing public expenditure will require stricter budgetary control through the system of central government spending limits as well as more effective control over municipal finances.



Source: Statistics Finland, Ministry of Finance

1 Economic outlook

1.1 International economy

Last year was the worst for the global economy since the 1930s Great Depression. Triggered by disruptions in the housing and financial markets, the economic crisis led to a contraction in world economic output, a decline in world trade by over 10% and a sharp fall in manufacturing output.

The threat of a complete meltdown of the world financial system has now been averted by massive fiscal and financial policy measures, and the situation in the financial markets has stabilized. As that threat began to subside, world trade and manufacturing output began quickly to pick up from their rock-bottom levels.

The recovery of world trade that started in the latter half of 2009 seems to be continuing, and the outlook has become brighter. Emerging economies have been in the forefront of the recovery. In particular, strong growth in the Chinese economy, boosted by the government's stimulus package in infrastructure development, has supported demand in other emerging Asian economies, too. However the economic development in China is not without its problems. In some parts of the country high rates of credit expansion have contributed to a sharp rise in property prices. Therefore the Chinese government now faces the challenge of trying to strike the right balance between continued stimulus measures and a tightening of fiscal policy. This may have the effect of slowing output growth, which would begin to show up towards the end of the year and into 2011. For the time being, though, there is reason to believe that growth will continue at its current rate of 8–9%.

Developments in advanced economies have been more subdued and the problems seem more deep-rooted. General government deficits have increased sharply as a result of the recession and stimulus spending, effectively limiting the economic policy options available.

The upturn in prices of oil and other production supplies indicates that the downturn has now bottomed out. However part of the growth in demand is due to the rebuilding of inventories that were depleted during the crisis and therefore will not be sustained. It is projected that by the end of this year crude oil will climb to USD 79 per barrel. The increase in prices for other production

supplies will begin to slow once the inventory boom is over. The exchange rate between the euro and the dollar has been pegged at the January-February level where one euro buys 1.4 dollars.

The United States posted fairly strong economic growth in the last quarter of 2009. Output growth accelerated to an annualized rate of 5.7% from the previous quarter. Output for the whole year was still down by 2.4%. However it is expected that growth will now begin to slow as the impacts of the stimulus package wear off by the end of the year and the measures taken to normalize the financial markets begin to cut into the growth of demand. US public finances seem to be in dire straits. The federal deficit for the previous fiscal year (October–September) jumped to USD 1,400 billion. The deficit-to-GDP ratio over 2010–2011 is expected to remain within the range of 9–11%. Unemployment will probably continue to hover around 10%. The US current account deficit shrank substantially last year as a result of the economic downturn. The deficit will begin to swell again with the growth of imports. It is projected that US economic growth will accelerate to 2½% this year. Next year, with a tighter economic policy in place and the introduction of measures to trim the budget deficit, the figure will be somewhat lower.

The sluggish recovery seen in the euro area has stemmed mainly from temporary factors, in the exact same way as in the United States. The most important of these factors have been the adjustment of inventories and the massive fiscal stimulus spending. Indicators of economic development suggest that growth in the euro area will continue, although the latest figures for manufacturing and retailing trends have been less encouraging. Manufacturing output declined in the last quarter of 2009. Likewise, construction has struggled because of the cold weather. Exports have developed favourably on the back of growing international demand. The situation in the labour market has continued to deteriorate. Although the growth of unemployment in the euro area has temporarily stalled, a more permanent turnaround will not be seen until 2011. The state of public finances has deteriorated very rapidly, and it is expected that the general government deficit to GDP ratio will climb to 7% this year. Public debt will reach 80% of GDP.

The recent turbulence in the financial market and the widening of interest rate differentials provide a clear indication of the uncertainty that now surrounds future economic trends. The better-than-expected development of the world economy is good news at least for the euro area. If this can be turned into an advantage, output in the euro area might increase by close to one per cent this year and by 1½% next year.

The very recent unease in the financial market following from the Greek situation and the widening interest rate differentials in the euro area reflect the profound uncertainty that continues to surround economic development. Therefore it is expected that the ECB will proceed cautiously with the normalization of monetary policy. Excess liquidity will be gradually drained from

the system, and the reference rate will probably not be increased until late 2010 earliest. Interbank short-term interest rates will start rising from their current exceptionally low level. With economic recovery and rising inflation expectations, more widespread increases in interest rates will follow in 2011.

Gross domestic product

| | 2007 | 2008* | 2009* | 2010** | 2011** |
|----------------|---------------------|------------|-------------|------------|------------|
| | change in volume, % | | | | |
| United States | 2.1 | 0.4 | -2.4 | 2.7 | 2.3 |
| Japan | 2.4 | -1.2 | -5.0 | 1.0 | 1.9 |
| EU-27 | 2.9 | 0.8 | -4.2 | 0.8 | 1.7 |
| Germany | 2.5 | 1.3 | -5.0 | 0.9 | 1.8 |
| France | 2.3 | 0.4 | -2.2 | 1.2 | 1.9 |
| Italy | 1.6 | -1.0 | -4.7 | 0.9 | 1.3 |
| United Kingdom | 2.6 | 0.5 | -5.0 | 0.7 | 1.8 |
| Spain | 3.6 | 0.9 | -3.6 | -1.1 | 1.2 |
| Sweden | 2.5 | -0.2 | -4.9 | 1.5 | 2.0 |
| Denmark | 1.7 | -0.9 | -5.1 | 1.3 | 1.6 |
| Finland | 4.9 | 1.2 | -7.8 | 1.1 | 2.1 |
| OECD | 2.7 | 0.6 | -3.5 | 1.7 | 2.2 |
| China | 13.0 | 9.0 | 8.7 | 9.0 | 9.0 |
| Russia | 8.1 | 5.6 | -7.9 | 2.0 | 3.5 |
| World | 5.2 | 3.0 | -0.8 | 3.3 | 3.6 |

Economic development in the euro area

| | 2007 | 2008* | 2009* | 2010** | 2011** |
|---|---------------------|-------|-------|--------|--------|
| | change in volume, % | | | | |
| Private consumption | 1.7 | 0.4 | -1.0 | 0.3 | 1.1 |
| Public consumption | 2.3 | 2.0 | 1.2 | 1.0 | 1.0 |
| Gross fixed capital formation | 4.8 | -0.4 | -10.7 | -2.4 | 2.0 |
| Exports of goods and services | 8.4 | 6.0 | 1.6 | -9.8 | 2.0 |
| Imports of goods and services | 8.3 | 5.3 | 1.6 | -8.7 | 2.5 |
| GDP at market prices | 2.8 | 0.6 | -4.0 | 0.8 | 1.7 |
| | % | | | | |
| Private consumption deflator | 2.2 | 2.9 | 0.1 | 1.5 | 1.6 |
| Unemployment rate | 7.5 | 7.5 | 9.5 | 10.9 | 11.0 |
| General government net lending, % of GDP | -0.6 | -2.0 | -6.4 | -7.0 | -6.7 |
| Current account, % of GDP | 0.1 | -1.1 | -1.0 | -0.5 | -0.5 |

1.2 Foreign trade

1.2.1 Exports

Exports fell by 24½% last year. Figures were down in all branches and all export markets, but the sharpest decline was seen in metal industry exports and in exports to Russia. Export prices also fell sharply in the wake of dwindling demand. Exports nosedived in the first quarter of 2009, and then slowly picked up throughout the rest of the year. In the last quarter of 2009 exports rose strongly in comparison with the previous quarter, which in part was explained by the delivery of a large cruise liner.

Export order books in industry remained weak at the start of the year. However it is expected that world trade will pick up during the course of 2010, and in many branches export expectations improved early in the year. Hopes are further buoyed by the depreciation of the euro during the first months of the year. Optimism is highest in the wood products industry, which is typically the first to see the effects of economic turnaround. The paper industry, too, has witnessed an upturn in demand. Metal exports are buoyed by the brisk demand for metals in the world markets. Export prospects in the electronics industry are in turn improved by the growing interest in high-quality mobile phones. Demand for machinery and equipment, on the other hand, will not yet turn around during the early stages of economic recovery. The export outlook is also clouded by the fact that Finnish exports go largely to the EU area, where growth prospects are weaker than average. The projection for 2010 is that exports will rise by 5½%. Foreign trade may however receive a boost from the recovery of transit exports to Russia, which in 2009 lingered at very low levels, but this will not, of course, increase Finnish output figures. Export prices will rise by 3%. This projection is based on price trends for sawn goods, metals and oil-based chemical products.

Export growth will slow in 2011 despite the continued strengthening of the world economy, among other reasons because unlike this year and last, no new cruise liner is coming off the production line. Metal industry exports are nevertheless expected to grow with the increase in deliveries of new machinery. In the forest industry, on the other hand, it is expected that the growth of export demand will peak during the current year. In 2011 exports will grow by 4½%.

1.2.2 Imports

Imports fell last year by 22.5%, i.e. slightly less than exports. Imports from the leading import countries decreased quite evenly across the board. Russia continued to remain the single most important country of origin for imports. The sharpest decrease was recorded for the import of cars, partly on account of dwindling domestic demand, but primarily because of reduced transit imports and exports. Import prices plummeted, but in the last quarter turned around

and started rising along with the increase in energy prices. Annualized import prices dropped by as much as 7.5%.

Imports of industry raw materials and intermediate goods are set to rise in 2010 with the resurgence of manufacturing output. The growth of manufacturing output will also contribute to increase energy consumption, but the exceptionally cold winter has caused an additional spike in consumption and the need for imports. Imports of investment goods will slow down because of sluggish domestic investment in machinery and equipment. Imports of consumer durables will begin gradually to pick up from their rock-bottom levels: in early 2010 the number of new car registrations, for instance, has exceeded the level recorded last year. Imports will rise by 3.5% this year, which is a relatively modest increase compared to the sharp fall last year. Rising world market prices will push up import prices by 4%.

In 2011 import growth will remain at a moderate 4% because both domestic output and consumption growth will rise only modestly. Price pressures will ease in 2011.

Foreign trade

| | 2007* | 2008* | 2009* | 2010** | 2011** |
|-------------------------------|----------------------------|-------|-------|--------|--------|
| | change in volume, % | | | | |
| Exports of goods and services | 7.9 | 6.5 | -24.3 | 5.5 | 4.6 |
| Export of goods and services | 6.0 | 6.6 | -22.3 | 3.7 | 4.0 |
| | change in price, % | | | | |
| Export of goods and services | 1.1 | -1.1 | -5.7 | 3.2 | 1.7 |
| Imports of goods and services | 1.9 | 2.0 | -7.3 | 4.2 | 3.1 |

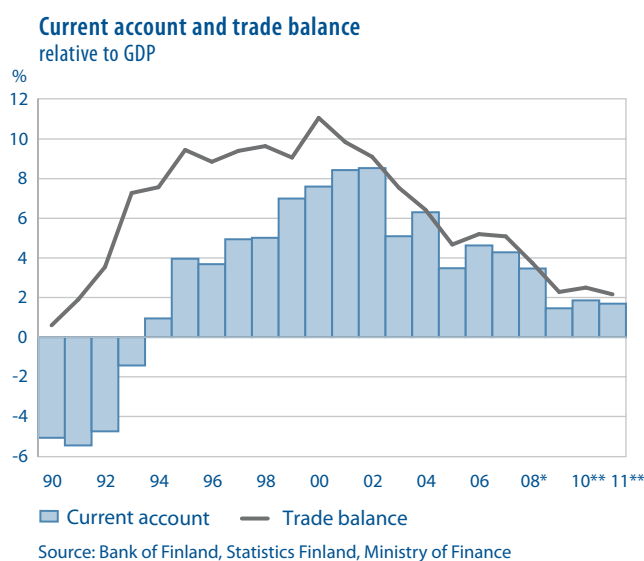
1.2.3 Current account

In 2009 the current account contracted to EUR 2.5 billion or 1.5% of GDP. Because of the high content of imports in exports, export and import trends follow largely similar patterns. Last year both collapsed more or less in tandem and therefore the current account did not fall into deficit, but more than half of the surplus was wiped out. The fall was further escalated by the widening of the deficit in the factor incomes and current transfers balance, which was one billion euros more than the year before. The trade balance declined by 40% and the services balance improved as service export prices increased from the previous year.

In 2010 and 2011 export growth will outpace import growth to some extent, which will help to lift the current account from last year's rock-bottom level. However decelerating export growth and deteriorating terms of trade will in 2011 erode the current account surplus compared to this year.

Current account

| | 2007* | 2008* | 2009* | 2010** | 2011** |
|--|--------|-------|-------|--------|--------|
| | EUR bn | | | | |
| Balance of goods and services | 9.3 | 7.4 | 4.7 | 5.6 | 5.5 |
| Factor incomes and income transfers, net | -1.7 | -1.0 | -2.2 | -2.4 | -2.4 |
| Current account | 7.7 | 6.4 | 2.5 | 3.3 | 3.1 |
| Current account, % of GDP | 4.3 | 3.5 | 1.5 | 1.9 | 1.7 |



1.3 Domestic demand

1.3.1 Private consumption

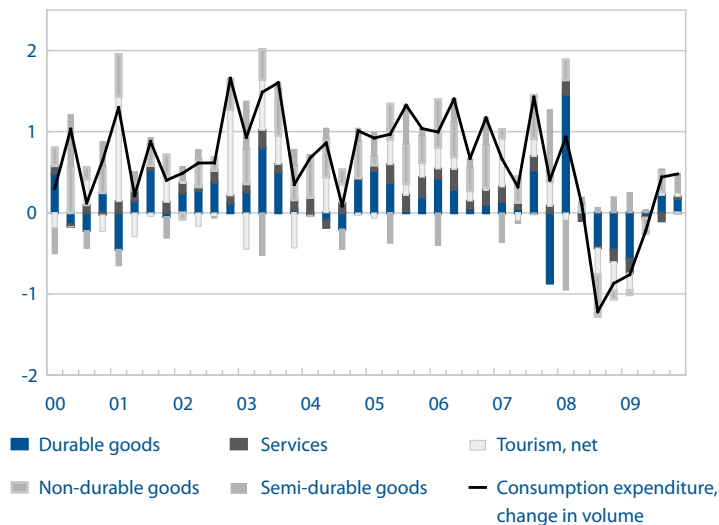
Households reduced their consumption, i.e. increased their saving last year. From July-September 2008 onwards, household consumption expenditure declined without interruption for a whole year. Purchases of durables collapsed first, followed by other goods and finally services. Last summer, household consumption was 3% lower than before the downturn. Consumption picked up in July-September 2009 as purchases of both goods and services accelerated. Consumption of durable goods in particular showed vigorous growth. With the exception of semi-durables, spending on goods and services

at year-end 2009 was at a higher level than the lowest level to which it dipped during the course of the year. Consumption by non-profit institutions (associations, foundations, funds, etc.) followed, somewhat later, the same trend as was observed for private households, and their consumption expenditure was still falling in October-December. Therefore one might have expected to see private consumption expenditure decline more sharply than household consumption, but this was not the case. In Finland private consumption expenditure fell by 2.1% last year, compared to approximately one per cent in the euro area. The growth of nominal income slowed sharply with the rise of unemployment, even though both earnings and pensions continued to increase apace. However with the slowdown in prices, the rise in real income did not slow down as much as nominal income and purchasing power increased, by around one per cent. As consumption declined despite the increase in real income, the savings rate went from negative to positive. Household total debts continued to grow more rapidly than income, and the debt ratio again reached a new record high at an estimated 106% of disposable income.

Household consumption will start rising again, which means that saving will fall back and indebtedness also looks set to continue increasing. Favourable conditions are in place for the continued growth of consumption both this year and next. It is expected that growth will be sustained by the still high level of consumer confidence given the current weak employment outlook and by rising wages and property income. Prices are expected to rise moderately. In addition, the impact of higher municipal tax rates on net incomes is offset by the fact that central government taxes on earned income in 2010 will remain

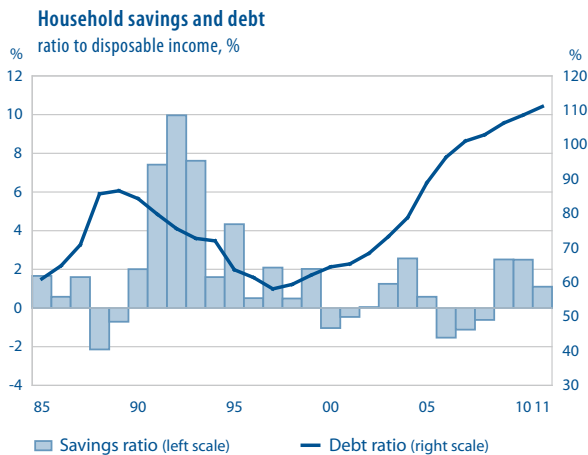
Growth contributions to household consumption

seasonally adjusted, quarter-on-quarter
percentage points



at the same level as last year. In 2011 it is projected that together with accelerating prices, taxation will have the effect of curbing the growth of household disposable income. The increase in durable goods consumption that started in 2009 is expected to continue at least through to the end of this year, because large numbers of consumers have plans to buy a new car and because low interest rates and high rents are inducing people to buy into property, which is likely to increase purchases of furniture, for instance. The growth of expenditure on daily consumer goods and services, on the other hand, will probably be affected by the higher level of unemployment. With unemployment continuing to rise, households will probably give careful thought to any purchases they make, and therefore the growth of consumption will probably slow towards the end of the year and fall well short of the long-term average of around 2.5%. However it is expected that the savings rate will begin to fall slowly in 2011. Housing purchases will add to household debt levels, and it is projected that by the end of next year the household debts will climb to over 110% of disposable income.

The scenario outlined above rests on the condition that the continued deterioration of the unemployment situation does not persuade consumers to postpone their planned purchases. Sustained consumer confidence during the current year is therefore of crucial importance to future consumption trends. It seems that household real disposable income will grow more rapidly than last year, but pressures to raise income tax rates are threatening to curtail the growth of purchasing power in 2011. If, contrary to expectations, households continue to save at the same rate as last year, consumption growth will slow more than forecast, or consumption expenditure may even start falling again.



1.3.2 Public consumption

The level of public consumption to GDP rose to 25% last year, and the ratio will remain at this almost record level both this year and next. Individual consumption expenditure, primarily on municipal education, social and health care services, accounts for two-thirds of public consumption. Approximately two-thirds of public consumption is made up of municipal spending, less than one-third by central government spending and some 7% by social security fund expenditure.

The volume of public consumption will remain unchanged this year and next. The number of central government personnel is decreasing in line with the government productivity programme, which will reduce the volume of central government consumption. The nominal growth of central government expenditure will be curbed by a slower rate of earnings growth than in recent years.

The tight economic position will reduce pressures to increase local government expenditure. In fact in 2010 local government expenditure will fall to some extent, and next year increase only marginally. It is expected that real increase will only be recorded for contracted municipal social and health care services. Nominal consumption expenditure is forecast to rise by around 2.5% this year and by 3% next.

Consumption

| | 2009* | 2007* | 2008* | 2009* | 2010** | 2011** |
|--|----------|---------------------|------------|-------------|------------|------------|
| | share, % | change in volume, % | | | | |
| Private consumption | 100.0 | 3.4 | 1.7 | -2.1 | 2.0 | 1.7 |
| households | 95.5 | 3.3 | 1.9 | -2.2 | 2.0 | 1.7 |
| durables | 8.2 | 4.1 | 8.9 | -12.0 | 6.0 | 1.5 |
| semi-durables | 8.6 | 6.6 | 3.3 | -4.2 | 1.5 | 1.5 |
| non-durable goods | 27.8 | 3.2 | -0.1 | -2.2 | 1.6 | 1.4 |
| services | 50.7 | 2.4 | 1.3 | -0.8 | 1.6 | 1.8 |
| consumption by non-profit institutions | 4.5 | 5.9 | -1.0 | -1.4 | 1.5 | 1.5 |
| Public consumption | 100.0 | 1.1 | 2.7 | 0.7 | -0.1 | 0.0 |
| central government | 29.0 | -0.2 | 2.2 | 1.5 | 0.0 | -1.0 |
| local government | 63.8 | 1.2 | 2.6 | 0.0 | -0.4 | 0.3 |
| social security funds | 7.2 | 6.3 | 5.6 | 3.3 | 2.6 | 1.7 |
| Total | | 2.7 | 2.0 | -1.3 | 1.3 | 1.1 |
| Individual consumption expenditure in general government | | 1.1 | 2.9 | 0.8 | 0.1 | 0.5 |
| Total individual consumption expenditure | | 2.9 | 2.0 | -1.4 | 1.6 | 1.4 |
| Real disposable income of households | | 3.6 | 2.1 | 0.8 | 2.0 | 0.2 |
| | | per cent | | | | |
| Share of consumption in GDP (at current prices) | | 72.0 | 74.4 | 80.3 | 80.5 | 80.0 |
| Household savings ratio | | -1.1 | -0.6 | 2.5 | 2.5 | 1.1 |
| Household debt ratio ¹⁾ | | 101.0 | 102.9 | 106.3 | 108.6 | 111.1 |

¹⁾ Household debt at end-year in relation to disposable income.

1.3.3 Investment

Investment fell sharply in 2009 from its peak levels in 2008 in all capital asset categories. Overall, fixed investment dropped by 13.4 % from the year before. In 2010 it is expected that fixed investment will contract further by around 3½ %, but projections for next year are that investment will increase by the same amount. Private investment will drop by almost 5 % in 2010, but is expected to rise by the same amount next year. Public investment will rise by around 1½ % this year but fall by around 3½ % next year.

Investment by type of capital asset

Housing construction started to decline in 2008 and fell even more sharply in 2009. However the slump in residential construction investment has now bottomed out because in the last quarter of 2009 the number of new residential starts was more than twice as high as the year before. Stocks of unsold housing have also been lower than normal for some time now. In 2010 it is expected that housing construction will increase by 5 % and next year by almost the same amount.

Non-residential construction investment is not yet expected to recover, but on the contrary to continue to fall substantially in 2010 for a second consecutive year, primarily because of a dearth of office and industrial building projects. As the economic climate begins to improve, non-residential construction will begin to pick up in 2011.

Civil engineering investment fell by more than one-tenth last year, but in 2010 it is expected to turn around and start rising in response to economic stimulus measures. Public transport projects in the metropolitan Helsinki area, a few other transport projects elsewhere in the country and major mining projects will restore civil engineering to a moderate level in 2010 and 2011.

Investment in machinery and equipment declined sharply for four consecutive quarters until it turned around in Q4 2009. It is thought that this has now marked the end of a period of steep decline in investment in machinery and equipment. During the current year the bulk of industrial investment will be focused on replacements because there is only limited need for increased production capacity. The forecast for 2010 is that investment in machinery and equipment will fall by a further 5 % or so, but by 2011 it is expected to rise somewhat as improving output expectations give added impetus to the launch of business investment projects.

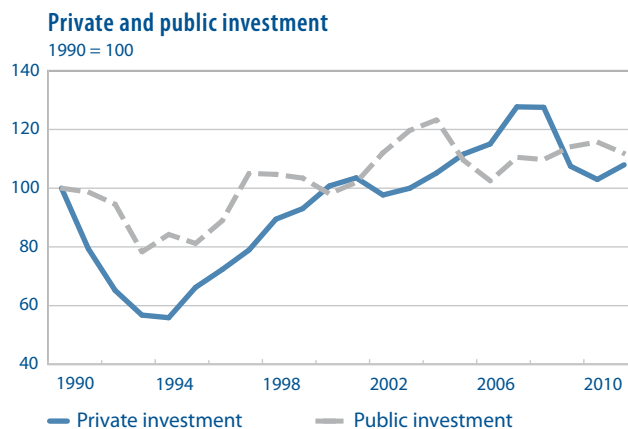
Private investment fell sharply in 2009, but looking back in time, the drops recorded in 1991 and 1992 were sharper still. In the early 1990s private investment dropped markedly for several consecutive years. During the present recession it is thought that the most significant adjustment happened last year. Public investment also dropped during the early 1990s recession, but in the 2000s it has been countercyclical.

Fixed investment by type of capital asset

| | 2009* share, % | 2007* | 2008* | 2009* | 2010** | 2011** |
|---|----------------------|----------|-------|-------|--------|--------|
| | | | | | | |
| Buildings | 54.5 | 8.9 | -1.5 | -16.5 | -4.2 | 3.8 |
| residential | 29.3 | 0.0 | -9.5 | -12.4 | 5 | 3 |
| non-residential | 25.2 | 22.7 | 8.9 | -21 | -15 | 5 |
| Civil engineering investment | 9.7 | 12.9 | 0.3 | -11.5 | 4 | 3 |
| Machinery and equipment | 25.8 | 17.0 | 3.8 | -14.4 | -5 | 4 |
| Other investment | 9.9 | 2.6 | -4.3 | -10.5 | -2 | 2 |
| Total | 100.0 | 10.6 | -0.2 | -13.4 | -3.4 | 3.6 |
| private | 86.0 | 11.0 | -0.2 | -15.7 | -4.8 | 4.8 |
| public | 14.0 | 7.9 | -0.7 | 4 | 1.4 | -3.4 |
| | | per cent | | | | |
| Ratio of investment to GDP (at current prices) | | | | | | |
| Fixed investment | | 21.3 | 21.6 | 19.8 | 18.9 | 19.0 |
| private | | 18.9 | 19.1 | 17.0 | 16.1 | 16.4 |
| public | | 2.4 | 2.5 | 2.8 | 2.8 | 2.6 |

1.3.4 Public investment

Public investment as a proportion of total investment is less than 15% and less than 3% of total domestic demand. Central government investment consists mainly of civil engineering investment, whereas most of the investment from local government goes into non-residential building construction. The local government sector accounts for two-thirds of public investment.



Source: Statistics Finland, Ministry of Finance

In 2010 central government investment is one-quarter higher than three years ago, and it will remain high in 2011. Local government investment is not expected to fall despite the difficult economic position in the sector. Investment by local government will remain high both this year and next, particularly because of low interest rates and major projects undertaken in large cities.

1.3.5 Inventory investment

Businesses made substantial inventory adjustments last year to accommodate the decline in demand and the poor future outlook. The change in inventories (and statistical discrepancies) reduced total output by two percentage points. In manufacturing the value of inventories fell by EUR 3,5 billion during 2009. Inventories of raw materials and intermediate products declined more sharply than finished products inventories. The decline in inventories was most noticeable in the forest industry and traditional metal industry. In the chemical industry the value of inventories of finished products started rising towards the end of the year.

The value of new orders in industry relative to existing inventories started slowly to rise in the second half of the year, thus improving the outlook for industrial output. Expectations of a pick-up in demand will probably persuade industries to increase their inventories, and therefore it is thought that the value of raw materials and intermediate products inventories will no longer fall this year. The development of finished products inventories will depend above all on the development of final demand, but it is unlikely that the projected upturn in demand would significantly increase the impact of inventories on total output growth.

1.4 Domestic production

1.4.1 Total output

In 2009 the national value added dropped by 8.5 %, more steeply than during the worst years of recession in the early 1990s. The Finnish economy fell into a serious downturn in late 2008. The impacts of the international financial crisis filtered through to the Finnish economy via various channels, and as a consequence output plunged by almost one-tenth in the space of six months. However the decline in total output came to a halt by the middle of 2009, since which economic activity has begun to slowly recover.

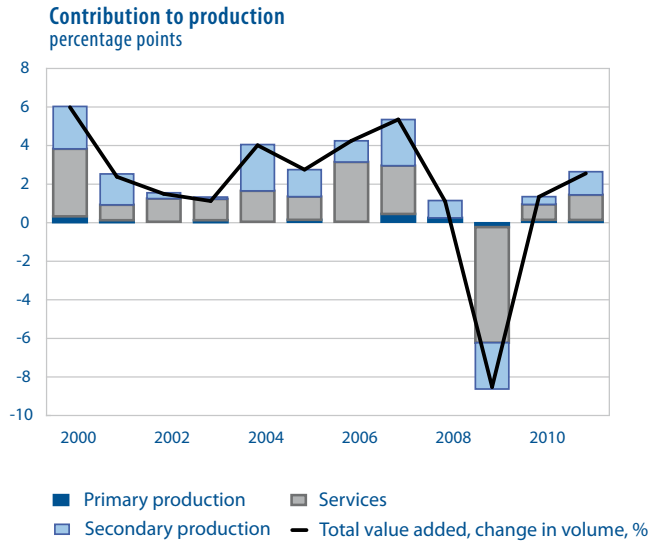
The fall in output was exceptional, both in terms of its depth and extent. Growth was not recorded in any major branch. The most significant negative growth contribution – some three-quarters – came from the collapse of secondary production, while services accounted for around one-quarter of the decline in output. The effect of primary production, on the other hand, was virtually neutral. Following the collapse of foreign demand, Finnish industrial output slumped by one-fifth. In the metal industry output dropped by as much as one-quarter. As the economic outlook continued to worsen, the economic turnaround intensified and quickly spread to domestic trade, building construction and the service sector. The delays from branches most directly dependent on foreign trade to other industries were exceptionally short, which was due to the sudden change in output expectations in all industries.

Output expectations have since recovered and export industries are pulling the Finnish economy back onto a tentative growth track. The recovery of world trade and the inventory cycle are helping to pull manufacturing back to growth, but even so it is projected that manufacturing output in 2011 will be more than 10 % down on 2008 figures.

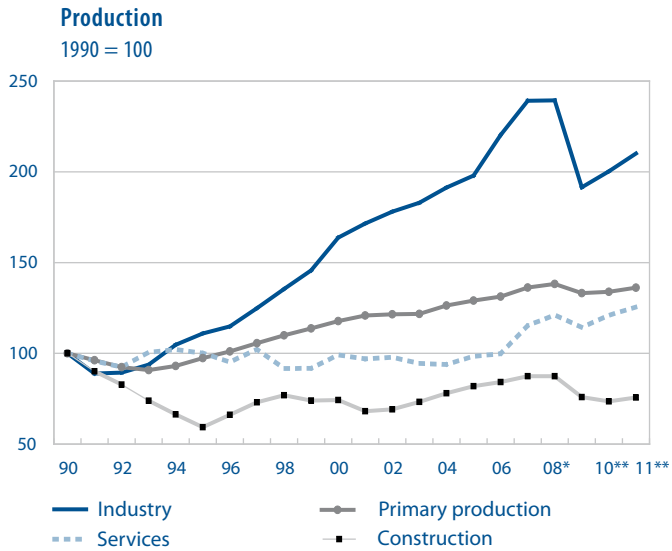
It is expected that growth will not pick up in building construction and service industries until a later stage. For the time being the cyclical outlook for building construction is weaker than normal and order books are running low. The overall picture for the construction sector is rather mixed in that although residential construction has already bottomed out and started to recover, other building construction will continue to fall in 2010 owing to its post-cyclical nature. In 2011 total construction output is set to increase. In services, demands for consumer services will remain subdued throughout 2010 because although wage earnings will rise and price pressures are low, employment is still predicted to decline. In service production, on the other hand, business services will develop more favourably than consumer services on the back of growing demand generated by the export industry.

This year it is projected that gross value added for the whole economy will increase by just over one per cent and next year by around 2½ %. Secondary production will account for almost two-thirds of this year's total growth. In

2011 growth will be more widely spread, with secondary production and services both accounting for equal shares to the growth contribution. The levels of output produced before the onset of recession will not be reached during the forecast period. In 2011 output will continue to remain around 5 % lower than during the peak year of 2008.



Source: Statistics Finland, MoF



Source: Statistics Finland, MoF

1.4.2 Secondary production

Manufacturing output plummeted at the turn of 2008 and 2009 as a result of the world economic crisis and the slump in export demand. In all, manufacturing output fell by 21 % last year. The hardest hit was the metal industry, where output nosedived by 27 % from 2008. Forest industry output declined by 21 %. Relying more heavily on domestic market industries than other branches, other manufacturing performed somewhat better and recorded a fall of just 11 %. Output was at its lowest during the summer. Production began to revive in the latter half of the year, but even in the last quarter it remained 15 % down on the figure last year.

At the start of the year industry order books were still at just half the normal level, but the cyclical outlook and output expectations started to improve. It seems that the forest industry has moved most firmly back onto a growth track. In January manufacturing output was still quite sluggish and growth remains unstable. However the percentage rate of output growth following the downtrend can be quite high because of the low starting level and because there is much idle production capacity. Growth prospects are also enhanced by the fact that industry inventories have dropped to a very low level. Manufacturing output will rise by 4½ % this year. Because of its impact on acquisitions of raw materials and production supplies, the stevedoring strike in March will adversely affect output not only in export industries but in domestic-market industries, too.

In 2011 manufacturing output growth will accelerate to 5 % with the continuing recovery of both the world markets and the domestic economy. However global industries are increasingly keen to move closer to consumers, and during the forecast period output will not return to the levels recorded the year before last.

In 2009 the volume of building construction decreased by 13½ %. The construction of new buildings declined as predicted by one-quarter; the sharpest falls were seen in office, industrial and warehouse construction. Although these drops were quite steep, they effectively were a movement back to normal levels. Renovation continued at even higher than anticipated levels in 2009, in large part by virtue of renovation subsidies made available to residential housing companies as well as the increased domestic help credit. Renovation now accounted for 60 % of all hours worked in building construction. The number of new housing starts increased much more sharply than forecast in the summer by virtue of the Government's successful stimulus policy and low interest rates, and climbed to 23,000. The volume of state-subsidized housing production was more than three times higher than in 2008, and the introduction of intermediate rental housing units for which the minimum period of rental use is just five years contributed to increase production by some 4,000 units. Civil engineering declined less than housing construction: this is largely attributable to the greater stability provided by the maintenance and repairs of the road and rail network.

The state of the construction sector

Economic situation and employment

Turnover in building construction fell in tandem with the declining volume of production throughout 2009, but most steeply during the first half of the year. Sluggish demand led to an increase in bankruptcies, the number of which was highest in the building construction sector.

According to Statistics Finland, the number of employed in construction in 2009 averaged 175,000 (building construction 60,000, civil engineering 22,000, specialized construction activities 93,000). The employed labour force in construction will no longer fall in 2010, but during the past winter the number of unemployed job applicants might have peaked at as high a level as 25,000 plus. Despite the sluggish development in the sector, there have been no major redundancies. One reason for this is the prominent role of the SME sector in construction: in 2008 it accounted for 60 % of industry turnover and for almost 72 % of personnel. On the other hand contractors especially in the Helsinki area are keen to retain their skilled workforce as the exit of baby boomers from the workforce continues to gather speed and create labour availability problems.

Trends in lines of production

The total number of planning permissions granted in December 2009 was up almost 90 % on the figure for December 2008. It is thought that this increase is attributable to builders rushing to get in their applications before the entry into force of new energy regulations at the start of 2010. The number of new building starts also increased towards the end of the year. In particular, new starts of high-rise housing, measured in terms of cubic metres, almost tripled from the last quarter of 2008. The proportion of small housing units is on the increase, and the average size of new builds in 2010 will still be smaller than just a couple of years ago. This reflects the shift in housing demand. In 2008 the proportion of one or two person households in Finland was up to 74 %.

Business construction, where access to good building sites and decisions on strategic location have a more direct bearing on construction activity than in other non-residential building construction, has shown stronger development than office, industrial and warehouse construction, especially in the metropolitan Helsinki area. In the current sluggish economic environment the vacancy rate for office and industrial space is comparatively high, and there is only limited need for extensions. In the Helsinki region the vacancy rate of office premises rose last year to 12 %, and in almost all growth centres it was close to 8 %. Market forecasts suggest that the vacancy rate for offices will continue on a clear upward trend in 2010.

Renovation work accounted for over one-half of total output in construction in 2008. The bulk of renovation was carried out on residential buildings. It is projected that residential renovation work will continue to increase because the current level of investment in Finland is not very high.

The outlook for civil engineering is improving and the sector will resume growth this year. The risks to the forecast stem primarily from the local government side, where infrastructure investment may decline somewhat because of the stringent financial environment. On the other hand it is expected that investment in road maintenance will remain stable, and government stimulus measures in civil engineering repairs and maintenance will also increase activity. The utilization rate for construction and earth-moving machinery is projected to rebound to close to 75 %.



Sources: Report by the cyclical monitoring group for the construction sector: Construction 2010; Statistics Finland, VTT Finland, Catella Property Oy

The outlook for building construction remains depressed and order books are thin. In 2010 it is projected that housing construction will decline by an estimated 5 %, and the volume index for new building construction is expected to drop by a further 5–10 %. However the situation in this sector overall is decidedly mixed in that housing construction is on the increase and housing renovations are continuing at a high level. Non-residential construction, on the other hand, will continue to decline in 2010: this applies both to office construction and to industrial and warehouse construction, which reacts to cyclical expectations with a lag. The difference is further emphasized by the fact that repairs and renovations in the non-residential sector suffer much more severely from the recession than the residential housing sector. It is expected that business construction will start to pick up very sharply over the next few years among other reasons because there are many plans in the pipeline for the development of new shopping centres. It seems that the development of public service premises will begin to accelerate again, with the number of planning permissions standing at 20 % higher than the year before. Civil engineering is expected to turn around and post moderate growth of around 4 per cent on the back of accelerating housing construction and a few major projects. These include the development of the Ring Rail Line and the underground and the start-up of two new mining developments (Pampalo and Kevitsa). In 2011 growth will continue, but at a slightly slower pace than this year.

Housing demand and prices have risen since last year. The stock of unsold housing is low and the average market time has dropped below normal. Even so the number of market-financed housing construction starts has remained relatively low. In 2010, however, it is expected that the number of residential start-ups will pick up to 25,000–26,000 units, and the figure in 2011 is expected to be the same or slightly higher. State-subsidized production is forecast to decline by almost one-fifth from the level last year, and the number of market-financed housing start is expected to reach approximately 15,000. The sluggishness of the national and international economy is reflected in non-residential building construction, and the building construction sector as a whole is not expected to turn around until 2011.

1.4.3 Services

In 2009 value added declined in all main service sectors. Service output fell by 3.7 %, almost as much as the worst figures recorded in the early 1990s. Nevertheless the decline in service output was not nearly as sharp as in manufacturing.

Although employment continued to fall throughout 2009, domestic trade recovered from its collapse around the turn of the year and started to grow in the summer. Retail trade returned to a slow growth track as early as March, and sales of motor vehicles began to improve by the middle of the year. The growth of trade sales volumes was supported by the gradual restoration of confidence, moderate price trends, the increase in wage earnings and tax cuts. The same factors contributed to the development of consumer services more generally and slowed their slide. Branches with close links to the export industry ran into serious difficulty. Value added in transport, storage and communications fell by 7 %. In wholesale, value added fell by 11 %.

Consumer confidence has recovered from its low levels to the long-term average, but even so consumers remain justifiably cautious. Demand for consumer services will remain subdued in 2010, because even though wages are rising and price pressures are low, employment is expected to continue to fall. Next year the upturn in employment will bolster the demand for services.

The recent spate of new orders received in industry is good news that in time will filter through to the provision of services to industry. It is expected that, with the growth of export industries, business services will develop more dynamically than consumer services.

In 2010 it is projected that service output will increase by half a per cent and next year by 1½%. Even though it is forecast that services will remain on a growth track, the levels of output achieved before the onset of recession will not be reached during the forecast period. Indeed the development of service output, especially business services, will depend crucially on the success that the country's export-driven industry has in latching onto the growth of our export markets.

Production by industry

| | 2009 ² | 2007* | 2008* | 2009* | 2010** | 2011** |
|---|-------------------|----------------------------|-------|-------|--------|--------|
| | share, % | change in volume, per cent | | | | |
| Industry | 21.6 | 8.6 | 0.1 | -20.0 | 4.6 | 4.9 |
| Manufacturing | 18.7 | 8.9 | 0.6 | -21.3 | 4.3 | 5.0 |
| Construction | 6.7 | 3.8 | 0.1 | -13.2 | -3.1 | 3.0 |
| Wholesale and retail trade | 9.0 | 10.3 | -1.6 | -11.2 | 3.5 | 2.5 |
| Transport, storage and communications | 7.7 | 2.2 | 3.0 | -6.8 | 1.5 | 4.0 |
| Real estate and business activities | 22.4 | 5.0 | 3.8 | -3.3 | 0.0 | 2.3 |
| Other branches | 30.2 | 1.0 | 0.5 | -0.2 | -0.1 | 0.5 |
| Secondary production | 32.4 | 7.6 | 0.1 | -18.5 | 2.8 | 4.5 |
| Services | 64.9 | 3.8 | 1.5 | -3.7 | 0.5 | 1.7 |
| Total production at basic prices | | 5.4 | 1.1 | -8.5 | 1.3 | 2.6 |
| GDP at market prices | | 4.9 | 1.2 | -7.8 | 1.1 | 2.1 |
| Employment in the whole economy ¹⁾ | | 2.0 | 1.4 | -5.9 | -2.0 | 1.5 |
| Productivity in the whole economy | | 3.3 | -0.3 | -2.8 | 3.4 | 1.1 |

¹⁾ In terms of man hours

²⁾ Share of total value added .

1.4.4 Labour productivity

Labour productivity fell in 2009 for the first time since 1981. Productivity figures were down by 3%. The main reason for this was the economic slowdown, as a result of which output declined more rapidly than businesses were able to reduce their labour input. As in any economic downturn, productivity fell most sharply in manufacturing, dropping by almost 8%. In Finland the rise in labour productivity has been almost twice as high as the European average throughout the 2000s, even though the structural change in production has meant that lower-productivity services now account for a larger proportion of total economic output. Nonetheless in 2008 productivity levels for the whole economy were still more than 3% lower than the euro area average.

Labour productivity will no longer decline this year as production increases on the back of growing demand, albeit slowly. This slow growth will not yet be enough to induce an increase in labour input this year, when productivity will rise cyclically and for the exact opposite reason that it declined following the onset of recession. Manufacturing will see the fastest improvement in productivity, services the slowest. In 2011 labour productivity will rise slowly, with the average growth rate coming in at about half of the average for the past 10 years

1.5 Labour force

Despite the sharp cyclical downturn, 2008 was still a good year from an employment point of view: the numbers employed were higher than ever and the employment rate was at its highest and the unemployment rate at its lowest for two decades. The number of long-term unemployed was down to around one-third of the peak recession level.

The situation in 2009 was completely different. In export industries demand for labour declined for the second year running, particularly at both age poles of the labour force. Since attachment to the labour market presents the greatest difficulty for the youngest and the oldest age groups, failure to find a job leads more often to exit from the labour market. On the other hand companies are keen to retain their skilled, prime working-age employees, offering them part-time jobs and above all by favouring layoffs over redundancies. At year-end 2009 the number of employees classified as temporarily laid off and therefore entered in the statistics as people in employment was around 60,000, or just over 2% of the workforce. Primarily for the reasons just stated, the number of hours worked by persons employed fell twice as much as the number of people in employment: the number of hours worked dropped by 6% and the number of persons employed by 3%. The biggest difference between hours worked and number of persons employed was recorded in manufacturing, which also resorted to layoffs to a greater extent than other branches. In all, the number of people out of work increased by 49,000, and the unemployment rate went up to 8.2%.

In 2010 the number of people out of work will continue to rise even though output is already growing. Many companies are using existing staff to increase their output, and therefore the labour input is continuing to fall, but the relative change is smaller when measured in terms of hours worked than in terms of numbers employed. The number of persons employed will continue to decrease in virtually all branches except community, social and personal services, which include public services. The employment rate will fall back to 66.4%. The number of people out of work will rise by 50,000 and the unemployment rate will climb to 10.2%.

The poor employment situation has brought new challenges to labour policy. Supported employment programmes, for instance, have experienced growing problems with the slowing demand for labour because it is very difficult for companies that are laying off people to take on subsidized employees or trainees or even to offer summer jobs. In 2010 the main emphasis in labour policy measures will shift increasingly towards labour market training and other measures aimed at improving workplace skills. The numbers covered by such measures will rise to the equivalent of over 12,200 person-years. In all it is estimated that this year 3% of the labour force will be covered by labour policy measures. Labour policy and training resources in particular have been increased in order to improve young people's employability and employment prospects.

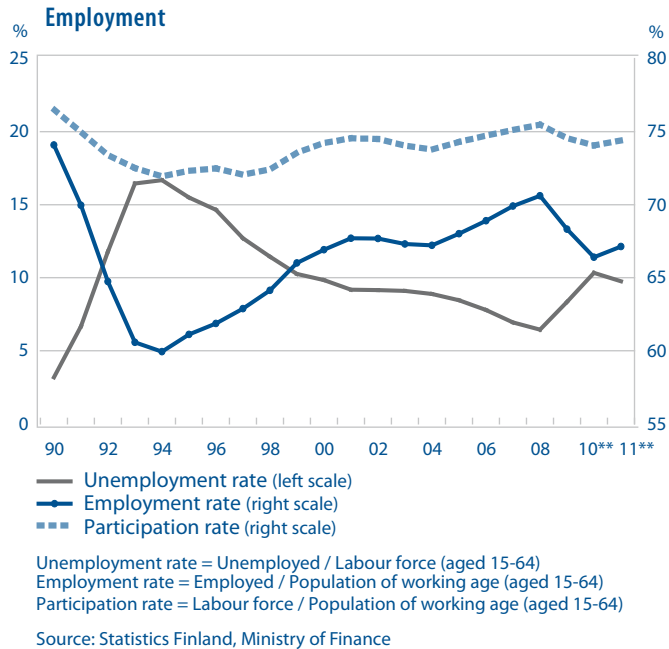
Balance of manpower resources

| | 2007 | 2008* | 2009* | 2010** | 2011** |
|---|--------------------------------------|-------|-------|--------|--------|
| | annual average. 1 000 persons | | | | |
| Population of working age ¹⁾ | 3 981 | 4 004 | 4 025 | 4 042 | 4 058 |
| Labour force | 2 675 | 2 703 | 2 678 | 2 653 | 2 661 |
| Unemployed labour force | 183 | 172 | 221 | 271 | 256 |
| Employed labour force | 2 492 | 2 531 | 2 457 | 2 382 | 2 404 |
| agriculture and forestry | 118 | 119 | 119 | 118 | 118 |
| industry | 446 | 443 | 406 | 370 | 371 |
| construction | 174 | 186 | 175 | 168 | 171 |
| service industries | 1 748 | 1 772 | 1 749 | 1 717 | 1 735 |
| wholesale and retail trade, accommodation and catering services | 389 | 399 | 381 | 366 | 367 |
| transport and communications information and communications | 247 | 247 | 247 | 242 | 243 |
| financial intermediation, insurance and real estate activities plus business activities | 320 | 325 | 314 | 294 | 303 |
| community, social and personal services | 792 | 801 | 807 | 815 | 822 |
| branch unknown | 6 | 12 | 9 | 9 | 9 |
| | % | | | | |
| Labour force participation rate | 67.2 | 67.5 | 66.5 | 65.6 | 65.6 |
| Employment rate (15-64 -year-olds) | 69.9 | 70.6 | 68.3 | 66.4 | 67.1 |
| Unemployment rate | 6.9 | 6.4 | 8.2 | 10.2 | 9.6 |
| aged under 25 | 16.5 | 16.5 | 21.5 | 24.0 | 22.0 |
| | 1 000 persons per annum | | | | |
| Immigration, net | 13.0 | 15.5 | 14.2 | 15 | 15 |

¹⁾ Persons aged 15 to 74.

In 2011 the gradual recovery of the economy and the underlying fiscal policy will begin to filter through to the labour market. New jobs will be created in manufacturing and services. The employment rate is expected to edge up to 67.1%, the number of people out of work will be slightly down on the current year and the unemployment rate will fall back to 9.6%. However economic growth still remains sluggish and tentative. In recent times the minimum requirement for sustained employment growth has been an increase in output of at least a couple of per cent, preferably over a number of years.

With unemployment running high for a third year in succession, long-term unemployment is set to start rising. On the other hand the dwindling labour supply caused by the ageing of the workforce may create an increasing mismatch problem in the labour market. Even though large numbers are out of work, it is expected that in some occupations and in some regions there will be a shortage of qualified human resources.



1.6 Incomes, costs and prices

National income

National income dropped by almost 9 % in 2009. The sharpest falls were recorded for property income and business income. Most of the drop of over 40 % in those items resulted from the declining operating surplus in the private business sector, i.e. falling business profits. Other income items increased their share of national income accordingly, and labour income as a proportion of national income rose to 63.6 %.

Household entrepreneurial income increased by almost one-quarter, but this was primarily attributable to the doubling of imputed housing income from the year before. Imputed housing income, which is not liquid income for households, rises when interest rates fall. Excluding the net effect of housing income, household entrepreneurial income was up 1.4 % last year. Entrepreneurial income from forestry fell 14 % from 2008, whereas income from agriculture increased as a result of the good harvest.

Earnings increased very rapidly in 2009 in view of the cyclical environment. Following the 2007 round of collective bargaining, negotiated wages increased by 3.7 % and the earnings level by 3.9 %. The contribution of other factors impacting earnings remained at an historically low level at 0.2 %, as measured as the difference between the index of wage and salary earnings and the index of negotiated wage rates. In contrast to earlier developments regular earnings

Index of wage and salary earnings and labour costs per unit of output

| | 2007* | 2008* | 2009* | 2010** | 2011** |
|---|------------|------------|------------|------------|------------|
| | change, % | | | | |
| Index of negotiated wage rates | 2.1 | 4.2 | 3.7 | 2.1 | 1.8 |
| Wage drift, etc. | 1.3 | 1.3 | 0.2 | 0.7 | 0.7 |
| Index of wage and salary earnings | 3.4 | 5.5 | 3.9 | 2.8 | 2.5 |
| Real earnings ¹⁾ | 0.9 | 1.4 | 3.9 | 1.3 | 0.0 |
| Average earnings ²⁾ | 3.8 | 4.9 | 6.4 | 2.4 | 1.8 |
| Labour costs per unit of output ³⁾ | | | | | |
| whole economy | 0.5 | 5.5 | 7.7 | -1.5 | 1.1 |
| of which: manufacturing | -4.7 | 2.5 | 28.8 | -2.8 | -2.0 |

¹⁾ The index of wage and salary earnings divided by the consumer price index.

²⁾ Computed by dividing the national wage bill by the number of hours worked by wage and salary earners. The figures are affected by structural changes in the economy.

³⁾ The index of wages, salaries and employers' contributions to social security schemes divided by the volume index of production.

Disposable income

| | 2009* | 2007* | 2008* | 2009* | 2010** | 2011** |
|---|----------|-----------|-------|-------|--------|--------|
| | share, % | change, % | | | | |
| Wages and salaries | 51.2 | 6.1 | 6.6 | -1.0 | 0.3 | 3.5 |
| Employers' contributions to social security schemes | 12.4 | 5.2 | 7.0 | -3.1 | -2.2 | 4.5 |
| Household entrepreneurial income | 8.2 | -0.5 | -6.4 | 24.3 | 2.7 | -0.6 |
| from agriculture | 0.6 | 21.5 | -32.0 | 7.8 | 2.0 | 3.0 |
| from forestry | 1.2 | 68.2 | -1.4 | -14.2 | 11.0 | 5.0 |
| from other sources | 6.4 | -13.2 | -3.5 | 37.4 | 1.3 | -2.0 |
| Property and other entrepreneurial income | 13.9 | 16.4 | -5.0 | -41.1 | 29.2 | 6.2 |
| Taxes on production and imports minus subsidies | 14.4 | 3.4 | 1.7 | -5.0 | -1.5 | 13.5 |
| National income | 100.0 | 7.4 | 2.4 | -8.9 | 4.0 | 5.1 |
| Disposable income | | 7.4 | 2.3 | -9.1 | 4.2 | 5.2 |
| Gross national income, EUR bn | | 179.6 | 185.1 | 170.9 | 175.6 | 183.1 |

increased much more rapidly last year than the index of wage and salary earnings because total performance pay (which is included in the latter) declined sharply following the onset of recession.

The overall wage bill for 2009 was lower than year before because of the significant reduction in the labour input. Because of the decrease in the unemployment insurance contribution, employers' social insurance contributions fell more than the wage bill.

By mid-March 2010, new collective agreements have been signed for some two-thirds of all wage earners, or close to one million people under the new round of collective wage bargaining that started at the beginning of the year. The wage settlements concluded so far remain moderate. It is also expected that bonuses paid out in 2010 for 2009 performance will be quite low. Indeed more than half of the 2.8 % rise in the index of wage and salary earnings in 2010 will be attributable to the transfer effect of the high pay rises late in 2009. The new wage settlement negotiations during the current round only extend to the end of this year, and therefore the development of earnings in 2011 will largely depend on the economic outlook next spring.

National income will rise both this year and next as both property income and business income are expected to increase again. The wage bill will rise only marginally in 2010 because the labour input will continue to contract. In 2011, with the recovery of employment, it is projected that the wage bill will increase by 3.5 %. Taxes on production and imports, which fell last year and will continue to fall this year because of weak demand, are expected to rebound in 2011.

Inflation

In 2009 prices of crude oil and other raw materials began to pick up after a hefty fall the year before. The one exception was the price of grain, which was more or less unchanged throughout the year. This upturn in raw materials' prices began to feed through to monthly observations on producer and import prices in industry towards the end of 2009 and particularly in early 2010, but annualized producer prices are still expected to fall.

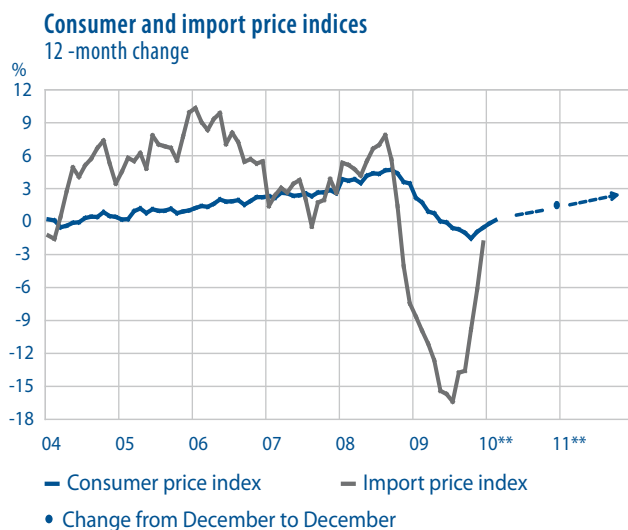
Consumer prices did not rise at all in 2009 as measured by the national consumer price index. During 2009 the index fell by 0.5 % from December to December and on average remained unchanged from the previous year. Although prices increased in virtually all other goods categories last year, the lowered costs of owner-occupied housing, lower mortgage interest rates and lower food prices meant that overall inflation was negligible. Food prices dropped most sharply in October when the VAT rate on food was lowered by five percentage points. However because of the food price spike early in 2009, average prices were still higher than the year before.

The harmonized consumer price index, which is used in EU country comparisons and which does not include interest rates or house prices, increased

Price indices

| | 2007* | 2008* | 2009* | 2010** | 2011** |
|---------------------------------------|-----------------|-------|-------|--------|--------|
| | change per cent | | | | |
| Export prices ¹⁾ | 1.1 | -1.1 | -5.7 | 3.2 | 1.7 |
| Import prices ¹⁾ | 1.9 | 2.0 | -7.3 | 4.2 | 3.1 |
| Consumer price index | 2.5 | 4.1 | 0.0 | 1.5 | 2.5 |
| Basic price index for domestic supply | 4.0 | 5.7 | -6.4 | 2.7 | 3.5 |
| Building cost index | 5.9 | 3.9 | -1.1 | 3.5 | 3.0 |

¹⁾ As calculated in the National Accounts.



Source: Statistics Finland, Ministry of Finance

by 1.6 % during 2009. At the same time prices in the euro area increased by no more than 0.4 %. The reason why inflation is continuing for a second year to run at a much higher level than in the euro area lies in the steeper increase in prices for food and services in Finland.

During 2010 inflation will accelerate to 1.5 % according to the national price index, as the projected sharp rise in world market prices of energy and other raw materials filters through to producer prices and eventually to consumer prices. House prices and interest rates will no longer fall. Furthermore the increase in the general VAT rate in July and the reduction in the VAT rate on restaurant meals will push up consumer prices by a few tenths of percentage points.

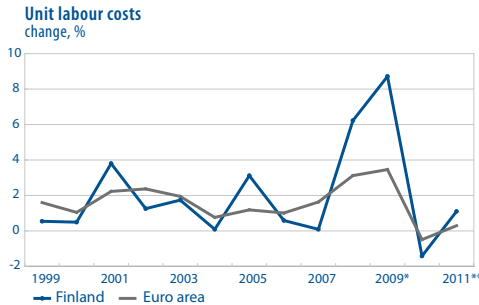
Cost competitiveness¹⁾

Since the start of EMU, labour costs have increased more rapidly in Finland than elsewhere in the euro area. Until very recently, however, the faster than average increase in compensation per employee has been offset by the fact that productivity trends in Finland have developed more strongly than in the euro area on average. Overall, unit labour costs increased at more or less the same pace in Finland as in the whole euro area.

In 2008 and 2009 Finland's unit labour costs increased more sharply than in any other

euro area Member State, at twice the rate as in the euro area on average, implying a significant deterioration in cost competitiveness vis-a-vis the euro area²⁾. The pay rises based on the autumn 2007 round of sectoral wage negotiations, extending through to the end of 2009, were set at a level that turned out to be high in view of the sharp economic downturn.

In Finland, employment reacted to the sharp decline in output with a decrease in the number of hours worked. Because of the increase in



Change in unit labour costs = change in compensation per employee / change in labour productivity

Source: Statistics Finland, EU, Ministry of Finance

part-time employment and the number of layoffs in particular, the number of hours worked fell twice as much as the number of people in employment. This does not, however, explain the increase in unit labour costs because the rapid rise in compensation per employee is countered by a sharp drop in productivity per employee. In 2008–2009 unit labour costs calculated on the basis of working hours also increased by almost 15 % cumulatively. Indeed it seems that the faster rise in Finnish unit labour costs compared to the euro area is due not only to the fall in output, but also to the absence of flexibility in the price of labour during the recession.

Despite the moderate wage settlements, compensation per employee will continue in 2010 to increase more rapidly in Finland than in the euro area, but the improvement in productivity will cause unit labour costs to fall more than in the euro area. It would however seem that next year unit labour costs will again rise more sharply than in the euro area.

In terms of national competitiveness the main focus of interest is on the sector that is open to international competition, i.e. roughly speaking the industrial sector. With the exception of 2001, unit labour costs in Finnish industry have declined since the beginning of EMU until 2008. The rise that started in 2008 accelerated last year to the exceptionally high level of 29 per cent when manufacturing declined more sharply than other sectors of the economy and wages continued to rise in accordance with negotiated settlements. In the space of one year, therefore, unit labour costs in industry, increased by more than they had decreased over the preceding ten years taken together (-25 %).

¹⁾ The development of cost competitiveness is examined here based on unit labour costs. Following the definition used by the European Commission, cost competitiveness is defined as the ratio of compensation per employee to productivity per employee.

²⁾ Detailed unit labour cost indicators for different countries can be obtained from Eurostat sources.

It is not expected that accelerating demand will create major inflationary pressure in 2011, but import and producer prices will continue to rise. The increase in energy tax at the start of the year together with the introduction of excise duty on sweets and an increase in the excise duty on soft drinks will slightly push up consumer prices. In all, consumer prices may rise by about 2.5 %. Since housing prices and interest rates are expected to rise, the annualized increase in the harmonized consumer price index will be somewhat lower at around 2 %.

2 Economic policy and public finances

2.1 Medium-term outlook for public finances

In 2009, under the pressure of the economic crisis, the general government budgetary position deteriorated even more than in 1991, bringing to an end a decade of continued surpluses. In the medium term public finances will remain in deficit, although the deficit will contract somewhat. With the exception of the current year, it is expected that the deficit will remain below the three per cent of GDP limit prescribed by the Stability and Growth Pact, but the budgetary position will not return to pre-recession levels.

The slight economic recovery in 2011 will help to strengthen public finances. As economic growth rebounds, it is expected that over the next few years tax revenue will also begin to recover. Nevertheless the rebound will remain relatively short-lived as the growth of tax revenue is slowed by demographic change. The impacts of population ageing will also be felt on the expenditure side through rising pension and health care costs.

The general government deficit is primarily due to the substantial deficit in central government finances. Without forceful measures to balance revenue and expenditure, the local government sector also looks set to remain in deficit for the foreseeable future. The annual state of local government finances will depend crucially on upcoming pay settlements, decisions on municipal tax rates and property taxes, and measures taken to curb expenditure growth. Only the social security sector will remain in surplus. However the financial position of employment pension funds is also beginning slowly to deteriorate with the growth of pension expenditure. The accounting transfer of the State Pension Fund from the central government sector to the employment pension funds sector will adversely impact the financial position of central government but improve the position of the employment pension sector accordingly. Therefore this move will have no effect on the overall budgetary position of general government.

The current situation is quite different from the aftermath of the recession in the early 1990s, when the recovery of public finances was driven both by adjust-

ment measures and brisk economic growth. The current recession will leave in its wake a permanent structural deficit because economic growth will not in itself be enough to turn public finances into a surplus by the middle of the decade.

The recovery of public finances is hampered by the fact that the Finnish economy is not expected to return to its previous growth track after the crisis. Even before the crisis it was predicted that during the current decade, annual growth of potential output would drop to below 2%. Medium-term potential output is now at a lower level than projected in pre-crisis forecasts.

The tax rate or the general government tax revenue to total output ratio is set to rise next year and beyond if new tax hikes are put in place. However the tax burden will not rise to the same levels experienced some ten years ago. In 2009 the expenditure rate increased by 6 percentage points as total output fell at record rates and spending continued to climb. The expenditure rate will remain high over the next few years ahead.

In 2014 the public debt to GDP ratio is expected to stand at 56%. For the time being, therefore, the debt ratio will remain below the Stability and Growth Pact 60% limit. From year-end 2009 to year-end 2014, public debt will increase by an estimated EUR 45 billion to around EUR 120 billion.

The development of general government EMU debt will depend above all on central and local government borrowing, the development of internal general government debt and security deposits related to government derivative contracts. The latter is a new and rapidly growing liability that jumped to EUR

Main economic indicators in general government

| | 2006 | 2007 | 2008* | 2009* | 2010** | 2011** |
|---|-----------------------|------|-------|-------|--------|--------|
| | in relation to GDP, % | | | | | |
| Taxes and social security contributions | 43.7 | 42.9 | 43.1 | 42.9 | 42.4 | 43.6 |
| General government expenditure ¹⁾ | 49.0 | 47.3 | 49.5 | 55.6 | 56.7 | 56.1 |
| Net lending | 3.9 | 5.2 | 4.1 | -2.4 | -4.1 | -2.2 |
| Central government | -0.2 | 1.0 | 0.5 | -5.1 | -6.3 | -4.7 |
| Local government | -0.4 | -0.2 | -0.4 | -0.4 | -0.5 | -0.3 |
| Employment pension institutions | 4.3 | 4.1 | 4.0 | 3.0 | 2.7 | 2.8 |
| Other social security funds | 0.2 | 0.3 | 0.1 | 0.1 | -0.2 | 0.0 |
| Primary balance ²⁾ | 3.5 | 4.5 | 3.2 | -3.0 | -4.8 | -3.0 |
| General government debt | 39.7 | 35.2 | 34.2 | 44.0 | 49.9 | 51.7 |
| Central government debt | 35.6 | 31.2 | 29.5 | 37.6 | 43.5 | 46.3 |
| General government employment, 1000 person | 611 | 610 | 614 | 613 | 608 | 605 |
| Central government | 146 | 144 | 143 | 142 | 141 | 140 |
| Local government | 455 | 456 | 461 | 461 | 457 | 455 |
| Social security funds | 10 | 10 | 10 | 9.9 | 10 | 10 |

¹⁾ EU-harmonized definition.

²⁾ Net lending before net interest expenses.

1.4 billion in 2009. Public sector internal debt, above all investments by employment pension institutions in government bonds, acts to slow the growth of EMU debt. Employment pension companies have been offloading their investments in government papers for the past 10 years now, which has slowed the decrease in general government EMU debt. Over the next few years, however, it is expected that employment pension funds will slightly step up their investment in government bonds.

General government finances¹⁾

| | 2006 | 2007 | 2008* | 2009* | 2010** | 2011** |
|--|-------------|-------------|-------------|-------------|-------------|--------------|
| | EUR billion | | | | | |
| Current taxes | 28.7 | 31.5 | 32.3 | 27.8 | 28.0 | 29.8 |
| Taxes on production and imports | 22.7 | 23.4 | 23.9 | 22.9 | 23.5 | 25.8 |
| Social security contributions | 20.5 | 21.6 | 22.5 | 22.2 | 22.7 | 24.0 |
| Taxes and contributions, total ²⁾ | 72.4 | 77.0 | 79.4 | 73.4 | 74.7 | 80.1 |
| Other revenue ³⁾ | 15.8 | 17.7 | 20.0 | 18.0 | 18.4 | 19.5 |
| of which interest receipts | 3.4 | 4.0 | 4.7 | 3.7 | 3.8 | 4.3 |
| Total revenue | 87.7 | 94.2 | 98.8 | 90.9 | 92.6 | 99.2 |
| Consumption expenditure | 36.7 | 38.6 | 41.6 | 42.9 | 44.0 | 45.0 |
| Subsidies | 2.3 | 2.3 | 2.5 | 2.5 | 2.6 | 2.8 |
| Social security benefits and allowances | 26.5 | 27.2 | 28.5 | 30.5 | 33.1 | 34.3 |
| Other current transfers | 4.3 | 4.4 | 4.8 | 5.2 | 5.3 | 5.5 |
| Subsidies and current transfers, total | 33.1 | 33.8 | 35.7 | 38.1 | 41.1 | 42.7 |
| Capital expenditure ⁴⁾ | 4.3 | 4.9 | 5.3 | 5.5 | 6.0 | 5.9 |
| Other expenditure | 7.1 | 7.6 | 8.5 | 8.5 | 8.8 | 9.5 |
| of which interest expenses | 2.6 | 2.6 | 2.7 | 2.4 | 2.4 | 2.6 |
| Total expenditure | 81.2 | 84.9 | 91.1 | 95.0 | 99.9 | 103.1 |
| Net lending (+) / net borrowing (-) | 6.5 | 9.3 | 7.6 | -4.1 | -7.2 | -3.9 |
| central government | -0.3 | 1.7 | 1.0 | -8.6 | -11.0 | -8.6 |
| local government | -0.6 | -0.3 | -0.7 | -0.7 | -0.8 | -0.5 |
| Employment pension schemes | 7.1 | 7.4 | 7.3 | 5.1 | 4.8 | 5.2 |
| Other social security funds | 0.3 | 0.5 | 0.1 | 0.1 | -0.3 | -0.1 |
| Primary balance ⁵⁾ | 5.8 | 8.1 | 5.8 | -5.2 | -8.4 | -5.4 |

¹⁾ As calculated in the national accounts, ESA95.

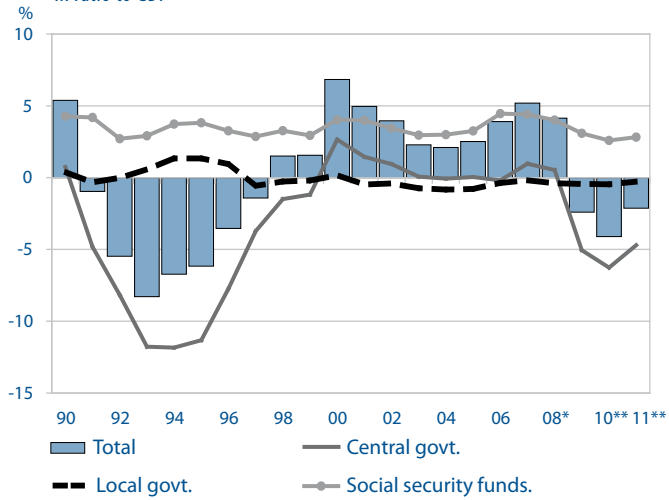
²⁾ Incl. capital taxes.

³⁾ Incl. capital transfers and consumption of fixed capital.

⁴⁾ Gross fixed capital formation and capital transfers

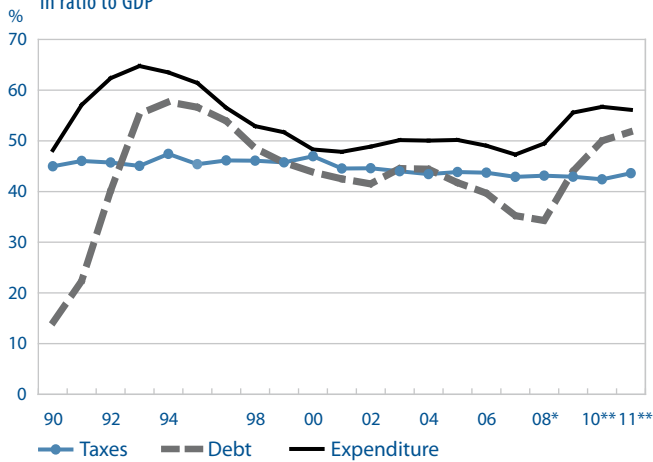
⁵⁾ Net lending before net interest expenses.

**The financial balance of general government subsectors
in ratio to GDP**



Source: Statistics Finland, Ministry of Finance

**General government taxes, expenditure and debt
in ratio to GDP**



Source: Statistics Finland, Ministry of Finance

Excessive deficit procedure

The EU Stability and Growth Pact was conceived to ensure the smooth operation of the European Monetary Union (EMU) and budgetary compliance after the introduction of a common currency. The Pact details the procedures for monitoring Member States' budgetary situations and the rules for the coordination of economic policies. EU Member States have committed themselves to avoiding excessive deficits, i.e. general government deficits in excess of three per cent of GDP. The deficit may exceed the reference value if it is exceptional, temporary and if it remains close to the reference value. An exceptional breach of the reference value is defined as one that is due to an unusual event, that is beyond the control of the Member State and that has a major impact on the general government budgetary position or that is due to a severe economic recession. A deficit exceeding the reference value is considered temporary if European Commission projections of public finances indicate that the deficit will fall below the reference value after the exceptional event or severe economic recession.

Public finances in Member States are monitored via reports that are submitted twice a year by 1 April and 1 October. In addition, Member States are required to present annual stability programmes, which are used to assess their medium-term budget strategies. Non-EMU countries prepare equivalent convergence programmes.

A breach of the 3 per cent reference value triggers the excessive deficit procedure. The Commission presents a report to the Council in which it investigates the existence of an excessive deficit based on the criteria mentioned above. The report also takes account of other factors that the Member State considers relevant to the assessment of an excessive deficit, in particular pension reforms.¹⁾ The Council issues its decision on the existence of an excessive deficit within four months of receiving the report.

If the deficit is considered excessive, the Council makes recommendations to the Member State with a view to rectifying the situation and sets a deadline by which the deficit must be brought back to under 3 per cent of GDP. The Member State is required to introduce effective corrective measures within six months. The Council also determines the annual pace at which the deficit must be reduced so that the excessive deficit can be eliminated within the time limit. For example, Greece is required to reduce its existing deficit by at least 3½ percentage points in 2010 and 2011 and by a further 2½ percentage points in 2012. The Council monitors the implementation of these recommendations and suspends the excessive deficit procedure if the Member State complies.

If the Member State fails to comply with the recommendations, the Council may decide to proceed to the next stage and translate its recommendations into requirements and eventually impose economic sanctions and invite the European Investment Bank (EIB) to reconsider its lending policy towards the Member State concerned.

The Lisbon Treaty of December 2009 expands the Commission's powers in the implementation of the excessive deficit procedure. The Commission can now independently issue advance warning to a Member State that fails to comply with economic policy guidelines or that may cause damage to the European Monetary Union. Furthermore, the Commission's deficit recommendations to a Member State can only be changed by unanimous consent of all Member States.

In mid-March 2010, 20 Member States are subject to the excessive deficit procedure, but it is expected that virtually all EU members will exceed the 3 per cent reference value during the current year; the only possible exceptions are Bulgaria and Estonia. The international economic downturn and the stimulus measures adopted in response have weakened government budgetary positions throughout Europe. Indeed Member States have exceptionally long deadlines (on average three years) to eliminate their excessive deficits.

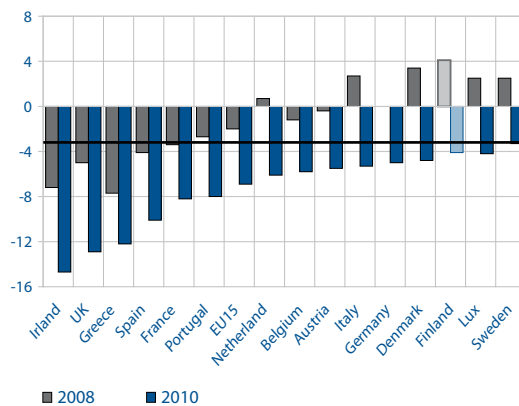
¹⁾ Other relevant factors mentioned in Article 104(3) of the EU Treaty include the medium-term economic position of the Member State (growth potential), the current cyclical situation, implementation of the measures under the Lisbon Strategy, particularly measures to promote research and innovation, the medium-term general government budgetary position, particularly efforts to stabilize public finances during periods of cyclical upswing, and the implementation of pension reforms. This list is not exhaustive, however.

Member States under the Excessive Deficit Procedure

| | Council Decision on existence of excessive deficit | Current deadline for correction |
|-----------------|--|---------------------------------|
| Austria | 2.12.2009 | 2013 |
| Belgium | 2.12.2009 | 2012 |
| Czech Republic | 2.12.2009 | 2013 |
| Germany | 2.12.2009 | 2013 |
| Italy | 2.12.2009 | 2012 |
| The Netherlands | 2.12.2009 | 2013 |
| Portugal | 2.12.2009 | 2013 |
| Slovenia | 2.12.2009 | 2013 |
| Slovakia | 2.12.2009 | 2013 |
| Poland | 7.7.2009 | 2012 |
| Romania | 7.7.2009 | 2012 |
| Lithuania | 7.7.2009 | 2012 |
| Malta | 7.7.2009 | 2011 |
| France | 27.4.2009 | 2013 |
| Latvia | 7.7.2009 | 2012 |
| Ireland | 27.4.2009 | 2014 |
| Greece | 27.4.2009 | 2010 |
| Spain | 27.4.2009 | 2013 |
| UK | 8.7.2008 | financial year 2014/15 |
| Hungary | 5.7.2004 | 2011 |

General government financial balance in EU-15 countries

in 2008 and 2010, % of GDP



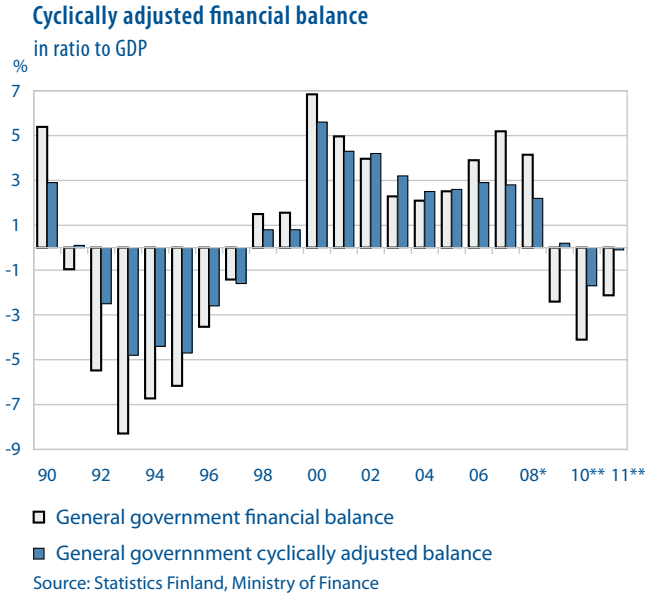
Source: European Commission, Autumn 2009, Finland forecast Ministry of Finance

Estimates of fiscal policy impact

It is estimated that in the late 1990s and early 2000s, the potential output of the Finnish economy grew by over 3% per annum. However the deep recession has severely curtailed the rate of potential output growth. The labour force has shrunk and structural unemployment increased during the downturn. The lowered level of investment has also hurt the economy's growth potential. As the recession bottoms out it is expected that potential output growth will begin to rebound, but it is possible that the recession will have permanently damaged the economy's potential growth. In any event, because of the continuing impact of population ageing, it is estimated that annual potential output growth in the coming years will remain at below 2%. With the labour force shrinking, future economic growth will mainly depend on productivity growth².

In the years preceding the recession, the cyclically adjusted general government balance remained virtually unchanged, which means that fiscal policy can be characterized as having been neutral. In 2009, by contrast, the cyclically adjusted balance declined sharply, and it is expected to continue to fall clearly in 2010. This has its background in the stimulus measures introduced to help soften the impact of the recession. It is forecast that in 2011, the cyclically adjusted balance will improve again. However any assessment of the impact of fiscal policy must take account of the uncertainties involved in calculating potential output and cyclically adjusted balance, for those uncertainties are most pronounced during periods of sharp cyclical fluctuations.

² The output gap and the level of potential output are estimated by the production function method, which is used by the European Commission and EU Member States. Cyclical sensitivity in general government is gauged by using OECD income and expenditure elasticity estimates.



2.2 Central government finances

2.2.1 Central government spending limits for 2011–2014

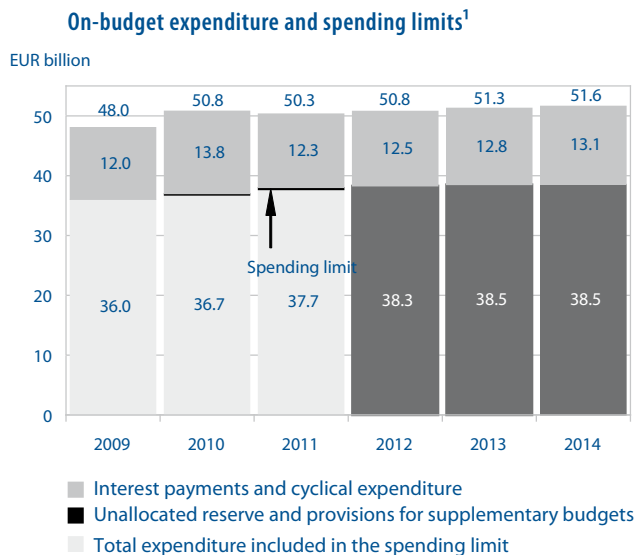
The first spending limits decision taken during the current government term set a ceiling for some three-quarters of total budgetary expenditure over the parliamentary term. The system of spending limits helps to provide a solid foundation for the stable and credible management of central government finances and for a fiscal policy that is conducive to economic stability.

Annual decisions on central government spending limits do not affect the underlying expenditure management regime, but their purpose is to technically revise and adjust the existing spending limits for the parliamentary term according to changes in cost and price levels and in the structure of the budget. At the same time, revenue and expenditure estimates for the forthcoming four-year term are updated.

In May 2007, the spending limit for 2011 was set at EUR 34,409 million (at 2008 price level), including the EUR 1.3 billion increase in expenditure adopted in the Government Programme. Following the EUR 2,985 million cost and price level adjustments made in 2007–2010 and the EUR 609 million adjustments due to structural budget changes, the spending limit for 2011, the last year of the current parliamentary term, now stands at EUR 38,003 million. Expenditure levels for 2012–2014 do not include any new policy initiatives. The spending

limits decision does, however, take account the impacts of the decisions by the current Government on expenditure levels over the next few years.

In the 2008–2011 parliamentary term, the volume of central government budget expenditure will increase by an average of 3% per annum. The increase was fastest in 2009, when real expenditure grew by almost 7%. This was due to both the rise in cyclical expenditure and Government stimulus measures, which in large part consisted of financial investments outside the spending limits. In 2011 expenditure will fall in real terms by around 2% from 2010, primarily because of the discontinuation of non-recurring investments to support the financial markets.



¹ Spending limit expenditure for 2010-2014 at 2011 prices and expenditure for 2009 and 2010 at current prices. Year 2009 according to budgeted, year 2010 according to supplementary budget proposal and years 2011-2014 according to Spending Limits Decision 30.3.2010.

Source: Ministry of Finance.

Balance in central government finances: estimate for 2010-2014, current prices EUR billion

| | 2010 | 2011 | 2012 | 2013 | 2014 |
|------------------------------------|----------------------------------|-------------|-------------|-------------|-------------|
| | at current prices, billion euros | | | | |
| Total expenditure (current prices) | 50.6 | 50.0 | 51.9 | 53.6 | 55.0 |
| Total estimated revenue | 38.3 | 41.5 | 43.8 | 45.5 | 47.1 |
| On-budget balance | -12.3 | -8.5 | -8.1 | -8.1 | -7.9 |

Expenditure outside the spending limits has increased at an exceptional pace during the current parliamentary term among other reasons as a result of cyclical expenditure, compensations for the discontinuation of the employer's national pension contribution, compensations to local governments for tax cuts and stimulus-driven financial investments. This has had an adverse effect on the on-budget balance, which is worse than predicted at the start of the parliamentary term. Despite the larger than anticipated deficit, the estimate for debt interest payments in 2011 is virtually unchanged from the projection in the 2007 spending limit decision because interest rates are at an exceptionally low level. However, it is expected that interest payments on central government debt will increase significantly towards the end of the budget planning period both because of the increasing amount of debt and because of rising interest rate levels.

In 2010, it is projected that on-budget revenue (excluding net borrowing) will increase by 2%. The estimate for the whole budget planning period is an average increase of 5½% per annum. Tax receipts, which account for around 85% of on-budget revenue, are expected to grow annually by an average of 6%. Apart from the growth of tax bases, other factors that will drive up tax receipts include increases in indirect taxes introduced in 2010–2011 and the expiry of the temporary apportionment rules for corporate tax revenue in 2012. All VAT rates will be increased by one percentage unit as of 1 July 2010, and at the same time the VAT rate on restaurant meals will be lowered to the same level as the rate for food, i.e. 13%. The tax rate hikes will bring in an estimated EUR 690 million in additional tax revenue each year, while the lowered VAT for restaurant meals will reduce tax receipts by some EUR 260 million. In 2011 energy taxes will be increased by EUR 750 million. At the same time the excise duty on soft drinks will be raised and a new duty on sweets introduced; together these moves will increase yearly tax receipts by around EUR 100 million.

The current expenditure management policy implements the Government's economic strategy, the aim of which is to increase the population's well-being by creating more jobs and boosting productivity growth. The main areas of emphasis are the development of social security, the promotion of skills and competencies, R&D, and climate and energy policy.

In order to create the necessary room for manoeuvre and to enable shifts in emphasis, the spending limits decision has extended some of the reallocations made in the 2010 budget. Under the spending limits decision, agencies' operating expenses are cut by EUR 47 million in 2011 and by over EUR 30 million through the rest of the budget planning period. Furthermore, funds available for development cooperation have been reduced compared to the previous spending limits decision, in 2011 by EUR 79 million. Despite this, development cooperation funds will increase by EUR 90 million in 2011 compared to 2010.

Since autumn 2008 the Government has on several occasions announced stimulus measures aimed at promoting employment and economic activity. These measures have included steps to support private consumption, various emplo-

yment-generating projects, employment increasing measures, business funding schemes as well as development programmes and investments that support longer-term growth and that integrate environmental and climate considerations. These measures affect appropriations primarily in 2009 and 2010, but increases in stimulus-related budget authorities, multi-year projects and increases in the number of education places will continue to drive up expenditures in the first year of the budget planning period by just under EUR 400 million. Implementation of the stimulus measures is discussed in more detail on page 62.

One of the social security reforms that will take effect during the forthcoming budget planning period is the introduction of a so-called guarantee pension from the beginning of March 2011. In addition, from the same date, basic security benefits not covered by indexation (minimum rehabilitation allowances and daily allowances, child benefit, child home care allowance and private child care allowance) will be linked to the national pension index.

During the 2007–2011 parliamentary term R&D funding has been increased by EUR 90 million as agreed in the Government Programme, plus by an additional EUR 177 million at 2011 level. All told, during this electoral term, public R&D funding will increase by EUR 320 million to EUR 2,060 million in 2011. Public R&D funding as a percentage of GDP will rise from 0.97% in 2007 to 1.12% in 2011.

A major overhaul of the university system from the beginning of 2010 means that universities are no longer part of the government sector. The Government has earlier taken the decision to allocate EUR 150 million for the initial capitalization of foundation universities, the Aalto University and Tampere University of Technology. Under the current spending limits the Government is prepared to invest in 2011 a total of EUR 100 million in other than foundation universities, provided that the full amount of private investment previously committed comes through.

Investment in the development of information systems will be stepped up in many administrative sectors with a view to improving productivity. In 2012–2014 EUR 80 million of centralized productivity funding has been reserved for this purpose. In total EUR 75 million has been reserved for the eServices and democracy project during the budget planning period.

Furthermore, the government productivity programme will be continued as per earlier decisions so that central government workforce needs can be reduced by the equivalent of 9,645 person-years by 2011 and by a further 4,800 person-years by 2015.

Implementation of 2009 stimulus measures

Stimulus decisions for 2009 were made in the 2009 budget; in the first supplementary budget in the winter of 2009; and in the second supplementary budget in early autumn 2009. The National Accounts bottom-up estimate of the costs of stimulus to central government in 2009 is EUR 3.2 billion¹, or over 1.8% of GDP. Based on reports received from the ministries in February 2010, stimulus projects have mostly gone as planned, although in some cases the most labour-intensive phases have been delayed into 2010.

The direct job-creating or job-retaining effect of stimulus projects, acquisitions and other measures is so far estimated at around 10,000 person-years. The overall employment effect (including indirect effects such as those via other branches) is estimated at just under 27,000 person-years². In addition, it is estimated that measures coordinated by the Housing Fund will have an overall employment effect of more than 19,000 person-years in 2009–2010, based on the assumption that an investment of one million euros in housing production investments generates 17 person-years of employment. No assessment is made here of the employment effects from stimulus-type measures impacting central government revenue, such as the reduction of the income tax rate and discontinuation of the employer's national pension contribution.

New housing construction and renovation

The stimulus decisions more than tripled state-subsidized housing production in 2009 compared to the previous year. Interest subsidy loan authorizations were increased to EUR 1,670 million, of which EUR 1,665 million was used (EUR 479 million in 2008). The number of state-subsidized housing starts was over 14,000 units, which accounted for around 60% of the total number of new housing starts. Access to loan funds required by housing production was secured by a fixed-term government capital investment in Municipality Finance. The overall employment effect is estimated at 19,400 person-years, half of which will extend into 2010. In addition, state interest subsidized housing renovation was extended.

Cyclical renovation grants were an even more effective and popular stimulus measure than expected. Grants applications were received for a total of EUR 250 million, while the combined value of all these projects was approx. EUR 2.5 billion. Part of this will be funded from the 2010 budget authority, which because of high demand was increased in the 2010 supplementary budget proposal. Work has started on projects worth around EUR 1.75 billion. The overall employment effect so far is estimated at 3,800 person-years. The employment effects will mainly materialize in 2010.

Under the increased investment authority, Senate Properties launched in 2009 new projects worth around EUR 80 million. Stimulus subsidies for the renovation of schools, children's day care centres and nursing homes have been allocated and most of the building work got under way in late 2009 and will continue into 2010. Building work at the Helsinki-Vantaa and Oulu airports is progressing as planned. The overall employment effect of these building projects so far is estimated at close to 1,000 person-years.

As a result of the stimulus measures described above, the situation in housing production and the construction sector as a whole developed much more favourably in 2009 than was

¹ The figure does not include costs incurred in later years from the authorizations and not either financial investments for the purpose of economic stimulus, which are not included in national accounts figures. The estimate does not either include the authorizations for stimulus measures done through the Housing Fund, the State Pension Fund, Finnvera and Senate Properties and neither the raising of the commitment ceilings of Finnvera.

² There are uncertainties related to estimating the indirect employment effects, the estimate is only an approximation.

widely predicted at the start of the year. As the low interest level and stimulus measures boosted household confidence, general housing demand recovered in 2009, leading eventually to an expansion of market-financed housing construction.

Transport and infrastructure projects

The new transport infrastructure projects announced in the 2009 budget are now primarily in the implementation phase and their overall employment effect to date is estimated at over 2,220 person-years. Most of the projects fast-tracked in the first supplementary budget for 2009 will get under way by February 2010.

The basic road and rail maintenance projects that received additional funding are now underway and will for the most part be completed during 2010–2011. The overall employment effect of these projects is estimated at close to 1,000 person-years.

Water maintenance projects and water construction work are underway and will mostly be completed during 2010. In addition new sewage pipeline projects were launched in 2009 and implementation of certain other projects was speeded up. The direct employment effect of water maintenance and sewage pipeline projects so far is over 100 person-years.

Business subsidies and R&D

Funding for employment-driven investment and business development projects has been increased in several stages by a total of almost EUR 50 million. Some two-thirds of total additional authorities have now been allocated. The direct employment effect of funding granted to date is estimated at 740 person-years.

R&D funding through the Finnish Funding Agency for Technology and Innovation (Tekes) has been increased by some EUR 70 million with a view to economic stimulus. These funds have been allocated among other things to R&D in the environment and energy sector, the experimental development of wood-based biofuels and new wood industry products, and to increase the volume of business and public sector R&D. With the exception of one major project, the funding has been made available to the applicants. General demand for R&D funding remained high throughout 2009.

The overall employment effect of R&D funding has been around 900 person-years higher than the year before. There has also been brisk demand for the energy aid authority: 89% (EUR 93 million) of the 2009 authority was used. The estimated employment effect has been over 500 person-years.

A total of EUR 3.7 billion was earmarked in loan authorisations for export refinancing, of which EUR 3 billion was included in the state budget. Demand for this funding remained much lower than anticipated among other reasons because of the revival of the financial markets. Refinancing loans worth EUR 280 million have been taken out and there are current financial bids worth close to EUR 900 million. The estimate for the employment effect is around 5,000 person-years.

EUR 150 million was invested in the capitalization of Finnish Industry Investment Ltd for purposes of economic stimulus. This made it possible to introduce counter-cyclical loans in spring 2009 to complement the EUR 100 million stabilization programme designed to ensure the continuity of stricken companies. Under this programme funding has been made available to seven companies, which together employ more than 5,100 people. Furthermore, the capitalization made possible the founding of a growth fund (Kasvurahas-tojen Rahasto Ky) together with employment pension investors. To date investment commitments totalling EUR 35 million have been given to three funds.

Employment and education policy measures

The additional student places (750) allocated to initial vocational training in the first supplementary budget were taken into use in the autumn of 2009. The new student places (500) allocated in the second supplementary budget have been taken into account in the final funding for 2009 and decisions on the provision of education have been made from the beginning of 2010.

The additional places allocated to further vocational training and apprenticeship training in the first supplementary budget were fully utilized (i.e. 1,250 new students places), those allocated in the second supplementary budget had around 60% impact (i.e. approx. 600 places). In the latter case the additional student places were allocated in collaboration with the Association of Finnish Entrepreneurs with a specific view to alleviating the impacts of recession in SMEs. Apprenticeship type training for academic graduates started up in the autumn of 2009.

In 2009 additional funding worth EUR 51 million was made available for employment and training measures, which also received funding through the European Social Fund programme. The job-to-job guarantee scheme was extended to apply to persons laid off, and additional staff was recruited to cope with the growing workload. It is estimated that the additional funding of EUR 51 million will increase the number of people covered under the scheme on average by around 5,900. The bulk of these extra funds or 86% were used in 2009. The activation rate was 23%.

Other stimulus measures

In 2009 the decision was taken to overhaul the oil combat vessel Halli. Work will be completed in June 2010. According to reports from the shipyard the employment effect of this project has been 20 person-years. In addition, the decision was made to purchase a new border guard vessel equipped with oil combating systems. This is now on the drawing board. The orders included in the first supplementary budget for defence material acquisitions are ready to be shipped and in fact most have been delivered. Furthermore many materials purchases have been brought forward. To date the employment effect here has been in excess of 70 person-years.

Funding authorities for EU Structural Fund programmes have been brought forward. The allocation of these authorities and their commitment to specific projects started in late 2009. Project planning under EU fisheries programmes has also been accelerated. Increases in funding for sustainable forestry have been spent among other things on coppice and energy-wood harvesting and wood chipping. The employment effect of the measures listed above has been over 1,000 person-years.

The first supplementary budget allocated funds from betting and lottery revenue to employment-generating projects. This has contributed significantly to employment projects in the culture, sports and youth sectors, most of which were completed in 2009. However some science funding projects are still in the implementation phase. The direct employment effect of projects funded from lottery revenue has been almost 450 person-years.

Off-budget operations

Finnvera's export guarantees were increased on 1 January 2009 and on 15 June 2009. Without these increases Finnvera would have had to hold back the issuing of new guarantee offers.

Finnvera's counter-cyclical loans and guarantees were taken into use in spring 2009, with the budget authority standing at EUR 900 million. Demand for funding was initially brisk, but began to ebb towards the close of the year: in the end only less than half of the projected sum of EUR 390 million was used in 2009. The counter-cyclical funding programme is set to continue until the end of 2011. So far it is estimated that the programme has contributed to creating 300 new jobs and safeguarding 1,700 existing jobs.

2.2.2 On-budget revenue

Estimates for on-budget revenue during the current budget period are based on medium-term projections for the national economy, which are used to extract forecasts for the development of tax bases. The recovery and moderate growth of total output during the budget planning period is also reflected in the development of tax revenue. In 2009, as a result of the decline in total output and tax rate changes, central government tax revenue fell by 15%, or EUR 5.7 billion. In 2010 it is projected that receipts from corporate tax and indirect taxes in particular will turn up and that tax revenue overall will increase by 1½%. In 2011 tax revenue is expected to increase by 10%, but the growth rate will then begin to slow. Over the planning period from 2011 to 2014, it is thought that the increase in tax revenue will average 6% per annum. In 2012 central government tax revenue is expected to reach the same level as in the 2008 accounts, and by the end of the planning period tax revenue is projected to come in at EUR 3.1 billion higher than in 2008. During the planning period tax receipts will be boosted not only by the growth of tax bases, but by the increases in indirect taxes that will take effect in 2010–2011 and by the termination in 2012 of the fixed-term reduction in the central government's apportionment of corporate tax revenue.

The tax policy principles set out in the Government Programme and other Government decisions on taxation are reflected in the current revenue estimates. Most of the tax cuts and increases included in the Government Programme have been put into effect during 2008–2010. Additionally, in connection with the preparation of the 2010 budget proposal, the Government decided to increase the VAT rate by one percentage point as from 1 July 2010. At the same time, VAT on restaurant food will be reduced to the same level as for foodstuffs. As of 1 January 2011, an excise duty on sweets will be introduced and the excise duty on soft drinks will be expanded. The lottery tax will be raised to 10% from the beginning of 2011. To offset the effects of the discontinuation of the employer's national pension contribution, energy taxes will be raised in 2011 so that net tax receipts will increase by EUR 750 million.

During the planning period, it is projected that central government budget revenue will increase on average by 5½% per annum and tax revenue will be up by 6% per annum.

Development of capital income constitutes a positive risk to tax revenue

Revenue from earned income and capital income taxes consists of receipts from progressive income tax, capital income tax and withholding tax paid by people with limited tax liability. From a tax accrual point of view the single most significant tax item is the progressive income tax. The annual budget

figures for earned income and capital income consist of payments made during the calendar year for more than one tax year.

It is projected that because of the tax cuts, receipts from earned income and capital income tax will fall by 1½% this year, but over the budget planning period they will increase on average by 5½% a year. Earned income will increase only marginally in 2010 as unemployment continues to rise and the increase in earnings continues to slow. The Government Programme set the target of reducing taxes on labour by EUR 1,110 million. The bulk of the tax cuts, close to one billion euros, took effect during 2009. This year's changes in tax bases prevent any tax hikes that would be caused as a result of increases in wage-earner contributions and earnings. It is not proposed that the remaining leeway to reduce taxes is used up in 2011 either. The calculation proceeds from the assumption that the bases of taxation are revised in 2011–2014, but in such a way that taxes do not rise as a result of increasing real earnings. This will have the effect of reducing tax revenue by a total of EUR 1.3 billion during the budget planning period. This estimate includes inflation adjustments to the income tax scale.

It is projected that after two years of sustained decline, capital income will turn around and show strong growth. The forecast is that capital income will rise by 10% in 2010, largely due to a substantial increase in capital gains and dividends paid out by companies. In the medium term it is expected that capital income will increase on average by 5% per annum over the budget planning period, while the increase in earned income will average 4%.

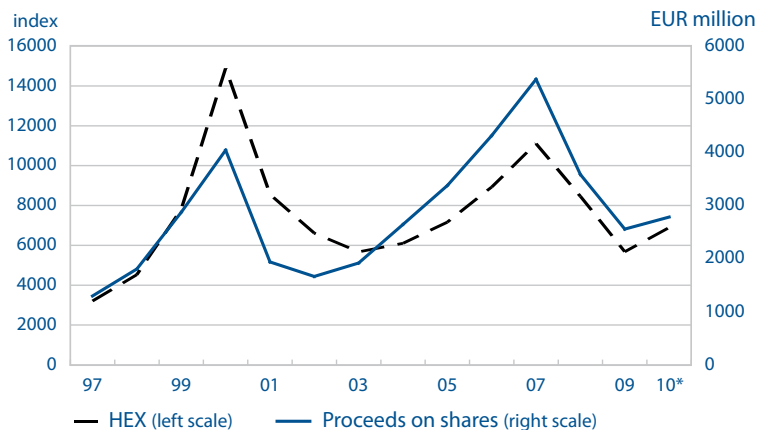
Forecasts for certain revenue and demand items impacting taxable income and the tax base in 2008-2014, annual change

| | 2008 | 2009 | 2010 | 2014/2011 |
|---|--------------------|-------|------|-----------|
| | change, % per year | | | |
| Taxable earned income and capital income | 3.7 | -0.2 | 2.6 | 4.3 |
| - Wage and salary earnings and other income | 6.8 | -1.0 | 0.3 | 4.1 |
| - Pensions and other social security benefits | 7.3 | 8.4 | 4.1 | 5.6 |
| - Capital income | -17.4 | -23.4 | 9.8 | 5.3 |
| Operating surplus | -7 | -24.3 | 17.0 | 7.2 |
| Value of household consumption expenditure | 5.3 | -1.0 | 3.5 | 4.3 |
| VAT base | 5.7 | -6.5 | 3.3 | 4.1 |
| Fuel consumption | -4.4 | -2.6 | -1.0 | -1.0 |
| Diesel consumption | 1.1 | -3.3 | 0.0 | 1.1 |
| Electricity consumption | -2.4 | -7.5 | -0.2 | 0.5 |
| Duty-paid alcohol consumption | -2.1 | -2.5 | -2.0 | 1.1 |
| New car registrations | 11.2 | -35.2 | 11.1 | 6.0 |
| Consumer price index | 4.1 | 0.0 | 1.5 | 2.1 |

The risks to the tax revenue estimates for earnings and capital income come primarily from the forecast for capital income. Capital income is subject to much greater cyclical fluctuation than earnings income. Only limited data are available during the course of the tax year on trends for capital income, and the final figure is only available once the tax assessment is completed in October of the year following the tax year. The cyclically most sensitive component of capital income is capital gains from securities. Lower securities values translate into lower capital gains and greater capital losses. Capital losses incurred for the tax year are deductible from capital gains over three consecutive years following the tax year in which the losses originate. This may reduce the amount of taxable capital gains over the next few years. On the other hand it is possible that capital gains may increase much more sharply than anticipated. In 2003–2007, during the upswing that preceded the current economic crisis, capital gains increased on average by 26% per annum.

In 2008 the amount of capital gains fell by one-third. Capital gains from securities plummeted by almost 60%, while other capital gains (e.g. from houses and flats) were up by 30%. In 2009 it is thought that capital gains from securities continued to fall by one-third in line with the general stock index. Other capital gains are expected to have fallen by one-quarter. The final amount of capital gains for the tax year 2009 will only be known once the tax assessment is completed at the end of October 2010. At this stage all taxes paid to the tax authorities for the year in question are adjusted based on the completed tax assessment. In earlier years the biggest adjustments have been made for substantial deviations from forecasts for the amount of capital income.

Share prices¹ and proceeds on shares



Source: OMX.

¹ Value for 2010 based on situation in March.

Improved business outlook is reflected in corporate tax revenue with delay

The steep downturn in the output of the economy has particularly impacted the level of corporate tax revenue. As a result of the economic crisis the final figure for corporate tax revenue fell by 24% in 2008, and the projection for 2009 sees a further drop of around 30%. The final sum for 2009 will only be available on completion of the tax assessment in autumn 2010. The final amount of tax payable by businesses is determined on the basis of their performance during each fiscal year, and they ordinarily pay around 78–90% of that final sum in the same year.

For reasons that have to do with the timing of tax collection, central government corporate tax revenue fell by just 7% in 2008, but in 2009 plummeted to around half of the previous year's level. The unfolding of the economic crisis in autumn 2008 was not reflected in full measure in tax receipts until 2009. Furthermore, central government corporate tax accrual was affected by the temporary increase in the share of the tax revenue going to local governments and parishes. In 2009–2011 the share of central government was reduced by 10.8 percentage points.

In 2010, with the improving cyclical outlook, business performance is expected to show significant improvement. Actions taken by businesses to trim expenses will further boost their profitability. The forecast for corporate tax revenue is based on the assumption that business performance will develop in line with the growth of National Accounts operating surplus. However the effects of recovery will not show up in tax revenue until later, towards the end of this year and in 2011. It is estimated that central government tax revenue will increase by more than one-fifth this year. During the budgetary planning period, corporate tax revenue is forecast to increase in tandem with the operating surplus, i.e. by an average of 7% a year.

However it is possible that corporate tax revenue will fall short of expectations. The accrual of tax revenue in Finland cannot be directly inferred from the global performance of listed companies. The way that tax revenue is shared between different governments depends among other things on the values used in group transfer pricing, or on outgoing tax credits. Secondly, businesses have generated deductible losses in the 2008 tax year and will do so in 2009, and they can carry forward those losses for 10 years, which may then be reflected in the amount of taxable income. Therefore the improvement in business performance will not necessarily be reflected in the 2010 accrual of tax revenue. Changes in tax revenue always show up with some delay, in both economic downturns and upturns.

Increased indirect taxation to strengthen central government's financial position

The most significant sources of indirect tax revenue are value added tax, the motor car tax and energy taxes.

In 2010 VAT revenue is forecast to increase by half a per cent and in 2011, once the various tax increases take full effect through the year, by 6½%. Over the budget planning period the projected average increase is 4½% per annum. Private household consumption accounts for around 60% of the VAT tax base, the rest is made up of intermediate consumption and investment by public, tax-exempt and private non-profit entities. Household consumption expenditure is expected to increase on average by 3.5% in 2010 and by 4½% over the budget planning period. Private consumption will increase somewhat more rapidly than household disposable income. The household savings rate has climbed above ordinary levels in the wake of the economic crisis, but it is expected to fall back closer to the long-term average with the improving cyclical outlook and employment prospects.

The VAT rate on food was cut by 5 percentage points as of 1 October 2009, which will reduce the amount of tax revenue in 2010 by some EUR 480 million and annually by some EUR 520 million. All VAT rates are going up on 1 July 2010, and at the same time the VAT rate on restaurant meals will be lowered to the same level as the rate for food, i.e. 13%. The increase in tax rates scheduled for 2011 will increase tax receipts by EUR 470 million, with the annual effect coming to around EUR 690 million. The decrease in the VAT rate on restaurant food will reduce tax receipts by EUR 170 million in 2011 and by EUR 260 million annually. VAT revenue in 2010 will also be affected by the introduction of a tax account system, which is estimated to reduce central government tax revenue by EUR 380 million.

Excise duty receipts are expected to increase on average by 5% a year over the planning period. Growth will be strongest in 2011, when energy taxes will be raised. These increases will offset the abolition of national pension contributions, and they will apply to all energy products except transport fuels. This will boost central government tax revenue by a net of EUR 750 million a year. Over the budget planning period it is projected that revenue from energy taxes will rise by an average of 7%. Transport fuels account for three-quarters of total energy tax receipts. It is forecast that the consumption of petrol will decrease at an annual average of 1% over the planning period, but at the same time diesel fuel consumption is expected to grow by 1% a year. Transport performance levels are expected to rise, but the increase in tax revenue will be dampened by improving fuel efficiency with the renewal of the vehicle fleet. Taxable electricity consumption is forecast to fall by 2% in 2011, but then to start rising at an average rate of 1% a year.

Revenue from duties on alcoholic beverages is expected to rise by an annual average of half a per cent over the planning period, and revenue from tobacco

tax by 1½%. In 2011–2014 it is estimated that taxable cigarette consumption will decrease by an annual average of ½%. The tobacco tax was raised at the start of the year, bringing in an estimated EUR 22 million in additional tax revenue.

The excise duty on soft drinks will be increased from the beginning of 2011, and a new excise duty will be introduced on sweets. Together, these changes are expected to increase tax receipts by around EUR 100 million a year.

Revenue from the car tax in 2009 was EUR 687 million, lower than the year before. Demand for new cars dropped from almost 140,000 in 2008 to around 90,000 in 2009. At the same time the demand for other vehicles fell sharply. In 2010 the demand for new cars is expected to stand at 100,000. During the budget planning period it is projected that the demand for new cars and revenue from the motor car tax will increase more rapidly than other private consumption at an average of 6% per annum.

The lottery tax will be raised to 10% from the beginning of 2011, which will increase tax revenue by more than EUR 10 million.

Other on-budget revenue

Miscellaneous on-budget revenue is forecast to total EUR 4.7 billion in 2010, rising further to EUR 4.8 billion in 2014. Miscellaneous revenue includes transfers from the State Pension Fund and the National Housing Fund, revenue from the EU, and income entered as revenue from the Finnish Slot Machine Association (RAY) and Veikkaus.

In 2010 interest earned and profit entered as income are expected to total EUR 1.3 billion, rising further to EUR 1.8 billion by 2014. Dividend income in 2011–2014 is expected to come in at around EUR 770 million a year, and annual revenue from sales of government-owned shares is projected at the usual EUR 400 million a year.

Central government on-budget revenue: estimates for 2010-2014, EUR billion

| | 2009 provisional final accounts | 2010 forecast 11 March 2010 | 2011 | 2012 | 2013 | 2014 | 2014/2010 annual change, % |
|---|---------------------------------------|-----------------------------------|-------------|-------------|-------------|-------------|----------------------------------|
| | | | | | | | |
| Total tax revenue estimates | 31.5 | 32.0 | 35.1 | 37.2 | 38.8 | 40.4 | 6.0 |
| - income and wealth taxes | 10.3 | 10.5 | 11.4 | 12.8 | 13.6 | 14.3 | 7.9 |
| - taxes based on turnover | 14.0 | 14.1 | 15.1 | 15.7 | 16.3 | 17.0 | 4.7 |
| - other taxes | 7.2 | 7.4 | 8.6 | 8.8 | 8.9 | 9.1 | 5.4 |
| Miscellaneous revenue | 4.6 | 4.7 | 4.6 | 4.7 | 4.8 | 4.8 | 0.7 |
| Interest income and profit entered as income | 1.2 | 1.3 | 1.6 | 1.7 | 1.7 | 1.8 | 8.5 |
| Total revenue estimates | 37.5 | 38.3 | 41.5 | 43.8 | 45.5 | 47.1 | 5.3 |

2.2.3 On-budget accounts and national accounts

For national accounting purposes, central government is defined as comprising all on-budget entities plus off-budget funds with the exception of the State Pension Fund and universities, which since the beginning of 2010 are no longer included in the state budget. Following a revision to the National Accounts in early 2010, the State Pension Fund is now classified under employment pension institutions. This technical change will adversely impact the National Accounts financial balance of central government because the State Pension Fund is solidly in surplus. It will bring National Accounts net lending closer to on-budget balance because the combined surplus of the central government's ten other off-budget funds in 2009 was around EUR 240 million, and this year it is expected that these funds will show a deficit of the same size. During the budget planning period it is expected that off-budget finances will gradually move closer towards balance.

Other differences between central government budgeting and national accounting rules derive from the system of net budgeting, the time of recording revenue and expenditure, the use of deferrable appropriations and the treatment of financial investments. The net budgeting principle lowers the level of budget revenue and expenditure, but it has no impact on overall balance. The annualized effect of net budgeting is just over EUR 1.5 billion.

In the national accounting system, economic flows are recorded on an accrual basis. In budget accounting, too, revenue and expenditure are primarily reported on an accrual basis. The only exceptions are taxes and tax-like revenue and property income, which are recognized on a cash basis, as well as state subsidies and statutory aid, which are entered according to the date of decision.

One significant difference comes from the use of deferrable appropriations. These are two or three-year grants that are entered in the budget for one year only. In the national accounts, deferrable appropriations are recorded on the basis of their use. The net effect of deferrable appropriations may vary widely from one year to the next, but in recent years it has primarily strengthened the National Accounts net lending measure by EUR 200–400 million, with the amount deferred each year continuing to rise.

Various financial investments such as central government loans and capitalizations appear in the Budget as expenditures. In the National Accounts, these items are entered as financial transactions, which do not show up in real net lending by central government but under financial accounts. Financial accounts constitute the other half of the national accounting system, which describes the value of financial assets and liabilities and how they have changed. During the recession central government financial investment has increased as a result of several stimulus measures aimed at securing access to funding. The 2010 Budget includes a provision of EUR 1.5 billion for the refinancing of exports. Research and innovation is supported with an annual lending authority of over EUR 100

million. In addition, central government financial investments include funds for the capitalization of foundation-based universities and a reserve for financing other universities in line with the Government's resolution.

Guarantees issued by central government represent a financial risk that materializes if the Government has to pay off those guarantees. Guarantee authorities have been increased as part of the Government's stimulus measures, and therefore the volume of state guarantees is sharply rising. At year-end 2009 the figure stood at EUR 19.4 billion. New state guarantees issued in 2009 came to EUR 6.7 billion. The risk of guarantees translating into expenditures has increased with the onset of the economic crisis.

On-budget balance and central government net lending¹, EUR billion

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|--|-------------|------------|------------|-------------|--------------|-------------|
| | EUR billion | | | | | |
| On-budget surplus (+)/deficit (-)²⁾ | 1.5 | 2.9 | 0.8 | -9.3 | -12.3 | -8.5 |
| Privatisation proceeds (net proceeds from equity sales) | -1.6 | -0.9 | -0.1 | 0.0 | -0.1 | -0.4 |
| Financial investment, net | 0.3 | 0.3 | 0.5 | 1.1 | 2.0 | 0.4 |
| Revenue surplus in off-budget finances (eg. State Pensions Fund) | -0.1 | 0.1 | -0.1 | 0.1 | -0.3 | -0.1 |
| Cash/accrual basis adjustment | 0.0 | -0.1 | -0.2 | -0.1 | -0.1 | 0.0 |
| Other adjustment items ³⁾ | -0.4 | -0.5 | 0.1 | -0.4 | -0.3 | -0.1 |
| Central government net lending (+)/-borrowing (-) | -0.3 | 1.7 | 1.0 | -8.6 | -11.0 | -8.6 |

¹⁾ In national accounts terms.

²⁾ Incl. government debt servicing.

³⁾ Incl. debt cancellations, profit on reinvested foreign direct investment, super dividends.

2.2.4 Medium-term central government finances

As a result of the economic crisis, the financial position of central government, in national accounting terms, deteriorated by almost EUR 10 billion in 2009. Central government tax revenue fell by 15%, and at the same time escalating unemployment and stimulus measures contributed to drive up expenditure by 6.5%. State debt increased by 18% and by the end of 2009 stood at EUR 64 billion.

In order to reduce its borrowing, the Government will have to take measures both to contain expenditure and increase revenue. Tax hikes have been postponed until after the deepest phase of the crisis so as not to jeopardize economic recovery. The improving cyclical outlook will create better conditions for the consolidation of central government finances through tax increases.

In 2010 the revival of economic growth coupled with tax increases will increase central government tax revenue by around 3%. Most of the tax increases will affect indirect taxes and they will take effect mid-year; therefore their full impact on tax revenue will not be seen until 2011. VAT rates will be raised by one percentage point from the beginning of July. Further tax increases are scheduled for the beginning of next year, including an increase in energy tax that will generate EUR 750 million in tax revenue.

One of the main goals of the Government Programme is to reduce taxes on labour. If no changes were made to tax bases, taxes on earned income would increase as a result of higher earnings levels and tax progression. The medium-term baseline scenario is based on the assumption that taxes on labour shall not be allowed to increase through tax progression. Depending on the development of earnings, the changes in tax bases that would be needed to prevent an increase in the tax rate on earned income would reduce tax revenue in 2010–2014 by just over EUR 300 million per annum. In 2010 a change in income tax bases will also offset the effects of the increase in social security contributions, which will reduce tax revenue by EUR 470 million. In addition, the baseline scenario for tax revenue from earned income will be affected by a tax cut included in the Government Programme, which for cyclical reasons was implemented almost in full in 2009.

Under the conditions of economic crisis, tax revenue has fallen more sharply than the output of the economy. One of the reasons for this is that corporate tax revenue has dropped by half following a major downturn in business performance. However cost-cutting measures taken by companies along with improving export prospects mean that businesses should be in the position to radically improve their performance, which will then filter through to tax revenue with some delay. Indeed because the fall was so sharp, tax revenue as a proportion of GDP will rise steeply in the medium-term baseline scenario, even though a return to pre-crisis levels is a long way off.

It is forecast that the Government's National Accounts expenditure will increase rapidly at over 6% during 2008–2010, and that this growth will then begin to slow. One-quarter of central government expenditure is made up of consumption expenditure, which is expected to continue to increase moderately.

Over 40% of central government expenditure consists of current transfers to other public sub-sectors, which have increased substantially in recent years. In 2009 interest outlays accounted for less than 5% of total expenditure; in 1997 that figure peaked at 16%. Interest expenditure will continue to remain relatively low in 2010 and 2011 because of the low interest rate in the baseline scenario, but they will then begin to edge up. By the end of the spending limits period interest outlays will be more than EUR 1.5 billion higher than this year.

However this scenario for interest expenditure involves some risks and the situation could change very quickly. A fall in sentiment or, in the opposite case, accelerating economic growth and the consequent tightening of mone-

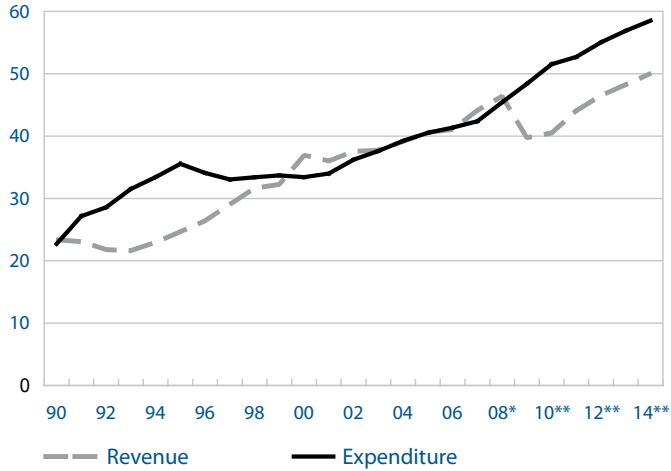
tary policy would probably drive up long-term interest rates with the outflow of assets to other investment markets. One of the risks involved in the current international stimulus policy is that the economic situation in EU countries that have rapidly expanding debt may filter through to affect the costs of borrowing in Finland, too.

The costs of Government borrowing are affected not only by the general interest rate, but also by the risk premium demanded by investors, which reflects prevailing market perceptions of the sustainability of the state's budgetary position and associated risks. For the time being the Finnish Government has had no difficulty accessing credit. Indeed demand for government loans has remained high even under the financial crisis. The relative price paid by the Finnish Government (the spread vis-à-vis the German yield) has increased, but less so than in other euro countries. However this is not a permanent condition. Assessments of the ability of the state to manage the economic situation may impact investor confidence, and the Government's credit rating may be lowered in the future unless adequate fiscal policy measures are taken to strengthen central government finances.

Central government debt will increase each year throughout the budget planning period, most sharply in 2010 by EUR 12 billion. Beyond 2010, the baseline scenario projects that the annual amount of new government debt will come to around EUR 8 billion, and by the end of the planning period the level of outstanding debt will exceed EUR 100 billion.

Central government revenue and expenditure

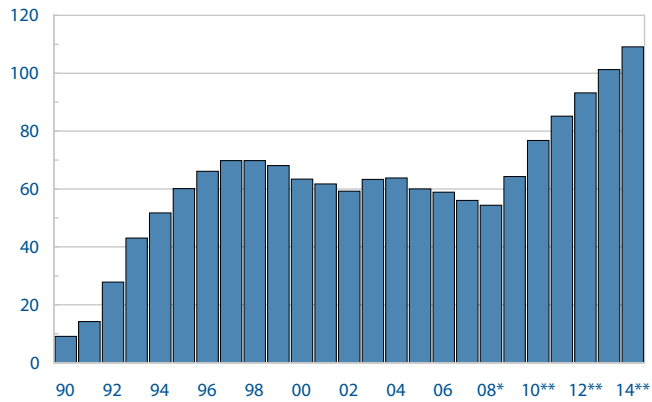
EUR bn



Source: Statistics Finland, Ministry of Finance

Central government debt

EUR bn



Source: Statistic Finland, Ministry of Finance

State Pension Fund transferred under employment pension institutions

Statistics Finland has undertaken a major revision of general government sector accounts by reassigning the State Pension Fund under employment pension institutions. This will worsen the budgetary position of central government and have a positive impact on the balance of employment pension institutions. However it has no impact on the aggregate financial position of general government. As a result of this reclassification, central government net lending decreased in the 2000s by over ½ percentage point relative to GDP. The State Pension Fund was established in 1990, and the reclassification has taken effect from that date.

The revision was made to improve the transparency of national accounting and to increase its information value by bringing all employment pensions into the same sector. The Local Government Pensions Institution already comes under this sector. According to the revised classification central government and central government employees pay their pension contributions to the employment pension sector, which will earn income by investing these funds and make payment to central government through current transfers.

The State Pension Fund does not pay out pensions, but all pensions under the central government pension scheme are paid out of the budget. This being the case, the Fund can make annual transfers to the State reserves to cover pension expenditures. The statutory amount transferred from the Fund to the state budget each year is 40% of the annual expenditure arising from pensions based on years of service covered by the state pension scheme. Investment into the State Pension Fund will continue for another ten years or so, by which time it should cover 25% of total pension liabilities under the state pension scheme. No decision has as yet been made on the timetable for the use of these funds.

Up until the year 2000, State Pension Fund assets were invested exclusively in Government debt, since then they have been invested in other sectors as well. In 2006 the Ministry of Finance issued new guidelines for pension fund investment. According to these guidelines the State Pension Fund must invest at least 45% of its assets in interest-bearing papers. The Fund may invest no more than 45% of its assets in stocks and no more than 12% in other than interest-bearing papers and stocks.

Central government¹⁾

| | 2006 | 2007 | 2008* | 2009* | 2010** | 2011** |
|--|-------------|-------------|-------------|-------------|--------------|-------------|
| | EUR billion | | | | | |
| Current taxes | 13.5 | 15.1 | 14.8 | 10.2 | 10.4 | 11.5 |
| Taxes on production and imports | 22.7 | 23.4 | 23.9 | 22.9 | 23.5 | 25.8 |
| Taxes and contributions, total ²⁾ | 36.6 | 39.0 | 39.4 | 33.6 | 34.4 | 37.7 |
| Other revenue ³⁾ | 4.3 | 5.0 | 6.8 | 6.0 | 5.9 | 6.1 |
| of which interest receipts | 0.7 | 0.9 | 1.0 | 0.7 | 0.6 | 0.7 |
| Total revenue | 40.9 | 43.9 | 46.2 | 39.6 | 40.3 | 43.8 |
| Consumption expenditure | 10.7 | 11.0 | 11.9 | 12.4 | 12.8 | 12.9 |
| Subsidies and current transfers, total | 25.5 | 26.1 | 28.1 | 31.1 | 33.4 | 34.3 |
| to general government | 16.2 | 16.6 | 18.0 | 20.3 | 22.2 | 22.6 |
| Interest expenses | 2.5 | 2.4 | 2.4 | 2.3 | 2.2 | 2.4 |
| Capital expenditure ⁴⁾ | 2.6 | 2.6 | 2.8 | 2.4 | 3.0 | 2.8 |
| Total expenditure | 41.2 | 42.2 | 45.3 | 48.2 | 51.3 | 52.4 |
| Net lending (+) / net net borrowing (-) | -0.3 | 1.7 | 1.0 | -8.6 | -11.0 | -8.6 |
| Primary balance ⁵⁾ | 1.5 | 3.3 | 2.4 | -7.0 | -9.4 | -6.9 |

¹⁾ As calculated in the national accounts.

²⁾ Incl. capital taxes.

³⁾ Incl. capital transfers (excl. capital taxes) and consumption of fixed capital.

⁴⁾ Gross fixed capital formation and capital transfers.

⁵⁾ Net lending before net interest expenses.

2.3 Local government

Local government finances to remain in deficit this year and next

As in the previous year, local government finances showed a deficit of 0.4% of GDP in 2009. However the deficit did not grow as much as had been feared because in connection within its spending limits decision in March 2009, the Government announced a range of substantial measures to support local government finances. The most significant of these measures was the temporary 10 percentage point increase in the apportionment of corporate tax revenue to municipalities. In addition, upper and lower real estate tax rates were raised from the beginning of 2010 and the employer's national pension contribution was phased out from 1 April 2009.

Local government revenue growth slowed to less than 2% from around 7½% in 2008. This was primarily due to tax revenue growth grinding to a halt. Corporate tax revenue fell by one-fifth, despite the increased apportionment to local government. In contrast to pessimistic projections, revenue from municipal taxes was up by 2% because of better than expected employment trends and timing factors

related to tax accounting. As revenue growth began to falter, local government expenditure growth slowed to around 2%. The growth of consumption expenditure slowed from around 8% in 2008 to less than 3% in 2009, but investment remained at roughly the same level as in 2008 at around EUR 3.1 billion.

In 2010, weakening employment prospects and the consequent erosion of the municipal tax base mean that the crisis will spread to the whole local government sector. Almost 200 municipalities put up their tax rates for 2010, and the mean municipal tax rate increased by 0.4 percentage points. Exceptionally sharp increases were also made to real estate taxes. The combined effect of these tax hikes comes to over EUR 500 million. Furthermore, it is projected that corporate tax revenue will rise by some EUR 200 million. Nevertheless local government tax revenue will not increase, but in fact decrease by 2½% because of the employment situation and income tax cuts. Central government transfers to local government will increase by around 6% in 2010 among other things to offset the effects of tax cuts. It is expected that local government tax revenue will pick up in 2011 as receipts from both municipal taxes and corporate income tax begin to recover.

In the tightening financial climate it is necessary for local governments to curb the growth of their expenditure. It is projected that local government staff numbers will decrease somewhat both this year and next. Earnings in the municipal sector will rise by over 3% this year. Decisions on pay rises for 2011 will not be made until next year, and therefore it is expected that earnings in 2011 will rise in line with general earnings by around 2½%. Local government expenditure pressures will be significantly eased by the discontinuation of the municipal employer's national pension insurance contribution. Over the next few years it is expected that the single biggest employer contribution, i.e. the municipal pension insurance contribution, will remain at the same level as in 2009 at 23.6%. The unemployment insurance contribution is set to rise slightly in 2010, and there will remain upward pressure on the contribution rate even later. It is projected that with the growth of unemployment, local government expenditure on living allowances will increase this year and remain high into 2011.

Local government real consumption is expected to decrease somewhat in 2010, and nominal consumption expenditure growth will slow to around 2½%. In 2011, nominal consumption expenditure will rise by around 3%. It is projected that the volume of consumption will rise marginally primarily as a result of an increase in contracted services. Investment in both 2010 and 2011 is expected to remain at last year's level at just over EUR 3 billion.

Local government net lending will remain at around -0.5% of total output in 2010. The achievement of financial balance in 2011 will largely depend on the recovery of economic activity and on decisions taken by local governments on municipal tax rates and measures to curb expenditure growth. On the assumptions applied, it is projected that local government net lending will edge up to -0.3% relative to GDP.

Local government¹⁾

| | 2006 | 2007 | 2008* | 2009* | 2010** | 2011** |
|--|-------------|-------------|-------------|-------------|-------------|-------------|
| | EUR billion | | | | | |
| Taxes and social security contributions | 15.3 | 16.5 | 17.5 | 17.6 | 17.6 | 18.4 |
| of which municipal tax | 13.2 | 14.1 | 15.1 | 15.4 | 15.0 | 15.6 |
| corporate tax | 1.2 | 1.5 | 1.4 | 1.2 | 1.4 | 1.6 |
| real estate tax | 0.8 | 0.9 | 0.9 | 1.0 | 1.2 | 1.2 |
| Other revenue | 12.3 | 13.2 | 14.3 | 14.8 | 15.6 | 16.0 |
| of which interest receipts | 0.3 | 0.4 | 0.4 | 0.3 | 0.4 | 0.4 |
| of which transfers from central government | 9.0 | 9.5 | 10.5 | 11.1 | 11.7 | 12.0 |
| Total revenue | 27.6 | 29.6 | 31.8 | 32.4 | 33.2 | 34.3 |
| Consumption expenditure | 23.4 | 24.8 | 26.7 | 27.3 | 28.0 | 28.8 |
| of which compensation of employees | 16.4 | 17.1 | 18.2 | 18.6 | 18.9 | 19.3 |
| Income transfers | 2.4 | 2.5 | 2.8 | 2.7 | 2.8 | 2.9 |
| of which social security benefits and allowances | 0.9 | 0.9 | 1.1 | 1.1 | 1.1 | 1.1 |
| subsidies and other transfers | 1.2 | 1.2 | 1.3 | 1.4 | 1.4 | 1.4 |
| interest expenses | 0.3 | 0.4 | 0.4 | 0.3 | 0.4 | 0.4 |
| Capital expenditure | 2.5 | 2.7 | 3.1 | 3.2 | 3.1 | 3.1 |
| Total expenditure | 28.3 | 30.0 | 32.5 | 33.2 | 34.0 | 34.8 |
| Net lending (+) / net borrowing (-) | -0.6 | -0.3 | -0.7 | -0.7 | -0.8 | -0.5 |
| Primary balance | -0.7 | -0.4 | -0.7 | -0.8 | -0.8 | -0.5 |

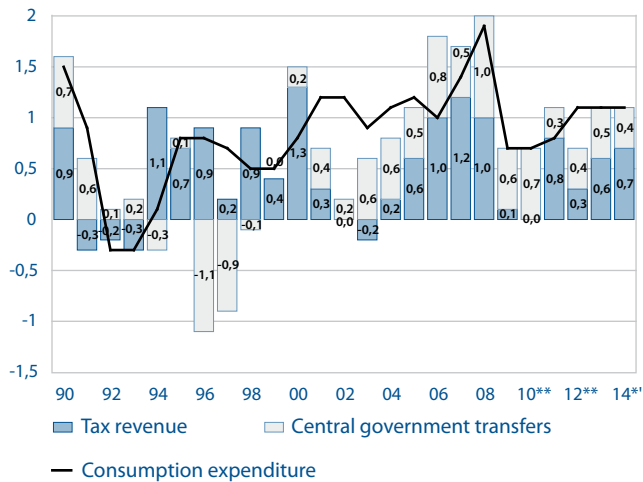
¹⁾ As calculated in the national accounts.

Without measures to curb expenditure growth, local government finances will be caught in a cycle of indebtedness and taxes will have to go up

As well as having to get through the current acute crisis, the local government sector faces a number of difficult years ahead. Local government revenue will certainly not recover to the levels recorded in 2006–2008, as demographic factors begin to limit the growth potential for tax revenue over the next few years. Furthermore, the increased apportionment of corporate tax revenue going to local government will be discontinued after 2011. Because of the large deficits in central government finances, it is also unlikely that the Government can repeat the kind of massive intervention that was seen in 2009. Given the weaker baseline situation, questions about securing the long-term sustainability of local government finances will also gain increasing prominence as not only uncertainties surround revenue levels but also the growing demand for basic services will continue to escalate in the future.

Local government taxes, central government transfers and consumption expenditure

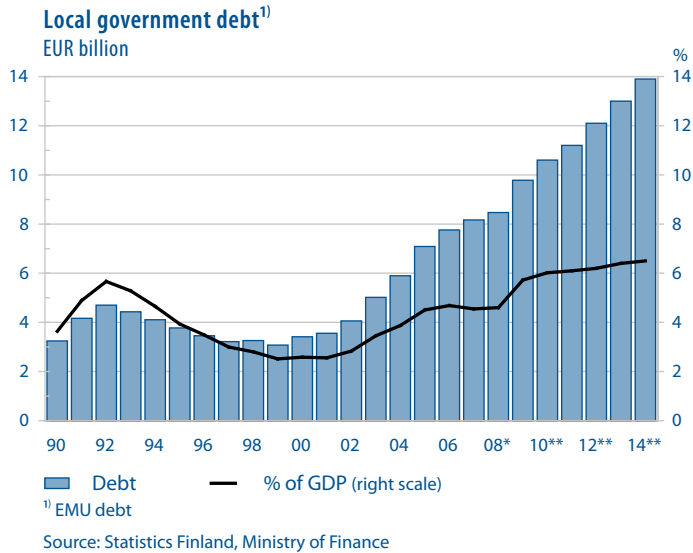
change on the previous year, EUR billion (at current prices)



Source: Statistics Finland, Ministry of Finance

Both local government operating expenditure and investment have increased markedly in recent years. These increases go a long way towards explaining the sharp rise in local government debt. Investment has continued to remain at high levels even during the recession, when interest rates have been exceptionally low and cost pressures on building construction have eased. The current situation is very different from the 1990s recession, when local government investment almost halved within two years. What is more, Local governments are under considerable pressure to invest over the next few years, among other reasons because of structural reforms, necessary building renovations and major infrastructure projects in population growth centres.

Increasing expenditure pressures and dwindling prospects for tax revenue growth mean that local governments are faced with pressing needs for change. Repayments of loans taken out in the early 2000s are also curtailing local governments' budgetary room for manoeuvre, and the anticipated medium-term rise in interest rates will push local government finances into even deeper trouble. Unless local government expenditure growth is reduced significantly and permanently, local government taxes and debts will inevitably continue to increase over the next few years. This underscores the need for reforms to increase productivity in the provision of basic services and particularly the importance of maintaining a sustainable level of staff numbers.



2.4 Social security funds

The balance of employment pension funds will deteriorate in 2010, but then improve as the economy rebounds

Retirement among baby boomers accelerated in 2009. Large numbers will be retiring on old-age pension in 2010 and 2011, but the rate of retirement is then expected to slow somewhat.

Pension funds recovered from the global economic crisis in 2009. During 2009 the market value of pension assets increased by around EUR 20 billion or 19%. This increase was primarily due to the strong stock market. At the end of 2009 employment pension funds stood at 73% of GDP.

A statistical revision effected in early 2010 saw the State Pension Fund reclassified in the National Accounts system under the earnings-related pension sector as from 1990 when the Fund was established. Under the new rules central government and central government employees pay their pension contributions to the earnings-related pension sector, which will earn income by investing these funds and make payment to central government through current transfers. The state will continue to pay out the pensions. The change will improve pension institutions' net lending by 0.3% of GDP, but at the same time adversely impact central government net lending. Therefore it will have no effect on the overall budgetary position of general government.

The shrinking of the contribution base caused by the economic downturn coupled with the growth of pension expenditure has rapidly reduced the surplus in pension funds in 2009 and 2010. This year it is expected that the wage

bill will increase to some extent, which will slowly push up pension contribution accruals. Following the sharp rise in 2009, it is expected that pension expenditure will rise more slowly, primarily because of a lower index-linked increase. The Pension institutions' dividend income will likely decrease from last year. It is projected that the surplus-to-GDP ratio in pension funds will contract from 3.0% last year to 2.7% this year.

In 2011 both the employers' and employees' pension contribution rates are projected to rise somewhat. At the same time, it is expected that the wage bill will increase as the economy continues to recover. As a result, the accrual of pension contributions will accelerate more rapidly than the year before. Pension expenditure will also increase more rapidly than during the current year, mainly because of a higher index-linked rise. It is projected that in 2011, the surplus-to-GDP ratio in pension funds will increase marginally to 2.8%.

In March 2009 the Government and the social partners reached agreement on the target of raising the average retirement-age expectancy in the population aged 25 or over by at least three years by 2025. Discussions on how this target could be met were conducted in two tripartite working groups until the end of

Finances of social security funds¹⁾

| | 2006* | 2007* | 2008* | 2009** | 2010** | 2011** |
|--|-------------|-------------|-------------|-------------|-------------|-------------|
| | EUR billion | | | | | |
| Investment income | 3.6 | 4.1 | 4.8 | 3.6 | 3.8 | 4.3 |
| Social security contributions | 20.5 | 21.6 | 22.5 | 22.2 | 22.7 | 24.0 |
| of which contributions paid by employers | 14.9 | 15.7 | 16.7 | 16.2 | 16.0 | 16.7 |
| contributions paid by insured | 5.6 | 5.9 | 5.8 | 6.0 | 6.7 | 7.3 |
| Transfer from general government | 8.2 | 8.0 | 8.5 | 10.4 | 11.7 | 11.8 |
| Other revenue | 0.8 | 0.8 | 0.7 | 0.2 | 0.2 | 0.2 |
| Revenue | 33.1 | 34.5 | 36.5 | 36.4 | 38.4 | 40.3 |
| Consumption expenditure | 2.7 | 2.8 | 3.0 | 3.1 | 3.2 | 3.2 |
| Social security benefits and allowances | 22.2 | 22.7 | 23.7 | 25.5 | 27.9 | 29.0 |
| Other outlays | 0.8 | 1.1 | 2.4 | 2.6 | 2.7 | 2.8 |
| Expenditure | 25.7 | 26.5 | 29.1 | 31.1 | 33.8 | 35.1 |
| Net lending (+) / net borrowing (-) | 7.4 | 7.9 | 7.4 | 5.3 | 4.6 | 5.3 |
| Employment pension schemes | 7.1 | 7.4 | 7.3 | 5.1 | 4.8 | 5.2 |
| Other social security funds | 0.3 | 0.5 | 0.1 | 0.1 | -0.3 | -0.1 |
| Primary balance ²⁾ | 5,0 | 5,3 | 4,2 | 2,6 | 1,8 | 2,0 |

¹⁾ As calculated in the National Accounts.

²⁾ Net lending before net interest expenses.

January 2010. Their outcomes were assessed by both the OECD and domestic research institutes. The discussions will be continued on a tripartite basis. It is crucial that effective decisions are reached in this process because lengthening working careers is one of the most important ways of strengthening the sustainability of public finances.

Other social security funds reflect changes in the employment situation

Other social security funds, i.e. the Social Insurance Institution (SII) and unemployment insurance funds, are responsible for the provision of basic social security and earnings-related unemployment security. In 2010 it is projected that the 0.1% surplus ratio recorded by these funds in 2009 will turn into a 0.2% deficit. This is mainly due to the Unemployment Insurance Fund moving into deficit. As the economy continues to recover and the contribution base to strengthen, other social security funds are expected to be in balance in 2011.

Employers' national pension insurance contribution was lowered by 0.8 percentage points from April 2009, and discontinued altogether from the beginning of 2010. As a consequence SII revenue fell by around EUR 400 million last year and by around EUR 1 billion in 2010. However this decision has no effect on SII finances since the losses of revenue will be fully compensated by central government. It is projected that both employers' and employees' unemployment insurance contributions will increase by 0.2 percentage points in 2011. This is partly due to the decisions taken under the Social Agreement, which will increase the level of unemployment benefits.

Expenditure on national pensions is expected to decrease somewhat in 2010, only to start rising again in 2011, mainly because of an indexation and the introduction of the guarantee pension scheme. The purpose of this scheme is to secure a reasonable level for the lowest pensions. The number of guarantee pension recipients is estimated at 123,000. Earnings-related unemployment expenditure will show strong growth in 2010, but this trend will slow in with the improving employment situation. Labour market support and basic unemployment allowances will increase less rapidly since long-term unemployment will increase more slowly than cyclical unemployment during the period under study. It is projected that sickness insurance expenditure will continue to rise quite sharply both this year and next. The Government-appointed SATA Committee on social security reform issued its final memorandum in December 2009. The Committee's proposals concern such matters as the improvement of basic protection and earnings-related security and the promotion of employment. Taken together, the proposals form a package that is intended to increase incentives for labour participation, reduce poverty and guarantee an adequate level of basic security in all life situations. According to the Committee the social protection proposals can only be implemented in so far as they do not threaten the sustainability of public finances.

Social security contributions rates and pension indices

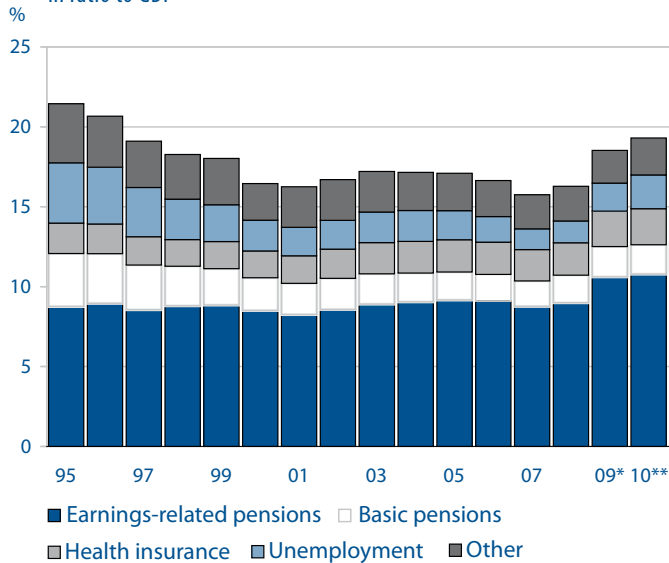
| | 2007 | 2008 | 2009 | 2010** | 2011** |
|---|-------|------|-------|--------|--------|
| Social insurance contributions ¹⁾ | | | | | |
| Employers | | | | | |
| National pension insurance | 1.66 | 1.52 | 0.89 | 0.00 | 0.00 |
| Sickness insurance | 2.05 | 1.97 | 2 | 2.23 | 2.19 |
| Unemployment insurance | 2.29 | 2.06 | 1.92 | 2.12 | 2.32 |
| Employment pension insurance | 16.7 | 16.8 | 16.8 | 16.90 | 17.00 |
| Local government pension insurance | 23.93 | 23.8 | 23.60 | 23.60 | 23.60 |
| Employees | | | | | |
| sickness insurance | 2.03 | 1.91 | 1.98 | 2.40 | 2.36 |
| unemployment insurance | 0.58 | 0.34 | 0.2 | 0.40 | 0.60 |
| employment pension insurance | 4.5 | 4.3 | 4.5 | 4.7 | 5.0 |
| Pensioners | | | | | |
| sickness insurance | 1.45 | 1.41 | 1.45 | 1.64 | 1.64 |
| Pension indices | | | | | |
| Employment pension index (over 65) | 2127 | 2178 | 2286 | 2292 | 2335 |
| National pension index | 1401 | 1436 | 1502 | 1502 | 1511 |

The figures are weighted averages.

¹⁾ Annual averages. The contributions of employers and the unemployment and employment pension contributions of beneficiaries as percentages of wages and salaries. Beneficiaries' health insurance contributions as percentages of taxable income subject.

²⁾ As of 2006, the wage earners' sickness insurance contribution is comprised of the contribution for medical care (% of taxable income) and of the contribution for earned income insurance (% of income subject to tax). Pensioners are subject to the contribution for medical care insurance only.

Benefits and allowances paid social security funds in ratio to GDP



Sources: Statistics Finland, Ministry of Finance

Social benefits and allowances and refunds of medical expenses were at their lowest in 2007 at 15.7% of GDP. Since then these expenditures have started rising again. In 2010 and 2011 the increase will come largely from the rapid growth of earnings-related pension expenditure.

2.5 Long-term sustainability of public finances

The long-term outlook for Finnish public finances is overshadowed by the rising costs associated with population ageing and by the consequent erosion of the revenue base. Population ageing is already reflected in current economic trends, with the working-age population starting to shrink in 2010 and with pension expenditure starting to rise in the wake of the retirement of the baby boom generation.

Over the next two decades the Finnish population will be ageing faster than anywhere else in Europe. The country's old-age dependency ratio, i.e. the population aged 65 or over as a proportion of the working-age population, will also rise faster in Finland than elsewhere through to the 2030s. According to the latest population projection from Statistics Finland (2009), the number of people aged 65 or over will increase by almost 615,000 by 2030. At the same time the population of working age (15–64) will decline by almost 170,000.

Age-related expenditure associated with population ageing will increase dramatically over the next few decades. The rise in pension expenditure will be fastest during the decade that has just started, and the sharpest rise in the costs of long-term care will come in the 2020s as the baby boom generation reaches old age. According to the latest national figures, age-related expenditure will increase by around 5½% of GDP by 2030. A large part of this increase is attributable to the growth of pension expenditure, but rising costs of long-term care are also a significant factor.

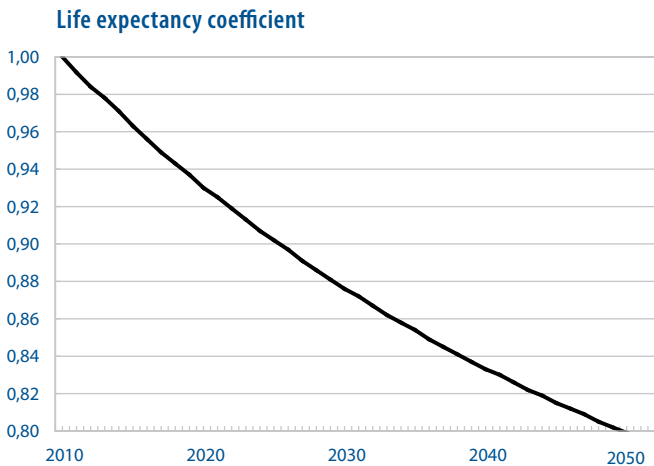
Various steps have been taken to prepare for the expenditure pressures exerted by population ageing on the country's public finances. These include the build-up of substantial pension funds to meet future pension liabilities, measures to improve the sustainability of the pension system, and steps to enhance the efficiency of public service provision through the central government productivity programme and the reform to restructure municipalities and services.

Finland is better prepared to meet the challenges of population ageing than many other countries, but even so our public finances are not fully sustainable. The long-term sustainability of public finances is here assessed against the demographic and age-related developments described above as well as a certain set of economic assumptions. According to the latest estimate the sustainability gap in public finances is around 5½% of GDP. This means that the balance of public finances should be improved by this amount by cutting expenditure, by increasing revenue, or by means of longer-term structural reforms so as to ensure that debt levels do not rise exponentially. The assessment of the sustain-

nability gap is rather sensitive to assumptions about the baseline state of public finances. The state of public finances has deteriorated sharply in the wake of the financial and economic crisis, and at the same time the estimate of the sustainability gap has increased. A more stable indicator than the sustainability gap is the surplus level that ensures sustainability, which is assessed on the basis of the increase in age-related expenditure at around 4% of GDP. A public finances surplus of this magnitude would ensure the long-term sustainability of public finances, and public indebtedness would remain at a manageable level.

One structural measure to improve the sustainability of public finances would be to extend working careers, for that would strengthen the financial base of general government. According to a recent estimate, a one year increase in the average working career would reduce the sustainability gap accordingly by around one percentage point. Based on the outcomes of two tripartite working groups there has been considerable public debate recently about how to encourage people to stay on longer in the labour market. The key is to reach agreement on reforms that would provide clear incentives for people to postpone their decision to retire.

To strengthen the sustainability of the pension system, a new life expectancy coefficient (see diagram below) adopted in connection with the 2005 pension reform will be applied to people retiring on old-age pension from the beginning of the current year. The life expectancy coefficient is used to adjust new pensions to the general rise in life expectancy. The impact of the coefficient on pension accrual can be compensated by staying on in employment. If the life expectancy continues to increase in line with Statistics Finland's 2009 population projection, then the life expectancy coefficient will reduce the pensions of people retiring in 2011 by 1.6%, which can be offset by staying on for two more months. According to the same projection the life expectancy coefficient will reduce the pensions of people born in 1958 and retiring in 2020 by 7½%, which can be offset by working close to one year longer.



Source: Finnish Centre for Pensions, according to the Statistics Finland 2009 population forecast

Recent policy measures September 2009 – February 2010

11 September 2009

The President of the Republic submitted to Parliament the second supplementary budget proposal for 2009. The net reduction in revenue estimates is EUR 3,232 million and the net reduction in appropriations EUR 990 million. The second supplementary budget proposal thus shows an overall deficit of EUR 2.2 billion. Proposed central government net borrowing for 2009 is EUR 10.3 billion.

15 September 2009

The President of the Republic submitted to Parliament the Government's proposal for the 2010 budget. Excluding net borrowing, actual revenue is estimated at EUR 37.2 billion and appropriations at EUR 50.2 billion. It is proposed that the deficit of EUR 13.0 billion be covered by borrowing. According to the Government's proposal on-budget revenue will decrease by 15% from the 2009 ordinary budget and by 1.6% compared to the figure budgeted for 2009 (including the second supplementary budget proposal). The aim of revisions made to tax rate changes for taxes on earned income is to prevent tax rises as a result of the anticipated increase in earnings levels and wage earner contributions. Taxes on pensions will be eased. In order to reduce the tax burden in the lowest income brackets, the maximum amount of the basic deduction in municipal income taxation will be increased. These changes to tax bases will reduce income tax revenue by EUR 1,060 million, of which the central government's share is EUR 630 million. It is proposed that VAT rates be increased by one percentage point as of 1 July 2010, and at the same time the VAT on restaurant meals is reduced to the same level as VAT for food. This will increase tax revenue in 2010 by a net amount of EUR 130 million. An increase is proposed in tobacco tax, generating EUR 22 million in additional tax revenue.

When rising price levels and structural changes are taken into account, proposed appropriations for different administrative sectors are up 7½% compared to the 2009 ordinary budget. Three-quarters of this increase is due to swelling expenditure outside the spending limits. The proposed sum total of appropriations outside the spending limits is EUR 13.6 billion, increasing by 2.9 billion from the 2009 ordinary budget. The increase in the amount of appropriations earmarked for administrative sectors is in large part attributable to stimulus measures and growth of cyclical expenditure. It is projected that, as a result of the fall in interest rates, interest outlays on central government debt will decrease by 4.5% compared to the 2009 ordinary budget. Spending limits appropriations are proposed at EUR 36.6 billion. The unallocated reserve in the proposal would be EUR 48 billion. The budget proposal includes proposed reallocations of almost EUR 230 million. It is proposed that operating expenses of offices and agencies be reduced by EUR 56 million and development cooperation funds be cut by EUR 60 million. This would bring spending on development cooperation in 2010 to 0.55% of GNI. The budget proposal includes a number of recommendations on bringing forward investments and other employment-generating measures, which would increase expenditure by around EUR 110 million in 2010. It is proposed that an additional EUR 83 million be allocated to employment, training and special measures, with a special focus on young people and recent graduates. It is proposed that the number of vocational training places be increased. An increase of EUR 76 million is proposed to cover the costs of receiving asylum seekers and for compensations payable to municipalities. Unemployment security and training benefits for the unemployed will be reformed. Improvements are proposed to social security and social services for families with children, students, self-employed persons and old people.

8 October 2009

The Government approved “The Lisbon Strategy for Growth and Jobs 2008–2010. Finland National Reform Programme – Implementation Report 2009”. The implementation report is based on the Government Programme, central government spending limits, the Government Strategy Document, the interim review of the Government Programme, other economic policy objectives set by and measures taken by the Government, the March 2009 European Council, and the Commission’s Integrated Guidelines.

9 October 2009

Parliament decided that the second supplementary budget for 2009 will be put into effect as of 15 October 2009.

29 October 2009

The 2010 wage coefficient, within the meaning of section 96 of the Employees' Pensions Act, is 1.231. This means an increase of close to 3.3% compared to 2009. The Decree enters into force on 1 January 2010. The 2010 employment pension index, within the meaning of section 98 of said Act, is 2292. This means an increase of 0.3% compared to 2009. The Decree enters into force on 1 January 2010.

4 November 2009

The Cabinet Finance Committee gave its support to proposed changes to the State Treasury's borrowing and debt servicing authority. The borrowing authority will be increased from EUR 73 billion to EUR 110 billion, and the short-term borrowing authority included in this maximum amount will be increased from EUR 10 billion to EUR 15 billion. These increases will make possible the borrowing that is needed to balance the 2010 budget and to meet the anticipated borrowing needs over the next few years.

6 November 2009

The President of the Republic ratified an Act on the application of the national pension index in 2010. Exceptionally, the national pension index number for 2010 is the same as it was for 2009, i.e. 1502. The Act applies to national pensions and other benefits that are linked to the national pension index or otherwise tied to the amount of national pension. It also applies to the criteria determining benefits linked to the national pension index. The Act enters into force on 1 January 2010.

19 November 2009

The Government issued a Decree on sickness insurance contribution in 2010. Based on calculations by the Social Insurance Institution, the contribution rates are as follows: contribution for medical care coverage 1.47% (+0.19),

contribution on pensions and benefit income 1.64% (+0.19), wage earner's and entrepreneurs' daily allowance contribution 0.93% (+0.23), additional charge levied on entrepreneurs 0.12% (+0.03) and employer's sickness insurance contribution 2.23% (+0.23). The Decree is effective from 1 January to 31 December 2010.

Endorsement of employment pension insurance contribution rates for 2010. As of 1 January 2010 the pension fund supplement factor value that is based on the average solvency of pension institutions is 0.24%, while the current value is 0.00%. The technical rate of interest is 3.50%, while the current rate is 3.00%. The average employment pension contribution rate for 2010 is 22.0% of wages, which is the same as in 2009. This contribution will be temporarily reduced by 0.6 percentage points in order to trim the surplus in unemployment pensions from 2010 onwards. The last unemployment pensions will be paid out in 2012 with the termination of unemployment pension insurance. Half of the reduction will be applied to employees' pension contributions and half to employers' pension contributions, where the contributions are collected as tariffs. Employers whose contributions are partly levied as tariffs will also be eligible for the temporary reduction in the same ratio as their tariffs. Repayment of the unemployment pension surplus will therefore be done in the same way as in the case of the surplus that has accumulated from disability pension contributions. For persons under 53 the employee's pension contribution rate in 2010 is 4.5%, which is 0.2 percentage points higher than in 2009. For employees over 53, the contribution in 2010 is 5.7%, i.e. 0.3 percentage points higher than in 2009. The average contribution rate for employers in 2010 will be 16.9%, 0.1 percentage point higher than in 2009.

20 November 2009

The President of the Republic endorsed amendments to pension acts. The purpose is to raise the level of disability pension for people who are disabled at a young age and to prevent pensions from falling when the disability pension is replaced by an old-age pension. The lower age limit for part-time pension is raised to 60 years and part-time pension recipients will no longer be eligible to receive full pension accrual. The Acts enter into force on 1 January 2010.

The system of state regional administration (state provincial offices, employment and economic development centres, regional environmental centres, environmental permit authorities, road districts and occupational health and safety inspectorate offices) is reorganized under two state regional authorities, viz. Regional State Administrative Agencies (AVI) and Centres for Business and Industry, Transport and the Environment (ELY). Services at the new regio-

nal authorities, six Regional State Administrative Agencies and 15 Centres for Business and Industry, Transport and the Environment, will start at the beginning of 2010. Regional State Administrative Agencies are charged with promoting regional parity through the implementation and supervision of legislation in their respective regions. The mission of Centres for Business and Industry, Transport and the Environment is to foster and promote regional development through the implementation and development of government activities. The Acts enter into force on 1 January 2010.

Employers' national pension insurance contribution will be discontinued from the beginning of 2010. The Social Insurance Institution's share of tax administration operating expenditures will be lowered. Following the discontinuation of the employer's national pension contribution the costs of national pensions and the operating expenditures for benefits paid out of the National Pension Fund will be covered by central government alone. The employer's only social insurance contribution in 2010 is the sickness insurance contribution. The Acts enter into force on 1 January 2010.

25 November 2009

Decree on unemployment insurance contributions for 2010. The unemployment insurance contribution for employers is set at 0.75% of the payroll to a maximum of EUR 1,846,500 and at 2.95% for any amount exceeding that limit. The unemployment insurance contribution for wage earners is confirmed at 0.40% of wages. The employer's average contribution and the wage earner's unemployment insurance contribution are raised by 0.20 percentage points from 2009. The rate for unincorporated state enterprises is 0.75% of the payroll to a maximum of EUR 1,846,500 and 1.90% for any amount exceeding that. The wage-earner contribution for business co-owners, within the meaning of chapter 1, section 6, subsection 2 of the Unemployment Security Act, is set at 0.15% of wages and the employer contribution at 0.75% of wages paid to co-owners. The Decree is effective from 1 January to 31 December 2010.

26 November 2009

Government Decree on state subsidies granted in 2010–2012 for the construction of public utilities in new residential areas, specifically for the construction of roads and parks. The maximum subsidy is 30% of total project costs. Subsidies are available for centres of population growth and the Helsinki area in particular. The Decree enters into force on 1 January 2010.

27 November 2009

The lower and upper limits for tax rates on real estate will be raised. The range of general real estate tax will be increased from 0.50–1.00% to 0.60–1.35% and the tax rate for permanent residential buildings from 0.22–0.50% to 0.32–0.75%. Furthermore the upper limit for tax rates applicable to power plants and final storage facilities for spent nuclear fuel will be raised from 2.50% to 2.85%. The Act enters into force on 1 January 2010 and will be enforced for the first time for the 2010 taxation year.

The President of the Republic ratified an Act that allows for the use of rental housing interest subsidies for purposes of constructing residential housing company flats that tenants have the right to buy. The tenant's right to buy only applies to rental developments financed under the interest subsidy scheme. The right to buy takes effect two years after the rental accommodation has been taken into use. The Act enters into force on 1 December 2009.

3 December 2009

The Government issued a Decree on the assessment criteria for the determination of housing allowance in 2010. It is projected that the number of housing allowance recipients will increase by around 13,600 from 159,600 at the end of 2009 and reach around 173,200 by year-end 2010. The average housing allowance is expected to rise from EUR 250 at the end of 2009 to EUR 260 by the end of 2010. The Decree enters into force on 1 January 2010.

4 December 2009

An extension is approved to the validity of the Act on the allocation of counter-cyclical grants through to the end of 2010. From the beginning of 2010 through to the end of March, grants may be allocated for the same purposes as in 2009. From the beginning of April to the end of the year, grants will be awarded for projects to improve the energy efficiency of residential buildings and for the introduction of renewable energy sources. The Act enters into force on 1 January 2010.

7 December 2009

Parliament decided that the Government may, under conditions it prescribes and without requiring any counter-securities, grant state guarantees as security for bonds issued by Finnish deposit banks or mortgage banks or a Finnish

parent company of such a credit institution for purposes of securing the functioning of financial markets and the supply of financing. The combined nominal value of current guarantees may not exceed EUR 17 billion. This authorisation to award guarantees expires at the end of 2010.

9 December 2009

The Ministry of Finance set the base rate at 1.25% as from 1 January 2010 through to the end of June 2010. Since 1 July 2009, the base rate has been 1.75%.

10 December 2009

Government Decree on assessment criteria for the determination of pensioners' housing allowance in 2010. According to the Act on pensioners' housing allowance the Government will each year set the maximum permissible heating, water and maintenance costs for allowance recipients living in detached houses. In addition, the Government will set the maximum permissible level of housing costs for recipients of pensioners' housing allowance. The housing allowance water norm is increased to reflect rising costs. The increase is EUR 0.64 per person per month. The same water norm will be applied in homes that have no running or hot water. The heating norm and maintenance norm applied for purposes of the housing allowance remain unchanged with the exception of the heating norm for non-central heated homes, which is increased by EUR 0.03–0.04 a month per square metre of living space. The maximum permissible housing costs will also be increased to reflect the 5.0% rise in rents paid by pensioners' housing allowance recipients. The Decree is effective from 1 January to 31 December 2010.

11 December 2009

The validity of the Act limiting the use of the indexation clause is extended by three years to the end of 2012. The Act enters into force on 1 January 2010.

18 December 2009

Parliament took the decision that the budget for 2010 shall be put into effect as of 1 January 2010.

22 December 2009

The President of the Republic ratified an Act that allows the state to make capital investments in fully operational deposit banks of unquestionable solvency by subscribing to a subordinated loan issued by a Finnish deposit bank. The state may subscribe to subordinated loans up to a maximum of four billion euros, or within the limits of the appropriations or authorities given in the state budget. The state may only subscribe to a subordinated loan the amount of which is equivalent to no more than two per cent of the sum total of the loan issuer's consolidated items or items weighted by the risk coefficients set out in the Act on Credit Institutions. The Act specifies the conditions that the subordinated loan must satisfy in order that the state can subscribe to a loan. The Act enters into force on 1 January 2010.

Amendments are made to the Income Tax Act to increase the employment income deduction and basic deduction, to raise the calculation coefficient for the pension income deduction in central government taxation and to lower the percentage that decreases the pension income deduction in local government taxation. Taxpayers are entitled to demand that shared business income and agricultural income from a partnership is taxed in its entirety as earned income. Capital gains from the sale of fixed assets are tax exempt if landed property is sold as a nature reserve to the state or a state enterprise. The tax-exempt sum for employer-subsidized public transport tickets is specified in euro terms and the ceiling for the tax-free benefit is increased. The tax-exempt sum of employer-subsidized loans is tied to commonly used reference interest rates rather than the base rate. Changes are also made to a number of other tax acts that regulate the minimum interest rates used for various taxation purposes. The tax surcharge rate, the late payment interest rate and penalty interest rate are temporarily reduced by one percentage point for 2010. The reference value for unlisted stocks, as determined by the Tax Administration, and the tax value of a share in an agricultural partnership are defined as information in the public domain. The temporary rules on tax surcharges, late payment and penalties are applied to surcharges and interests calculated for the period from 1 January to 31 December 2010. The Acts enter into force on 1 January 2010.

Amendments are made to the rules in the Tax Accounting Act and the Income Tax Act concerning the apportionment of corporate tax revenue so that the share received by municipalities is decreased by 0.04 percentage points and the share of central government is increased accordingly as from the beginning of the tax year 2010. Changes are also made to the temporarily revised percentages that are applied in 2010 and 2011. The Acts enter into force on 1 January 2010.

29 December 2009

The President of the Republic ratified an amendment to the Act on Local Authority Boundaries. Changes are made to clarify the structure of the Act and its concepts and administrative procedures. The aims of the local authority development project and the conditions for redrawing local authority boundaries will be clarified. The Act will more clearly highlight the decisive role of local governments in preparing and instigating the changes as well as in decision-making. Steps to create new opportunities for local residents and other stakeholders to contribute will be taken when the proposed changes are under preparation at the local government level. The Government decision on municipal amalgamations is conditional on local government councils submitting a joint proposal for such an amalgamation. More detailed provisions will be issued on the content and binding nature of the amalgamation contract as well as on the necessary economic reporting when part of a local government is transferred to another local government. The Act enters into force on 1 January 2010.

The President of the Republic ratified an Act on central government transfers for the delivery of basic municipal services. The following central government transfers to local government that are brought under the jurisdiction of the Ministry of Finance: the general government transfer to local government, transfers for social and health care provision, pre-primary and primary education, general libraries, municipal cultural actions and per capita transfers for basic art education. The Acts enter into force on 1 January 2010.

The standard rate of VAT is raised from 22% to 23%. The tax rate applied to food and fodder is increased from 12% to 13% and the rate for restaurant food and meals services lowered from 22% to 13%. The tax rate for books, medicines, sporting services, passenger transport, accommodation services, television licence revenue, cultural and entertainment events, the sale of works of art by the artist, the importation of all works of art, copyright payments received by copyright organizations, hairdressing services and certain minor repair services will be increased from 8% to 9%. The tax on insurance premiums is increased from 22% to 23%. The Acts enter into force on 1 July 2010.

The tax treatment of pension savings based on voluntary individual pension insurance shall be extended to apply to bound savings based on contracts under the new act on long-term saving. Monthly payments under a long-term savings contract between individual savers and a deposit bank, fund management company or investment firm are deductible in income taxation in the same way as premiums paid on a voluntary pension insurance. During the savings period no taxes are levied on profits generated by funds invested under the savings contract. The payments made by the service provider to the taxpayer upon reaching retirement age or when other relevant criteria are met are taxed as capital income. The Acts enter into force on 1 January 2010.

The Government issued a Decree on central government transfers for the provision of basic municipal services. The Decree lays down rules for the standard prices applied in the calculation of central government transfers under the revised transfer system, remoteness indices and their construction, tax revenue that is taken into account in the equalization of central government transfers that are based on tax revenue, the delivery of information concerning municipality of residence compensation, negotiations on the sharing of costs between central and local government and the basic services price index. The material content of the Decree is essentially the same as the repealed decree on central government transfers to local government. The basic prices established in the Decree are calculated in accordance with section 68 of the Act on central government transfers for the provision of basic municipal services. The figures are computed by adding to the 2009 prices estimated overall increases in cost levels and changes in the extent and type of central government transfer tasks. The basic prices for pre-primary and primary education take account of certain functions that are financed under the Act on the financing of educational and cultural administration. Per capita basic prices for art education and general cultural services in 2010 are set within the limits of the state budget. The Decree enters into force on 1 January 2010.

4 February 2010

Government resolution on permanent operating expenses savings and other operating expenses savings in 2010. The resolution outlines certain principles and practices related to the provision of joint services and lays down guidelines on how offices and agencies can cope under the increasingly tight economic constraints.

The Government approved Finland's Stability Programme Update, which details the country's economic policy objectives and premises, particularly in the fiscal policy area, and assesses the prospects for their achievement up to 2013. The Update draws 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 by the Ministry of Finance in December 2009. According to the Stability Programme the Finnish Government's budgetary position will deteriorate sharply as a result of the recession and breach the 3% deficit-to-GDP ratio set in the Stability and Growth Pact.

