MINISTRY OF FINANCE

Economic Survey

Autumn 2015

Ministry of Finance publications – 32c/2015

Economic Prospects

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Abstract

The Finnish economy is in a serious situation. GDP growth is close to zero. Unemployment is rising and unemployment spells are becoming longer. Even once the recession is over, growth will be painfully slow. Recent news about the global economic outlook has again highlighted cause for concern. Growth prospects in China are continuing to deteriorate, and the Russian economy remains on a downward course. During the outlook period the most robust period of growth in emerging economies will also peak and turn down. On the other hand, many of Finland's major trade partners have seen healthy economic development. It is predicted that the US economy will reach growth of almost 3%, and in the UK economic growth is broadly based. The euro area, too, is back on a track of moderate growth.

In 2015, Finland's GDP is forecast to show growth of 0.2%. The forecast predicts a very moderate cyclical improvement in the latter half of 2015. Exports of goods and services will increase by 0.9%, while imports will fall by just 0.2%. The contribution of net exports will therefore be clearly positive. The only demand item expected to show growth in 2015 is private consumption, which will be up one per cent. Private investment will decline for the fourth year in succession, this year by 2%. It is estimated that the number of persons employed will be 0.7% lower than last year, and the annual average unemployment rate is predicted to come in at 9.6%. The sharp rise in long-term and structural unemployment is a particular cause for concern. Earnings levels will rise slowly over the forecast horizon. In 2015 the index of wage and salary earnings will rise by 1.1% and over the next two years by 1.2%.

The annual growth forecast for 2016 is 1.3%. This growth will be driven by favourable investment trends. The effect of net exports on economic growth will turn negative. Despite the gradual rebound of exports, imports will show stronger growth than exports on the back of recovering domestic demand. Because of the modest development of real incomes, private consumption growth will slow somewhat from 2015. The projected unemployment rate is 9.4%. Consumer prices will accelerate, but inflation will still remain moderate at around one per cent.

The projected 2017 GDP growth rate is 1.4%. Growth will be driven by domestic demand, as the net contribution of exports will remain negative. Over the forecast horizon the Finnish economy will grow slightly faster than potential output, and therefore the negative output gap will shrink.

General government will continue to run a deficit until the end of the decade, although substantial adjustment will help to reduce the amount of deficit. Finland's public debt will exceed the 60% limit in 2015, and the debt ratio will continue to rise in the next few years, albeit at a slowing rate.

Preface

The autumn 2015 Economic Survey is an offprint of an annex to the Government's 2016 budget proposal. It offers projections of Finland's economic outlook for 2015–2017. In addition to short-term prospects, the survey includes medium-term projections extending to 2019.

The forecast and trend projections in the survey are prepared independently by the Ministry of Finance Economics Department based on the Act on the implementation of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union and on multi-annual budgetary frameworks (869/2012).

The analyses presented in the survey are based on provisional national accounts data for 2014 published by Statistics Finland in July 2015 and on other public statistical sources available before 7 September 2015. The cyclical forecast and medium-term projections also take into account the Government's budget proposal for 2016.

Helsinki September 2015

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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
**	forecast
CPB	CPB Netherlands Bureau for Economic Policy Analysis
HWWI	Hamburgisches WeltWirtschafts Institut
IMF	International Monetary Fund
MoF	Ministry of Finance

Each of the figures presented in the tables has been rounded separately.

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Boxes:

Summary

Economic outlook 2015-2017

Provisional figures from Statistics Finland show that the economy contracted by 0.4% in 2014. The latest figures for Q2 2015 are poor as quarter-on-quarter growth was only 0.2%. It is forecast that the Finnish economy will grow by 0.2% from last year. The projected growth rate for the next two years is less than 1½%.

The Finnish economy is in an extremely difficult situation. It is projected that the level of industrial output in 2017 will be one-quarter lower than 10 years ago. Finland's export performance has been subdued in the first part of the year, and the loss of market shares in global trade will continue in the immediate future. Over the next couple of years economic growth will be slower than in our competitor countries, and unemployment will remain relatively high. In the medium term potential output growth, which reflects the level of output possible given the resources on hand, will be less than one per cent.

Recent news about the global economic outlook has again highlighted cause for concern. Growth prospects in China are continuing to deteriorate, and the growth rate is now forecast to drop back to 6.5%. However, it is important not to draw too far-reaching conclusions from developments in the Chinese stock market, since its structure and operation differ markedly from the Western markets. The Russian economy is continuing to contract, and for the next couple of years it will at least not grow. This will be reflected in a sharp fall in Russian imports. Russia now accounts for less than 5.5% of total Finnish exports. During the forecast horizon the most robust period of growth in emerging economies will also peak and turn down.

On the other hand, many of Finland's major trade partners have seen healthy economic development. It is predicted that the US economy will reach growth of almost 3% over the next couple of years, and in the UK economic growth is broadly based and expected to remain strong over the outlook period. The euro area, too, is back on a track of moderate growth, and the annual growth forecast for 2016 and 2017 is around 2%. Growth in Germany, a key export market for Finland, is expected to remain around 1½%, and Sweden will continue to post clearly stronger growth than the euro area.

The monetary policies conducted by central banks remain supportive of growth. Short-term interest rates will remain extremely low, and the three-month Euribor interest rate in 2017 is expected to average 0.2%. The ten-year interest rate will also remain low, and is predicted to stand at 1.2% in the last year of the forecast horizon. It is anticipated that the euro to dollar exchange rate will weaken by some 10% by 2017, which will bolster the price competitiveness of exports in markets where payments are settled in dollars. Some four-

fifths of Finnish exports are invoiced in euros or dollars. Lower energy prices, and oil prices in particular, are good news for the growth prospects of energy-intensive economies such as Finland. Despite the recent sharp falls, it is projected that the price of oil will start rising moderately over the next couple of years. Nonetheless it will remain clearly lower than in recent years, at around 60 euros a barrel.

Finland's GDP in 2015 is forecast to show growth of 0.2%. Provisional figures indicate that during the first half of the year, the economy have not grown compared with the same period last year. The forecast predicts a very moderate cyclical improvement in the latter half of 2015. Exports of goods and services will increase by 0.9%, while imports will fall by 0.2%. The contribution of net exports will therefore be clearly positive. The very slow exports growth rate primarily reflects Finland's poor cost competitiveness, but also reduced export demand. The only domestic demand item expected to show growth in 2015 is private consumption. Despite the worsening employment situation, household real disposable income will increase by one per cent, and because consumer prices will fall by 0.1% this year, private consumption will also be up one per cent. Civil engineering investment is the only private investment category that will show growth. Instead investment in machinery and equipment do not contract in 2015. R&D investment will decrease by some 5% from last year. Private investment will decline for the fourth year in succession, this year by 2%. Industrial output is into its fifth consecutive year of decline, and service production will increase by 0.6%. In 2017 the level of industrial output will be around one-quarter lower than 10 years ago. Employment has been weak in the early part of the year. It is estimated that the number of persons employed will be 0.7% lower than last year, and the annual average unemployment rate is predicted to come in at 9.6%. The sharp rise in long-term and structural unemployment is a particular cause for concern. Earnings levels will rise slowly over the forecast horizon. In 2015 the index of wage and salary earnings will rise by 1.1% and over the next two years by 1.2%.

The annual growth forecast for 2016 is 1.3%. This growth will largely be driven by favourable investment trends. Decisions already in place mean that industrial construction investment will accelerate significantly in 2016. Investment in machinery and equipment will also increase, and therefore it is predicted that private investment will increase by more than 6%. However several reasons make it difficult to predict investments, and risks are associated with their timing. Timing is one reason where there is a downside risk to the 2016 growth projection. The effect of net exports on economic growth will turn negative. Despite the gradual rebound of exports, imports will show stronger growth than exports on the back of recovering domestic demand. Because of the modest development of real incomes, private consumption growth will slow somewhat from 2015. It is predicted that industrial output will increase by 2½%, but this is still historically a very slow rate of growth. Industrial output growth will also drive service production to growth of almost one per cent. In the labour market the number of persons employed will start to edge up with the slight improvement in the cyclical situation. The employment rate will increase by 0.3%, and the projected unemployment rate is 9.4%. Consumer prices will accelerate, but inflation will still remain moderate at around one per cent.

The projected 2017 GDP growth rate is 1.4%. Growth will be driven by domestic demand, as the net contribution of exports will remain negative. The forecast is that cumulative growth in 2015–2017 will reach no more than 2.5%, and GDP will be 3.6% lower than in 2008. In other words the Finnish economy is very weak and faced with huge challenges. Over the forecast horizon the Finnish economy will grow slightly faster than potential output, and therefore the negative output gap will shrink.

Persistent cyclical weakness coupled with long-term structural problems have driven Finland's general government finances into a permanent state of deficit during the current decade. In 2014 the deficit breached the 3% EU limit. General government will continue to run a deficit until the end of the decade, although substantial adjustment will help to reduce the amount of deficit.

Central government will remain in deficit despite austerity, as the predicted slow rebound of the economy will not generate sufficient tax revenue. It is predicted that the local government deficit will remain at less than 1% of GDP. The financial position of earnings-related pension funds shows a surplus of around 1%. Other social security funds will slowly recover towards balance. Finland's public debt will exceed the 60% limit in 2015, and the debt ratio will continue to rise in the next few years, albeit at a slowing rate.

The risks to the forecast for the global economy are skewed to the downside. In China, indebtedness has continued to grow rapidly in the private sector. The high and increasing debt burden coupled with slowing growth may cause shocks that because of the size of the Chinese market and global value networks may have wide-ranging effects. In the euro area, households may have even greater difficulty than predicted recovering from the debt and financial crisis. Sluggish private sector demand for credit may reduce consumption or investment more than expected. Geopolitical tensions in Russia, the Middle East and elsewhere continue to cast a shadow over growth prospects. Russia remains in a very difficult economic situation, and it is unclear how the country will be able to adapt to slow growth in the post-recession period.

There is also growing unease in the financial market. An environment of low interest rates and growth-supportive monetary policy has increased the willingness to take risks and directed investment flows into the housing and stock market. Prices have risen sharply in several markets, which has increased the risk of major corrective movements. One of the lessons of the past few years is that developments in the financial market can have very rapid and dramatic effects on the real economy.

The domestic risks are related to the development of the real economy and labour market. In the short term, Finland will see slower economic growth than its competitor countries. Competitiveness remains weaker than in those countries, and Finland will continue to lose market shares in global trade. There is still not enough recognition that an improvement in public finances can only be achieved under conditions of favourable real economic development. The projected economic scenario will not be enough to improve the health of public finances in Finland.

In the economic policy realm, priority should be given to reforms aimed at increasing the output potential of the open sector. The most crucial factors with respect to the cost competitiveness of the open sector are the prices of production inputs and ease of access to those inputs. For these reasons alone, key reform priorities should include enhancing the incentive effects of the tax system and improving the efficiency of the labour market. The employment situation will not improve simply on the strength of a cyclical rebound, but it is also important to address regional and occupational mismatch problems. It is extremely worrying that employment has clearly deteriorated in the age group 25–54.

A predictable economic policy and a determined strategy that directly addresses the challenges facing public finances will help to create a sense of faith in the future at times of economic hardship and add to the credibility of economic policy both domestically and internationally.

Table 1. Key forecast figures

	2014 EUR bn	2012	2013	2014	2015**	2016**	2017**
		change in volume, %					
GDP at market prices	205	-1.4	-1.1	-0.4	0.2	1.3	1.4
Imports	79	1.6	0.0	0.0	-0.2	3.4	3.5
Total supply	285	-0.6	-0.8	-0.3	0.1	1.9	2.0
Exports	78	1.2	1.1	-0.7	0.9	3.0	3.3
Consumption	165	0.4	0.0	0.3	0.8	0.5	0.6
private	114	0.3	-0.3	0.5	1.0	0.8	0.8
public	51	0.5	0.8	-0.2	0.2	-0.2	0.3
Investment	42	-2.2	-5.2	-3.3	-1.3	5.4	4.2
private	33	-3.2	-7.1	-3.9	-2.0	6.4	5.3
public	8	2.6	3.5	-0.9	1.4	1.6	-0.3
Total demand	285	-0.6	-0.5	-0.2	-0.2	1.9	2.0
domestic demand	208	-1.2	-1.1	0.0	-0.6	1.4	1.4
		2012	2013	2014	2015**	2016**	2017**
GDP, EUR bn		200	203	205	206	212	218
Services, change in volume, %		0.6	-1.8	-0.1	0.6	0.8	1.4
Industry, change in volume, %		-8.5	-0.6	-0.3	-1.5	2.7	3.4
Labour productivity, change, %		-2.1	0.0	0.3	0.8	0.9	1.5
Employed labour force, change, %		0.4	-1.1	-0.4	-0.7	0.3	0.5
Employment rate, %		69.0	68.5	68.3	67.9	68.2	68.4
Unemployment rate, %		7.7	8.2	8.7	9.6	9.4	9.1
Consumer price index, change, %		2.8	1.5	1.0	-0.1	1.1	1.5
Index of wage and salary earnings, change, %		3.2	2.1	1.4	1.1	1.2	1.2
Current account, EUR bn		-3.9	-3.6	-3.8	-2.4	-2.8	-2.8
Current account, relative to GDP, %		-1.9	-1.8	-1.9	-1.2	-1.3	-1.3
Short-term interest rates (3-month Euribor), %		0.6	0.2	0.2	0.0	0.1	0.2
Long-term interest rates (10-year govt. bonds), %		1.9	1.9	1.4	0.7	1.0	1.5
General government expenditure, relative to GDP, %		56.1	57.6	58.3	58.8	58.2	57.6
Tax ratio, relative to GDP, %		42.7	43.8	43.9	44.5	44.2	43.9
General government net lending, relative to GDP, %		-2.1	-2.5	-3.3	-3.4	-2.8	-2.4
Central government net lending, relative to GDP, %		-3.6	-3.6	-3.9	-3.1	-2.8	-2.6
General government gross debt, relative to GDP, %		52.9	55.6	59.3	62.6	64.3	65.8
Central government debt, relative to GDP, %		42.0	44.3	46.4	48.7	49.9	51.2

Calculations of the effects of declining household and business confidence

The Kooma model developed at the Ministry of Finance Economics Department has been used to study the macroeconomic effects of a temporary decline in household and business confidence. The analysis covers the period from 2015 to 2019. The results are reported in relation to a steady state path, such as the Ministry of Finance's outlook forecast as set out in this survey.

Consumers' and businesses' perceptions of the state of the economy are measured using a variety of questionnaires. These so-called confidence indicators are used to study how groups of economic operators view the current situation and what they expect of the future. If forward-looking businesses' and households' optimism wavers, current investment and consumption decisions will be adversely affected.

Some confidence indicators have shown signs of moderate improvement in 2015, but it is too early to say whether there has been a sustainable turn for the better. In the service sector, confidence has improved since year-end 2014, and especially in the construction sector confidence has begun to return. Consumer confidence has also been improving early in the year. New orders received in industry have increased in the second quarter of 2015, and based on the results of the investment survey it is expected that fixed manufacturing investment will, at long last, show a substantial increase. Despite these encouraging signs, general industry confidence remains subdued. The optimism about the future has no firm direction, and it may be easily undermined by unwanted news or failures.

There is no variable in the model that directly describes the confidence of the economic agent. However, changes in confidence can be described based on the consumer or investment preference shock. The consumer preference shock changes the consumer's perceived utility of consumption compared to leisure. If the preference shock is positive, the economic agent will want to increase consumption. The investment preference shock impacts the adjustment cost function, which describes the costs associated with changing the level of capital. Investment adjustment costs increase when the availability of funding tightens or when there is increased uncertainty about the commencement of investments.

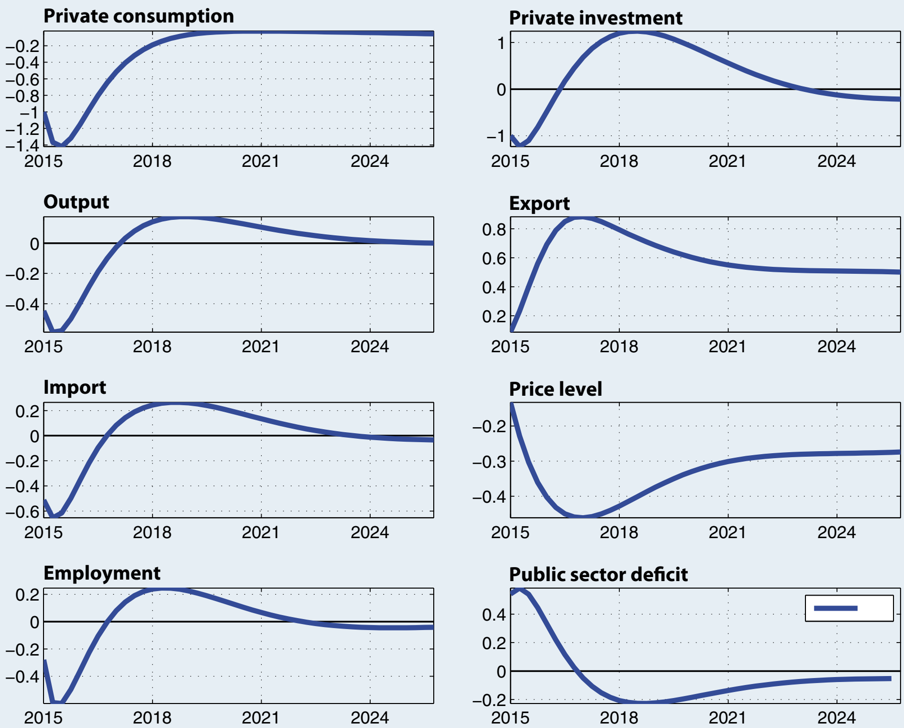
If the model is used to examine the consumption and investment forecasts presented in this outlook, we find that a positive consumption preference shock is needed to explain the growth of consumption in early 2015. Furthermore, it is assumed that the consumption preference shock will remain positive throughout the forecast horizon. The investment preference shock (adjustment cost) would appear to be negative in 2014 and 2015, but a recovery of investment during the outlook period also requires that the investment preference shock moves back towards normal.

The calculation assumes a temporary wavering in economic agents' optimism about the future. Technically, the performance of the calculation involves reducing both the consumption and investment preference shock so that during one quarter, consumption and investment decrease by one per cent from the baseline. Both of the shocks are eliminated from the economy within a few years, and the economy returns to its baseline path.

Reduced consumption and investment will also have the effect of reducing supply. Both GDP and imports will fall. Slowing GDP growth will contribute to reduce employment and slow the growth of wages. Taken together, these factors will reduce household purchasing power and depress consumption even after the first quarter. The low level of demand and wages will also push down price levels. According to the calculation the lowered level of wages and reduced business costs compared with the baseline will have a positive rebound effect on production, and consequently exports will pick up in response to lowered export prices. This aspect of the model underscores the great importance of exports to a small open economy such as Finland.

The calculation shows that the confidence of economic agents has a bearing even on economic growth in the short term. If the economic agents' optimism about the future wavers, this will clearly slow consumption and investment growth, which will also have an adverse effect on GDP and employment. A predictable economic policy and a determined response to the challenges facing public finances will strengthen optimism about the future at times of economic hardship and bolster the confidence of domestic economic agents.

Economic agents' confidence weakens



Medium-term outlook

Finnish GDP contracted in 2014 for the third consecutive year. At the same time, industry and the economy as a whole have been undergoing restructuring, which has also affected the longer term growth prospects of the economy. It is expected that the economy will turn to slight growth in 2015 and then slowly pick up momentum. However it is thought that growth will remain historically slow even in the medium term.

The medium-term outlook can be examined via potential output, which is thought to determine the economy's medium-term growth prospects. In its assessments of potential output the MoF Economics Department uses the production function method as developed jointly by the EU Commission and Member States, in which potential output growth is divided between projections of potential labour input, capital and total factor productivity. Potential output is an unobservable variable and its assessment is challenging, especially during a strong economic cycle and under conditions of rapid changes in the production structure.

The shrinking of the working age population will reduce the labour input over the next few years, but labour participation rates are expected to increase somewhat, especially in older age groups. Another factor determining labour input growth is the structural unemployment rate: this is the level of unemployment below which upward wage pressures begin to emerge in the labour market. In practice this means that unemployment is above its structural level when real unit labour costs are falling, i.e. when wages are rising more slowly than productivity and inflation taken together. Using the EU harmonised method, it is estimated that Finland's structural unemployment level is around 8%. The medium-term forecast is that unemployment will begin to approximate this level as the output gap closes. On average the contribution of labour input to potential output growth will be slightly negative in the medium term.

Increasing total factor productivity has been a major source of economic growth for the past few decades. In recent years, however, total factor productivity has increased only modestly. This slowdown has been attributed to both cyclical and structural factors. Output has dropped significantly in high-productivity branches, and at the same time the economy as a whole has become more service-oriented. The total factor productivity trend can be extracted from observed productivity based on the capacity utilisation rate and other cyclical indicators. In recent years total factor productivity trend growth has been around zero, and it is expected that in the medium term the growth rate will remain much slower than in the early 2000s.

Potential output is also affected by the existing capital stock. Several years of low investment have acted to slow capital stock growth and therefore undermined the economy's future growth potential. An increased investment rate over the outlook period will strengthen the economy's growth potential. Overall it is projected that the economy's growth potential will rise to just 0.8% a year by 2019.

The difference between total actual output and potential output, i.e. the output gap is negative when actual output is lower than potential output. This means there is idle capacity in the economy and output can grow more rapidly than potential output without creating price pressures. In 2015 the output gap is estimated to stand at almost –3% of potential output. In 2015–2019 it is predicted that the economy will grow at an average annual rate of one per cent. According to the EU's common production function method, Finland's potential output growth is slower, on average 0.5% per year. When GDP growth exceeds its potential, the output gap contracts, and according to the forecast the output gap will close in 2019. When the output gap closes, unemployment will approach its structural level, the labour participation rate will be at its trend level and total factor productivity growth will be equivalent to trend growth once all idle production capacity has been put to use.

Finnish public finances have been deep in deficit since 2009. Although economic growth is rebounding and the output gap is contracting, this growth is not enough to bridge the deficit in public finances. At the same time, population ageing is continuing to weigh down on public finances. General government revenue is no longer enough to sustain all the structures and functions of the public sector that were created on the foundations of stronger economic growth.

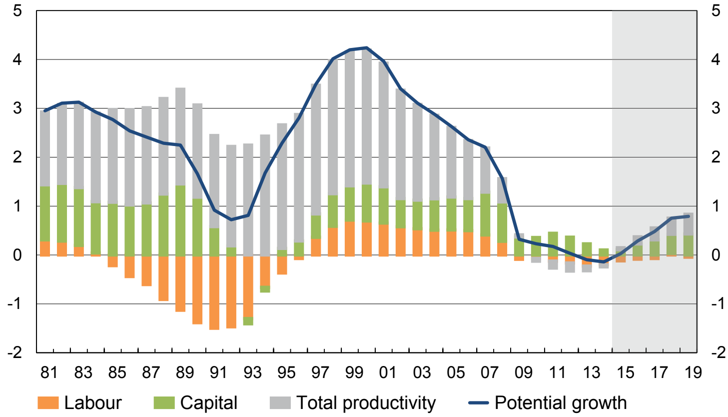
Slow potential output growth is having an adverse effect on public finances as economic growth and therefore tax revenue growth are expected to remain subdued in the years ahead. Despite the adjustment efforts that have been made, public finances will remain in structural deficit. The public debt to GDP ratio will exceed the 60% threshold in 2015. However, fiscal consolidation will contribute to slow the growth of the public debt to GDP ratio by 2019.

Table 2. Key forecast figures for the medium term

	2013	2014	2015**	2016**	2017**	2018**	2019**
GDP at market prices, change in volume, %	-1.1	-0.4	0.2	1.3	1.4	1.3	1.2
Consumer price index, change, %	1.5	1.0	-0.1	1.1	1.5	1.8	2.0
Unemployment, %	8.2	8.7	9.6	9.4	9.1	8.7	8.3
Employment rate, %	68.5	68.3	67.9	68.2	68.4	68.9	69.3
General government net lending, % of GDP	-2.5	-3.3	-3.4	-2.8	-2.4	-1.9	-1.4
Central government	-3.6	-3.9	-3.1	-2.8	-2.6	-2.2	-1.7
Local government	-0.7	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8
Social security funds	1.8	1.3	0.5	0.8	0.9	1.1	1.2
Structural balance. % of GDP	-1.0	-1.7	-1.8	-1.8	-1.9	-1.7	-1.4
General government gross debt, % of GDP	55.6	59.3	62.6	64.3	65.8	66.4	66.6
Central government debt, % of GDP	44.3	46.4	48.7	49.9	51.2	51.9	52.1
Output gap, % of potential output [1)]	-2.7	-2.9	-2.7	-1.8	-0.9	-0.4	0.0

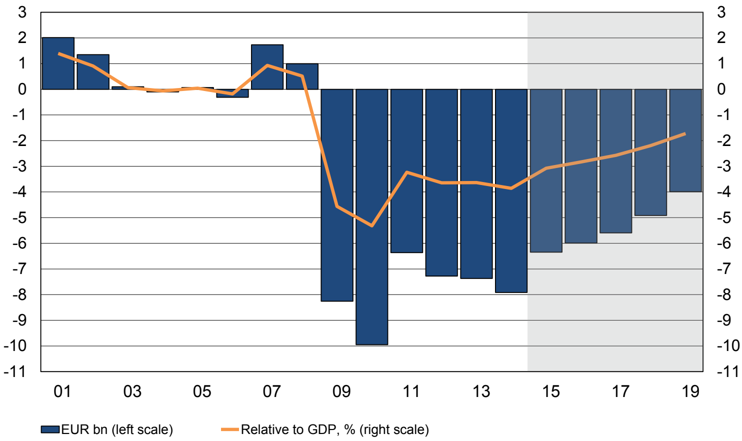
[1)] Estimated according the method developed jointly by the EU Commission and Member States.

Contributions to potential growth
according to EU method, %



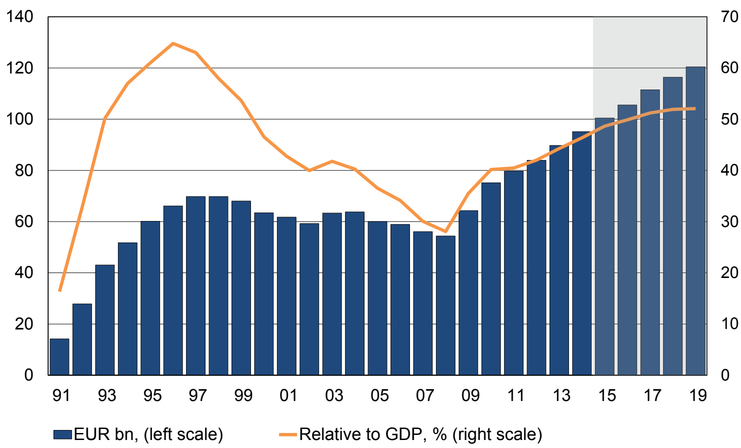
Sources: Statistics Finland, MoF

Central government financial balance



Sources: Statistics Finland, MoF

Central government debt



Sources: State Treasury, MoF

Fiscal policy

The Finnish economy is in a serious situation. GDP has declined three years in a row. Unemployment is rising and unemployment spells are becoming longer. Even once the recession is over, growth will be painfully slow.

Years of recession have left the public economy heavily in deficit. The public deficit to GDP ratio exceeded the 3% EU threshold in 2014, and the deficit will remain over the reference value in 2015 as well. Even after the economic downturn eases, general government finances are faced with the risk of persistent structural imbalance.

Public debt has increased rapidly with the persistent deficits in central and local government finances. Public debt will exceed 60% of GDP in 2015, and it does not seem likely that the growth of public debt can be halted in the immediate future.

At the same time, continuing aging will limit the labour input for almost two decades. During this time the growth of output is mainly driven by productivity growth. Accordingly, the estimated growth potential will be around 1–1½% in the long term.

General government expenditure is financed by revenue generated from output in the economy. Hence, output growth determines the limits to the growth of public expenditure in the long term.

Age-related pension and health care expenditure increase rapidly with aging. This means that existing revenue levels are inadequate to cover current general government expenditure. The Ministry of Finance's assessment is that the structural imbalance between revenue and expenditure – the sustainability gap – now stands at approximately 3½% of GDP.

There are three ways in which government can reduce the structural imbalance in public finances: 1) through fiscal consolidation measures that immediately increase general government revenue and reduce expenditure; 2) through institutional reforms that improve the conditions for labour input and productivity growth in the longer term; and 3) through reforms of the welfare benefit system that curb the growth of benefit payments under this system.

According to the economic programme of Prime Minister Juha Sipilä's Government, the GDP-to-debt ratio will level off by the end of the government term. The Government is also committed to incur no further debt after 2021. In addition, the Government is committed to making the savings and structural reforms decisions that are necessary to cover the sustainability gap.

The Government will set out its targets in more detail in the general government fiscal plan. Its aim is to reduce the central government deficit and bring it below 0.5% of GDP by 2019. Furthermore, following the upper limit set for expenditure arising to municipalities from central government measures, the Government aims to steer and improve the quality of local government finances so that the local government deficit can be brought below 0.5% of GDP by 2019. Once these targets have been reached, the EU's requirements for the management of public finances will also be satisfied.

The Government outlines the measures it intends to apply to achieve its targets in the Government Programme, and details them in the general government fiscal plan. The Ministry of Finance's macroeconomic forecast only takes into account those measures whose impact on public finances can be reliably assessed, i.e. on which specific and final information is available. Based on the current forecast, the targets set for budgetary position and debt ratio will only be reached on condition that the unspecified or provisional measures set out in the Government Programme, which are not taken into account in the forecast, are implemented in full.

The package of immediate public finances consolidation measures included in the Government Programme consists of steps to reduce public expenditure and to reallocate appropriations. Taken together, these measures will strengthen public finances by some EUR 4 billion at an annual level in 2019.

The Government will seek to improve the conditions for employment and economic growth by means of taxation and through measures designed to bolster the competitiveness and productivity of the economy.

The Government's tax policy is conditioned by its commitment to avoid increasing the overall tax rate. Taxation will be restructured so that the focus of taxation will be shifted from taxing labour and entrepreneurship towards environmentally and health motivated taxation. These changes should have a neutral impact on public finances at an annual level in 2019.

The Government was disappointed in its efforts to negotiate an inclusive social contract aimed at boosting the competitiveness of the economy. It will nonetheless continue to try and find other avenues to achieve the goals it was hoping to achieve through the social contract. At September 8, 2015 the Government announced several exceptional measures to reduce unit labour costs by 5 per cent and measures to enhance workers' change security. Prime Minister Sipilä will submit the Government's proposed measures to improve competitiveness to Parliament in the form of a government statement by the end of September 2015. The aim is to make the legislative amendments necessary by June 2016 at the latest. If these measures can reliably be estimated to strengthen public finances by an amount equivalent to 0.5% of GDP by 2019, the Government is prepared to cancel the plans it has for savings and tax increases of EUR 1.5 billion in case no agreement is reached on an inclusive social contract.

Furthermore, the Government has decided to allocate a total of one billion euros to projects aimed at promoting health and well-being, employment, competitiveness and growth, training and skills, the bioeconomy and clean technologies as well as the development of best practice solutions. In addition, EUR 600 million is earmarked for transport infrastructure repairs. These are one-off allocations that will be paid out on a staggered basis in 2016–2018. The allocations will be financed with a view to ensuring that their impact on public finances is neutral in both budgetary and national accounts terms.

The immediate measures taken by the Government to curb the growth of general government debt are ultimately aimed at creating the leeway it needs to put in place the measures that will ensure the long-term sustainability of public finances.

The most important long-term measures include cutting local government costs by reducing municipalities' statutory duties and obligations as well as restructuring social welfare and health care services and financing, including the reform of regional and central administration. Through its measures targeting public administration and service provision, the Government is looking to achieve savings of around EUR 4 billion in the long term. In addition, the Government will implement the pension reform as agreed upon by the social partners.

1 Economic outlook

1.1 Global economy

Sluggish growth in emerging economies and investment spending slows down global economy

US economic growth is rebounding after a temporary slowdown early in the year. Economic activity in the United States slowed following a difficult winter and industrial action in the country's ports, which momentarily reduced demand and hampered the flow of goods. Because of the weight of US private consumption and global value chains, these temporary factors spilled over to affect many other economies as well. US growth will remain slower than usual.

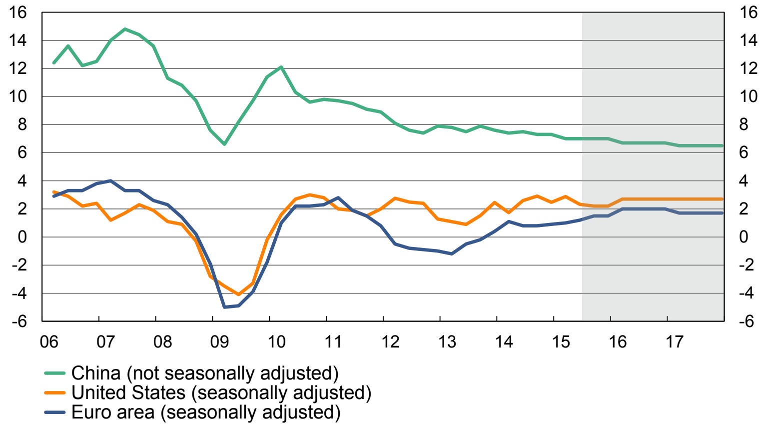
The Chinese economy is set to slow after an exceptionally long period of vigorous growth. Manufacturing, construction and export growth have already slowed significantly. China is now in transition from an export and investment-driven economy to one led by domestic consumption and services. If the country is successful in its policy, the slowdown of growth will be well controlled, initially to around 6%. This slowdown and economic restructuring in China will also be reflected in many other economies and raw materials producers in particular. Brazil and many other emerging economies will see slower growth over the outlook period than in recent years. Russia will remain in recession.

Private investment remains at a significantly lower level than before the crisis, especially in advanced economies, and in the euro area private investment has continued to fall. Investment growth will remain subdued over the outlook period. It is held back by low current and especially projected demand, high uncertainty and balance sheet adjustments necessitated by high levels of debt. In crisis-hit countries, investment is furthermore limited by the high costs and limited availability of financing.

The fragility of growth in the euro area stems from the lingering effects of the debt crisis, and even unconventional monetary policy measures have failed to kick start more robust growth. In several member states growth is hampered by poor competitiveness, which is limiting supply opportunities. In Europe, the British and Spanish economies in particular are showing significant promise, having returned to strong growth despite substantial austerity. Earlier reform efforts have contributed to this return to growth.

In Europe, persistently high unemployment is preventing consumption growth from rebounding. However, consumption growth is also sluggish in Germany where employment is at record high levels. The German current account surplus will remain high and even increase, which is indicative of low domestic demand. In Europe, high levels of public debt will for some time limit the options available to governments when addressing possible future shocks.

Gross domestic product
change in volume, %



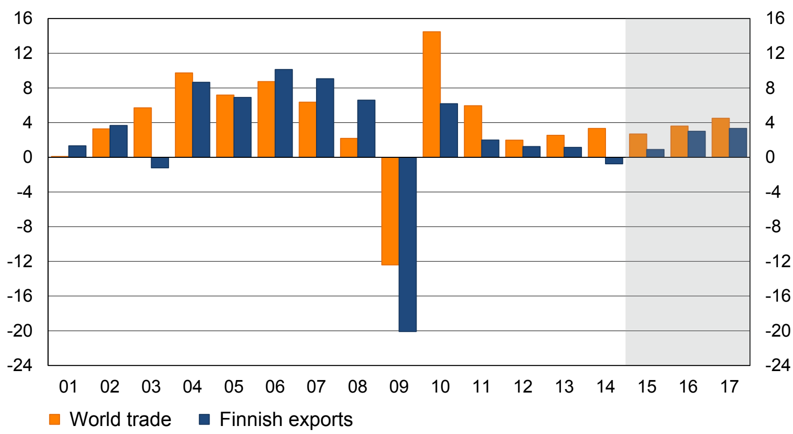
Sources: Statistical authorities, MoF

1.1.1 World trade to remain modest

World trade growth has slowed, among other reasons, because of the slowdown of Chinese manufacturing and sluggish investment activity in industrial countries. The growth of world trade is set to remain exceptionally modest. Pre-crisis trade growth was almost twice as high as output growth. Global output and trade growth rates will now be at more or less the same level.

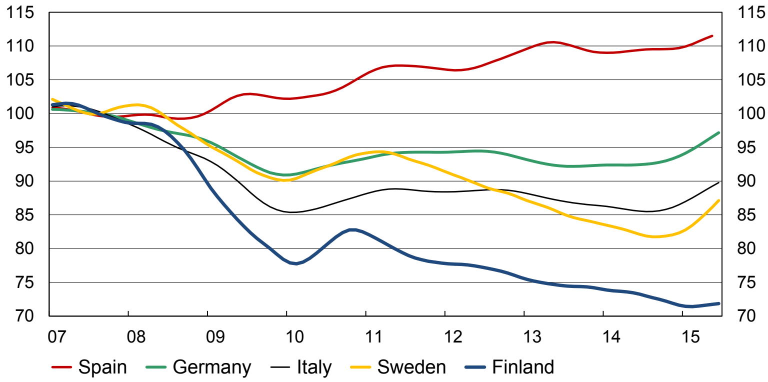
Finland's market share in global trade has declined, but the slide is slowing. In the euro area, Finland has regained the same market share as it had before the crisis. By contrast, in the Swedish and Russian markets, for instance, Finland is continuing to lose market shares. Global trade will not provide a strong demand impetus for Finland exports.

World trade
change in volume, %



Sources: CPB Netherlands Bureau for Economic Policy Analysis, Statistics Finland, MoF

Market share in goods exports[1)]
2007=100, trend (HP)



1) Ratio of goods exports growth to world trade growth

Sources: Macrobond, MoF

1.1.2 Inflation set to remain very moderate

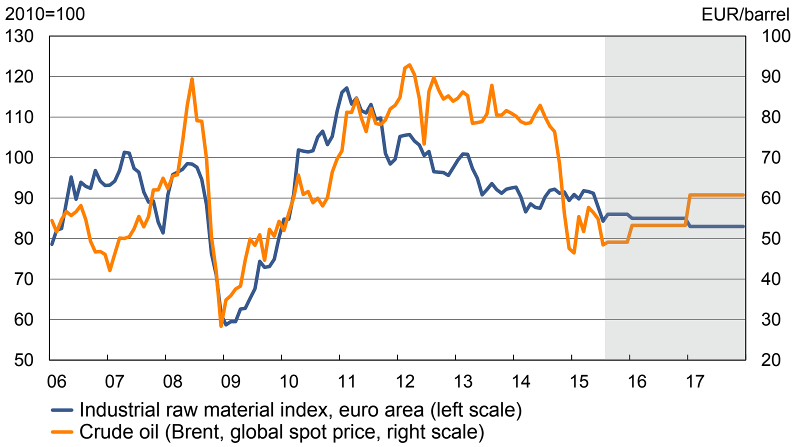
The price of crude oil has fallen sharply in response to the deteriorating outlook in emerging economies, increasing US production and continued high OPEC supply. The supply of crude oil will continue to expand following the understanding reached in the Iranian nuclear negotiations. It is expected that prices will rise only very moderately. As energy is an intermediate input in all products and services, the effects of the oil price shock will be felt throughout the economy.

Given the slowdown of demand from emerging economies and continued extensive supply, prices of industrial raw materials have also fallen sharply. Raw material prices are approaching the bottom.

Import and producer prices are falling in several countries. Inflation expectations are also extremely low, allowing central banks in advanced economies to persist with the unusual monetary policy stance. Greece is struggling to avoid deflation, but otherwise the weakening of the euro is reducing the risk of deflation in the euro area. There is no real threat of a deflationary cycle in sight.

In crisis countries interest rates on bank loans are still significantly higher than in the countries with the best credit ratings, which is deterring both consumption and investment. In the United States interest rates will begin to move back to normal this year. Interest rates in the euro area will rise very slowly over the outlook period.

Raw materials prices
EUR



Sources: Hamburgisches WeltWirtschafts Institut, Macrobond, MoF

1.1.3 Risks remain on the downside

In China, indebtedness has continued to grow rapidly, especially in the private sector. The high and increasing debt burden coupled with slowing growth and economic restructuring may cause shocks that, because of the size of the Chinese market and global value chains, may have wide-ranging effects, in particular on raw materials and investment goods suppliers. In the longer term it is also unclear how China will succeed in changing its economic model from one that relies on manufacturing, investment and export to one led by domestic consumption and services.

In the euro area, risks are still predominantly on the downside as households may have even greater difficulty than predicted recovering from the debt and financial crisis. Sluggish private sector demand for credit may reduce consumption or investment. It is unclear how committed indebted member states are to adjusting their public sector balance sheets.

The investment outlook includes a risk for a negative spiral. As investment is being deterred by low expected demand, demand for investment may also remain more subdued than predicted.

Growth prospects remain overshadowed by geopolitical tensions in Russia, the Middle East and elsewhere. Confidence has not, however, weakened to the same extent as in some earlier political and currency crises.

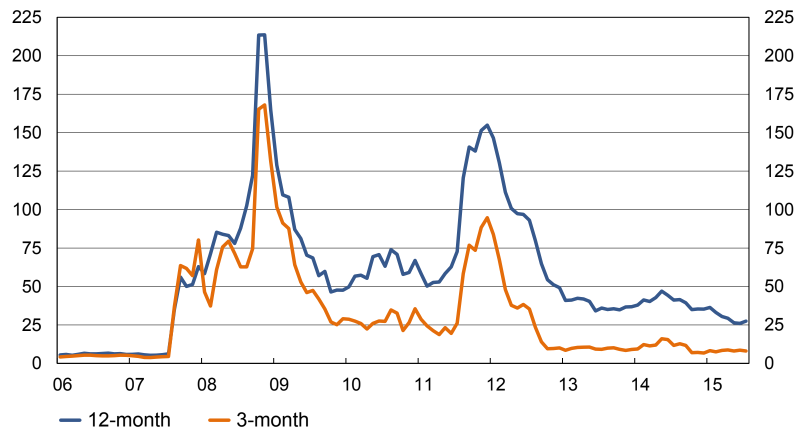
The economic situation in Russia remains dire. Post-recession growth will be significantly slower than earlier, and it is unclear how the country will be able to adapt. If the crisis in Ukraine persists, uncertainty would remain high and possibly lead to an increased outflow of capital from Russia, reduce investment, and further deepen the recession in Russia. The geopolitical risks may adversely affect confidence and slow growth in the EU.

Extremely low interest rates in industrial countries and "search for yield" have steered investment flows into the housing and stock market, for example, which may have led to overvaluations. The end of unconventional monetary policy over the outlook period, an incipient rise in interest rates and the strengthening of the US dollar may cause strong reactions in the financial market. Many emerging economies in particular have taken out dollar-denominated loans, which may give rise to strong movements of capital.

One upside risk is that falling oil prices might increase demand from oil-importing countries more than predicted.

Banking system risks

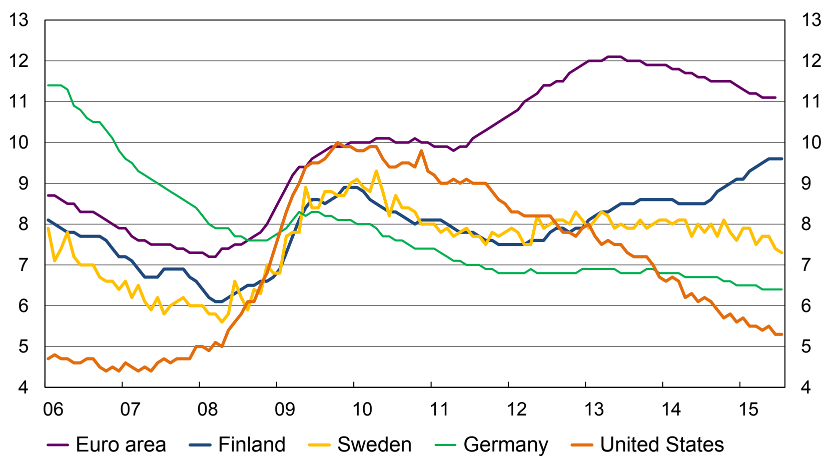
difference between secured Euribor and unsecured Eonia interest rate swap yield, basis points



Source: Macrobond

Unemployment rate

seasonally adjusted, %



Sources: Macrobond, statistical authorities

Table 3. Gross domestic product

	2012	2013	2014	2015**	2016**	2017**
	change in volume, %					
World (PPP)	3.2	3.2	3.2	3.0	3.6	4.0
Euro area	-0.5	-0.5	1.0	1.5	2.0	1.7
EU	-0.7	1.0	1.4	1.6	2.0	2.0
Germany	0.6	0.4	1.6	1.5	1.5	1.5
France	0.2	0.7	0.2	0.7	1.2	1.7
Sweden	1.3	1.6	2.0	2.2	2.7	2.5
United Kingdom	0.7	1.7	3.0	2.7	2.7	2.5
United States	2.3	2.2	2.4	2.2	2.7	2.7
Japan	1.7	1.6	-0.1	0.7	1.5	1.0
China	7.8	7.7	7.5	7.0	6.7	6.5
Russia	3.4	1.3	0.0	-5.0	-2.0	0.0

Sources: Eurostat, statistical authorities, IMF, MoF

Table 4. Background assumptions

	2012	2013	2014	2015**	2016**	2017**
World trade growth, %	2.1	2.7	3.3	2.7	3.6	4.5
EUR/USD	1.29	1.33	1.33	1.12	1.07	1.02
Industrial raw material price index, EA, € (2010=100)	100.7	94.8	90.0	86	85	83
Crude oil (Brent), €/barrel	87.1	82.0	74.5	49.1	53	61
3-month Euribor, %	0.6	0.2	0.2	0.0	0.1	0.2
Government bonds (10-year), %	1.9	1.9	1.4	0.7	1.0	1.5
Export market share (2000=100) [1)]	82	79	76	73	73	72
Import prices, %	2.1	-1.4	-1.6	-0.9	1.0	1.6

[1)] Ratio of export growth to world trade growth

Sources: Statistical authorities, CPB, HWWI, Reuters, MoF

Uncertainty about economic stabilisation continues in Greece

Uncertainty surrounding the Greek situation has had a major impact in increasing euro area instability during the current year. The political crisis in Greece led to the uncontrolled expiry of the country's financial assistance programme at the end of June 2015. The Greek government abandoned the economic reforms tied to the financial assistance, and Greece was on the verge of insolvency. The country defaulted on its debt obligations to the IMF in June. The Greek banking system was in acute crisis.

The negotiations on the conclusion of the assistance programme were extremely difficult and in the end broke down on 26 June. The situation came to a head when Greece made the surprise announcement that it would hold a referendum on the proposed bailout package. During the summer euro area ministers of finance or heads of state met on 17 occasions to discuss ways of stabilising the situation. There were two options: either Greece continues on the path of economic reform and receives continued assistance, or it temporarily leaves the euro.

Greece had to resort to restricting movements of capital in order to stem the persistent flight of deposits. Almost EUR 50 billion of deposits had been withdrawn from Greek banks. In the meantime, the Greek central bank issued some EUR 90 billion in Emergency Liquidity Assistance (ELA) to Greek banks. On Monday 29 June 2015, the Greek banks and stock exchange remained closed. The banks did not reopen until Monday 20 July 2015, and the stock exchange on 3 August 2015.

The Greek situation had a variety of effects, including the following:

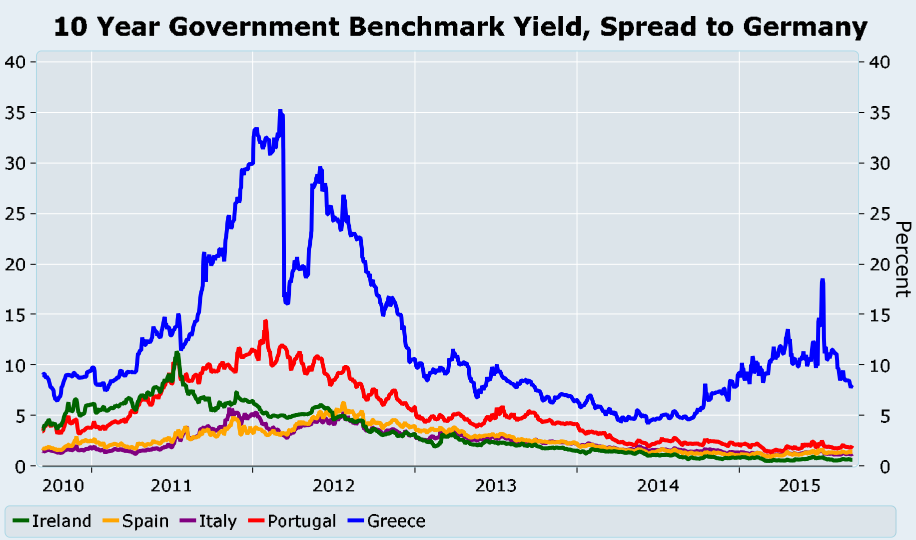
1) The tension in Greece caused unease in the financial market during the spring and the summer. In the sovereign debt market, however, Greece was largely viewed as an isolated case. There was only limited contagion effect on other countries recovering from the debt crisis.
2) The situation led to profound economic uncertainty in Greece and its neighbouring countries. The favourable trends that started in the early part of 2014 were reversed and business companies, banks and the public sector were severely affected.
3) There was mounting uncertainty in the euro area. The expiry of the Greek financial assistance programme and the political uncertainty also prompted debate about the future and the unity of the euro area. One of the options discussed in the political debate was Greece's temporary exit from the euro area. This would have had unpredictable consequences in the international financial market.
4) Greek insolvency might have had unforeseeable consequences for the rest of the euro area. The direct long-term costs to the Finnish state could have been as high as around EUR 3–4 billion. In the short term, it would have had various indirect effects and the guarantees provided by the government would have been called upon. It is difficult to estimate the magnitude of the indirect adverse effects.

Greece failed to pay back some 38 billion euros in loans and interests under the second financial assistance programme that ended in June (including payments due to euro countries and the IMF). Greece's financial situation was dire, so in the end it had to commit itself to following through with the economic reform programme. Once Greece had taken this decision, the Eurogroup approved on 14 August 2015 a new bailout package of up to 86 billion euros under the European Stability Mechanism. The size of this package reflected the fact that persistent uncertainty had left the Greek economy and financial system in a state of paralysis for months. In the end Greece managed to avoid insolvency. Greece received the first instalment of 13 billion euros on 20 August 2015. Greek debts to the euro countries and the IMF now total around 216 billion euros.

One of the key considerations for the approval of the third assistance programme was Greece's debt sustainability. In autumn 2014 Greece was still ahead of the debt sustainability targets set out in the programme. Given the events this year, it was necessary to downgrade the economic assumptions and projections of the debt sustainability analysis, both for economic growth and primary balance. A major undercurrent was a deep sense of distrust in the Greek government's commitment to reform the country's economy. The situation was further aggravated by the restrictions announced in the summer on the movement of capital and the banks' increased needs for recapitalisation. According to the EU baseline scenario (in which Greece complies with the reforms required by the new assistance programme), Greece's public debt would rise to 200% of GDP in 2016, dropping back to 122% of GDP by 2030. Greece's debt sustainability is significantly improved by the very low interest rates and long repayment dates on the bailout loans. The interest on the loans granted by euro countries (which amount to 65% of Greece's total debt) is the same as that charged to countries with the highest credit rating. In annual terms this has the effect of reducing Greece's financing costs by up to 9 billion euros.

Euro area stability is a condition for economic growth in Finland. For the integrity of the euro area as a whole, it is imperative that the common rules and agreed-upon commitments are followed and adhered to. Access to financial assistance always requires that agreed reforms are implemented. The new financial assistance programme was justified from the point of view of Finland's national interests and responsibilities when compared with the option that would have resulted in Greek insolvency and the consequent writedowns and increasing uncertainty in the euro area. Providing financial assistance under the European Stability Mechanism means that the bailout will not increase the Finnish state's financial liabilities, nor will it have any affect on central government debt or expenditure.

The decisions and steps taken in August provide a basis for the restoration of confidence and Greek economic stability. However, the situation will remain volatile at least until such time as the new elections have been held in Greece, the political situation in the country has stabilised, and the economic reform programme can be resumed.



Source: Macrobond / MoF

1.2 Foreign trade

Exports set to grow with improving outlook in euro area

According to Statistics Finland's national accounts figures out in July 2015, exports fell by 0.7% in 2014. Export of goods and services have grown moderately in early 2015:
The poor performance in exports reflects several factors, the most significant of which have to do with the structure of the export industry, Finland's poor cost competitiveness, and reduced export demand. Exports are projected to return to moderate growth. This will be on the back of rebounding economic growth in Finland's most important export markets, even though global trade has entered a phase of slower growth.

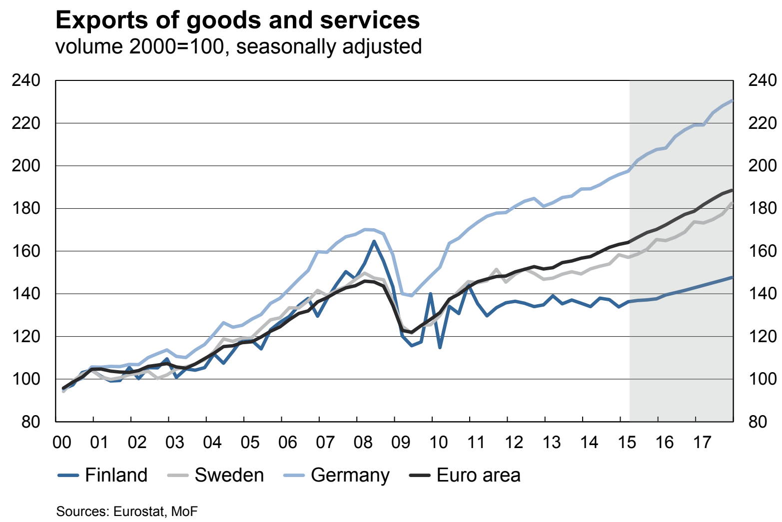
It is projected that exports will grow by 0.9% in 2015. Euro area growth in 2015 will be faster than last year. In the short term, the weakening of the euro against the US dollar will improve export opportunities from Finland. Although the weaker euro will bolster Finnish exports, the exchange rate also has indirect effects, for instance by increasing export demand in the euro area. Furthermore, continued low oil prices will serve to maintain world demand and drive Finnish exports. On the other hand the problems in the Russian economy will continue to hamper Finnish export growth.

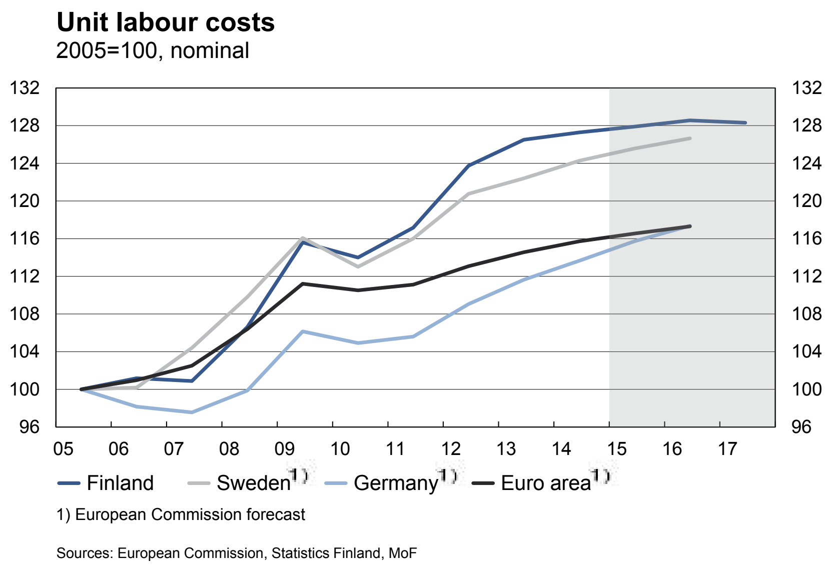
There are many different ways to measure competitiveness. Measured by the real trade-weighted exchange rate, Finland's competitiveness deteriorated in 2014, but has improved clearly early in the year. When measured by unit labour costs, Finland's competitiveness improved slightly last year over the euro area average. Compared with Sweden and Germany, however, the improvement was more marked since wages have risen more rapidly in these two countries than in Finland. Over the outlook period Finnish unit labour cost competitiveness will continue to improve as wage growth remains moderate and as labour productivity starts to increase. However this will not yet be enough to close the gap that has opened up over a period of several years between unit labour costs here and in our competitor countries.

In 2016 exports growth is 3% and in 2017 pick up further to 3.3% on the back of increasing global trade. As emerging economies remain on a faster growth track than Europe, Finland will continue to see its export market shares decline. However, accelerating growth in the euro area will improve the prospects of Finnish companies to hold on to their market shares.

Table 5. Foreign trade

	2012	2013	2014	2015**	2016**	2017**
	change in volume, %					
Exports of goods and services	1.2	1.1	-0.7	0.9	3.0	3.3
Imports of goods and services	1.6	0.0	0.0	-0.2	3.4	3.5
	change in price, %					
Exports of goods and services	1.1	-1.0	-0.7	-0.3	1.0	1.7
Imports of goods and services	2.1	-1.4	-1.6	-0.9	1.0	1.6





According to the July national accounts, the volume of imports in 2014 was unchanged from the previous year. Imports have been subdued in the early part of the year. Quarterly statistics show that imports have declined 4% in the first half of 2015.

In 2015 imports will fall, even though exports and private consumption will grow. Accelerating investment and export growth will increase the use of imported inputs in 2016 and 2017. The contribution of net imports to GDP growth will positive in 2015 ,but turns negative as domestic demand growh gathers momentum.

Current account remains on deficit

In 2014 the current account deficit stood at EUR 3.8 billion, or almost 2% of GDP. In the early part of 2015 the deficit has decreased very rapidly. Over the outlook period the trade and current account deficits will decrease by around EUR 1 billion. Nonetheless in 2017 the current account will show a deficit of EUR 2.8 billion, or 1.3% of GDP. The trade balance has long been positive, and even the deficit in the balance of services has decreased in the early part of the year.

The improved terms of trade is mainly a result of the sharp fall in oil prices. The slide in export prices has already come to a halt, import prices, on the other hand, will continue to fall in 2015.

The divergence of export and import prices is explained, among other factors, by the development of the price of energy. World market prices of crude oil have fallen more than the price of processed fuels. Indeed, energy products account for an increased proportion of total exports: the figure has climbed to over 6%. Furthermore, export prices for raw materials in mining and quarrying, the chemical industry and the forest industry, for instance, have developed more strongly than import prices. The fact that raw materials account for a larger proportion of exports than imports accentuates the differences in price changes and contributes to improve the terms of trade. In the case of consumer and investment goods the impact on the terms of trade have been less pronounced. The improvement of the terms of trade is thus an indication of a strong market position in certain branches.

In 2016 and 2017, it is predicted that foreign trade prices will begin to edge up. However import prices will rise only slowly as sluggish world trade growth means that the development of export prices from rival countries will remain moderate and as oil prices will only increase slightly over the outlook period. The weaker exchange rate will initially be reflected in higher import prices and, with some delay, in export prices.

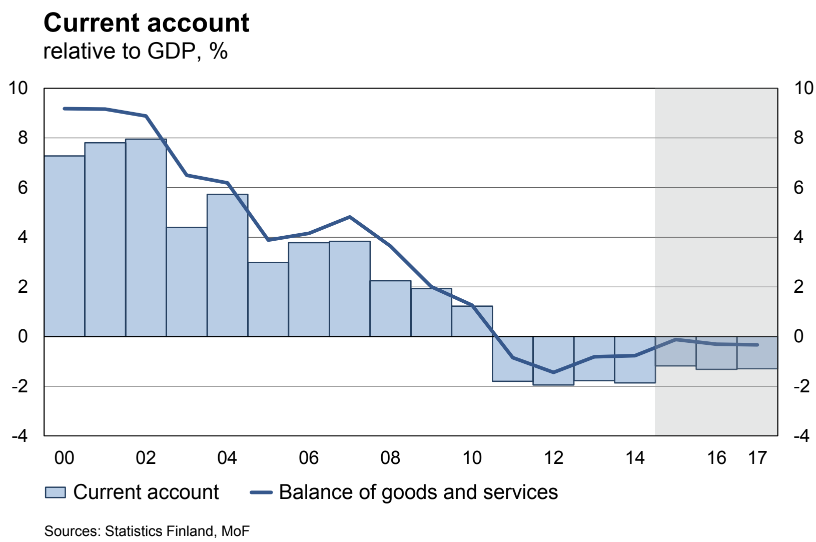


Table 6. Current account

	2012	2013	2014	2015**	2016**	2017**
	EUR bn					
Balance of goods and services	-2.9	-1.6	-1.6	-0.2	-0.7	-0.7
Factor incomes and income transfers, net	-1.0	-2.0	-2.2	-2.2	-2.1	-2.1
Current account	-3.9	-3.6	-3.8	-2.4	-2.8	-2.8
Current account, relative to GDP, %	-1.9	-1.8	-1.9	-1.2	-1.3	-1.3

1.3 Domestic demand

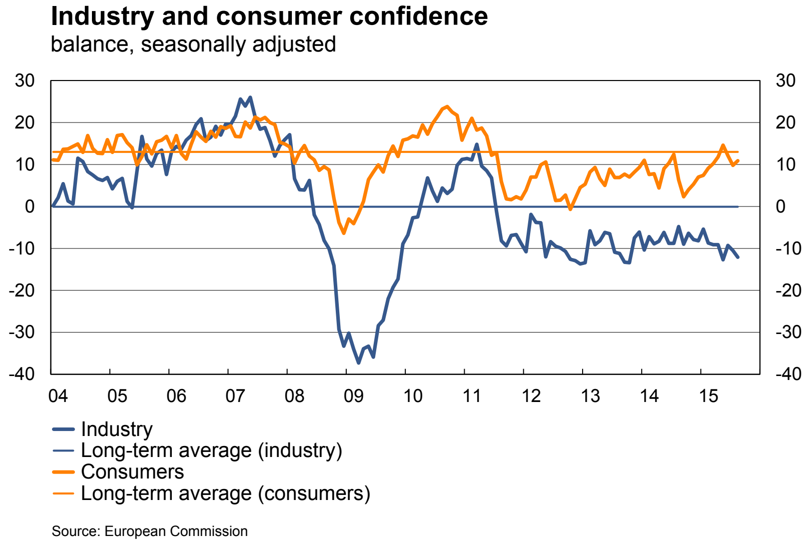
1.3.1 Private consumption

Private consumption growth bolstered by moderate price trends

In 2014 Finnish total output continued to decline. Private consumption growth was not enough to offset the adverse effects of declining exports and investment on economic activity. Private consumption was up 0.5%, even though household real disposable income fell by one per cent. Household purchasing power is currently at the same level as three years ago, and in recent years private consumption growth has been dependent on household confidence.

The employment situation will continue to deteriorate this year. As a result household wage and salary income growth will be no more than 0.5%. Increasing unemployment-related transfers will contribute to mitigate the effects of increasing unemployment of household incomes. Social transfers to households will be up 4% because of increasing unemployment, among other reasons. Despite the weak employment situation and increasing taxes, the growth of household real disposable income will accelerate to one pert cent this year. This is explained by the exceptionally moderate development of prices, which in turn is due to the falling world market price of oil. The price of private consumption will remain unchanged from last year. Private consumption growth will average one per cent this year.

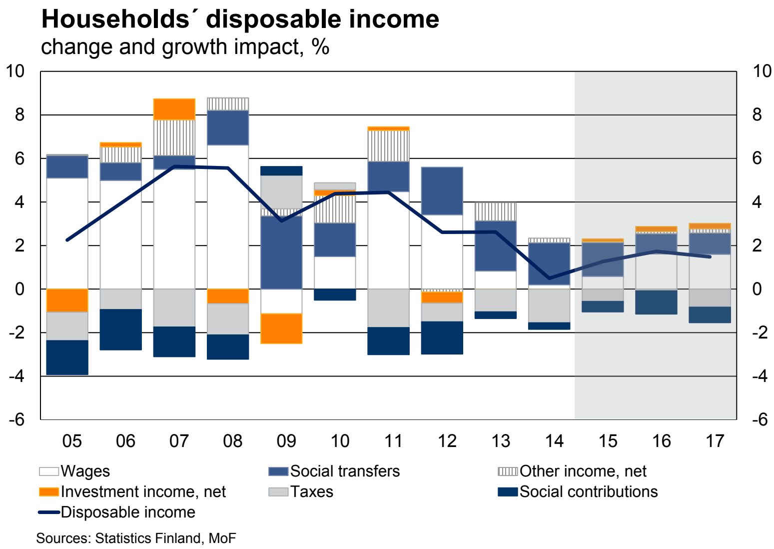
In recent years increasing household debt has contributed to bolster private consumption demand. In 2015 private consumption growth will be supported by the housing loan repayment holidays offered by banks. Since February, banks have offered their housing loan holders the option to apply for a 6–12 month loan repayment holiday without extra cost. In January–June, the total value of mortgage rearrangements was almost EUR 12 billion. In comparison, the typical figure in recent years has been around EUR 2.4 billion for the whole year. Loan repayment holidays will drive private consumption growth this year, but on the reverse side of the coin this will also increase the overall household debt burden, which in turn will augment the effect of rising interest rates on household interest expenses over the years ahead.



The potential for private consumption growth this year is overshadowed by rising unemployment and a more cautious consumer sentiment since the early spring. Despite these factors, consumption growth in 2015 will be strongest in the category of durables. According to Statistics Finland's Consumer Survey, people still feel this is a good time to make purchases of durables. In 2015 demand for cars, for instance, will be bolstered by an experimental car scrapping bonus paid by the government and car importers. As it is Finland has the second oldest existing stock of cars in the EU. The ageing stock of cars has increased pent-up demand.

Growth of household real disposable income to slow in 2016–2017

Wages and salaries are the single most important income item from the point of view of purchasing power. In 2014, households earned a total of EUR 82 billion in wages and salaries. Moderate collective wage increases mean that over the outlook period, earnings will increase by just over one per cent a year. Moderate wage settlements will support the demand for labour, which is set to grow with rebounding export and investment demand. With the improving employment situation, household wage income growth will accelerate from half a per cent this year to just over 1½% in 2017. Social transfers to households came in at almost EUR 42 billion last year, and it is projected that they will increase on average by almost 2½% in 2016–2017. One of the factors driving the growth of social transfer expenditure is population ageing: over the outlook period the number of pensioners is set to rise by 1½%. Pensions account for around 65% of total income transfers. The growth of current transfers will be curbed by adjustments to public expenditure. In 2016 and 2017 transfers to households will be cut by EUR 0.3 billion a year, among other things by freezing certain index-based increases.

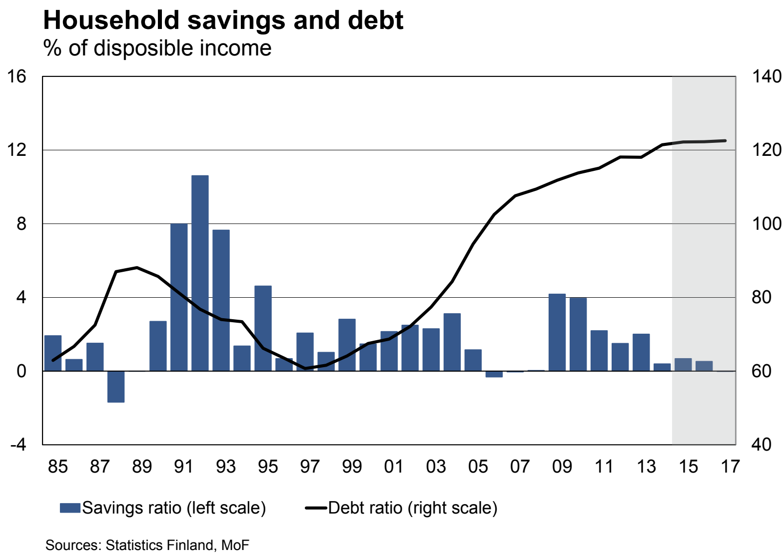


Over the outlook period the average wage earner tax rate will rise slightly. In 2016 the insured employee's unemployment insurance contribution will increase by 0.5 percentage points, and in 2017 employment pension contributions will be raised by 0.25 percentage points. Following a revision of central government income tax scales and changes to the earned income deduction, the average wage earner tax rate will fall slightly next year, but rise in 2017.

Despite the improving employment situation it is anticipated that the growth of household real disposable income will slow towards the end of the outlook period in response to accelerating inflation, cuts to income transfers and higher taxes. Private consumption growth in 2016–2017 will reach just 0.8%. This will require a positive development of consumer confidence, which will be reflected in a reduced savings rate during the outlook period. Furthermore, the changing population age structure may contribute to reducing the savings rate in retiring age groups if consumption habits do not change in line with the income available to the newly retired.

The risks to the development of private consumption are in opposite directions. Consumption growth in 2015 might even be stronger than predicted if consumer uncertainty, which has been rising since the spring, gives way to a stronger consumer sentiment. In 2016–2017 the most significant risk to private consumption is related to the development of the labour market situation. If there is no improvement in the employment situation, there will be little prospect of continued private consumption growth.

The debt burden of Finnish households has continued to rise for a long time, but even so it is still close to the European average. Although the growth of household indebtedness presents no immediate risk to the stability of the banking system, for instance, a rise in interest rates would have a very significant impact on indebted households. Current interest rates are so low that any movement in those rates would drive up debt servicing costs considerably. Rising interest rates would also be reflected in property income, but the positive effects from this would probably ripple through to affect consumer behaviour more slowly than the adverse effects of higher interest outlays.



1.3.2 Public consumption

Public consumption consists of central government, local government and social security funds consumption expenditure and amounts to over EUR 50 billion, around one-quarter of GDP and over 40% of total general government spending. The biggest public consumption items are wages and employers' social security contributions as well as intermediate consumption, i.e. the value of goods and services used as inputs. The volume of public consumption declined slightly in 2014, and in the next few years public consumption will remain more or less unchanged as a result of fiscal adjustment.

Central government consumption accounts for over one-quarter of the value of public consumption. Staff numbers in central government are on the decline, which is contributing to reduce consumption, but it is anticipated that intermediate goods inputs will increase somewhat. Wages and salaries are also rising very moderately, which means that the value of consumption will also remain low. Over one-quarter of people working in central government are employed in extra-budgetary units, the biggest of which are universities.

Local government accounts for two-thirds of total public consumption. Local government consumption will increase very moderately over the next few years. In 2015 consumption growth will be curbed by local authorities' own savings measures. The price of local government consumption will also show very moderate growth in the next few years. Age-related expenditure growth resulting from population ageing will increase local government consumption. Health care expenditure will also be increased by technological development and advances in treatments.

Expenditure by social security funds consists mainly of wages and social benefits in kind paid out by the Social Insurance Institution Kela (reimbursements for medicines and travel and rehabilitation allowances). The savings set out in the Government Programme will significantly reduce expenditure on social benefits in kind in 2016–2017.

Table 7. Consumption

	2014 share, %	2012	2013	2014	2015**	2016**	2017**
		Change in volume, %					
Private consumption	100.0	0.3	-0.3	0.5	1.0	0.8	0.8
Households	95.1	0.4	-0.3	0.4	1.0	0.8	0.8
Durables	8.0	-0.5	-0.5	1.7	2.8	1.0	1.6
Semi-durables	8.1	1.0	0.6	-0.7	0.3	1.0	0.7
Non-durable goods	27.5	-0.3	-0.7	-0.4	-0.1	0.5	0.2
Services	51.3	0.9	-0.6	0.1	1.1	0.9	0.9
Consumption by non-profit institutions	4.9	-0.4	-0.7	3.2	0.5	1.0	1.0
Public consumption	100.0	0.5	0.8	-0.2	0.2	-0.2	0.3
Central government	27.0	-0.3	4.2	-1.4	-0.4	0.1	0.4
Local government	65.9	0.9	-0.4	0.4	0.4	0.3	0.5
Social security funds	7.0	0.1	-0.1	-0.8	0.5	-5.7	-1.6
TOTAL		**0.4**	**0.0**	**0.3**	**0.8**	**0.5**	**0.6**
Individual consumption expenditure in general government		0.6	-0.3	0.0	0.3	-0.4	0.4
Total individual consumption expenditure		0.3	-0.3	0.3	0.5	0.8	0.9
Households´ disposable income		2.6	2.6	0.5	1.3	1.7	1.5
Private consumption deflator		2.8	2.3	1.6	0.0	1.1	1.3
Households´ real disposable income		-0.2	0.3	-1.0	1.2	0.6	0.2
	%						
Consumption as proportion of GDP (at current prices)		79.0	79.7	80.2	80.6	79.9	79.2
Household savings ratio		1.5	2.0	0.4	0.7	0.5	0.0
Household debt ratio [1)]		118.1	118.0	121.4	122.2	122.3	122.5

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

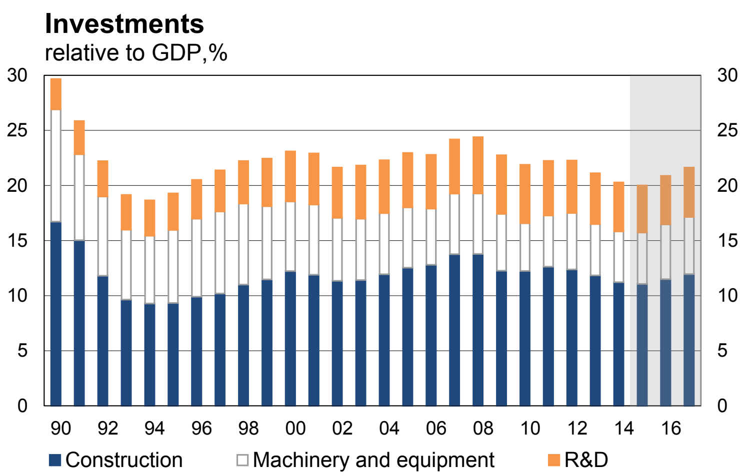
1.3.3 Private investment

Economic outlook buoyed by private investment

Updated Statistics Finland figures show that gross domestic investment in 2014 declined by 3.3% and private investment by 3.9%, much less than anticipated in March. In particular investment in machinery and equipment, which were revised from a fall of almost 10% to a fall of just 0.2%.

Gross domestic investment is predicted to fall by 1.3% and private investment by 2% in 2015. However, there has been minor growth in investment in the beginning of this year. The investment outlook for 2016 and 2017, however, is bright and private investment growth is expected to pick up to 5–6%: this growth will be driven by the construction of the bio-product mill in Äänekoski and other major investment projects that are now underway. The Confederation of Finnish Industries EK investment survey in June 2015 also promises strong growth in investment activity, particularly in the forest industry, chemical industry and building materials industry. The technology industry likewise anticipates an increase in investment activity in 2015. Furthermore, turnover and sales figures for construction indicate a clear upward trend.

A strong macroeconomic turnaround would pose an upward risk to the investment forecast. The downside risks are associated with the timing of investments and their entry in the national accounts. These negative risks are increased above all by the prospects of continued macroeconomic instability and Finland's longer-term export outlook. Investment projects always involve the risk that they are delayed or that investment financiers revise their assessments of the risks and yields. However, it seems that some investments are already underway. Construction investment seems to be on a solid and steady foundation and in some areas showing signs of improvement.



Sources: Statistics Finland, MoF

In 2015 fixed private investment to GDP will drop to almost its lowest level in 25 years. In 2016 and 2017, investment will outpace GDP growth, creating a somewhat more favourable ratio. Despite these favourable trends the private investment ratio in 2017 will still be around one percentage point lower than the 2004–2014 average, standing at 17.5% of GDP.

Housing investment increasing slowly

Housing investment is the single biggest category of private investment, accounting for 35%. State-subsidised housing accounts for one-third of total housing investment.The number of new housing starts in 2014 was 25,900.

Housing investment are projected to turn to growth in the third quarter of 2015, but nonetheless will further contract from last year. Market-financed housing construction is sluggish, and this year's increase in new housing starts will mainly come from state-subsidised housing units. However the good news is that the number of completed and unsold housing units has continued to fall in the second quarter.

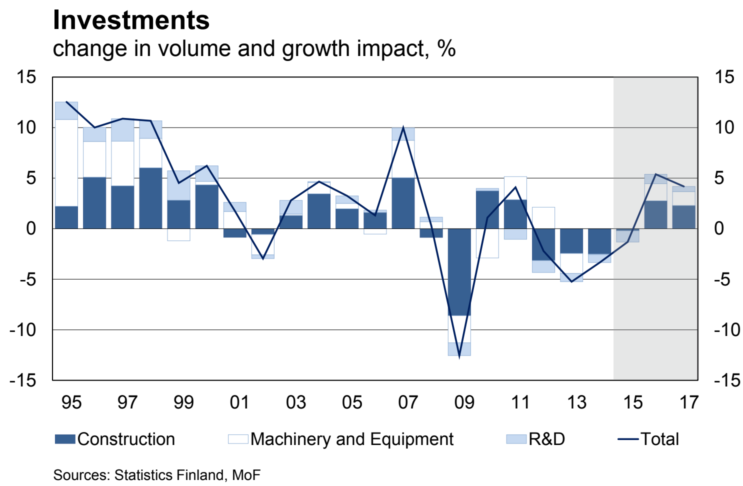
In 2016 and 2017 it is projected that housing investment will continue to grow over 4%. The number of housing units constructed next year is expected to be around one thousand higher than this year, and it is thought that the same increase will be seen again in 2017. Major multi-storey development projects are underway in the metropolitan Helsinki area, and these will continue beyond the outlook period. Outside the major cities, however, housing investment in other parts of the country will remain quite low.

Housing renovation is expected to continue to slow as the stimulus funding for renovation dries up. However there is an ongoing need for repairs because of the age and condition of the existing housing stock. It is predicted that in 2015–2017, residential renovation investment will increase by around 2–3% a year. The renovations undertaken by housing corporations are also reflected in the amount of loans they are holding, which has increased sharply. Loans to housing corporations account for one-third of the total corporate loan stock, and in spring 2015 they were increasing at a rate of around 10%.

Industrial and warehouse construction set to accelerate

Industrial construction investment is set to accelerate significantly this year and next. The major driving factor is the Äänekoski bioproduct mill, the biggest ever single investment project in the Finnish forest industry. It represents around 4% of the total value of other building construction investment. This and other smaller investment projects will drive other building construction to growth, and in 2016 investment will be more than 7% higher than this year. In the last year of the outlook period growth will slow somewhat from 2016. There are some major construction projects scheduled for launch in 2017, including the Kuopio pulp mill and the Pyhäjoki nuclear power plant, but in the absence of firm construction decisions they have not been taken into account in this forecast.

Investment in hospitals and other public services has turned upwards again. Furthermore the number of starts of commercial buildings has begun to rise during the spring. The figures that are now falling the most are those for agricultural building investment.



Inexpensive oil and government measures driving demand for civil engineering investment

According to the most recent national accounts, civil engineering investment has been increasing by 2–4% for the past two years. The strongest growth figures for the early part of the year (January–May) are recorded for the volume of civil engineering at over 12%. The halving of oil prices from last year's average has reduced the costs of civil engineering development and bolstered demand.

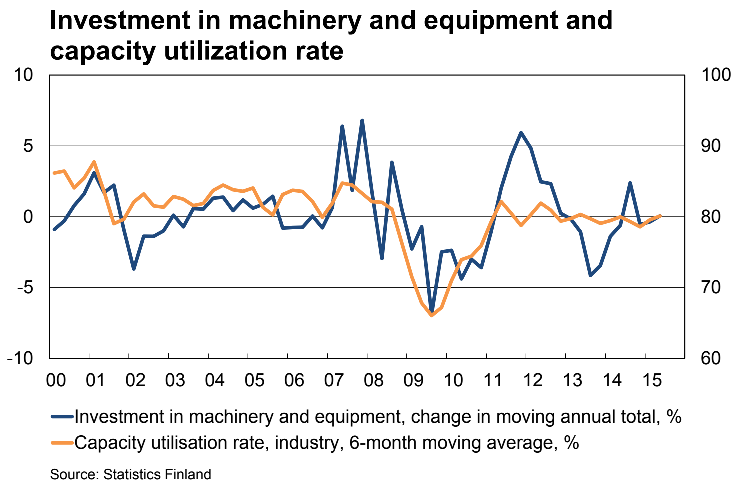
Investment projects are starting up in the energy supply network, the water supply network, the rail network, the metro and at airports, for instance. This year's forecast promises continued growth in civil engineering investment, and over the next two years growth will gain further momentum with the government's EUR 600 million investment package for transport infrastructure maintenance. Civil engineering investment will also be bolstered by accelerating housing construction.

Major machinery and equipment investments in the pipeline

The highest quarterly growth rates in the investment forecast are for investment in machinery, equipment, transport equipment and weapons systems. This is explained by the machinery and equipment acquisitions for the Äänekoski bioproduct mill, which are estimated at EUR 720 million, representing 7.5% of the total investment item. This substantial investment will also have knock-on effects for suppliers of investment goods in this project. It is estimated that 70% of the main equipment in the project will be procured from domestic suppliers.

During the first half of the year the number of new registrations of transport equipment is somewhat lower than last year. New registrations of trailers are down most sharply, and the number of new bus and coach registrations is also considerably lower than last year.

Investment in machinery and equipment will grow quarter to quarter in 2015, but annual level remain lower than last year. In 2016 and 2017, growth will pick up to 6–7% a year.



R&D investment slowly improving

R&D investment has fallen at a rate of 4–5% for four years in succession. The investment survey promises a small improvement in this year's R&D investment, but this is not yet reflected in the forecast.

It is expected that R&D investment will also gradually return to growth, but figures for the current year will still show a substantial fall. In the next years ahead, the forest industry and chemical industry in particular have plans for R&D investments. The growth projection for 2016 and 2017 is 2–4%. In 2017 R&D investment will edge up to 4.5% of GDP.

Table 8. Fixed investment by type of capital asset

	2014 share, %	2012	2013	2014	2015**	2016**	2017**
		Change in volume,%					
Buildings	45.2	-5.6	-6.1	-5.8	-1.1	5.4	4.2
Residential buildings	27.4	-3.5	-5.2	-5.9	-0.5	4.3	4.4
Non-residential buildings	17.8	-8.6	-7.4	-5.6	-2.0	7.0	4.0
Civil engineering construction	10.2	-5.4	4.2	1.8	2.7	3.5	3.9
Machinery and equipment	22.7	10.2	-8.6	-0.2	0.0	7.2	5.7
R&D-investments*	21.9	-5.3	-3.8	-3.6	-5.0	4.4	2.5
Total	100.0	**-2.2**	**-5.2**	**-3.3**	**-1.3**	**5.4**	**4.2**
Private	79.9	-3.2	-7.1	-3.9	-2.0	6.4	5.3
Public	20.1	2.6	3.5	-0.9	1.4	1.6	-0.3
		%					
Investment to GDP ratio (at current prices)							
Fixed investment		22.3	21.1	20.3	20.0	20.9	21.6
Private		18.3	17.0	16.2	15.9	16.7	17.5
Public		4.0	4.1	4.1	4.1	4.1	4.1

* Includes cultivated assets and intellectual property products

Urbanisation increases economic growth prospects

Urbanisation is an ongoing long-term trend. In the early part of the 20th century less than 10% of the world's population lived in cities, today the figure is around one-half. In Europe, the current urbanisation rate is over 70% and it is predicted to rise even further. Broadly speaking, urbanisation has always been driven by technological advances and the economic benefits from those advances. Issues surrounding urbanisation have again surfaced prominently in recent economic research and public debate. The geographical allocation of public investment and housing investment has attracted much interest and debate. The research evidence suggests that the urban structure is favourable to innovation and human capital, and that urbanisation therefore is beneficial to the economy as a whole.

Hsieh and Moretti (2015) have studied the impacts of urbanisation on economic growth in the United States. Their data comprises 220 urban areas and spans the period from 1964 to 2009. Labour productivity in urban areas is higher than in other areas, but the macroeconomic benefits from this depend largely on the operation of the public sector. Labour productivity and the demand for labour grew fastest in New York, San Francisco and San Jose, but the macroeconomic benefits remained limited because housing production did not meet the growing demand. In these cities the rapid growth of productivity drove up wages and housing prices rather than the number of people employed. Cities with less constraints on housing production saw a marked increase in the number of people employed, and the price effects were limited. The researchers estimated that if the regulation of housing production in the three cities mentioned had been at the same level as in the 'median city', the United States GDP figure would be higher by 9.5%.

Dougal, Parsons and Titman (2014) have studied the history of corporate growth. Companies operating in urban areas have shown the fastest growth, and they have a higher rate of investment than companies based in other areas. The faster rate of investment growth is explained by the proximity of other companies, population density and the population growth rate, and the higher educational level than in other areas. Davis and Dingel (2014), for their part, reported that in major cities, business activity is concentrated in branches with high educational and high productivity levels. These branches also have greater employment flexibility, and especially in major cities employment rates are higher in all industries.

Glaeser and Gyourko (2008) have also studied the US housing market and the reform of US housing policy. One of the key problems that they single out is the low level of planning in certain cities and in one area (California). According to their calculations the housing stock in growth regions should increase at an annual rate of 3–4%, otherwise housing supply may become an obstacle to growth. They suggest that the inadequacy of planning can be addressed by encouraging good policy in local government, for instance through direct subsidies. In contrast, they do not believe that these cities will change their behaviour unless they are supported by central administration. Glaeser and Gyourko say that aid to meet planning costs should be quite substantial (in the United States USD 30,000 per housing unit) for it to have any effect on local municipalities. The aid should be tied directly to new housing construction in order to increase the housing stock.

Oswald (1999) explored the associations between the housing market and unemployment. He found that unemployment is highest in countries with the lowest supply of rental housing and vice versa. In a tight housing market an increase in the supply of any type of housing is beneficial, but an increased availability of rental housing contributes to boost productivity by facilitating the mobility of labour.

The Finnish urbanisation rate of just over 60% is below the average for western industrial countries. However, Finland was a relatively late starter, and predictions are that urbanisation will continue at a fairly high pace over the next few decades. Already there are indications that in the metropolitan Helsinki region, inadequate infrastructure and housing production may be hampering economic development. It is clear that at least in this region, the shortage of affordable housing is one of the obstacles to employment. It is noteworthy that this is affecting not just the metropolitan Helsinki region, but in the future other fast-growing urban regions will probably be faced with the same problem. Inadequate housing production in growth centres has the potential to lower economic activity.

Infrastructure projects in growth centres are another important factor. Recent attempts to bolster planning in the Helsinki region have included letters of intent on land use, housing and transport and the linking of financing for major transport projects with housing planning. A 25% increase in housing planning activity, in line with central government requirements, would drive the housing supply of municipalities in the metropolitan Helsinki region to growth of 2–2.7%, with the housing stock in Espoo growing the fastest and in Helsinki the slowest. Figures from the Pellervo Economic Research Institute PTT (2015) indicate that ongoing rail and metro projects are aiming for an output of 34 housing units per one million euros of investment. If this planning target could be even slightly scaled up, it would in the long term have a positive impact both on housing prices and rents as well as on employment. This would translate into increased tax revenue from housing construction and at the same time increase the potential for people to use an effective public transport system.

Davis D.R. & Dingel, J.I. (2014), The comparative advantage of cities, NBER Working Paper 20602.

Dougal C., Parsons C.A. & Titman S. (2014), Urban vibrancy and corporate growth, NBER Working Paper 20350.

Glaeser E.L. & Gyourko J. (2008), Rethinking Federal Housing Policy, The American Enterprise Institute for Public Policy Research, AEI Press; Washington D.C.

Holm P., Hietala, J & Härmälä V. (2015), Liikenneverkko ja kansantalous – Suomi-Ruotsi vertailua, PTT raportteja 249.

Hsieh C-T. & Moretti E. (2015), Why do cities matter? Local growth and aggregate growth, NBER Working Paper 21154.

Oswald A. (1999), The Housing Market and Europe’s Unemployment: A Non-Technical Paper. http://www2.warwick.ac.uk/fac/soc/economics/staff/ajoswald/homesnt.pdf

1.3.4 Public investment

Public investment moved to a slight downward trend in 2014 following three years of solid growth. Overall it is anticipated that over the next couple of years, public investment will remain at last year's relatively high level.

Central government will be injecting EUR 600 million in transport infrastructure maintenance in 2016–2018. On the other hand, the need for adjustment will have the effect of reducing investment in new infrastructure projects and other investment, so there will be no significant increase in overall investment. Infrastructure investment accounts for less than one-third of total central government investment as measured in the national accounts.

Local government investment expenditure has increased sharply in the current decade. However, 2014 saw a slowdown in investment growth. Projections for the current year are that investment growth will continue to decelerate and turn to a slight decline towards the end of the outlook period. Local government investment will nonetheless remain high over the medium term among other reasons due to large-scale hospital projects, repair debt and major investment projects in growth centres.

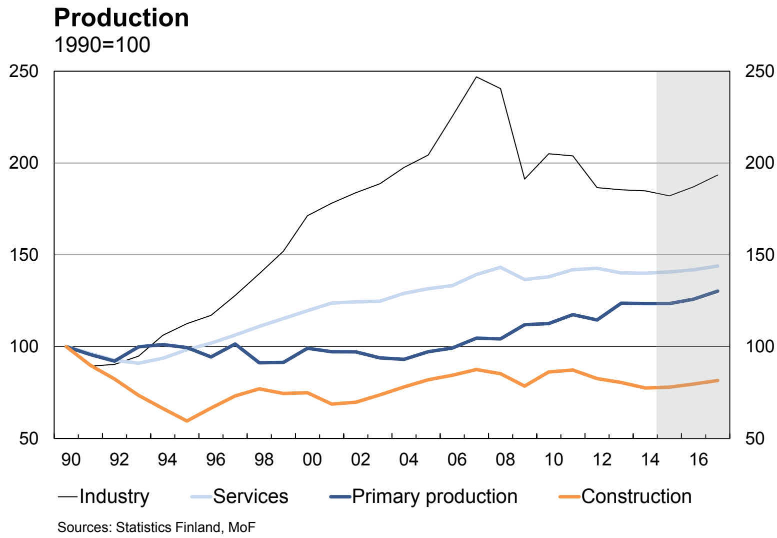
1.4 Domestic production

1.4.1 Total output

Economic growth slowly rebounding

The Finnish economy is firmly in recession. Value added for the economy has been virtually unchanged at its current level for nearly 12 quarters in succession, and unemployment has increased for seven successive quarters. The weak performance of the economy is attributed above all to the decline in construction and other main sectors of the economy. In 2014 total value added declined by 0.4%. The fall was broadly based in that figures for both secondary production and public service production were in the red. Growth was recorded in the metal industry and a few private service branches. In January–June GDP increased only marginally from late 2014, mainly in real estate and financial services as well as in construction.

The cyclical outlook has not changed since the spring. With the exception of the construction industry, the outlook has taken a turn for the worse in all main sectors of the economy. Preliminary data suggest that total output has been unchanged after rising in January–March, and early indications are that output growth will be sluggish in the second half of the year. Companies are suffering from a lack of demand both in industry, construction and services. Industrial companies in particular have excess production capacity relative to the existing demand for products, and the level of order books is lower than average. In services, profitability is continuing to decline as sales prices are falling at the same time as production costs are rising. Building construction has taken a turn for the better during the summer as the cyclical outlook has improved, with order books recovering from poor to normal. The worsening mismatch problems in the labour market are reflected in an increasingly limited availability of skilled labour especially in the construc-



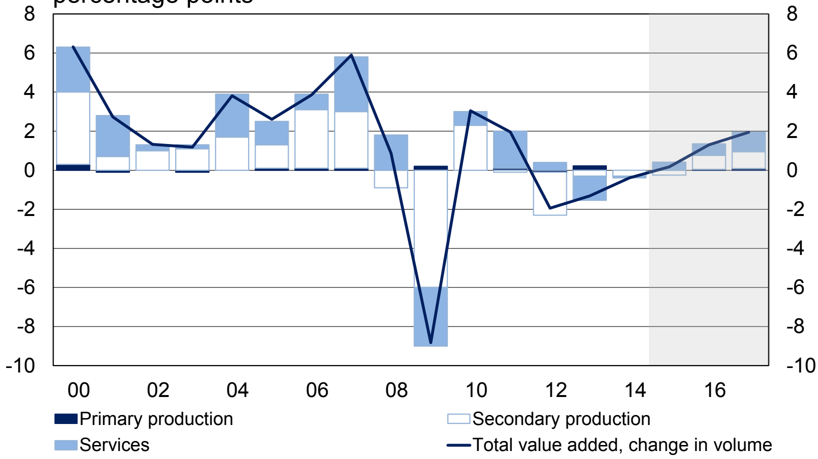
tion industry. In addition to the cyclical barriers to growth described above, the Finnish economy is hampered by structural changes that are eroding capacity, especially in the forest and electronics industry.

The performance of the economy in the first half of 2015 was poor. The improvement of output expectations in the summer has been unevenly distributed and subdued, but the gradual recovery of international demand is driving export-oriented industrial production and related services. Following the poor performance early in the year, it is forecast the value added will increase by 0.2% this year. In 2016 growth will be more broadly-based as output picks up in a larger number of branches and total output growth climbs to over one per cent. In 2017, growth will again be broadly-based with the exception of public service production, and it is projected to reach almost 2%, even though output volumes will still be 4% lower than in the peak year 2008. Over the outlook period of just over two years, production to meet business demand will grow faster than production to meet consumer demand because of the sluggish development of household purchasing power.

There are both upside and downside risks to the projected economic trends over the outlook period. On the one hand, a deterioration in the international geopolitical situation could undermine export demand, which would mean lower than predicted output in export industries in particular. On the other hand, if it were possible to achieve a rapid improvement in the competitiveness of export and domestic companies, that would improve conditions for production and the economy would grow more rapidly than forecast.

Contribution to total production

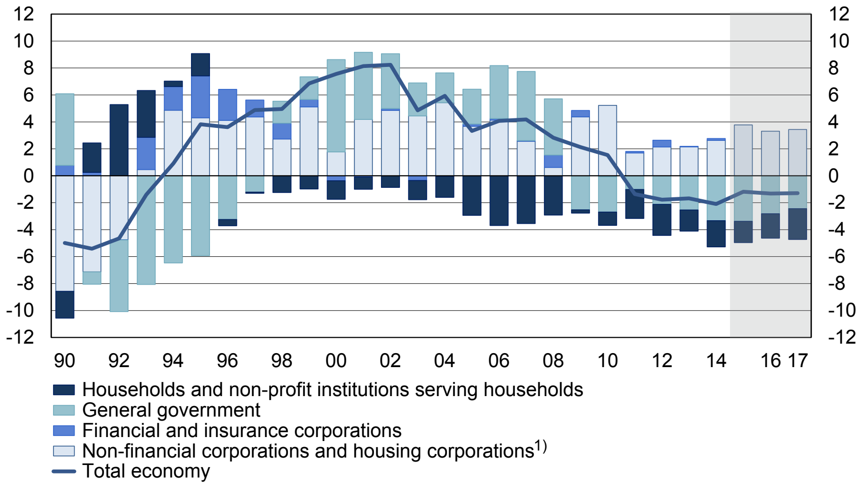
percentage points



Sources: Statistics Finland, MoF

Net lending by sector

relative to GDP, %



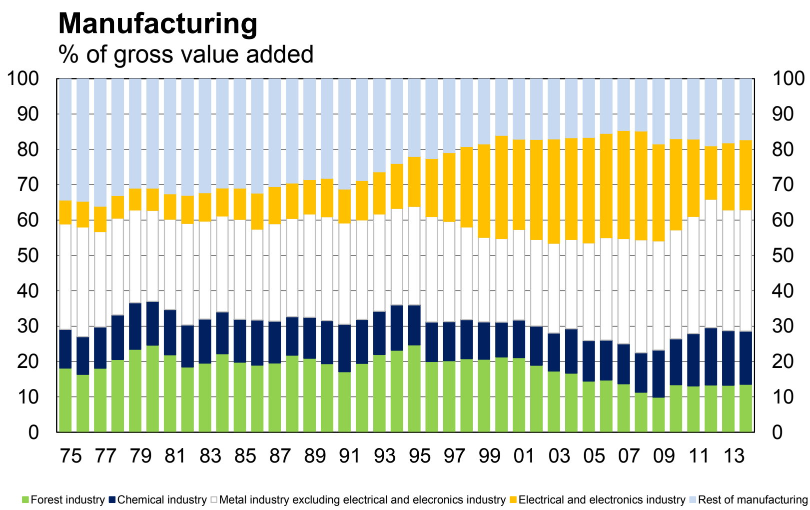
1) Including financial sector in 2015-2017

Sources: Statistics Finland, MoF

1.4.2 Secondary production

Few strong performers in industry

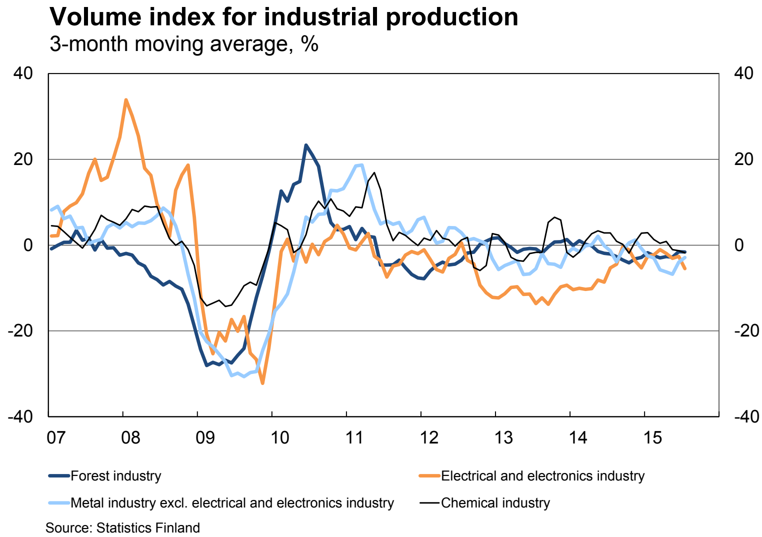
Industrial production currently accounts for a historically low share (20.3%) of total output. In 2014 industrial production fell for the fourth year in succession, declining by 0.3%. The beginning of the current year was just as poor as the end of last year, with output falling sharply in January–March. The decline affected all main sectors of the economy, which posted poorer performance than in late 2014. Output performance was particularly weak in the chemical industry, forest industry and energy supply. Output turned to growth in the second quarter, following mainly the growth of these same three branches.



Source: Statistics Finland

The outlook for industry is bleak. Export demand is weaker than average, many branches are struggling with competitiveness, and competition for market shares is intense. However, the outlook for businesses has improved moderately since the spring, and output is expected to increase slightly towards the end of the year. The outlook is brightest in the technology industry, where order books improved early in the year with the receipt of new shipbuilding orders, and in the building materials industry. In other branches the short-term outlook is subdued, and overall industry output is expected to fall by 1½% this year.

Despite the turnaround, the growth rate looks set to remain historically modest as the forest industry and electronics industry, formerly the powerhouses of the economy, have scaled down their production capacities in Finland. Furthermore, the world market shares of Finnish export companies are continuing to fall. Therefore industrial production will increase by around 2½% in 2016 and by just over 3% in 2017. The good news coming recently from the shipbuilding industry and the forest industry means that output in these branches will be increasing, but this is not yet enough to drive total industrial production to significant growth, and they will only be noticeably reflected in industry performance figures after 2017.

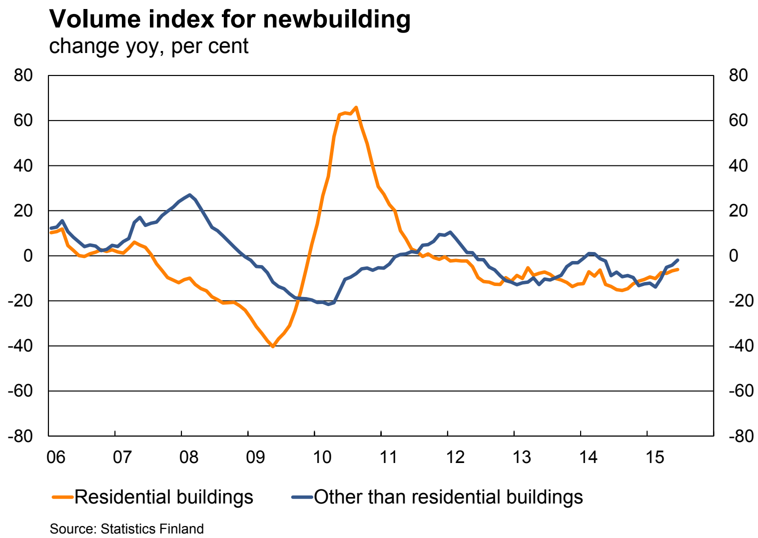


New building construction improving gradually

Value added in construction fell by 3.7% last year, for the third year in succession. However, in the first half of this year, construction output rebounded to growth and in the second quarter output volumes matched the level a year ago.

Indeed, the outlook for construction output has improved significantly. Although the number of planning permissions granted does not yet show growth, construction companies' order books have improved and capacity utilisation rates have increased. Demand is stronger and the number of unsold housing units has fallen. Because of the poor performance early in the year, value added in the construction industry will increase by less than 1% this year.

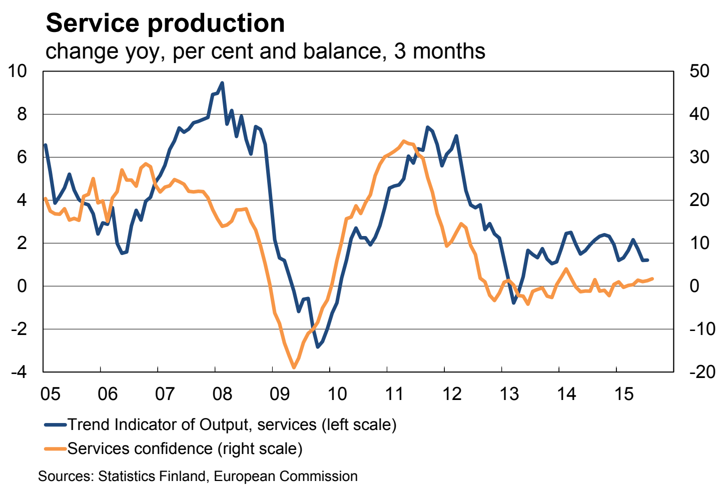
Buoyed by a few major warehouse and commercial building projects and a steady increase in renovation, the construction industry will accelerate to around 2% growth next year. In 2017 residential building construction and public investment will also contribute to keep construction output on a growth track of over 2%.



1.4.3 Services

Private services set to increase

The share of services in gross value added continued to increase in 2014 and now stands at over 70%, close to the euro area average of 73%. Nonetheless service production fell by 0.1% last year. Output declined especially in the trade sector and public services. On the other hand, the financial intermediation and insurance sector and information and communication services posted strong growth. Figures for service production in January–March were up slightly, but figures for the second quarter showed no growth from the first quarter.



The development of service production is dependent upon secondary production and consumption demand. Most services are used in the business sector, and therefore it will be necessary for business to rebound before conditions for service production can improve. Business tendency surveys suggest that the outlook in services deteriorated in the summer, and therefore there is no quick recovery on the horizon. On the other hand, sales expectations are slightly positive and lack of demand is hampering the growth of fewer service companies than before. The outlook is weakest in trade sectors serving consumers and industry and in the transport sector serving companies. Output expectations are particularly modest in sectors serving private consumption as household purchasing power will remain weak both this year and next. Demand is also sluggish in the hotels and restaurants sector. On the other hand turnover in information and communication services is rising strongly and sales expectations remain positive. The outlook and sales expectations are also rising in financial intermediation and insurance services.

Service production growth will remain subdued because of the weakness in secondary production, and therefore it will increase by ½% this year. In 2016 the rebound of business activity will drive service production to growth of almost 1% and in 2017 further to 1½%. In 2017 service output will exceed its pre-crisis level, in contrast to other main sectors of the economy.

Table 9. Production by industry

	2014 share, %[1]	2012	2013	2014	2015**	2016**	2017**	Average 2014/ 2004
		change in volume, %						
Industry	20.3	-8.5	-0.6	-0.3	-1.5	2.4	3.4	-0.7
Manufacturing	16.7	-11.5	0.4	-0.8	-1.8	2.8	3.7	-1.0
Construction	6.2	-5.3	-2.6	-3.7	0.7	2.1	2.4	-0.1
Agriculture and forestry	2.8	-2.5	8.0	-0.2	-0.1	1.9	3.5	2.9
Industry and construction	26.5	-7.8	-1.1	-1.1	-1.0	2.7	3.2	-0.5
Services	70.6	0.6	-1.8	-0.1	0.6	0.8	1.4	0.8
Total production at basic prices	100.0	-1.9	-1.3	-0.4	0.2	1.3	1.9	0.5
GDP at market prices		-1.4	-1.1	-0.4	0.2	1.3	1.4	0.6
Labour productivity in the whole economy		-2.1	0.0	0.3	0.8	0.9	1.5	0.4

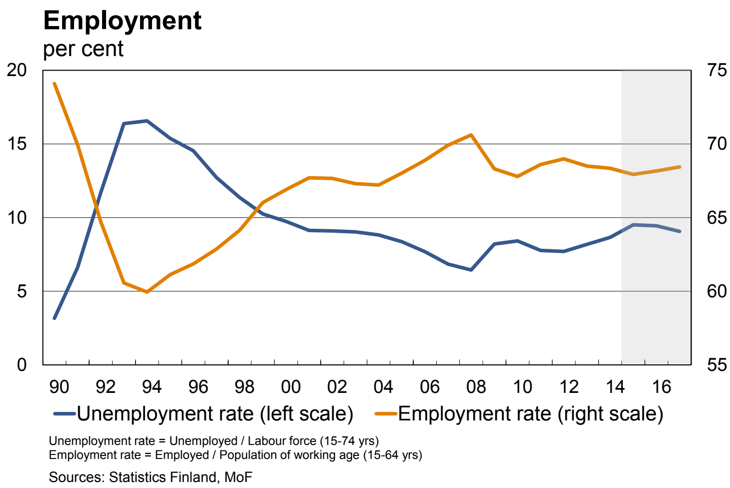
[1] Share of total value added at current prices.

1.5 Labour force

Unemployment to increase clearly this year

Employment trends in early 2015 have been weaker than predicted. In January–July the number of persons employed was 0.7% lower than in the corresponding period last year. The lack of economic growth in Finland is undermining this year's employment prospects, and it is projected that the number of employed persons will remain 0.7% lower than last year, even though employment will turn to moderate growth towards the end of the year.

Unemployment has continued to rise even more sharply than predicted, according to both Statistics Finland's sample-based Labour Force Survey and the employment service statistics compiled by the Ministry of Employment and the Economy. In July the trend of the unemployment rate was 9.6%. In the latter half of the year it is expected that the seasonally adjusted number of unemployed persons will remain at the same level as in June–July, and therefore the projected unemployment rate for the whole year is 9.6%.



Employment will return to moderate growth and unemployment will begin to slowly edge down with GDP growth in 2016 and 2017. Nonetheless unemployment will remain high throughout the outlook period. In 2016 it is predicted that employment will improve by 0.3% and in 2017 by 0.5%. The unemployment rate is expected to fall back to 9.4% in 2016 and to 9.1% in 2017.

The continuing growth of long-term and structural unemployment is a particular cause for concern. In July the number of people who had been out of work for more than a year reached 113,000, over 20,000 more than one year earlier. According to the Ministry's employment service statistics the number of structurally unemployed people in July was 220,000, or some 26,000 more than the corresponding figure last year. Even under improving cyclical conditions the high level of structural unemployment will slow the decline in the unemployment rate.

Indeed, one of the major challenges for the new government is to resolve structural unemployment. It is crucial that steps are taken to intervene in unemployment spells at as early a stage as possible and to increase incentives for unemployed people to actively search for work. However, the termination of an unemployment spell by labour policy measures cannot be considered a successful intervention if upon completion of these measures the individual returns to unemployment or recurring periods of labour policy measures.

Apart from the lingering weakness of the economy in general, another obstacle to an improvement in the employment situation is presented by regional and occupational mismatch problems between unemployed job seekers and job vacancies. Restructuring has resulted in large numbers of job losses in traditional industries, and these people's prospects for re-employment in other branches are often poor. There are also indications of mismatch problems in the construction sector, as employment service statistics indicate that both unemployment and job vacancies have increased rapidly this year.

In the current year the growth of unemployment has been more evenly distributed across all regions and occupational groups. Likewise, unemployment has increased more evenly at different educational levels. In fact in recent months unemployment has increased more rapidly in higher educated groups.

Figures for both the employment rate and the labour participation rate convey the worrying message that employment has recently fallen most particularly in the age group 25–54 years. The growth of long-term unemployment has also been fastest in this age group. In the oldest age groups both the employment and labour participation rates have risen, which is good news because these age groups represent a growing proportion of the population. Indeed over the outlook period employment in older age groups will increase more rapidly than in younger age groups.

Table 10. Labour market

	2012	2013	2014	2015**	2016**	2017**
	annual average, 1,000 persons					
Population of working age (15-74 yrs)	4 075	4 087	4 096	4 107	4 114	4 121
change	16	12	9	12	7	7
Population of working age (15-64 yrs)	3 524	3 508	3 491	3 477	3 465	3 454
change	-15	-16	-17	-15	-12	-11
Employed (15-74 yrs)	2 483	2 457	2 447	2 430	2 437	2 449
of which 15-64 yrs	2 431	2 403	2 386	2 362	2 362	2 364
Unemployed (15-74 yrs)	207	219	232	257	254	244
	%					
Employment rate (15-64 yrs)	69.0	68.5	68.3	67.9	68.2	68.4
Unemployment rate (15-74 yrs)	7.7	8.2	8.7	9.6	9.4	9.1
	1,000 persons per annum					
Immigration, net	16.8	17.0	17.5	17.4	17.4	17.3

Besides restructuring the labour market, efforts to raise the employment rate should focus on preventing retirement on disability pension and promoting well-being in the workplace. The number of people working part-time in Finland is relatively low by international comparison, and it seems that a significant improvement in the employment rate can only be achieved through increased part-time employment.

Figures for unemployed job seekers registered with employment offices and Statistics Finland's sample-based Labour Force Survey give a slightly different picture of the level and development of unemployment. Figures for unemployed job seekers compiled by the Ministry of Employment and the Economy are clearly higher than those given by Statistics Finland.

At the moment the discrepancy between the unemployment figures reported by Statistics Finland and the Ministry of Employment and the Economy is further accentuated by the fact that some unemployed people have given up their active search for work because of the weak economic situation. The Statistics Finland concept of unemployment is based on the criterion of active search for work, and the inactive unemployed are classified in the Labour Force Survey as 'disguised unemployed'. The differences between the two sets of figures are also explained by changes in statistical methods and legislation.

1.6 Incomes, costs and prices

1.6.1 National income

National income refers to domestic primary income, i.e. employee compensations, taxes on production and imports net of subsidies, operating surplus and property income. Last year national income was lower than GDP for the first time in a decade. What this means is that payments of wages and property income out of Finland exceeded payments of the same into Finland. In other words, less income remains available in Finland for purposes of consumption, for instance.

In 2014 nominal net national income increased by 1%. This was the same rate of growth as in the previous two years, although the reasons driving this growth were very different. In earlier years national income growth has been bolstered by increasing employee compensations, but last year this trend was brought to a halt by the deteriorating employment situation and lower pay rises than previously. In contrast to earlier years, national income growth was driven instead by increasing property and entrepreneurial income. Property and entrepreneurial income increased by close to 4%, as business profitability improved following steps taken to cut expenses as well as the lower corporate income tax rate. As a result operating surplus, which describes levels of business profits, was up 6%.

In 2015 national income is projected to increase at a rate of 0.8%, slightly more slowly than last year. Due to the weakness of the labour market and moderate wage settlements, total wage and salary payments will continue to show only modest increase this year. At the same time, employers' social security contributions will be increased and therefore rise more sharply than wages. It is forecast that the difficult economic environment will limit the growth of operating surplus, meaning that property and entrepreneurial income growth will slow from last year. Indirect tax hikes will increase the amount of revenue gained from production and imports.

Table 11. Disposable income

	2014 share, %	2012	2013	2014	2015**	2016**	2017**	On average 2014/2004
		change, %						
Compensation of employees	61.1	3.6	0.9	0.2	0.6	1.7	1.7	3.2
Wages and salaries	49.6	3.5	0.9	0.3	0.5	1.5	1.7	3.3
Employers' contributions to social security schemes	11.5	4.1	1.0	-0.2	1.2	2.8	1.8	2.6
Property and entrepreneurial income, net	22.8	-7.6	-0.8	3.6	1.4	3.9	4.7	-1.2
Taxes on production and imports minus subsidies	16.1	3.8	4.8	0.5	0.6	1.8	2.4	3.5
National income	100.0	0.9	1.1	1.0	0.8	2.2	2.5	2.1
Disposable income		1.0	0.7	1.1	0.8	2.3	2.6	2.1
Gross national income, EUR bn		200.8	203.5	205.0	206.3	211.5	217.6	

Table 12. Index of wage and salary earnings and labour costs per unit of output

	2012	2013	2014	2015**	2016**	2017**	On average 2014/2004
	change, %						
Index of negotiated wage rates	2.9	1.4	0.7	0.5	0.5	0.5	2.3
Wage drift, etc.	0.3	0.6	0.7	0.6	0.7	0.7	0.8
Index of wage and salary earnings	**3.2**	**2.1**	**1.4**	**1.1**	**1.2**	**1.2**	**3.2**
Real earnings[1)]	0.4	0.6	0.4	1.2	0.0	-0.2	1.3
Average earnings[2)]	3.3	1.6	1.3	1.1	1.1	1.3	3.1
Labour costs per unit of output[3)]							
whole economy	5.6	2.2	0.6	0.5	0.5	-0.2	2.7

[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)] Compensation of employees divided by gross value added in volume at basic prices.

In 2016 and 2017 national income growth will accelerate to over 2%. Improving economic activity will have the effect of increasing businesses' operating surplus over the outlook period. It is projected that employee earnings will continue to rise only moderately, but the recovery of the labour market and improving employment will boost employee compensation growth. Agreed increases to employers' social security contributions will also drive up employee compensations.

Employee compensations as a proportion of national income fell to 61% last year. This, however, remains a high proportion. In the wake of the financial crisis the functional distribution of income changed as a result of the increasing proportion of employee compensations, which is now at the same high level as after the 1990s recession. In the depth of recession in the 1990s, the proportion of employee compensation was as high as 74%. At the end of the outlook period the figure will drop back to 60%, so the functional distribution of income will change slightly. The share of taxes on production and imports net of subsidies will remain unchanged at its current level.

1.6.2 Wages and salaries

Nominal earnings, as measured by the index of wage and salary earnings, increased by 1.4% last year. Contractual wages increased by 0.7% and other factors pushed up the index of wage and salary earnings by 0.7%.

In 2015 earnings will develop in line with the framework agreement negotiated by the social partners in autumn 2013. The Pact for Employment and Growth will push up contractual wages by an average of 0.5%. It is estimated that the most recent settlement in June 2015 will increase contractual wages by an average of 0.5% in 2016.

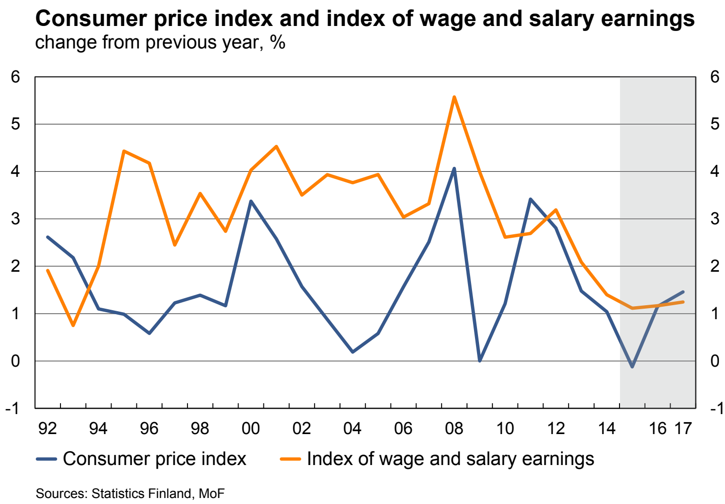
The forecast for the development of earnings is based on the assumption that the contribution of factors other than contractual wage increases will drive up earnings by over half a per cent a year. Therefore it is predicted that nominal earnings will rise by 1.1% in 2015. It is thought that earnings will continue to rise moderately at a rate of 1.2% in 2016 and 2017. This is clearly slower that the average rate of growth in the 2000s, which is well in line with the sluggish economy and employment trends.

1.6.3 Consumer prices

Consumer prices to fall temporarily

Inflation will be slower than usual over the outlook period, and inflationary pressures are low for several reasons. There is an abundance of idle resources in the economy since unemployment is high and business companies have substantial unused capacity. It follows that the output gap is still clearly negative. Consumers' inflation expectations are also fairly moderate. The forecast is based on assumptions of slight increases in import and oil prices, low interest rates, a slight deterioration in the euro exchange rate, and moderate pay rises.

Consumer prices will fall temporarily in 2015. Measured by the national consumer price index, prices will drop by 0.1%. Inflation came to a halt early in the year, and in January–June prices fell by 0.1%. This is the first time that consumer prices have fallen in Finland since 2009, in the wake of the international financial crisis. Consumer prices have decreased as a result of a sharp fall in the world market price of crude oil. Other factors have also contributed to the sluggish prices, but the single biggest reason early in the year has been the low price of oil. World market prices of oil and other raw materials have been falling in response to the fragility of global economic growth and declining demand from emerging economies. Although the euro has weakened against the dollar, the euro-denominated price of oil in June was more than 30% lower than last year. As a result the domestic consumer price of energy has fallen appreciably. Since June the world market price of oil has begun to fall again in response to the understanding reached in the Iranian nuclear negotiations, among other reasons, and there-



fore there will be no significant upward pressure on the price of energy for the remainder of the year. The forecast assumes that the average price of oil in 2015 will be 55 euros a barrel.

The low price of energy is not the only factor that has contributed to curb inflation. Prices of goods and foodstuffs have fallen early in the year in response to weak demand and lowered import prices. It is possible that second-round effects of falling oil prices have also contributed to this. Prices of foodstuffs have been falling since the beginning of the year as operators in the retailer sector have responded to stiffening market competition by reducing the prices of selected foodstuffs[1]. The only significant main category in the consumer price basket where prices have increased is that of services. Service prices have risen at a rate of almost 2% early in the year, a far more moderate increase than in earlier years. The slower growth is explained by moderate wage increases and weak consumer demand.

Inflationary pressures will remain lower than usual over the years ahead. Inflation will gradually pick up over the outlook period as economic growth gets back on track and the output gap narrows. The output gap will nonetheless remain wide and unemployment will fall only slowly, and therefore inflation will be slower than usual. The rate of inflation measured by the national consumer price index will edge up to no more than just over 1% next year with rising energy and service prices. Core inflation, on the other hand, which excludes the effect of energy and fresh food prices, will remain at less than 1%. In 2017 inflation will come in at 1.5%. The harmonised consumer price index[2] will rise somewhat more slowly towards the end of the outlook period as the slight increase in the interest rate is not directly reflected in the index.

1 For example the fall in dairy products prices alone reduced inflation in June by -0.1 percentage points.

2 The harmonised consumer price index has a narrower coverage than the national consumer price index. For example, it excludes interest rates and most costs of owner-occupied housing.

Table 13. Price indices

	2012	2013	2014	2015**	2016**	2017**	On average 2014/2004
	change, %						
Export prices[1]	1.1	-1.0	-0.7	-0.3	1.0	1.7	0.6
Import prices[1]	2.1	-1.4	-1.6	-0.9	1.0	1.6	1.7
Consumer price index	2.8	1.5	1.0	-0.1	1.1	1.5	1.9
Harmonised index of consumer prices	3.2	2.2	1.2	0.0	1.1	1.3	2.1
Basic price index for domestic supply	3.1	0.2	-1.3	-2.5	1.4	2.2	2.5
Building cost index	2.4	1.0	1.0	0.5	1.3	2.0	2.5

[1] As calculated in the National Accounts

In 2015 tax hikes will drive up prices. As in 2014, several indirect taxes (including the tobacco tax, electricity tax and annual vehicle tax) were raised at the beginning of the year. In 2015 it is predicted that indirect tax hikes will increase the national consumer price index by around 0.3 percentage points. In 2016 and 2017 changes to the car tax, annual vehicle tax and tobacco tax will increase the national consumer price index by an estimated 0.2 percentage points a year.

Prices have not been rising in the early part of the year in the euro area either. In recent months, however, the slide in prices has come to a halt and core inflation has reached almost one per cent. Among the major items in the euro area consumer price basket, only the price of energy has fallen, in contrast to Finland where a wider range of prices have dropped. The ECB forecast is that inflation will accelerate to 1.5% in 2016 and 1.8% in 2017. This means that the rate of price increases in Finland will be slower than in the euro area – for the first time in a long time. The price level of private consumption in Finland is the highest in the euro area.

2 Economic policy and public finances

2.1 General government finances

Persistent cyclical weakness coupled with long-term structural problems have driven Finland's general government finances into a state of permanent deficit in the current decade. In 2014 the deficit stood at EUR 7 billion, or 3.3% of GDP. The deficit will continue until the end of the decade, although substantial fiscal consolidation will help to reduce the amount of deficit. The general government budgetary position is constantly burdened by the growth of expenditure caused by population ageing. The public debt to GDP ratio will increase over the forecast horizon.

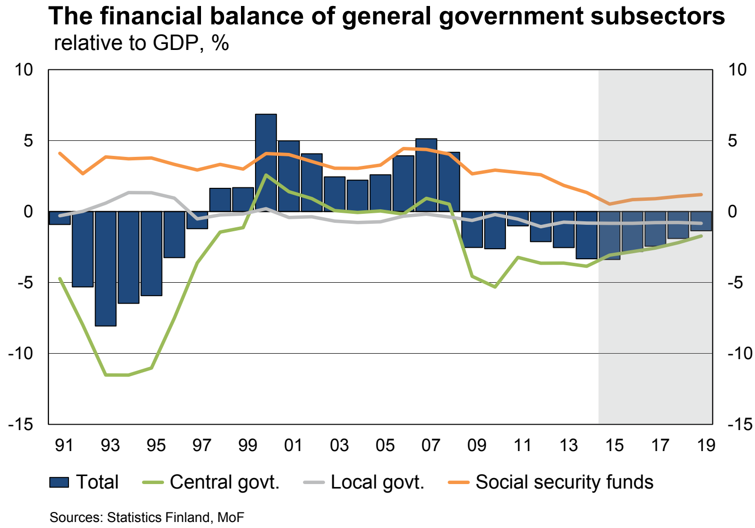
General government in Finland consists of central government, local government, and social security funds. The latter are further divided between earnings-related pension funds, which manage statutory earnings-related pension insurance, and other social security funds. The sector most exposed to cyclical fluctuations is central government, particularly because of the high cyclical sensitivity of tax revenue.

The central government deficit grew to almost EUR 8 billion last year. Central government tax revenue showed very slow growth. Expenditure was above all driven by transfers paid to other sectors. It is projected that the central government deficit will decrease moderately over the outlook period.

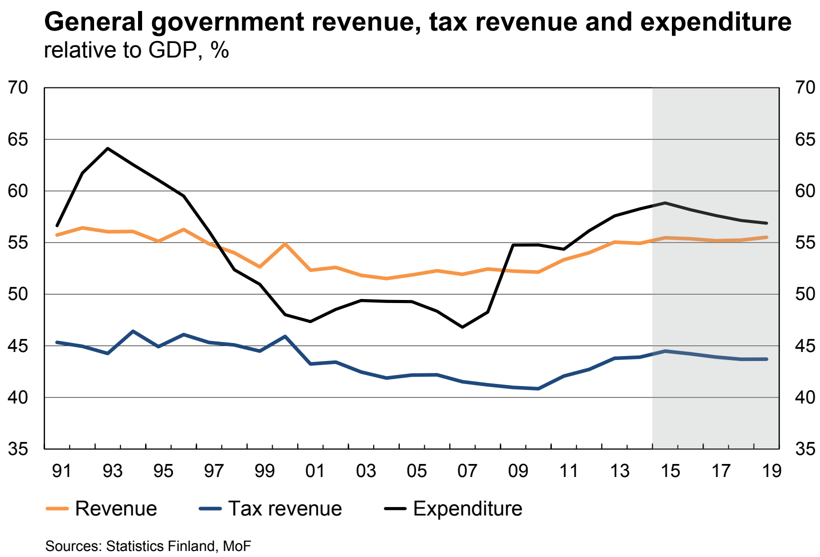
The local government deficit increased slightly in 2014. It is forecast that the local government deficit will remain at 0.8% of GDP throughout the outlook period. The adjustment measures outlined in the Government Programme will help to strengthen local government finances in the years ahead, but these measures – insofar as they have been elaborated and specified – will not yet be enough to meet the expenditure pressures from population ageing.

Rising pension expenditure and falling property income in response to low interest rates have reduced the surplus of earnings-related pension funds. That surplus is projected to stay at around one per cent over the outlook period. Other social security funds were driven into deficit last year due to increased unemployment expenditure. During the forecast horizon the position of other social security funds will be boosted by the unemployment insurance contribution hike and the slowly improving employment situation.

The expenditure rate has risen sharply in recent years. Not only unemployment and ageing-related expenditure, but also slow GDP growth are having an adverse effect on the pubic expenditure to GDP rate. Over the forecast period it is expected that the expenditure rate will fall slowly in response to the Government's adjustment efforts and the improving employment situation. In recent years tax hikes have driven up the tax rate, i.e. the ratio of taxes and tax-like levies to GDP. The tax rate is projected to remain more or less steadily at around 44% of GDP over the outlook period.



Finland's general government deficit exceeded the 3% reference value in 2014, and continues to exceed it this year. According to the Ministry of Finance September forecast the full implementation of the savings measures announced in the Government Programme will be enough to bring the deficit below the 3% in 2016. Therefore Finland meets the deficit criterion, as also concluded by the European Commission in June. Even though debt exceeds the 60% limit this year, and the debt criterion is not met from 2016 and onwards, the breach of the debt criterion alone will not yet lead to opening an excessive deficit procedure. Also the European Commission in June came to the conclusion that opening an EDP is not warranted based on the deficit nor the debt criterion.



Finland continues to be in the preventive arm of the Stability and Growth Pact. The medium-term objective (MTO) for general government finances in Finland is still a structural budget balance of −0.5% of GDP. Finland was broadly compliant with the preventive arm requirements in 2014. According to the forecast Finland will be broadly compliant with the preventive arm requirements also in 2015. In 2016 the deviation from the required adjustment towards the medium-term objective will, based on an overall assessment, not be significant. The possibility for a significant deviation cannot however be completely ruled out. The fulfilment of the EU fiscal rules is analysed in more detail in the box below.

Table 14. General government finances [1)]

	2012	2013	2014	2015**	2016**	2017**
	EUR billion					
Current taxes	31.2	32.9	33.8	34.8	34.8	35.7
Taxes on production and imports	28.1	29.3	29.5	29.6	30.2	30.6
Social security contributions	25.5	25.9	26.3	26.8	27.8	28.5
Taxes and contributions, total [2)]	85.4	88.8	90.1	91.8	93.6	95.6
Other revenue [3)]	23.1	23.5	23.1	23.3	24.3	25.3
of which interest receipts	2.5	2.5	2.2	2.0	2.1	2.4
Total revenue	**107.9**	**111.7**	**112.7**	**114.5**	**117.2**	**120.1**
Consumption expenditure	48.7	50.3	50.9	51.5	52.0	53.0
Subsidies	2.7	2.7	2.8	2.7	2.6	2.6
Social security benefits and allowances	36.1	38.4	40.3	41.8	42.8	43.8
Other current transfers	5.6	6.0	6.0	5.8	5.6	5.3
Subsidies and current transfers, total	44.4	47.1	49.1	50.4	51.0	51.7
Capital expenditure [4)]	8.6	8.9	9.1	9.1	9.3	9.7
Other expenditure	10.6	10.4	10.5	10.5	10.8	11.1
of which interest expenses	2.8	2.6	2.5	2.4	2.4	2.4
Total expenditure	**112.2**	**116.8**	**119.5**	**121.5**	**123.1**	**125.4**
Net lending (+) / net borrowing (-)	**-4.2**	**-5.1**	**-6.8**	**-7.0**	**-6.0**	**-5.3**
Central government	-7.3	-7.4	-7.9	-6.3	-6.0	-5.6
Local government	-2.1	-1.5	-1.7	-1.7	-1.8	-1.7
Employment pension schemes	4.8	3.7	3.4	2.1	2.3	2.3
Other social security funds	0.4	0.0	-0.7	-1.1	-0.5	-0.3
Primary balance [5)]	-3.8	-5.0	-6.4	-6.4	-5.6	-5.1

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.

Excessive Deficit Procedure still possible during outlook period

In spring 2015 it transpired that the 2014 general government deficit was considerably larger than expected and exceeded the 3% reference value set out in the Treaty.[1] In the spring it was predicted that the deficit would remain over the 3% threshold in the current year, and would not drop below that limit until 2018. The same forecast predicted that public debt would breach the 60% Treaty threshold in 2015 and that this could no longer be explained by other relevant factors (solidarity operations and cyclical situation) from 2016 onwards. For these reasons, under Article 126 (3) of the Treaty, the Commission prepared in May a report for Finland which concluded that the country does not comply with the deficit and debt criterion.[2]

Following the publication of the new Government's strategic programme in late May, the Commission undertook a new analysis of the Finnish situation. Based on its findings the Commission concluded that full implementation in 2016 of the savings measures announced in the Government Programme will be enough to bring the deficit sustainably below the 3% threshold.[3] The deficit criterion was thus considered to have been met, and therefore it was not considered necessary to open the Excessive Deficit Procedure. Compliance with the deficit and debt criterion will be reassessed in the light of this autumn's general government fiscal plan (Stability Programme).

The forecast by the Ministry of Finance Economics Department only takes into account those measures whose impact on public finances can be reliably assessed, i.e. on which specific and final information is available. Based on this forecast, the general government deficit will fall below the 3% threshold in 2016 and remain there. This means that Finland will be in compliance with the deficit criterion, as concluded by the Commission in June. Although the current forecast indicates that public debt will also exceed the 60% limit and that the debt criterion will be breached from 2016 onwards, this does not yet in itself trigger an EDP. In other words, Finland is still not faced with the opening of an EDP.

Finland remains under the preventive arm of the Stability and Growth Pact and is therefore subject to the relevant rules and requirements. The medium-term objective remains unchanged at a structural budget balance of –0.5% of GDP as set out in the spring 2013 stability programme. Adherence to the MTO is assessed based on the two-pillar structure, i.e. by reference to structural balance and the expenditure benchmark.

The Commission concluded that in 2014, Finland – as indeed all other states – was in compliance with the requirements of the preventive arm. This year, in line with the country-specific recommendations approved by the Council in July 2015, Finland is required to deliver a structural adjustment of 0.1% of GDP and in 2016 an adjustment of 0.5% of GDP towards the MTO. It is anticipated that from 2017 onwards, the requirement for annual adjustment will be increased to 0.6% of GDP.[4] If these requirements were met in full, the MTO would be achieved by 2018 at the latest.

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1 For more details on EU procedures and related terminology, see www.vm.fi

2 http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/126-03_commission/2015-05-13_fi_126-3_en.pdf

3 http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/20_scps/2015/26_fi_scp_addendum_en.pdf

4 The annual fiscal consolidation requirements are specified in the matrix included in the Commission's January Communication. These requirements are always frozen in the previous spring for the following year based on the Commission's forecast.

According to the forecast set out in Chapter 2 in this outlook, the change in structural balance in 2015 will be -0.1% of GDP, which means that there is some deviation but it is not significant. Because of negative growth in 2014, the cumulative deviation in 2014–2015 will also not be significant. The expenditure benchmark will be met both in 2015 and cumulatively 2014-15. Therefore, based on this forecast, Finland will be broadly compliant with the requirements of the preventive arm in 2015.

The Ministry's forecast for 2016 is that the structural balance will remain at the 2015 level, i.e. the deviation from the required adjustment path will be slightly below 0.5% of GDP. Either one year deviation or cumulative deviation over 2015-2016 may, if realised, be significant. However, the expenditure benchmark – both 2016 stand alone and cumulative will still be met. Since the structural deficit and the expenditure benchmark provide a contradictory picture of Finland's compliance with the requirements of the preventive arm, it will be subjected to an overall assessment. In the current economic situation it seems that the expenditure benchmark is a more reliable indicator of the current fiscal policy stance than structural balance.[5] Therefore, in the light of the current overall assessment, it does not seem that next year's deviation will be significant. Finland is furthermore looking to benefit from the structural reform clause and the investment clause in 2016.[6] However this assessment will be reviewed on an ongoing basis as updated information becomes available.

According to the forecast presented in Chapter 2, the MTO will not be reached in 2019. The achievement of the MTO requires that the unspecified or provisional measures outlined in the Government Programme, which are not taken into account in the forecast, are put in place in order to achieve the level of adjustment foreseen in the Government Programme.

Structural deficit, change in structural deficit and required adjustment

	2014	2015**	2016**	2017**
Structural deficit	-1.7	-1.8	-1.8	-1.9
Change in structural deficit	-0.7	-0.1	0.0	-0.1
Required adjustment	**0.0**	**0.1**	**0.5**	**0.6**
Deviation	**0.7**	**0.2**	**0.5**	**0.7**

5 It seems that the expenditure benchmark provides a more robust indicator than structural balance change under conditions of slow growth, low inflation and low interest rates.

6 Member States are called upon to notify in their stability programmes if they wish to activate the structural reform clause and the investment clause introduced by the Commission in January 2015. Since these clauses cannot be applied retrospectively, and given the uncertainties related to the calculation of the structural balance, Finland considers it worthwhile to take advantage of these clauses in 2016. Making use of the flexibility built into the structural reform clause is justified on grounds of the pension reform agreed upon by the social partners in autumn 2014, which has a verifiable effect on the long-term sustainability of public finances. Finland also meets the requirements specified for the application of the investment clause. Based on data for the 2007–2013 programming period, Finland's public sector contributions to jointly funded investment projects averaged around 0.1% of GDP per annum. Since the figure for domestic financing in 2016 is not yet known, this average can be used as a rough estimate of the deviation acceptable under the investment clause.

Table 15. Main economic indicators in general government

	2012	2013	2014	2015**	2016**	2017**
	% of GDP					
Taxes and social security contributions	42.7	43.8	43.9	44.5	44.2	43.9
General government expenditure [1]	56.1	57.6	58.3	58.8	58.2	57.6
Net lending	**-2.1**	**-2.5**	**-3.3**	**-3.4**	**-2.8**	**-2.4**
Central government	-3.6	-3.6	-3.9	-3.1	-2.8	-2.6
Local government	-1.1	-0.7	-0.8	-0.8	-0.8	-0.8
Employment pension institutions	2.4	1.8	1.7	1.0	1.1	1.1
Other social security funds	0.2	0.0	-0.3	-0.5	-0.3	-0.2
Primary balance [2]	-1.9	-2.5	-3.1	-3.1	-2.6	-2.4
General government debt	**52.9**	**55.6**	**59.3**	**62.6**	**64.3**	**65.8**
Central government debt	42.0	44.3	46.4	48.7	49.9	51.2
General government employment. 1000 person	630	633	627	624	620	617
Central government	139	142	138	135	133	132
Local government	480	480	478	478	476	475
Social security funds	11	11	11	11	11	11

[1] EU-harmonized definition.

[2] Net lending before net interest expenses.

Table 16. Fiscal balance and debt ratios in some EU economies

	2014	2015**	2016**	2014*	2015**	2016**
	Fiscal balance			Debt		
	% of GDP					
*Finland	-3.3	-3.4	-2.8	59.3	62.6	64.3
Finland	-3.2	-3.3	-3.2	59.3	62.6	64.8
United Kingdom	-5.7	-4.5	-3.1	89.4	89.9	90.1
Sweden	-1.9	-1.5	-1.0	43.9	44.2	43.4
Denmark	1.2	-1.5	-2.6	45.2	39.5	39.2
Ireland	-4.1	-2.8	-2.9	109.7	107.1	103.8
Spain	-5.8	-4.5	-3.5	97.7	100.4	101.4
Netherlands	-2.3	-1.7	-1.2	68.8	69.9	68.9
Luxembourg	0.6	0.0	0.3	23.6	24.9	25.3
Portugal	-4.5	-3.1	-2.8	130.2	124.4	123.0
Austria	-2.4	-2.0	-2.0	84.5	87.0	85.8
Germany	0.7	0.6	0.5	74.7	71.5	68.2
France	-4.0	-3.8	-3.5	95.0	96.4	97.0
Belgium	-3.2	-2.6	-2.4	106.5	106.5	106.4
Italy	-3.0	-2.6	-2.0	132.1	133.1	130.6
Greece	-3.5	-2.1	-2.2	177.1	180.2	173.5

Source: EU Commission forecast spring 2015; *Finland: Ministry of Finance, September 2015

2.1.1 Estimates of fiscal policy impact

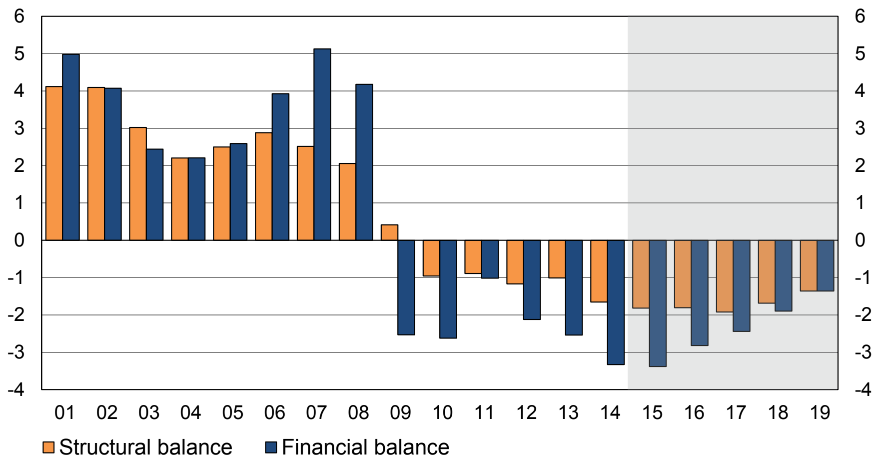
In 2015 the fiscal policy stance at general government level will be restrictive. The Government's adjustment measures will tighten central government fiscal policy by some EUR 3 billion. In 2015 it is projected that the tax rate will rise to 44.5% of GDP. The tax rate will fall moderately in 2016–2019 as the most important tax bases such as the wage bill and private consumption will increase more slowly than output. The expenditure rate will start slowly to fall in 2016 in response to savings measures and reduced cyclical expenditure.

The current fiscal policy stance can also be examined based on changes in the structural balance as assessed using the EU harmonised method. Structural balance is assessed by removing the cyclical effect from the public sector balance. The remainder describes the effect of the policy pursued and other than cyclical factors on the balance. Changes in the structural balance thus describe changes in the overall fiscal policy stance. A strengthening structural balance suggests fiscal consolidation, while a weakening structural balance suggests fiscal expansion.

An examination of the fiscal policy stance via changes in the structural balance does not give the exact same picture as an examination derived from individual revenue and expenditure measures. It is forecast that the structural balance will remain almost at the same level as last year. In contrast to the conclusion suggested by an examination of individual measures, the structural balance will remain more or less constant in 2015–2017 and improve moderately in 2018–2019.

The difference between the fiscal policy stance as measured on the basis of changes in the structural balance and the combined effect of individual fiscal policy measures is explained by several factors that are mainly related to the measurement of the structural balance. For instance, increasing age-related expenditure contributes to increase the structural deficit even in the absence of any decisions to increase expenditure.

General government financial balance and cyclically adjusted balance[1)]
relative to GDP, %



1) Based on the European Commission's production function approach

Sources: Statistics Finland, MoF

2.1.2 General government debt

General government debt increased by EUR 9 billion last year. In six years, general government debt has almost doubled. At the same time, total output growth has been relatively weak, and therefore the debt to GDP ratio has also almost doubled. In 2015 the debt ratio will breach the EU's 60% limit, and there is no turnaround in sight.

The general government debt forecast is based on central government's budgeted net borrowing needs and on the central government debt forecast derived from those figures. Central government on-budget debt accounts for around four-fifths of total general government debt. In addition, the forecast takes into account the debt accrued by off-budget entities that in the national accounts are included in central government. The general government debt figure is also impacted by local government deficits and the need for borrowing derived from those deficits. Social security funds have so far had no debt at all, but last year the Unemployment Insurance Fund was forced to borrow to cover the costs of increased outlays on unemployment benefits, and borrowing will continue in 2015.

General government debt also includes some other items, such as loans granted by the European Financial Stability Facility (EFSF) to recipient countries, security deposits related to government derivative contracts, debts related to PPP and life cycle projects, the capital assets of the State Nuclear Waste Management Fund and coins in circulation. Internal general government debt is consolidated out of the measure of public debt. The biggest single internal general government debt item are investments by earnings-related pension funds in government debt securities.

In 2014 general government debt to GDP increased by 3.7 percentage points. The table below details the factors contributing to the change in the general government debt ratio. The purpose of the table is to clarify the relationship between the general government budgetary position and debt ratio change in the national accounts. A plus sign indicates that the factor has the effect of increasing the debt ratio, a minus sign that it decreases the debt ratio.

Table 17. Change in general government debt ratio and related factors

	2013	2014	2015**	2016**	2017**	2018**	2019**
Debt ratio. % of GDP[1]	55.6	59.3	62.6	64.3	65.8	66.4	66.6
Change in debt ratio	2.7	3.7	3.3	1.7	1.5	0.6	0.2
Factors impacting change in debt ratio							
Primary budgetary position	1.3	2.1	2.2	1.7	1.3	0.8	0.1
Interest expenditure	1.3	1.2	1.2	1.1	1.1	1.1	1.2
Change in GDP volume	0.6	0.2	-0.1	-0.8	-0.9	-0.8	-0.8
Change in GDP price	-1.5	-1.0	-0.3	-0.8	-1.0	-1.2	-1.3
Acquisition of financial assets (net)	1.8	1.7	1.0	1.1	1.1	1.1	1.0
Other factors 1[1]	-0.8	-0.5	-0.8	-0.7	-0.1	-0.3	-0.1

[1] Includes privatization proceeds. lending and factors related to the valuation and timing of revenue and expenditure.

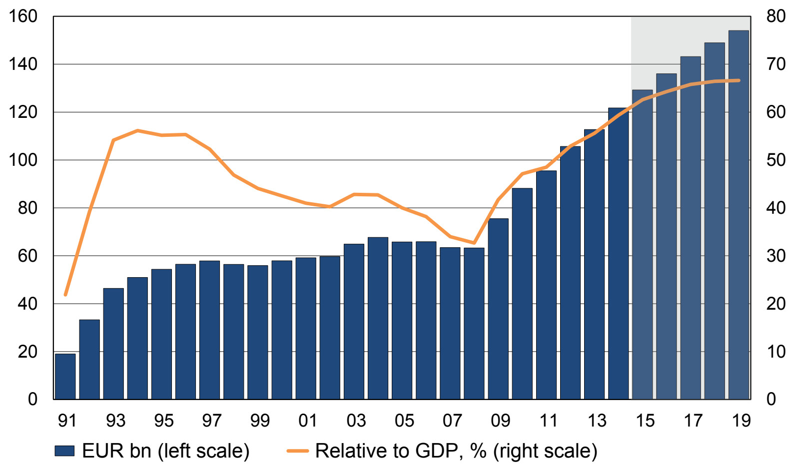
Plus indicates increasing effect on debt ratio. minus a lowering effect on debt ratio.

The general government primary balance (revenue minus expenditure, excluding interest payments) showed a deficit last year, driving the growth of debt by 2.1 percentage points. Interest payments accounted for 1.2 percentage points of the increase in the debt ratio. When the level of debt is compared with GDP, GDP growth has the effect of lowering the debt ratio. In 2013 the fall in GDP volume slightly increased the debt ratio, but the GDP price change lowered it by 1.0 percentage points.

Earnings-related pension funds, which come under the definition of general government, are in surplus. In 2014 that surplus was 1.7% of GDP ('Acquisition of financial assets (net)'). Since the surplus of earnings-related pension funds is included in the primary budgetary position of general government, but it is not used to pay off general government debt, this surplus must be excluded from the range of factors impacting the change of debt ratio.

In addition to these factors, central government lending and factors related to the valuation and timing of revenue and expenditure decreased the general government debt ratio by 0.5 percentage points in 2014.

General government debt



Sources: Statistics Finland, MoF

2.2 Central government

Central government has been in substantial deficit since 2009. In 2014 the national accounts deficit grew to almost EUR 8 billion. Revenue increased by no more than 1%, at the same time as expenditure growth was faster. Expenditure was increased most by transfers paid to other sectors.

In 2015 GDP growth is forecst to show growth of 0.2%. Sluggish tax base growth offers no support for tax revenue growth. At the same time, the growth of unemployment is driving up unemployment-related expenditure. However, the expenditure adjustments introduced by previous governments will reduce the central government's deficit considerably. A one-off transfer of EUR 500 million from the State Pension Fund will also contribute to narrow the deficit.

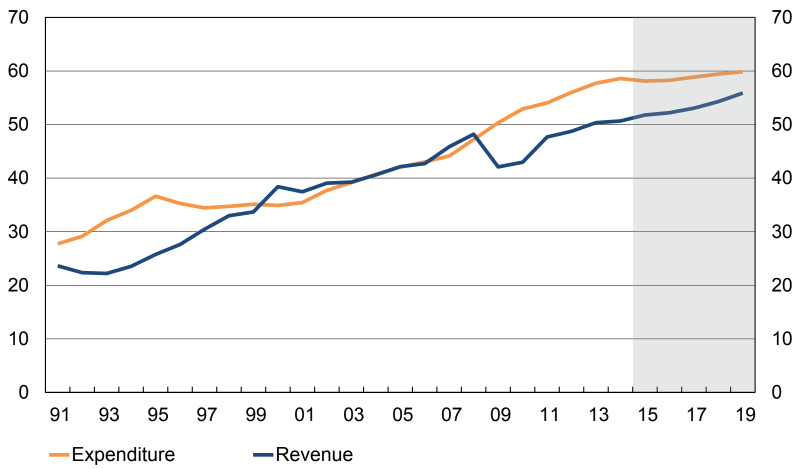
In 2016 the deficit will continue to shrink as steps are taken to implement the adjustment measures announced by the Government of Prime Minister Juha Sipilä. Tax revenue growth will also be driven by the gradual economic rebound.

In the medium term expenditure will grow at a historically very moderate rate. Expenditure growth will be curbed above all by fiscal consolidation. At the same time, revenue will remain on a fairly steady growth track. Despite the fiscal consolidation, central government finances will remain quite weak, and in 2019 it is expected that central government will show a deficit of almost EUR 4 billion.

At year-end 2014 state debt stood at EUR 95 billion. As budgets will continue to run deficits over the forecast horizon, central government debt will continue to increase. It is projected that over the outlook period, central government debt will increase by around EUR 25 billion. However, the growth of debt to GDP ratio will slow by 2019.

State guarantees are not an expenditure item and do not show up in the State Budget or in the national accounts. The amount of government-issued guarantees has increased rapidly in recent years. At the end of Q2 2015, the stock of state loan guarantees stood at EUR 43 billion.

Central government revenue and expenditure
EUR bn



Sources: Statistics Finland, MoF

Table 18. Central government [1)]

	2012	2013	2014	2015**	2016**	2017**
	EUR billion					
Current taxes	11,8	12,2	12,6	13,0	13,2	13,6
Taxes on production and imports	28,1	29,3	29,5	29,6	30,2	30,6
Taxes and contributions, total [2)]	40,5	42,2	42,6	43,3	44,1	45,0
Other revenue [3)]	8,5	8,7	8,6	9,1	8,9	9,0
of which interest receipts	0,5	0,4	0,4	0,3	0,3	0,4
Total revenue	**49,0**	**50,8**	**51,2**	**52,4**	**53,0**	**54,0**
Consumption expenditure	12,9	13,7	13,8	13,8	14,0	14,3
Subsidies and current transfers, total	36,1	37,5	38,1	37,9	37,9	38,1
to general government	24,5	25,5	25,9	25,8	26,2	26,6
Interest expenses	2,7	2,4	2,5	2,4	2,3	2,3
Capital expenditure [4)]	4,6	4,5	4,8	4,7	4,8	5,1
Total expenditure	**56,3**	**58,2**	**59,1**	**58,7**	**59,1**	**59,8**
Net lending (+) / net net borrowing (-)	**-7,3**	**-7,4**	**-7,9**	**-6,3**	**-6,1**	**-5,8**
Primary balance[5)]	-5,1	-5,4	-5,8	-4,3	-4,1	-3,8

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.

2.2.1 Central government expenditure

Central government's national accounts expenditure increased 1.5% last year, or by some EUR 0.9 billion. In recent years the ratio of central government expenditure to GDP has been around 28%. In the past 10 years nominal total expenditure has increased by EUR 18 billion, or 44%.

Given the fiscal adjustment efforts of the previous and the current government, it is projected that central government expenditure will show fairly slow growth in the current year and over the medium term. This year's adjustment on the expenditure side of the budget is greater than last year, and total expenditure is expected to fall for the first time since 2000. There will be very limited expenditure growth over the parliamentary term, and the expenditure to GDP ratio will fall by a couple of percentage points. Apart from the austerity measures put in place, expenditure growth will be constrained by reduced price changes to on-budget spending limits expenditure.

Current transfers account for over one-half of total central government expenditure. Amounting to EUR 31 billion, these transfers go predominantly to the local government sector and social security funds, but they also include transfers to non-profits, fees paid to the EU, and development aid to foreign countries. Almost one-quarter of total expenditure, EUR 14 billion goes to consumption, i.e. labour costs and acquisitions of production inputs. Other major expenditure items include subsidies paid and property and investment expenditure.

Interest expenses have long remained rather moderate because of low interest rates and the country's strong credit rating, even though central government debt has risen appreciably for seven years in a row. In 2014 national accounts interest expenses amounted to 4.2% of total expenditure, compared with the peak figure of over 16% in 1997. In the medium term central government debt will continue to rise year on year, and by the end of the parliamentary term it is projected that interest outlays will increase more noticeably as interest rates gradually move higher.

2016 State Budget and Central Government Spending Limits

The 2016 budget proposal is based on the April 2015 technical spending limits decision and on the May 2015 programme of Prime Minister Sipilä's Government. Central government on-budget expenditure in 2016 will be around EUR 54.1 billion. Expenditure will be around EUR 0.3 billion lower than budgeted for 2015 (including supplementary budget proposals). The budget proposal takes into account the expenditure savings and increased revenues from fees and payments set out in the Government Programme, which together have a net effect of around EUR 0.8 billion on the State Budget in 2016. On the other hand, investments in key projects identified by the Government for the parliamentary term will drive up the expenditure level by some EUR 0.3 billion. Other factors that will contribute to increase expenditure from 2015 include the increased costs attributable to asylum seekers, the additional expenditure resulting from the revised distribution of costs between central and local government, the growth of central government pension expenditure, and increased Defence Forces materiel acquisitions due to timing changes and additional investments. Interest outlays on central government debt total around EUR 1.6 billion, which is roughly the same than in 2015.

In 2016 it is estimated that on-budget revenue (excluding borrowing) will reach around EUR 49.1 billion and tax revenue around EUR 40.8 billion. On-budget revenue will be around approximately the same than budgeted for 2015 (including supplementary budget proposals). The revenue projections include the tax base changes announced by the Government of Prime Minister Juha Sipilä, which are aimed at strengthening growth, entrepreneurship and employment. In line with the commitments set out in the Government Programme, the focus of taxation will be shifted from taxing labour and entrepreneurship towards environmentally and health motivated taxation. The income tax rates for low and middle income earners will be reduced by increasing the earned income deduction. The tobacco tax, waste tax, and taxes on heating, power plant and machinery fuels will be raised. During the planning period the earned income tax scale will be revised annually to reflect rising earnings levels and/or inflation. The annual vehicle tax will be increased, and a new annual tax will be introduced on registered boats and motor vehicles. The motor car tax will be reduced. The list of new tax changes proposed by the Government will reduce on-budget revenue by a net total of EUR 0.1 billion in 2016.

Central government on-budget revenue, expenditure and balance, EUR billion

	2015 3rd supplementary budget proposal	2016 budget proposal	2017**	2018**	2019**
Revenue	49.1	49.1	49.4	50.8	51.7
Expenditure	54.4	54.1	55.2	55.7	55.7
Balance	**-5.3**	**-5.0**	**-5.9**	**-4.9**	**-4.0**

Spending limits for 2016–2019

The new Government will persist with the central government spending limits system. The expenditure rule ensures adherence to a responsible and long-term spending policy that promotes stability in central government finances. The spending limits system covers some 80% of total budgeted expenditure. Items excluded from the spending limits system include expenditure that fluctuates with economic cycles as well as automatic fiscal stabilisers such as unemployment security expenditure, pay guarantee, housing allowances, and the central government contribution to the cost of basic social assistance. However the expenditure effects resulting from changes to the criteria for these items are included in the spending limits. Also excluded from the spending limits are interest payments on central government debt, VAT expenditure, financial investment expenditure and expenditure corresponding to technically transmitted payments and external funding contributions.

Attached to the Government Programme is an Annex that details the spending limits rule for on-budget expenditure throughout the parliamentary period. The Government has approved the real expenditure ceiling for central government in 2016–2019 in its General Government Fiscal Plan dated 28 September 2015. The expenditure ceiling for the parliamentary term is based on the technical spending limits adopted by the previous government on 2 April 2015. Compared with these spending limits level, central government expenditure will be reduced by around EUR 1.3 billion at an annual level in 2019. The central government expenditure ceiling take into account the expenditure savings adopted in the spending limits decisions taken during the electoral term.

Compared with the spring 2015 technical spending limits decision, on-budget expenditure decrease some EUR 0.3 billion in 2016, increase some EUR 0.1–0.3 billion in 2017–2018 and decrease some EUR 0.4 billion in 2019. Expenditure savings announced by the Government lower the spending level. On the other hand, investments in key projects increase expenditure in 2016–2018, and in addition e.g. cyclical expenditure and compensation paid to local governments for tax revenue losses have increased. During the spending limits period 2016–2019, administrative branch expenditure will decrease in real terms on average by some 0.1% a year when structural changes are taken into account. In nominal terms, administrative branch expenditure will increase on average by some 0.6% a year.

Over the spending limits period, on-budget revenue is expected to increase by an average of slightly less than 1½% a year. It is estimated that tax revenue will increase by an annual average of 2½%.Central government on-budget revenue estimates are based on medium-term projections for the development of the economy. Projected economic growth will be modest over the medium term. and therefore tax base growth will also be slow. Figures for projected on-budget revenue in 2016–2018 are higher than in the spring 2015 technical spending limits decision. Figures for 2019 are lower than projected in spring 2015.The deteriorating economic outlook has attributed negatively to the revenue estimation. The investments in key projects identified by the Government will be largely financed by dividend income and selling state property which contribute positively to the revenue forecast for 2016–2018.

Factors impacting change in central government on-budget balance compared with 2015 General Government Fiscal Plan / Spending Limits Decision, EUR billion

	2016**	2017**	2018**	2019**
Estimated balance, General Government Fiscal Plan, 2 April 2015	**-6.0**	**-6.2**	**-5.6**	**-5.3**
Net savings and increases in central government expenditure in Government Programme (Annex 6), excl. financial investments	0.7	1.0	1.2	1.5
Government investment in key projects, excl. financial investments	-0.3	-0.6	-0.5	0.0
Change in financial investment expenditure (e.g. development assistance loans, key projects)	-0.2	-0.2	-0.3	-0.2
Central government transfers to offset losses in local government tax revenue	-0.2	-0.3	-0.3	-0.3
Increase in cyclical expenditure	0.0	0.0	-0.2	-0.2
Change in projected interest payments on central government debt	0.0	0.0	-0.1	-0.3
Other change (net), e.g. downward revision of expenditure price adjustments with freezing of indexations	0.1	-0.2	0.2	1.0
New tax base changes (net, incl. adjustment of earned income taxation to wage level increase 2016)	-0.1	-0.2	-0.4	0.0
Changes to miscellaneous revenue and interest and dividend revenue estimates (incl. central government payments etc. included in the Government Programme and financing of key projects)	0.8	0.4	0.8	0.2
Other factors impacting revenue estimate (incl. accrual data and new cyclical forecast)	0.0	-0.1	-0.2	-0.4
CHANGE TOTAL	**1.0**	**0.3**	**0.7**	**1.3**
Estimated balance, budget proposal 2016 and General Government Fiscal Plan 2016–2019, 28 September 2015	**-5.0**	**-5.9**	**-4.9**	**-4.0**

2.2.2 Central government revenues

The development of tax revenue depends largely on the overall performance of the economy and the structure of economic growth. Tax accrual and the structure of taxation is also affected by government decision-making. Taxes are the largest source of central government revenue. The most significant tax revenue items are taxes on earned and capital income paid by households, value added tax and corporate income tax.

The economy has shown no growth for three years. Nonetheless tax revenue has on average grown quite reasonably. This growth has been bolstered by several tax base changes. The most significant tax changes have been in the form of indirect tax hikes. The single most significant tax base change last year was the lowering of the corporate income tax rate, which reduced corporate income tax revenue.

The performance of the economy will remain weak in 2015, and tax revenue will increase only marginally. Several tax base changes that were decided by the previous government and that mainly affected indirect taxes, took effect from the beginning of the year. It is estimated that national accounts tax revenue will increase by 1½% this year.

In 2016 many tax bases will increase more rapidly than this year, although historically the growth of tax bases will still remain muted. The net effect of tax base changes will ease the overall tax burden next year. The biggest of these changes will be the increased earned income tax credit.

Tax revenue growth will gradually pick up pace over the medium term. This is explained in part by accelerating economic growth and tax base changes.

Other major sources of central government revenue include property income and transfers from the State Pension Fund. However, these sources account for a much smaller proportion of total revenue than taxes.

Transfers from the State Pension Fund cover 40% of central government's annual pension expenditure. Based on decisions taken by previous governments, a one-off transfer of EUR 500 million will be made from the State Pension Fund to the central government budget. It is estimated that central government property income will fall this year as a result of reduced interest and dividend revenue.

Table 19. Forecasts for certain revenue and demand items impacting taxable income and the tax base in 2013-2019. annual change

	2013	2014	2015**	2016**	2019/2015**
	change. % per year				
Taxable earned income and capital income	3.1	2.3	2.2	1.8	2
Wage and salary earnings and other income	0.8	0.8	0.5	1.5	2
Pensions and other social security benefits	6.6	4.9	4.3	1.9	2 1/2
Capital income	12.6	2.2	8.3	2.6	2 1/2
Index of wage and salary earnings	2.2	1.4	1.1	1.2	1 1/2
Operating surplus	0.2	6.1	1.2	3.4	4
Value of household consumption expenditure	-0.4	0.3	0.0	1.4	2
VAT base	0.7	0.1	0.1	1.8	2 1/2
Petrol consumption	-2	-2.5	-1 1/2	-1 1/2	-1 1/2
Diesel consumption	-0.8	-1.2	1 1/2	1 1/2	1
Electricity consumption	2.6	-1 1/4	1	1 1/2	1 3/8
Duty-paid alcohol consumption	-4.3	0	-3 1/2	-1	-1
New passenger cars	-7.2	0.8	2.9	1.9	2
Consumer price index	1.5	1.0	-0.1	1.1	1 1/2

Taxes on earned and capital income

Revenue from earned and capital income taxes consists of receipts from progressive income tax, slightly progressive capital income tax and withholding tax paid by people with limited tax liability. The most significant source of revenue is earned income tax. Almost 70% of the earned income tax base consists of wage and salary earnings, over 25% of taxable social benefits and less than 5% of other revenue, such as earnings from shared business income. Central government is the only beneficiary of capital income tax revenue, whereas revenue from earned income taxes is divided between central government, local governments and parishes.

In 2015 wage income and other taxable earned income will show very slow growth, but capital income will increase moderately. There will be no significant changes this year to central government earned income or capital income taxes.

In 2016 an increase in the earned income tax credit will reduce taxes on labour. Furthermore, tax scales for earned income will be adjusted to reflect changes in the index of wage and salary earnings. Coupled with very slow growth in the earned income and capital income tax bases, this means that tax revenue will not increase at all.

Over the medium term, revenue from earned income and capital income tax is projected to increase by around 3% a year. Employment will improve slowly, and the growth of wage and salary income will accelerate. Furthermore, pension income will increase with the growing number of pensioners. The technical background assumption in the earned income and capital income tax forecast for 2017–2019 is that index adjustments will be carried out annually to ensure that the tax burden on labour does not increase as a result of higher earnings or rising consumer prices.

Table 20. Impact of change in selected tax base items on tax revenue

Tax category	Tax base / Demand item	Change	Change in tax revenue, EUR million
Taxes on earned income	Wage and salary earnings	1-pp	378 of which central govt. 128 and local govt. 169
	Pension incomes	1-pp	117, of which central govt. 30and local govt. 76
Capital income tax	Investment income	1-pp	32
Corporate tax	Operating surplus	1-pp	40, of which central govt. 28 and local govt. 12
VAT	Value of private consumption	1-pp	118
Car tax	Sales of new cars	thousands	7
Energy tax	Electricity consumption	1%	10
	Petrol consumption	1%	13
	Diesel consumption	1%	14
Duty on alcoholic beverages	Alcohol consumption	1%	14
Duty on cigarettes	Cigarette consumption	1%	7

Corporate income tax

Businesses pay corporate income tax on their profits. From the beginning of 2016, revenue from the tax is shared between central government and local government only. The share formerly allocated to parishes will be replaced by an indexed appropriation. During the previous governments' term in office the corporate income tax rate has been lowered in total by 6 percentage points, which has significantly reduced revenue from corporate income tax.

In 2015 revenue from corporate income tax will be reasonably strong despite the sluggish economy. It is thought that this is due to the rapid growth of corporations' 2014 taxable income and the consequent supplementary prepayments on that income that were mostly made in 2015. Based on preliminary data it seems that another contributing factor may be one-off payments, which may have to do with the reduction of the corporate income tax rate from the beginning of 2014. The tax base changes affecting 2015 corporate income tax revenue had the effect of depressing tax revenue. The most important of these were the extension of the increased deductions on production-related investments in 2015–2016 and the reinstatement of deductions for corporate entertainment expenses.

In 2016 the operating surplus will again show faster growth, which will increase corporate income tax revenue. Furthermore, revenue from corporate income tax will increase more rapidly than payments, above all because of the expiry in 2016 of the temporary increase in the share of corporate tax revenue paid to local governments and parishes, and the transfer of parishes' share of corporate tax revenue to central government.

In 2017–2019 it is expected that corporate income tax revenue will increase in line with the operating surplus, growing on average by some 4% a year. Tax revenue will grow slightly faster than the operating surplus because of the discontinuation of the increased deductions on production-related investments at year-end 2016.

Indirect taxes

The tax hikes announced by the Government of Prime Minister Juha Sipilä are predominantly increases to indirect taxes. Indirect taxes have also been increased under previous governments in recent years.

There have been a number of changes to car taxation. The tax credit for taxis was halved and the tax credit for cars imported into Finland as removal goods was discontinued from the beginning of this year. In addition, the Government has decided to gradually ease the taxation of cars through to 2019. Overall tax revenue will be affected not only by lowered car taxes, but also by sluggish household consumption growth and falling CO2 emissions in new cars.

The vehicle tax is a time-based tax that is levied on an ongoing basis in 12-month periods on passenger cars, vans and heavy goods vehicles. Revenue from the vehicle tax is relatively stable. The vehicle tax will be increased in 2017. In addition, a new annual tax will be introduced on registered boats and motor vehicles.

The single most important source of indirect tax revenue is VAT. The value of private consumption will show very moderate growth over the forecast horizon, which will curb VAT revenue. On average it is projected that national accounts VAT revenue will increase by around 2.5% in 2016–2019. Two tax base changes will be introduced to the levying of VAT during the outlook period, which will result in one-off postponements of tax remittance dates to the following year. These changes are, firstly, that small businesses will be given the option in 2017 to pay their VAT returns on a cash basis, and secondly, that the administration of VAT on imports will be taken over from Customs by Finnish Tax Administration in 2018.

Energy taxes have been significantly increased in recent years. Tax base changes introduced from the beginning of the year include the increase to the CO2 tax on fossil heating, power plant and machinery fuels, the removal of the mining industry from the lower electricity tax band, and the cancellation of the tax credit for natural gas. Furthermore, the peat tax was lowered and electricity tax raised. Tax base changes will drive up energy taxes considerably during the current year. The waste tax and the CO2 tax on fossil heating, power plant and machinery fuels will be raised from the beginning of next year.

Revenue from other excise duties is usually highly stable, unless tax base changes are introduced. The tobacco tax was again increased from the beginning of the year; the previous tax hike was at the start of 2014. The tobacco tax will be gradually increased from the beginning of 2016 through to 2019.

Table 21. Central government on-budget revenue: estimates for 2012-2018. EUR billion

	2014 provisional financial accounts	2015 budget incl. supplementary budget proposal	2016**	2017**	2018**	2019**	2015/2019** annual change. %
Total tax revenue estimates	39.3	39.9	40.8	41.5	42.4	43.9	2
Income and wealth taxes [1]	12.3	12.6	12.9	13.3	13.7	14.4	3
Taxes based on turnover	17.5	17.6	17.8	18.0	18.4	19.2	2
Excise duties	6.6	6.9	7.1	7.1	7.2	7.2	2
Other taxes	2.9	2.8	3.0	3.1	3.1	3.1	1
Miscellaneous revenue	5.2	6.0	5.3	5.3	5.4	5.5	1 1/2
Interest income and profit entered as income	2.6	2.8	2.5	2.1	2.6	2.0	-4
Total revenue estimates	**47.7**	**49.1**	**49.1**	**49.4**	**50.8**	**51.7**	**2**

[1] Incl. YLEtax from 2013 onwards (on average 500 EUR million per year).

Table 22. Impact of discretionary tax measures on general government tax revenue

	2014	2015	2016**	2017**	2018**	2019**
	EUR million					
Earned income taxes	-5	-184	-507	-309	-137	-212
Average increase in municipal tax rate	350	101	0	0	0	0
Investment income tax	57	100	51	11	0	0
Corporate tax	-935	-85	122	63	-8	0
Other direct taxes	141	-122	25	9	-64	-40
Value-added tax	155	21	0	-149	-200	0
Energy taxes	151	267	103	28	-12	49
Other indirect taxes	222	156	119	113	68	68
Social security contributions	621	375	706	209	-5	5

2.2.3 On-budget accounts and national accounts

In 2014 the central government on-budget deficit stood at EUR 6.6. billion. The corresponding deficit in the national accounts was EUR 7.9 billion. In 2010–2013, the national accounts deficit was smaller than the on-budget deficit. The on-budget balance may differ quite substantially from the financial position described on a national accounts basis, and the difference may be in different directions in different years.

Perhaps the single most significant difference between the on-budget net financing requirement and national accounts net lending comes from financial investments. Financial investments such as central government loans and share purchases are entered in the State Budget as expenditures. Loan repayments, revenue from share sales, etc., are accordingly entered on the revenue side. In the national accounts, these items are entered as financial transactions, which do not affect central government's fiscal balance as measured by net borrowing. Various capitalisations in particular can often be subject to difficult interpretation. Some capitalisations are paid capital transfers, which adversely affect the national accounts financial position, while others are regarded as financial investments, which have no effect on national accounts balance.

National accounts interest outlays in 2014 were EUR 0.7 billion higher than on-budget interest outlays, which is mainly due to the fact that national accounts interest payments do not include the downward effect on interests of derivative instruments (swaps and futures), in contrast to the on-budget figures. By using derivatives, the Treasury has managed to achieve quite a significant reduction in the level of real interest payments from the State Budget. In the national accounts, derivative contracts are recorded as financial transactions, which have no effect on financial position.

The concept of state in the national accounts comprises not only on-budget entities, but also extra-budgetary funds (excluding the State Pension Fund), universities, property companies, the Finnish Broadcasting Company YLE, VTT Technical Research Centre, and Solidium.

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 entered on the basis of their use. The net effect of deferrable appropriations can vary widely from year to year.

All EU countries are required to report twice a year to Eurostat on the differences between their on-budget and national accounts figures in connection with their deficit and debt reporting. The next round of reports is due at the end of September. These reports describe the differences between on-budget accounting and national accounts not only for central government, but also for other general government sectors. Finland's figures will probably attract much interest since the country has breached the deficit limit and it is about to breach the debt limit.

Table 23. On-budget balance and central government net lending[1)]

	2013	2014	2015**	2016**	2017**
	EUR billion				
On-budget surplus (+)/deficitT (-) [2)]	**-8.4**	**-6.6**	**-5.3**	**-5.0**	**-5.9**
Privatization proceeds (net proceeds from equity sales)	0.1	-0.1	-1.2	-0.9	-0.5
Financial investment, net	0.3	-0.7	-0.1	-0.7	-0.6
Rvenue surplus in off-budget units	-0.6	-1.1	-0.2	-0.2	-0.2
Cash/accrual basis adjustment	0.1	0.4	0.0	0.0	0.0
Other adjustment items [3)]	1.2	0.1	0.4	0.8	1.6
Central government net lending (+) /-borrowing (-)	**-7.4**	**-7.9**	**-6.3**	**-6.0**	**-5.6**

1) In national accounts terms.

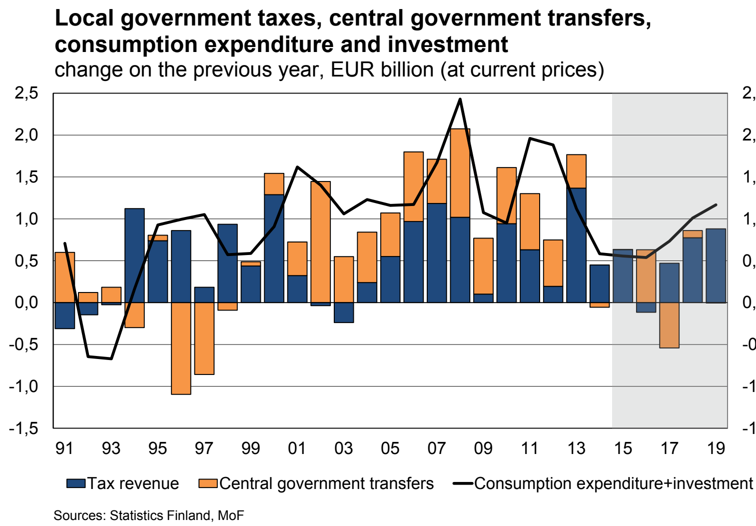
2) Incl. government debt servicing.

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

2.3 Local government

In 2014 the local government deficit to GDP ratio, as measured in the national accounts, came in at 0.8%, increasing slightly from the year before. Annual consumption expenditure growth was very low compared with the figures for the past two decades. Consumption expenditure growth was slowed by active municipal adjustment efforts and very slowly rising costs. Tax revenue growth remained reasonable in view of the cyclical situation, thanks to increases to the municipal tax rate and the real estate tax rate. However, the financial position of local government was adversely affected by cuts to central government transfers as part of fiscal consolidation. Investment continued to grow, but much more slowly than in earlier years.

In 2015 the local government deficit will remain unchanged at the same level as last year. Costs will continue to increase very moderately and therefore consumption expenditure growth will remain slow. Municipalities will also continue their own adjustment efforts, but it is estimated that they will be making somewhat less savings than last year. The average municipal tax rate rose by 0.1 percentage point at the start of the year to 19.84%. Several municipalities also put up their real estate tax rates. However, the increase in real estate tax revenue as a result of the statutory increases to the lower and upper tax rate limits will not contribute to strengthen local government finances, since it will be deducted from the transfers received from central government. The net effect of central government measures impacting local government finances is negative. The measure with the greatest impact on local government finances is the reduction of central government transfers by some EUR 190 million as part of fiscal consolidation.



Local government debt continues to grow

Local government finances will remain firmly in deficit in the years ahead. By 2019, local government debt will exceed EUR 25 billion. The 2016–2019 outlook is based on a pressure projection that only considers such specified and agreed measures that are included in the general government fiscal plan. The assessment does not take account of municipalities' and joint municipal authorities' adjustment measures for 2016–2019. The municipal tax rates are held constant at 2015 level.

Local government tax revenue will increase moderately in 2016–2019. The expiry of the temporary increase in the share of corporate income tax revenue will reduce local government tax revenue in 2016. However, local government tax revenue will increase again towards the end of the forecast horizon with the improving employment situation. The forecast takes into account the increase to the real estate tax rate as set out in the Government Programme (EUR 100 billion at an annual level in 2019).

Central government transfers to local government will increase in 2016 with the statutory revision of the distribution of costs between central and local government, in which basic prices and finances are adjusted to reflect true costs. On the other hand, the amount of transfers received from central government will decrease in 2017 as the Social Insurance Institution Kela takes over the payment of basic income support. This will have hardly any impact on local government net lending, since the social benefits paid out by local authorities will decrease accordingly.

The Government Programme's adjustment measures concerning the local government sector will contribute to slow the growth of local government consumption expenditure in 2016–2019. The measures taken into account in the forecast will strengthen local government finances in total by almost EUR 500 million at an annual level in 2019. Many of the direct adjustment measures outlined in the Government Programme have taken a concrete enough shape for them to be taken into account in the forecast for local government finances. Meas-

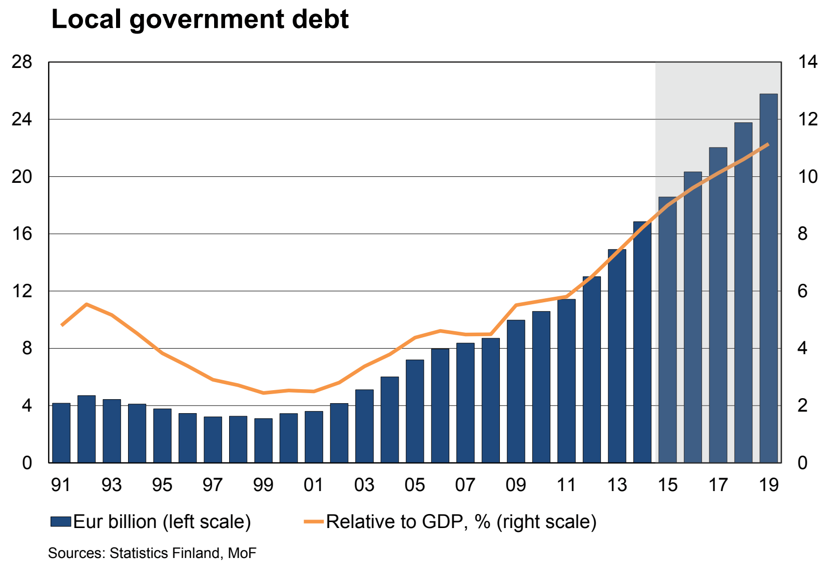


Table 24. Local government [1)]

	2012	2013	2014	2015**	2016**	2017**
	EUR billion					
Taxes and social security contributions	19.4	20.7	21.2	21.8	21.7	22.2
of which municipal tax	16.9	17.9	18.2	18.6	18.7	19.1
corporate tax	1.2	1.5	1.4	1.6	1.3	1.3
real estate tax	1.3	1.4	1.5	1.6	1.7	1.7
Other revenue [2)]	17.9	18.4	18.4	18.4	19.2	18.9
of which interest receipts	0.3	0.2	0.2	0.2	0.2	0.2
of which transfers from central government	13.5	13.9	13.8	13.8	14.5	14.1
Total revenue	**37.2**	**39.1**	**39.6**	**40.2**	**40.9**	**41.1**
Consumption expenditure	32.2	33.1	33.6	34.1	34.6	35.4
of which compensation of employees	21.4	21.7	21.7	21.7	22.0	22.2
Income transfers	3.0	3.1	3.1	3.3	3.4	2.7
of which social security benefits and allowances	1.2	1.3	1.3	1.4	1.4	0.7
subsidies and oher transfers	1.5	1.6	1.6	1.8	1.9	1.9
interest expenses	0.2	0.2	0.1	0.1	0.1	0.2
Capital expenditure [3)]	4.1	4.5	4.6	4.5	4.6	4.7
Total expenditure	**39.4**	**40.6**	**41.2**	**41.9**	**42.6**	**42.7**
Net lending (+) / net borrowing (-)	**-2.1**	**-1.5**	**-1.7**	**-1.7**	**-1.8**	**-1.7**
Primary balance [4)]	-2.2	-1.6	-1.8	-1.8	-1.9	-1.8

[1)] As calculated in the national accounts.

[2)] Incl. capital transfers and consumption of fixed capital.

[3)] Gross capital formation and capital transfers.

[4)] Net lending before net interest expenses.

ures that as yet remain unspecified are the incentive system for specialised health care, the reform of initial vocational education, and the reduced planning obligations in social and health care services. Furthermore, the forecast does not yet take into account the planned operational programme aimed at reducing municipalities' duties and obligations by a total of one billion euros. The same goes for the effects of the social and health care reform.

The local government sector faces substantial expenditure pressures over the decades ahead. Population ageing will continue to increase the need for health and care services as well as investment. At the same time, the costs of individual health care procedures will continue to rise with advances in treatments. Local government debt to GDP will increase sharply in the decades ahead unless steps are taken to curb or prepare for rising expenditure pressures. The direct adjustment measures taken into account in the forecast will slow the growth of the local government debt ratio in 2016–2019, but local government debt will nevertheless continue to grow rapidly. For reasons of stability in local government finances it is important that the measures outlined in the Government Programme for improving local government finances are specified and implemented in full and that the targeted savings effect is achieved. Among other things, it is particularly important to push ahead with social and health care reforms, which will help to contain future expenditure pressures. It is also important that municipalities continue to take steps to strengthen local government finances.

Local government accounting and national accounts

The closest local government accounting equivalent to the national accounts concept of net lending is the cash flow from operations and investments. However, the two accounting systems have different ways of defining sector boundaries and concepts, and they also differ in the timing of entries. The differences between the cash flow from operations and investments and net lending are detailed in the table below.

The major difference stems from sector definitions. Local government accounting is concerned with local government finances as defined in the statistics on finances and activities of municipalities and joint municipal authorities, i.e. municipalities, joint municipal authorities and municipally-owned enterprises. Excluded from local government finances under these statistics are such operations that are conducted by an independent legal entity, for instance in the form of a limited liability company. The national accounts definition of local government sector, on the other hand, does include such municipally-owned enterprises, that are treated as units serving their parent entity. For instance, Länsimetro, the underground constructor owned by the cities of Espoo and Helsinki, is placed in the national accounts under the local government sector, but in the statistics on municipal finances and activities it is not included in local government finances.

In the national accounts, the local government sector comprises the non-market activities of municipalities and joint municipal authorities that are primarily financed from tax revenue and by compulsory payments. Public corporations that primarily finance their operations from sales revenue from other sectors, such as water, waste and energy management as well as port activities, are therefore classified in the national accounts in the corporations sector, outside the local government sector. The joint municipal authority HSY (Helsinki Region Environmental Services) is also classified in the corporations sector.

Table 25. Financial position and local government net lending in local government accounting

	2013	2014	2015**	2016**	2017**
	EUR billion				
Cash flow from municipalities' and joint municipal authorities' operations and investments	**-1.1**	**-0.1**	**-1.6**	**-1.6**	**-1.5**
Other than municipalities' and joint municipal authorities' net lending effect [1]	-0.3	-0.3	-0.2	-0.2	-0.2
Effect of municipalities' and joint municipal authorities' operations outside the local government sector	0.1	-2.9	0.1	0.0	0.1
Acquisitions and sales of shares	0.1	2.1	0.1	0.1	0.1
Differences in concepts of property expenditure and income	-0.1	-0.1	-0.1	-0.1	-0.1
Timing differences	-0.1	-0.1	-0.1	-0.1	-0.1
Other differences [2]	-0.2	-0.3	0.0	0.0	-0.1
Local government net lending (+)/borrowing (-)	**-1.5**	**-1.7**	**-1.7**	**-1.8**	**-1.7**

1) Corporations classified under local government but not included in statistics on municipal finances as well as Government of Åland, Association of Finnish Local and Regional Authorities, Local Government Employers and Municipal Guarantee Board.

2) E.g. differences in capital transfers and investment grants.

Source: Statistics Finland, MoF

Statistics on municipal finances and national accounts have different definitions for the concept of investment expenditure. In the national accounts, acquisitions and sales of shares and equities are recorded as financial transactions and not under local government investment expenditure. Statistics on municipal finances, on the other hand, record share acquisitions as investments in fixed assets.

There are also differences in the concepts of property expenditure and incomes. In the national accounts, changes in the value of assets and liabilities are not included in income or expenditure. Therefore, municipalities' and joint municipal authorities' other financing costs and income (with the exception of dividends and interests) are not included in the national accounts definition of net lending.

There are also differences in the timing of entries in the national accounts and in local government accounting. In local governments' accounts, tax revenue describes the amount of tax collected during the calendar year. In the national accounts, tax revenue for the year in question is based on the tax authorities' accounts of tax remittance to central government from February through to the end of January the following year. This is intended to take into account the timing difference between advance tax payments and remittance to government.

Incorporations of local authority owned enterprises in 2014 caused a wide gap to open up between the figures for cash flow from operations and investments, on the one hand, and net lending, on the other. The incorporations had no effect on net lending, but there was a marked one-off increase in the cash flow from operations and investments. Sales of the incorporated municipal enterprises' assets increased revenue from the sales of shares in companies outside the local government sector. Furthermore, the incorporations of municipal enterprises brought a sharp increase in local authorities' shareholding acquisitions, which do not show up in national accounts investment expenditure.

2.4 Social security funds

2.4.1 Earnings-related pension funds

In 2014 the surplus of earnings-related pension funds fell to 1.7% of GDP. Since 2008, this surplus has contracted by well over two percentage points. Earnings-related pension expenditure has risen sharply in recent years with the growing number of pensioners and with the higher average level of pensions, as new pensions are higher than the old ones in payment. The weaker employment situation and slower rise in earnings have in turn dampened the growth of incomes from contributions, even though pension contribution rates have increased sharply in recent years. Low interest rates have in turn reduced property income earned on pension assets. However rising property and stock prices in particular have increased the total value of pension assets to over EUR 170 billion at year-end 2014.

The growing number of pensioners and the rise in the average level of new pensions will continue to drive earnings-related pension expenditure growth throughout the outlook period. Pension expenditure growth will be slowed by the decision taken in the spring 2014 spending limits discussions to freeze the earnings-related pension index increment to 0.4% in 2015. Slower inflation and expected moderate rises in earnings mean that annual indexations of pensions will remain at just over one per cent in 2016–2019. Earnings-related pension expenditure will increase at an annual average rate of 4% during the forecast period. Pension expenditure to GDP will climb to over 14% in 2019, compared with the figure of 10% in 2008.

Earnings-related pension contributions were once again increased at the beginning of 2015, by 0.4 percentage points. As is current practice, the burden of the increase was equally shared between employers and wage earners. In connection with the 2017 pension reform agreement the central labour market organisations also agreed on the level of earnings-related pension contributions. The 0.4 percentage point increase initially scheduled for 2016 was postponed until 2017, and the decision was made to freeze the contribution to the level of 24.4% in 2017–2019. The Finnish Centre for Pensions long-term projections suggest that when the pension reform is put in place, this contribution level will be sufficient to finance pensions even beyond 2019.

In the medium term, the freezing of pension contributions at the 2017 level will reduce the surplus of pension funds, as the downward effects of the pension reform on pension expenditure will only begin to be seen from the 2020s onwards. Until then, pension expenditure will continue to rise at a rapid clip. Moderate wage increases and slow employment growth mean that wage bill growth will remain sluggish, which will be directly reflected in revenue from pension contributions. It is projected that pension funds' interest and dividend revenue will turn to moderate growth from 2016 as interest rates begin to pick up.

In 2015 the surplus in earnings-related pension funds will fall to 1.0% of GDP. Part of the reason for this drop is the additional one-off transfer of EUR 500 million from the State Pension Fund to central government. In 2016–2019 the surplus in earnings-related pension funds will remain at around one per cent of GDP.

Table 26. Finances of social security funds[1)]

	2012	2013	2014	2015**	2016**	2017**
	EUR billion					
Investment income	3.8	3.7	3.5	3.3	3.6	4.0
Social security contributions	25.5	25.9	26.3	26.8	27.8	28.4
of which contibutions paid by employers	17.7	17.9	17.9	18.1	18.6	19.0
contributions paid by insured	7.8	8.0	8.4	8.6	9.1	9.5
Transfer from general government	12.3	12.9	13.5	13.7	13.5	14.3
Other revenue	0.5	0.5	0.5	0.6	0.6	0.6
Revenue	**42.0**	**43.0**	**43.8**	**44.4**	**45.5**	**47.4**
Consumption expenditure	3.6	3.5	3.6	3.6	3.5	3.5
Social security benefits and allowances	30.6	32.8	34.5	35.9	36.8	38.4
Other outlays	2.7	2.9	3.0	3.8	3.4	3.5
Expenditure	**36.9**	**39.2**	**41.1**	**43.3**	**43.7**	**45.4**
Net lending (+) / net borrowing (-)	**5.2**	**3.7**	**2.8**	**1.1**	**1.8**	**2.0**
Earnings-related pension schemes	4.8	3.7	3.4	2.1	2.3	2.3
Other social security funds	0.4	0.0	-0.7	-1.1	-0.5	-0.3
Primary balance[2)]	3.5	2.0	1.2	-0.3	0.3	0.2

[1)] As calculated in the National Accounts.

[2)] Net lending before net interest expenses.

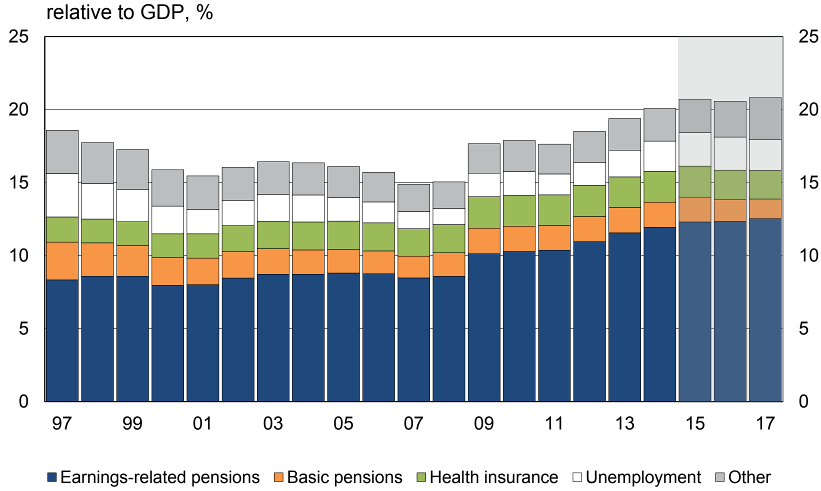
2.4.2 Other social security funds

Other social security funds consist mainly of the Social Insurance Institution (Kela) and the Unemployment Insurance Fund, which are responsible for the provision of basic security and for earnings-related unemployment security, respectively. The expenditure of other social security funds increased by 5.9% in 2014. The sharp rise in expenditure that has continued for more than a year is attributable to an increase of 15% in earnings-related unemployment security expenses and in basic unemployment security. Sickness insurance expenditure increased by 2.1% last year, around the average for the past few years. Because of the growth of unemployment expenditure the financial position of other social security funds turned to a deficit of 0.3% of GDP last year, even though transfers from central and local government to other social security funds increased by EUR 460 million from the previous year.

Other social security funds will remain deep in deficit in the current year as well, as unemployment expenditure will continue to rise sharply at over 10%. The growth of unemployment expenditure will be cut by savings of EUR 50 million made from the beginning of the year in earnings-related unemployment expenditure. The Government of Prime Minister Sipilä has for its part announced savings of EUR 250 million in earnings-related unemployment security and job alternation leave compensations. At the same time, it is expected that the gradual improvement in the employment situation will cause unemployment expenditure to fall.

In connection with the settlement of third-year wage increases under the Employment and Growth Pact, the central labour market organisations proposed that the unemployment insurance contribution be increased by over one per cent in 2016, and that this increase be divided equally between employers and wage earners. The current forecast assumes that this increase will remain in force for the time being and that it will help to bring other social security funds back close to balance during the outlook period. Without the planned

Benefits, allowances and medical care reimbursements
relative to GDP, %



Sources: Statistics Finland, MoF

increase in the unemployment insurance contribution rate, the Unemployment Insurance Fund would soon have breached its statutory debt ceiling, with earnings-related unemployment expenditure in 2015 already standing 50% higher than it was in 2012.

Savings of EUR 51 million will be realised in sickness insurance expenditure from this year onwards. The Government is committed to deliver further savings of over EUR 300 million in sickness insurance expenditure in 2016 and 2017. In addition, close to EUR 200 million will be saved by 2019 through cuts of the general housing allowance and the housing allowance for pensioners. The only measure that will increase expenditure is raising the guarantee pension, which will cost around EUR 30 million from 2016 onwards.

Social benefits and allowances tied to the national pension index were increased from the beginning of the year by 0.4%, or 0.7 percentage points less than a regular adjustment for inflation would have been. Based on indexation rules, the national pension index will be revised slightly downwards in 2016, as consumer prices are set to fall during the current year. According to the spending limits decision made by the Government in the beginning of September, the national pension index will not be increased in 2017–2019. However, the indexation of basic income support will not be frozen. Furthermore, the indexation of child allowances and student financial aid will be discontinued. The current estimate is that overall, the measures set out in the Government Programme will reduce the expenditure of other social security funds by more than one billion euros at an annual level in 2019. The savings achieved will largely be reflected in a reduced level of central government transfers to other social security funds.

Table 27. Social security contributions rates and pension indices

	2012	2013	2014	2015	2016**	2017**
Social insurance contributions [1]						
Employers						
Sickness insurance	2.12	2.04	2.14	2.08	2.12	2.11
Unemployment insurance	2.32	2.32	2.20	2.33	2.83	2.83
Earnings-related pension insurance	17.35	17.35	17.75	18.00	18.00	18.15
Local government pension insurance	23.60	24.00	23.79	23.65	23.21	22.96
Employees						
Sickness insurance	2.04	2.04	2.16	2.10	2.09	2.05
Unemployment insurance	0.60	0.60	0.50	0.65	1.15	1.15
Earnings-related pension insurance	5.45	5.45	5.85	6.00	6.00	6.25
Pensioners						
Sickness insurance	1.39	1.47	1.49	1.49	1.45	1.42
Pension indices						
Earnings-related index (over 65)	2407	2475	2509	2519	2516	2548
National pension index	1565	1609	1630	1637	1630	1630

[1] Annual averages. The contributions of employers and the unemployment and employment pension contributions of beneficiaries as percentages of wages and salaries. The figures are weighted averages.

2.5 Long-term sustainability of public finances

Despite the adjustment efforts, it is anticipated that balance will not be restored in public finances over the medium term, even though the increase in the public debt to GDP ratio will slow by 2019. The challenge of balancing public finances is further compounded by population ageing, which is driving up pension expenditure as well as health care and long-term care costs. The slowdown of productivity growth and stalling labour input growth are in turn curbing economic growth and therefore slowing the growth of tax revenue.

The long-term balance of general government is measured by the sustainability gap, which is the current value of future public finance deficits. The sustainability gap indicates the extent of medium-term adjustment that would be needed in public finances in order to prevent public debt from spiralling out of control, in the long term, as a result of rising age-related expenditure.

The MoF Economics Department's assessment of the long-term sustainability of public finances is based on EU harmonised methods and calculation rules. The assessment of age-related expenditure is based on a model developed by the Ministry of Social Affairs and Health for social expenditure analysis. The background assumptions (employment, productivity, interest rate and inflation) are based on those published last year for the 2015 report by the EU Economic Policy Committee's Ageing Working Group[1].

According to these assumptions productivity will increase in Finland on average by 1.4% in 2019–2060. There are two points where this forecast does not follow the Ageing Working Group's assumptions: these are the projections for demographic trends, which are based instead on Statistics Finland's 2012 population projection, and the 2015–2019 projections of economic development, which are based on the MoF Economic Department's forecast presented in this outlook.

The sustainability gap is estimated at around 3½ percentage of GDP at an annual level in 2019. Taking account of the adjustment measures announced in the Government Programme has improved the estimated structural balance of public finances at 2019 level by around 1½ percentage points at an annual level in 2019. At the same time, though, the deterioration of the macroeconomic outlook since last spring has lowered the same estimate by around half a percentage point to GDP. In other words the improved forecast for the general government structural balance in 2019 has reduced the projected sustainability gap by around one percentage point.

Both the spring forecast and the current estimate of the sustainability gap take account of the effects of the pension reform, which is scheduled for implementation from the beginning of 2017 and expected to reduce the sustainability gap by around one percentage point. It is projected that the reform will both increase the employment rate and reduce pension expenditure. The forecast does not take into account the measures set out in the Government Programme to improve public finances in the longer term.

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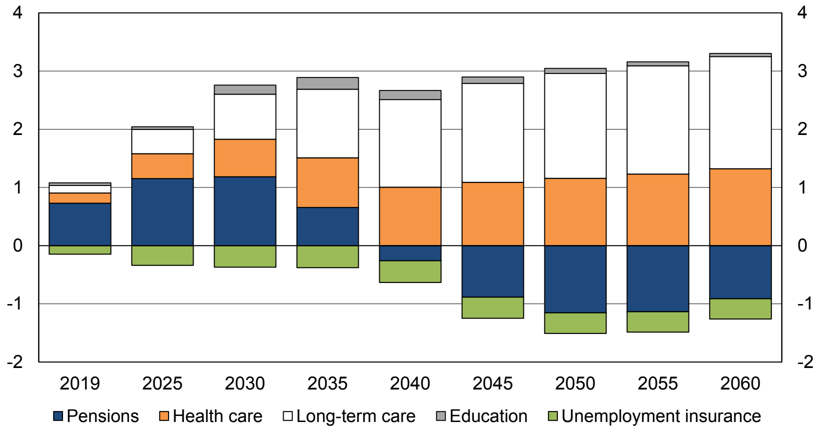
1 The 2015 Ageing Report: Underlying Assumptions and Projection Methodologies, European Economy 8/2014.

The sustainability projection is in essence a pressure projection that reflects future trends under the existing set of rules based on long-term population projections, the weight of spending in different age groups, and economic development. The further one reaches ahead of time with the projection, the greater the uncertainty, which is why the projection is highly sensitive to the assumptions on which it is based. Sustainability gap calculations are nonetheless useful tools in providing a consistent way of analysing and overcoming the future challenges that lie ahead for public finances.

Change in age-related expenditure
from year 2014, relative to GDP, %



The figure is compiled using the model developed by the Ministry of Social Affairs and Health for social expenditure analysis.

Source: MoF

Supplementary statistics

1. Evolution of forecasts over time
2. Outturn data and forecasts used in budget process for 2010-2014, average change, %
3. National balance of supply and demand
4. Financial balance of the Finnish economy

Table 1. Evolution of forecasts over time[1)]

	2014				2015**				2016**				2017**			
	es4	es1	es2	es3	es4	es1	es2	es3	es4	es1	es2	es3	es4	es1	es2	es3
GDP at market prices, change in volume, %	0.1	-0.1	0.0	-0.4	0.9	0.5	0.3	0.2	1.3	1.4	1.4	1.3	-	1.5	1.4	1.4
Consumption, change in volume, %	0.1	-0.1	0.0	0.3	0.3	0.4	0.9	0.8	0.7	0.7	0.7	0.5	-	0.8	0.7	0.6
Exports, change in volume, %	1.7	-0.4	-0.7	-0.7	3.3	1.5	0.3	0.9	4.2	3.0	3.3	3.0	-	3.5	3.7	3.3
Unemployment rate, %	8.6	8.7	8.7	8.7	8.8	8.8	9.3	9.6	8.6	8.6	9.0	9.4	-	8.3	8.7	9.1
Consumer price index, change, %	1.1	1.0	1.0	1.0	0.8	0.3	0.1	-0.1	1.7	1.4	1.2	1.1	-	1.7	1.4	1.5
Central government net lending, relative to GDP, %	-3.2	-3.7	-3.7	-3.9	-2.5	-3.2	-3.1	-3.1	-2.3	-3.1	-2.6	-2.8	-	-2.8	-2.5	-2.6
General government net lending, relative to GDP, %	-2.7	-3.2	-3.2	-3.3	-2.6	-3.4	-3.2	-3.4	-2.1	-3.2	-2.5	-2.8	-	-3.1	-2.4	-2.4
Central government debt, relative to GDP, %	46.6	46.6	46.6	46.4	48.0	48.7	48.7	48.7	48.7	50.2	49.8	49.9	-	51.6	50.8	51.2

[1)] Economic Survey / release date: 17.12.2014 (es4), 2.4.2015 (es1), 17.6.2015 (es2) and 28.9.2015 (es3)

Sources: Statistics Finland, MoF

Table 2. Outturn data and forecasts used in budget process for 2010-2014

	Years 2010-2014		Average forecast errors	
	Forecast averages, % ch.	Outcome averages, % ch.	Forecast under-/over-estimation[1], pp.	Magnitude of forecast error[2], pp.
GDP (volume)	1.4	0.8	0.6	2.4
GDP (value)	3.5	2.9	0.6	2.5
Private consumption (value)	3.3	3.6	-0.3	1.9
Current account, % of GDP	0.5	-0.7	1.2	1.6
Inflation	2.3	2.0	0.3	0.7
Wage bill	2.9	2.1	0.7	1.3
Unemployment rate	8.5	8.2	0.3	0.7
Central government debt, % of GDP	45.6	43.7	1.9	1.9
Central government net lending, % of GDP	-3.9	-4.0	0.1	0.7
General government net lending, % of GDP	-2.0	-2.3	0.3	1.2

Forecasts are compared with March/July preliminary national accounts data.
Averages for the past five years are calculated on the basis of spring and autumn forecasts concerning the budget year.

[1] Over- or understimation is indicated by average forecast error. [2] The average of absolute error values indicates the average magnitude of forecast errors, regardless of the direction of error.

3. National balance of supply and demand, EUR million

	Current prices					
	2012	2013	2014	2015**	2016**	2017**
GDP at market prices	199 793	202 743	205 178	206 474	211 609	217 642
Imports of goods and services	81 764	80 624	79 392	78 524	82 043	86 220
Total supply	**281 557**	**283 367**	**284 570**	**284 998**	**293 652**	**303 862**
Exports of goods and services	78 881	78 979	77 810	78 275	81 391	85 500
Consumption	157 790	161 622	164 523	166 335	169 027	172 309
private	109 108	111 311	113 621	114 820	117 058	119 493
public	48 682	50 311	50 902	51 515	51 969	52 816
Investment	44 489	42 805	41 608	41 332	44 210	47 013
private	36 537	34 415	33 225	32 792	35 439	38 118
public	7 952	8 390	8 383	8 541	8 770	8 896
Total demand	**281 160**	**283 406**	**283 941**	**285 943**	**294 628**	**304 822**
	At reference year 2010 prices; not additive					
	2012	2013	2014	2015**	2016**	2017**
GDP at market prices	189 173	187 052	186 295	186 725	189 122	191 698
Imports of goods and services	75 433	75 461	75 485	75 312	77 883	80 585
Total supply	**264 662**	**262 585**	**261 848**	**262 116**	**267 019**	**272 228**
Exports of goods and services	74 718	75 576	75 010	75 686	77 957	80 553
Consumption	147 682	147 731	148 174	149 295	150 065	151 025
private	102 815	102 489	103 015	104 059	104 913	105 724
public	44 867	45 234	45 156	45 239	45 164	45 318
Investment	41 669	39 485	38 163	37 662	39 692	41 354
private	34 246	31 800	30 544	29 936	31 847	33 535
public	7 421	7 679	7 611	7 715	7 837	7 813
Total demand	**264 452**	**263 193**	**262 705**	**262 178**	**267 082**	**272 292**

4. Financial balance of the Finnish economy

	2010	2011	2012	2013	2014
	relative to GDP, %				
Gross investment	**21.9**	**22.2**	**22.3**	**21.1**	**20.3**
households and non-profit institutions	6.5	6.6	6.5	6.2	5.9
non-financial corporations and financial and insurance corporations	11.8	11.9	11.8	10.8	10.3
general government	3.7	3.8	4.0	4.1	4.1
Gross saving [1]	**23.2**	**22.1**	**20.7**	**19.4**	**18.5**
households and non-profit institutions	5.7	4.7	4.5	4.9	4.1
non-financial corporations and financial and insurance corporations	16.4	14.6	14.3	13.0	13.6
general government	1.1	2.8	1.9	1.5	0.8
Financial surplus	**1.5**	**-1.4**	**-1.8**	**-1.7**	**-2.1**
households and non-profit institutions	-1.0	-2.2	-2.3	-1.6	-1.9
non-financial corporations and financial and insurance corporations	5.2	1.8	2.6	2.2	2.8
general government	-2.6	-1.0	-2.1	-2.5	-3.3
Statistical discrepancy	0.0	0.0	0.0	-0.2	-0.4

[1] Incl. capital transfers (net)

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