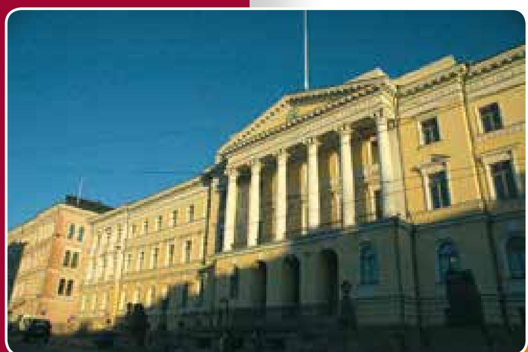
MINISTRY OF FINANCE

Economic Survey

Spring 2014



13b/2014

Economic outlook and economic policy

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Abstract

The world economy has shown some encouraging signs of late, although growth is still fragile and the situation varies quite considerably for different regions. However the world economic situation remains precarious and more sensitive than usual to negative shocks. This applies most particularly to the euro area, where economic growth is still very modest and where even relatively minor negative factors can easily cut down the incipient growth. Over time the turnaround of the world economy will also lead to a rebounding of the domestic economy.

Finnish GDP is expected to post growth of no more than 0.5% in 2014. The forecast includes the assumption of an economic turnaround, and the single biggest driver of economic growth is foreign trade. Private consumption will show no growth in 2014 because of the slow growth of real purchasing power, the subdued future outlook and the situation in the labour market. Private investment will continue to fall, and the rate of private investment to GDP will fall back to 15.4%. The unemployment rate will continue to edge up and the forecast for the average unemployment rate in 2014 is 8.4%. Employment will also be down by 0.3% from the year before. Productivity, measured in the number of hours worked, will develop quite slowly.

In 2015 GDP growth will pick up to 1.4%. This growth will be increasingly broadly-based, with public investment being the only demand item having a negative growth effect. Private consumption will rise by close to ½% as a result of improving future expectations. This will also have the effect of reducing the household savings rate. It is noteworthy that the rising trend in household debt ratio is stabilising at 119% of disposable income. It is forecast that private investment will turn around to show growth of 4.6%: this trend will mainly be driven by investment in machinery and equipment and investment in construction. Public investment will continue to fall. The situation in the labour market will continue to remain weak, and despite the slight improvement in economic activity the unemployment rate is expected to remain roughly unchanged at this year's level.

In 2016 economic growth is expected to reach 1.8%. The GDP growth rate will exceed potential output growth, despite the historically sluggish rate of economic growth. The level of total output will remain lower than potential output because of the underuse of economic resources. The economy's growth potential is low due to demographic factors, sluggish investment and changes in the production structure.

Despite the recent positive trend in the global economy and the improved outlook in the domestic economy, the risks in the outlook are still predominantly to the downside.

The general government budgetary position has been in deficit for five years now, and the same situation will continue in years 2014-2016. Following the past two years of recession, the relatively sluggish rate of economic growth will not be enough to turn public finances into a surplus. Population ageing is also putting a major strain on public finances, reducing the number of people of working age and at once driving up age-related public expenditure. Public debt to GDP will continue to rise and is set to breach the 60% limit.

Preface

The Spring 2014 Economic Survey appears for the eighth time in its present form as background material for the Government's spending limits decision. The Survey offers projections of Finland's economic outlook for 2014–2016. In addition to short-term prospects, the Economic Survey includes medium-term projections extending to 2018.

The forecast and trend projections in this Survey have been prepared independently by the Ministry of Finance Economics Department, without any outside input, based on the latest data available. The forecasts are based on provisional national accounts data for 2013 published by Statistics Finland in March 2014 and on other public statistical sources available before 7 March 2014. Both the short-term and medium-term projections take account of the decisions taken by the Government in its spending limits discussions on 25 March.

Helsinki April 2014

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

SYMBOLS AND CONVENTIONS USED

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

Economic outlook 2014-2016

According to preliminary data Finnish GDP fell by 1.4% last year, the second year of negative GDP growth in succession. Economic performance was weak throughout 2013: growth was not recorded in any quarter. In Q4 GDP dropped by 0.3% from the previous quarter, leaving a significant negative growth carryover from last year. Apart from exports, the only other demand items showing positive growth were public investment and public consumption.

The world economy has shown some encouraging signs of late, although growth is still fragile and the situation varies quite considerably for different regions. Nonetheless in the euro area economic growth in the last quarter of 2013 reached 0.3% from the previous quarter and 0.5% from last year. The figures for the EU-28 area were 0.4% and 1.1%, respectively. The United States has also continued to post reasonable growth. The forecast for 2014 projects a growth rate of 2.5% and for 2016 over 3%. In China growth is slowing, and the next few years will see annual GDP growth of around 7%. Despite intense stimulus, growth in Japan will struggle to strengthen over 1% during the outlook period. Russia's growth prospects are weak and depend quite heavily on natural resource extraction. In Russia there is also the possibility of a continuing escalation of political uncertainty, which would affect the Finnish economy as well.

However the world economic situation remains precarious and more sensitive than usual to negative shocks. This applies most particularly to the euro area, where economic growth is still very modest and where even relatively minor negative factors can easily cut down the incipient growth. It is difficult to form a coherent picture of the situation of financial institutions in the euro area, and it is too early to exclude the possibility of sudden imbalances in the financial market. However the outlook is based on the expectation that the situation in the euro area financial market will remain calm, and that both credit supply and demand will strengthen.

It is expected that short-term and long-term interest rates will rise moderately both this year and next. In the last year of the outlook horizon in 2016, the annual average three-month euribor rate is expected to stand at 1.3%, the ten-year rate at 3.5%. The euro-to-dollar exchange rate is expected to fall slightly, as are oil and other raw materials prices.

The forecast is that the recovery of economic growth will be driven by exports. Over time the turnaround of the world economy will also lead to a rebounding of the domestic economy. The outlook assumes that the rate of world trade growth will outpace global economic growth, which will improve the prospects of export industries. Domestic demand will decline during 2014, and in 2015 and 2016 it will have a stronger role in driving economic growth. The forecast makes no assumptions about possible future economic policy measures.

Finnish GDP is expected to post growth of no more than 0.5% in 2014. If contrary to expectations total output remains unchanged from the end of last year, GDP would decline by −0.2% this year. The forecast includes the assumption of an economic turnaround, with this year's internal growth projected to be clearly positive. It is predicted that imports will increase by some 2%, while exports will be up 3.5%. The contribution of net exports to GDP growth is therefore positive and the single biggest factor in kick-starting economic growth. Faster imports growth is hampered by weak domestic demand. Private consumption will show no growth in 2014 because of the slow growth of real purchasing power, the subdued future outlook and the situation in the labour market. Private investment will continue to fall, and the rate of private investment to GDP will fall back to 15.5%. The sharpest falls will be seen in investment in machinery and equipment and in investment in residential construction. The slide in industrial production will bottom out and turn to growth of 1.4% this year. In services the situation will continue to remain weak, and growth is projected to reach no more than 0.2%. The unemployment rate will continue to edge up and the forecast for the average unemployment rate in 2014 is 8.4%. Employment will also be down by 0.3% from the year before. Productivity, measured in the number of hours worked, will develop quite slowly. Upward pressures on prices are moderate, and inflation in 2014 will come in at 1.5%.

In 2015 GDP growth will pick up to 1.4%. This growth will be increasingly broadly-based, with public investment being the only demand item having a negative growth effect. In the wake of rebounding world trade, exports will pick up to show growth of over 4%, and increasing domestic demand will also drive imports to growth of over 3%. Private consumption will rise by close to ½% as a result of improving future expectations. This will also have the effect of reducing the household savings rate. It is noteworthy that the rising trend in household debt ratio is stabilising at 119% of disposable income. It is forecast that private investment will turn around to show growth of 4.6%: this trend will mainly be driven by investment in machinery and equipment and investment in construction. Public investment will continue to fall. On the supply side, industrial production will grow by over 2%. As a result of improving domestic demand the production of services will also turn more clearly onto a growth path, increasing by around 1.5%. The situation in the labour market will continue to remain weak, and despite the slight improvement in economic activity the unemployment rate is expected to remain roughly unchanged at this year's level. The labour market mismatch problems remain significant. Inflation is expected to remain at well below 2%.

In 2016 economic growth is expected to reach 1.8%. The GDP growth rate will exceed potential output growth, despite the historically sluggish rate of economic growth. The level of total output will still remain lower than potential output because of the underuse of economic resources. The economy's growth potential is low due to demographic factors, sluggish investment and changes in the production structure.

The general government budgetary position has been in deficit for five years now, and the same situation will continue in years 2014-2016. Following the past two years of recession, the relatively sluggish rate of economic growth will not be enough to turn public finances into a surplus. Population ageing is also putting a major strain on public finances, reducing the number of people of working age and at once driving up age-related public expenditure. Public debt to GDP will continue to rise and is set to breach the 60% threshold. The problems in public finances cannot be resolved by direct adjustment measures focused on general government revenue or expenditure, but it is also necessary to work on structural reforms that will contribute to strengthen the economy's growth potential, raise the employment rate and increase the efficiency of general government.

Despite the recent positive trend in the global economy and the improved outlook in the domestic economy, the risks in the outlook are still predominantly to the downside. In the euro area the recovery of households from the debt and financial crisis may take longer than predicted as the structural reforms designed to boost competitiveness have been a case of too little, too late. There is also uncertainty about the state of the banking sector, which may be weaker than previously estimated. In the United States, the sense of uncertainty is heightened by political tensions. Any disruptions in the United States will be reflected in the global economy in direct proportion to the country's substantial share of world market demand. On the other hand the improved net real investment position in the private sector may push demand onto a stronger than predicted growth track. Failure to resolve the crisis in Ukraine would add to uncertainty and possibly increase the outflow of capital from Russia, reduce investment rates, weaken the rouble and drive the Russian economy into recession, which inevitably would spill over to affect the Finnish economy. In the global economy one upside risk to the forecast is the possibility of developing countries returning to growth sooner that predicted.

Domestically the main risks come from how quickly and how strongly the real economy reacts to the improvement in the global economic situation. At the moment it seems that economic growth in Finland, at least in the short term, will be lower than in its rival countries. Structural policy measures will not yet have any growth effect in the short and medium term. If the credibility of the economic policy pursued is compromised in an environment of already weak economic growth, that could well lead to an accelerating downward cycle. Market-driven growth grounded in the real economy is also the key to achieving a true and sustainable improvement in public finances. The most critical factors with respect to open sector competitiveness are competitive input prices and the ready availability of inputs. Some of these factors are beyond the control of domestic economic policy. Others would require changes that have a genuine impact on the incentives of economic agents, both consumers and businesses.

One of the most significant domestic challenges is to improve the efficiency of the labour market. Population ageing coupled with the mismatch problems in the labour market may become a real obstacle to growth. Much of Finnish industry is facing intense foreign competition for the same markets, which underscores the key importance of the availability of labour and all input-related cost factors. Competition for market shares is not just about the costs of labour, but all input costs. In the long term it is important to consider not only how cost factors are moving in relation to the competition, but also the overall level of those cost factors. Making the necessary adjustments to achieve a competitive price level requires time and above all concerted and determined action.

Key forecast figures

	2013 EUR bn	2011	2012	2013	2014**	2015**	2016**
		change in volume, %					
GDP at market prices	193	2.8	-1.0	-1.4	0.5	1.4	1.8
Imports	78	6.2	-0.7	-1.8	2.1	3.3	3.9
Total supply	271	3.8	-0.9	-1.5	0.9	1.9	2.4
Exports	78	2.8	-0.2	0.3	3.5	4.1	4.8
Consumption	159	1.9	0.4	-0.3	0.1	0.3	1.0
private	109	2.5	0.3	-0.8	0.0	0.3	1.1
public	50	0.5	0.5	0.8	0.3	0.4	0.7
Investment	37	5.8	-0.8	-4.6	-3.1	3.6	3.1
private	31	6.3	-1.2	-6.4	-3.5	4.6	4.2
public	5	2.6	1.7	6.8	-0.9	-1.9	-3.6
Total demand	273	3.8	-0.6	-0.9	0.3	1.9	2.4
domestic demand	195	4.2	-0.8	-1.4	-1.0	1.0	1.4

	2011	2012	2013	2014**	2015**	2016**
Services, change in volume, %	3.1	0.7	-1.2	0.2	1.3	1.8
Industry, change in volume, %	-0.6	-5.3	-2.6	1.4	2.2	2.5
Labour productivity, change, %	1.0	-1.4	0.4	0.1	0.7	0.7
Employed labour force, change, %	1.1	0.4	-1.1	-0.3	0.4	0.7
Employment rate, %	68.6	69.0	68.5	68.5	68.9	69.5
Unemployment rate, %	7.8	7.7	8.2	8.4	8.3	8.1
Consumer price index, change, %	3.4	2.8	1.5	1.5	1.7	1.9
Index of wage and salary earnings, change, %	2.7	3.2	2.0	1.3	1.2	1.5
Current account, EUR bn	-2.7	-2.8	-1.6	-0.7	-0.3	0.5
Current account, % of GDP	-1.5	-1.4	-0.8	-0.4	-0.1	0.2
Short-term interest rates (3-month Euribor), %	1.4	0.6	0.2	0.3	0.5	1.3
Long-term interest rates (10-year govt. bonds), %	3.0	1.9	1.9	2.3	2.9	3.5
General government expenditure, % of GDP	55.1	56.7	58.4	58.8	58.2	57.9
Tax ratio, % of GDP	43.6	44.0	45.5	45.7	46.0	46.1
General government net lending, % of GDP	-1.0	-2.2	-2.4	-2.4	-1.4	-0.9
Central government net lending, % of GDP	-3.4	-3.8	-3.7	-3.5	-2.4	-2.0
General government gross debt, % of GDP	49.3	53.6	56.9	59.8	61.0	61.4
Central government debt, % of GDP	42.2	43.6	46.4	48.7	49.3	49.2

Calculations of fiscal adjustment using the Ecomics Department's KOOMA model

Simulations based on the KOOMA model developed by the Ministry of Finance Economics Department have been reported in previous Economic Surveys. The New Keynesian macro model, KOOMA describes the Finnish economy using quarterly national accounts data. A new version is now available of the model which incorporates the labour market into the model framework. This has the crucial benefit of shedding light on how the impacts of different policy measures are mediated. In contrast to most other models, KOOMA provides a genuine modelling of unemployment, and the behaviour of the labour market (wage formation, labour market tightness, hours, demand for labour, etc.) is described in a consistent manner. It follows that the interactions of the labour market with the real economy and nominal parameters can be realistically described. In the labour market wages and salaries are negotiated between employers and employees. The model assumes that wages do not immediately adapt to changes in the economy. A more detail account of the KOOMA model and its structure is provided in earlier Economic Surveys.

Contractionary fiscal policy

The fiscal policy calculations examine three different strategies for improving fiscal balance: adjusting public expenditure, increasing taxes on consumption, and increasing taxes on labour. In order to ensure the comparability of the different scenarios, they are all based on the same starting level of 1% of GDP. The period under analysis extends from 2014 to 2020. The results are reported in relation to a steady state path, for example the Ministry of Finance's latest outlook forecast.

The main result is that the fastest way to reducing general government debt is by cutting public expenditure. Tax hikes hamper output growth to a greater extent than expenditure cuts, and therefore their beneficial effect on the general government budgetary position is clearly lesser. Overall public expenditure cutbacks over the seven-year period reduce general government debt to GDP by 4.8 percentage points, whereas the improvement in the general government budgetary position achieved through tax increases is no more than half of this, 2.2 or 2.3 percentage points.

Cutting public expenditure directly reduces aggregate demand in the economy, and in the first year GDP is down by 0.3% compared to the baseline scenario. In the first quarter output will fall by 0.7%, which is interpreted as the short-term fiscal policy multiplier. Public consumption crowds out private consumption to some extent, and therefore the decrease in public expenditure leads to a slight increase in private consumption and dampens the growth-slowing effects of expenditure cuts. Since the reduction of public expenditure has the effect of curtailing aggregate demand, domestic prices will start falling. As a result demand for Finnish products will pick up in the world market and net exports will increase. With the growth of private consumption and net exports, output growth will also turn positive in the third year after expenditure cuts.

The effects of cutting public expenditure are channelled into the labour markets via two routes . Changes in aggregate demand are reflected in expected business profits, which will initially fall somewhat but then begin to grow in the wake of private consumption and exports growth. Job vacancies in businesses will therefore initially fall somewhat and unemployment will slightly increase, but as the outlook improves both these trends will be reversed: job vacancies will increase and unemployment decrease. During the seven-year period under analysis unemployment will fall by 4%, so for instance the MoF 2014 unemployment projection of 8.4% would drop to 8.1%. Cutting public expenditure also impacts the behaviour of consumer-employees through its wealth effects. Inclined to optimise over time, consumers see the expenditure cuts as future tax reliefs and therefore increase their consumption. Consumption appears as a more attractive option than working, and therefore the number of hours worked per capita falls. However with the increasing demand for labour the number of persons employed starts increasing. Indeed the net effect on the number of hours worked over the period under study is close to zero.

Increasing taxes on consumption has a greater restrictive effect on private consumption than the other two adjustment scenarios. However there is hardly any decline in output because falling domestic producer prices are accompanied by increasing net exports and investment. Increasing taxes on consumption has no major impact on the labour market because the opposite effects cancel each other out. On the one hand employees will attempt to offset the rising consumption tax through pay rises, but on the other hand the tax hike reduces the surplus left over from working and thus decreases the supply of labour. As the demand for labour also declines somewhat with the negative aggregate demand effect reducing expected business profits, collectively agreed wages and salaries are at somewhat lower level than the baseline in the first years of the scenario.

Fiscal adjustment through increased taxes on labour is the option with the most detrimental effects on the economy. Employees will be keen to compensate their reduced net income by calling for higher wages. As wages and salaries begin slowly to rise, demand for labour decreases and unemployment increases. Over the seven-year period unemployment will rise by 6%, i.e. from the MoF 2014 forecast of 8.4% to 8.9%. Rising wages also push up domestic producer prices, and therefore net exports and investment will fall with the lowered real yield of investment. Initially, before wages and salaries start rising, lower household net income has the effect of reducing consumption. As all main demand components react negatively to higher taxes on labour, GDP will also show slower growth than in the baseline scenario. GDP growth will on average be 0.1% slower than in the baseline scenario.

	GDP	Private consumption	Private Investment	Net exports	Unemployment	Total hours	Wage	Fiscal balance	Public debt %/GDP
Simulation: Cutting public expenditure by 1% of GDP									
2014	-0.3	0.0	0.5	1.1	-0.4	-0.2	-1.3	1.3	-1.3
2015	0.0	0.2	0.9	0.9	-1.5	0.1	-0.7	1.2	-2.5
2016	0.1	0.2	0.9	0.4	-0.9	0.0	-0.3	0.9	-3.4
2017	0.1	0.2	0.7	0.2	-0.5	0.0	-0.1	0.6	-3.9
2018	0.1	0.2	0.5	0.1	-0.3	0.0	-0.1	0.4	-4.3
2019	0.1	0.2	0.3	0.1	-0.2	0.0	0.0	0.3	-4.6
2020	0.1	0.1	0.1	0.1	-0.2	0.0	0.0	0.2	-4.8
Simulation: Increasing the labour tax by 1% of GDP									
2014	-0.1	-0.1	-0.1	-0.1	1.0	-0.2	0.3	0.8	-0.8
2015	-0.2	-0.1	-0.2	-0.2	1.7	-0.2	0.3	0.6	-1.4
2016	-0.1	-0.1	-0.3	-0.1	1.3	-0.2	0.2	0.4	-1.7
2017	-0.1	-0.1	-0.2	-0.1	0.9	-0.1	0.1	0.2	-2.0
2018	-0.1	0.0	-0.2	-0.1	0.6	-0.1	0.1	0.2	-2.2
2019	-0.1	0.0	-0.1	-0.1	0.4	0.0	0.1	0.1	-2.3
2020	0.0	0.0	0.0	-0.1	0.2	0.0	0.0	0.1	-2.3
Simulation: Increasing the consumption tax by 1% of GDP									
2014	0.0	-0.2	0.1	0.1	0.0	0.0	-0.1	0.8	-0.8
2015	0.0	-0.2	0.1	0.2	-0.1	0.0	-0.1	0.6	-1.4
2016	0.0	-0.1	0.1	0.1	-0.1	0.0	0.0	0.4	-1.7
2017	0.0	-0.1	0.1	0.0	-0.1	0.0	0.0	0.2	-2.0
2018	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.2	-2.2
2019	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.1	-2.3
2020	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	-2.3

Medium-term outlook

The Finnish economy has contracted for two consecutive years. At the same time industry and the economy as a whole have been undergoing structural changes that have affected the longer term growth prospects of the economy. It is expected that the economy will turn to cautious growth in 2014, but the forecast is that this growth will be historically slow even in the medium term.

The medium-term prospects of the economy can be examined by making a distinction between the cyclical component and potential output. Potential output is thought to determine the economy's medium-term growth prospects. In its assessments of potential output the Ministry of Finance uses the production function method as developed jointly by the EU Commission and Member States. This method divides total output between labour input and capital and total factor productivity[1]. Potential output is an unobservable variable and its assessment during a strong economic cycle and under conditions of rapid changes in the production structure is extremely difficult.

It is forecast that the contribution of labour input to output growth will remain close to zero in the medium term. The number of people in their prime working age has begun to fall, but it is expected that the higher activity rate among older employees will continue to offset this trend and to keep the labour supply almost unchanged. Structural unemployment has remained at around 7.3%, despite the weakness of the economy. The level of structural unemployment is estimated from the Phillips curve, which is used to determine the rate of unemployment below which labour market tightness will increase to such an extent that wage increases outpace productivity growth and unit labour costs consequently begin to rise.

Capital stock development is a more stable variable than other factors of production, and its contribution to labour productivity growth will be around 0.4% in the medium term. However continued weak investment levels would have the effect of reducing the economy's growth potential.

Total factor productivity growth has been particularly weak in recent years as employment has fallen much more slowly than total output. Key factors behind the decline of productivity include the difficulties experienced in high-productivity branches such as the electrical and electronics industry as well as the forest industry, but also the shift towards a more service-oriented economy. Assessing the medium-term potential growth of total productivity is particularly difficult at times of rapid structural change.

The potential growth of total productivity is separated from the cyclical component by using business cycle indicators.[2] Despite sluggish industry development, the capacity utilisation rate in 2013 did not deviate significantly from its long term average. On this basis it seems that the decline in total productivity has primarily been of a structural nature. History teaches us that total productivity growth usually resumes very quickly after the end of recession. The conditions for productivity growth, such as a high level of education and extensive innovation, are still in place. Factors suggesting that productivity growth will resume slowly include the

1 For a more detailed description of the method, see The production function methodology for calculating potential growth rates and output gaps. European Economy – Economic Papers 420. July 2010.

2 The industry capacity utilisation rate and services and building construction indicators.

relocation of high-productivity industries in third countries and the ever stronger service orientation of the economy. The present calculations work from the assumption that total productivity growth will slowly rebound.

The output gap, i.e. the difference between actual and potential output, is estimated to stand at 2.7% in 2014. In 2014–2018 it is projected that economic growth will outpace potential output growth, even though it will average no more than 1.3% a year. It is expected that the output gap will close in 2018. The slow growth rate means that the volume of total output will not recover to the level achieved in 2008 until 2018, which effectively means a decade of lost economic growth.

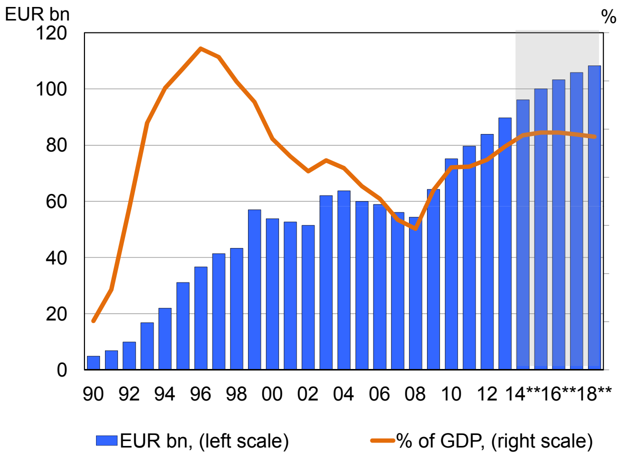
General government finances will improve slowly, and reach the balance over the medium term. Public debt to GDP will temporarily breach the 60% limit, but will after 2016 start falling slowly . It is estimated that central government net lending will show a deficit of 1.0%, with state debt reaching 48.4% of GDP in 2018. Local governments will also remain in deficit and their debt will increase over the outlook period. The surplus of earnings-related pension funds will continue to keep public finances afloat.

The weak economy coupled with rising age-related expenditure have pushed public finances into a structural deficit despite all adjustment efforts. It is estimated that the 2013 structural deficit will be –0.8% of GDP. The structural balance will improve in the medium term in response to central and local government adjustment and rising pension contributions.

Key forecast figures for the medium term

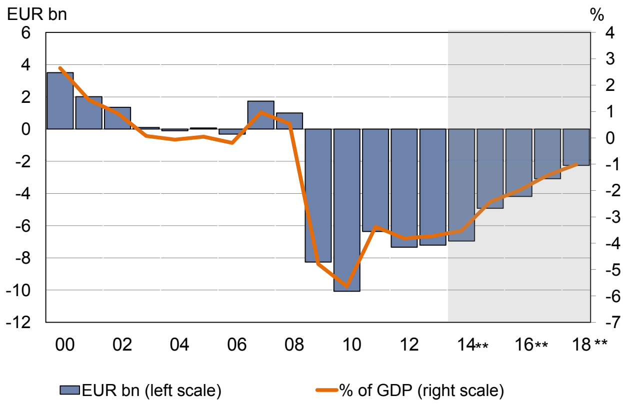
	2012*	2013*	2014**	2015**	2016**	2017**	2018**
GDP at market prices, change in volume, %	-1.0	-1.4	0.5	1.4	1.8	1.5	1.4
Consumer price index, change, %	2.8	1.5	1.5	1.7	1.9	1.8	1.8
Unemployment, %	7.7	8.2	8.4	8.3	8.1	7.8	7.5
Employment rate, %	69.0	68.5	68.5	68.9	69.5	69.6	70.0
General government net lending, % of GDP	-2.2	-2.4	-2.4	-1.4	-0.9	-0.3	0.0
Central government	-3.8	-3.7	-3.5	-2.4	-2.0	-1.4	-1.0
Local government	-1.1	-0.8	-0.9	-1.1	-1.1	-1.1	-1.1
Social security funds	2.7	2.1	2.0	2.1	2.3	2.2	2.1
Structural balance. % of GDP	-1.4	-0.8	-0.9	-0.4	-0.4	-0.2	0.0
General government gross debt, % of GDP	53.6	56.9	59.8	61.0	61.4	61.3	61.2
Central government debt, % of GDP	43.6	46.4	48.7	49,3	49,2	48,8	48,3

Central government debt

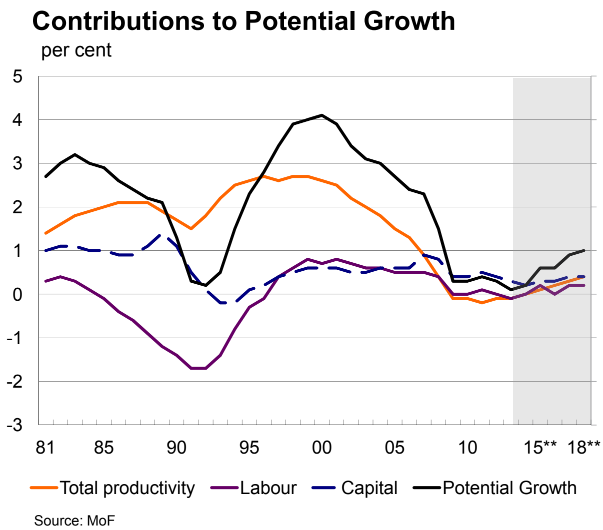


Sources: State Treasury, MoF

Central government financial balance



Sources: Statistics Finland, MoF



Fiscal policy

The framework for the conduct of fiscal policy is determined by the state and outlook of public finances, the national targets set by the Government as well as by the commitments arising from EU economic policy coordination.

The fiscal and economic policy followed by the Government of Prime Minister Jyrki Katainen is aimed at strengthening the conditions for economic growth and at securing sufficient funding for the welfare state and so to put public finances on a sustainable basis.

The Government's targets are detailed in the Government Programme. The Government's aim is to reduce the central government deficit to no more than 1% and to achieve a substantial reduction in central government debt to GDP by the end of the electoral term. In order to reach these targets the Government has committed itself to revenue and expenditure adjustments and to restructure the economy so as to facilitate stronger than predicted economic growth.

The target specified for Finnish public finances must also take account of EU regulations, i.e. the maximum limits for government deficit and debt set out in the EU Treaty as well the medium-term objective specified under the EU Stability and Growth Pact. The spring 2013 Stability Programme Update set the limit at –0.5% of GDP, which meets the minimum requirements of both the Stability and Growth Part and national legislation.

Fiscal and economic policy is geared to bridging the sustainability gap in public finances. The changing population age structure is contributing to reduce the number of people in working age and driving up age-related public expenditure. This is undermining the general government budgetary position. Assuming that the foreseeable economic development remains within normal range, general government revenue will not be sufficient to cover expenditure.

The Government has committed itself to launch by 2015 a package of measures designed to bridge the sustainability gap. On 29 August 2013 the Government announced a new structural policy programme aimed at improving the conditions for economic growth and to close the sustainability gap. The Government specified the steps it would take to restructure the economy in connection with its decision on the implementation of the structural policy programme on 29 November 2013.

In the structural policy programme the overall objective of bridging the sustainability gap is broken down into concrete targets concerning central government finances, local government finances, increasing the productivity of public service provision, work careers and the supply of labour, structural unemployment and the output potential and competitiveness of the economy as a whole.

The programme specifies the key elements that are needed to restructure the economy in a manner that supports economic growth and the sustainability of public finances: the budgetary framework and other joint central and local government actions aimed at restoring balance in municipal finances, improving the productivity of service provision by restructuring social and health care services and financing arrangements, and the extension of work careers through the pension reform and other measures focused on the beginning of and breaks in the labour market career. In addition other measures outlined in the structural policy programme, together with the labour market settlement that contributes to improve cost competitiveness, pave the way to faster than predicted growth in the long term. The Government's earlier structural policy decisions, such as the reduction of the corporate income tax rate, the reform of the dividend income tax system and measures to promote the employment of young people are in line with the objectives of the structural policy programme.

Economic growth and restructuring are key to sustainable fiscal management. Economic growth in the foreseeable future and the closing of the output gap are not enough to eliminate the sustainability gap. This will also require steps to implement the structural policy programme in the manner targeted by the Government. However most of the favourable effects of the reform on growth and fiscal sustainability will only materialise in the long term.

The state of public finances in Finland has time and again proved weaker than forecast, and the medium-term outlook has also deteriorated. This has been due not only to problems in the world economy and in the euro area, but also to structural changes in Finnish industry and its poor competitiveness.

As economic growth and employment look set to remain weaker than predicted, the targets set by the Government for central government finances have slipped beyond reach. The subdued growth prospects mean that the central government deficits will remain substantial and state debt will continue to climb sharply.

There is an increased risk that state debt will spiral out of control once interest rates return to normal. At the same time it has become increasingly challenging to bridge the sustainability gap by means of the structural policy programme. It looks like strengthening the conditions for growth via the structural policy programme might prove to be too slow a route.

In this situation it is important to reinforce confidence in Finland's ability to manage its public finances and meet its obligations. This confidence will create the necessary leeway for independent decision-making on how to halt the growth of debt and to secure the sustainability of public finances. Reducing central government deficits in a credible way is important to preserving confidence and to preventing a vicious circle of escalating debt in the medium term, before the structural reforms have the chance to make an impact.

In order to curb the growth of state debt in a credible manner and within a realistic timetable the Government has in its March 2014 fiscal plan discussions decided on new measures that will reduce central government expenditure and increase revenue by EUR 2.3 billion at an annual level in 2018. Most of these measures will be rolled out in 2015. At the same time the Government decided that it will submit the legislative changes required by these measures to Parliament during the current electoral term. These measures will satisfy all relevant EU obligations regarding the management of public finances.

In addition to these, the Government decided on measures which, when implemented, will strengthen central government finances, but the effects of which cannot at this stage be taken into consideration in the central government spending limit framework or in the macroeconomic forecast. These measures include those which will decrease the municipalities' expenditure, and which are conditional on stronger steering envisaged in the reform of the social and health care services. The strengthening effect on central government finances of these measures is estimated at EUR 130 million at the 2017 level. In addition, the already estimated effects of measures decreasing structural unemployment point to a strengthening of central government finances of EUR 230 million at the 2017 level.

During its term in office the Government has in various contexts decided on immediate measures designed to reduce central government expenditure and to increase revenue. At 2017 level the net effect of these measures comes to around EUR 6.8 billion, i.e. 3.1% of GDP.

1 Economic outlook

1.1 Global economy set to improve

Global economic growth is slowly rebounding. The recovery is mainly being driven by the United States and the UK, where the private sectors are shrugging off the long shadow of the financial crisis. Germany and Sweden are also picking up steam.

An extremely slack monetary policy in industrial countries and less aggressive fiscal policy adjustment are contributing to improve the cyclical situation. On the other hand private consumption and investment in particular are continuing to flatline or even contract in many industrial countries. High political uncertainty is deterring investment, particularly in Europe. In many developing economies growth over the forecast horizon will be significantly slower than in recent years.

World trade to remain sluggish

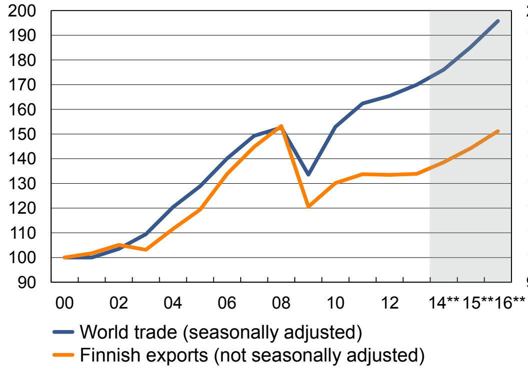
Since the crisis, world trade has grown more slowly than output. Trade growth will slowly gather momentum towards the end of the outlook period as investment demand rebounds.

Finnish exports have shown very poor performance both during and after the financial crisis, and still remain more than 10% lower than in 2008. Over the outlook period Finnish exports will grow more slowly than global trade, while Germany and Spain, for example, have already exceeded their previous peak performance years. The problem lies not just in the slowdown of demand caused by the euro crisis, but also in Finland's competitiveness and structure of supply.

Euro area moving onto slow growth path

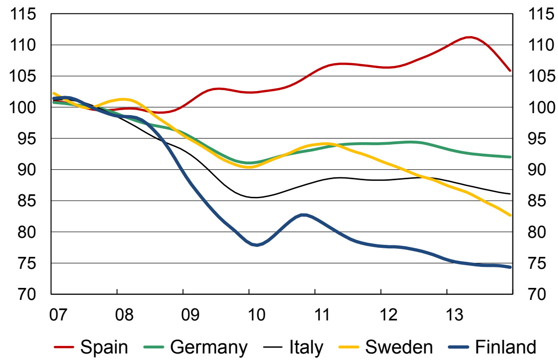
The euro area has emerged from six quarters of recession and is now turning onto a path of very slow growth. The fragility of this growth is attributable to the lingering effects of the debt and financial crisis. In several EU Member States growth is hampered by poor competitiveness, which is constraining opportunities on the supply side, and by the adjustment of private sector balance sheets, which is hampering consumption and investment.

World trade
2000=100



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

Other major economies more sluggish than before

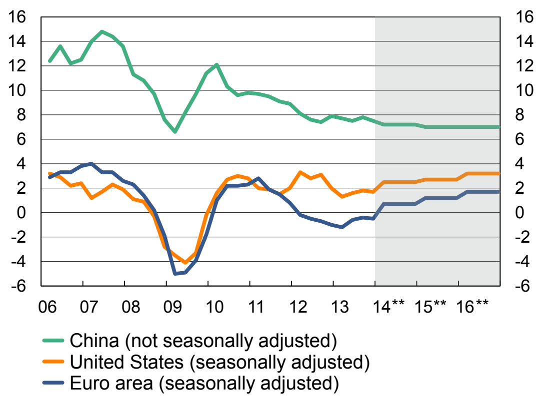
In the United States, too, recovery is historically slow. US growth is constrained by sluggish investment and the need to restore balances in the household sector. Although the rate of investment growth has rebounded, it will not reach its previous cyclical peak until 2015. Also, moderate demand means that employment is recovering slowly.

The outlook in Japan has improved with the announcement of the government's substantial stimulus and tax package plans and the central bank's extensive QE programme. These policy changes have resulted in a sharp decline in the value of the yen, which has seen deflation turn into moderate inflation, at least temporarily. The weak yen is supporting revenue generation in the export sector.

In Russia, the economic growth rate is set to slow by half to around 2%. Continued high oil prices will no longer be enough to sustain the kind of growth seen in previous years because of a shortage of capacity and low investment levels. In addition, Russian growth is hampered by the country's inflexible economic system and markets as well as by the absence of structural reforms designed to support innovation and growth.

Economic activity in China is dampened by sluggish demand from industrial countries, which cannot be fully offset by demand from the domestic market and other developing countries. Nonetheless the Chinese economy will continue to grow at around 7% throughout the outlook period, provided that the country's stimulus policy is successful.

Gross domestic product
change in volume, %



Sources: Statistical authorities, MoF

Absence of inflation pressures leaves room for unusual monetary policy

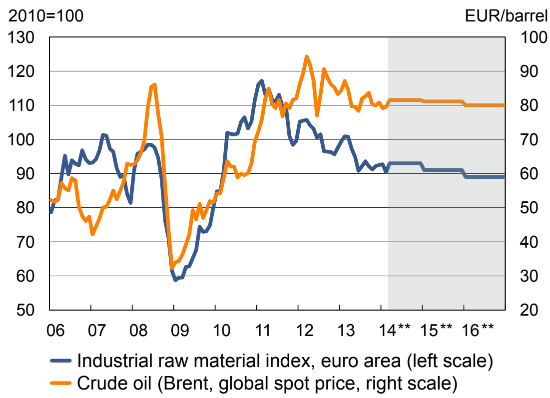
Inflation expectations in the financial markets are moderate, allowing central banks to persist with an unusual monetary policy stance.

Both interests and financial markets remain sharply polarised in the euro area. Lack of confidence has restricted the availability of cross-border financing, and the impact of monetary policy is not uniformly transmitted across the euro area. In the crisis countries interest rates on bank loans remain significantly higher than in the countries with the best credit ratings. ECB long-term financing operations have added substantial liquidity into the financial markets, helped to ease the financial crisis and contributed to creating the conditions necessary to overcome the crisis.

Both short-term and long-term interest rates will remain exceptionally low in industrial countries, except for those in crisis. Interest rates will edge up over the outlook period, partly as a result of rebounding confidence, but above all because of expectations that unconventional central bank policies will be withdrawn.

Prices of crude oil and other raw materials will fall moderately over the outlook period with the slowdown of growth in developing economies. With growth now on a more solid footing in the United States and the UK, it is expected that the euro will weaken against other currencies.

Raw materials prices
EUR



Sources: Hamburgisches WeltWirtschafts Institut, Macrobond, MoF

Risks increasingly balanced

The risks in the euro area are still predominantly on the downside as the recovery of households from the debt and financial crisis may take longer than predicted, as insufficient effort has been put into structural reforms to boost competitiveness, and as the banking sector may be in a weaker state than estimated. Sluggish private sector demand for credit may push consumption or investment back onto a downward track, and the fragility of growth may even lead back to crisis.

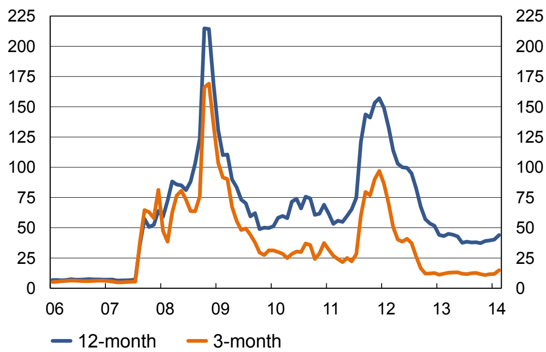
Failure to resolve the crisis in Ukraine will add to uncertainty and possibly increase the outflow of capital from Russia, reduce investment rates, weaken the rouble and drive the Russian economy into recession.

In the United States, the sense of uncertainty is heightened by political tensions. Any disruptions in the United States will be reflected in the global economy in direct proportion to the country's substantial share of world market demand. On the other hand the improved net real investment position in the private sector may push demand onto a stronger than predicted growth track. Furthermore, given its relatively low energy costs, the United States is well placed to improve its industrial base and price competitiveness.

Uncertainty hangs over both Japan's policy experiments and the extent and timing of their effects. For instance, the structural reforms may act to dampen demand before their beneficial effects on productivity and employment begin to filter through to the economy. It is also unclear whether Japan will be able to secure additional loans at the current very low interest rates.

Banking system risks

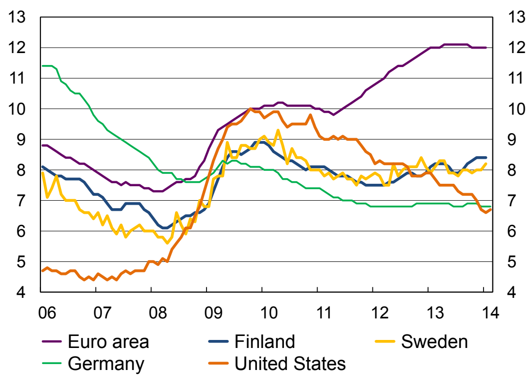
difference between secured Euribor and unsecured Eonia interest rate swap yield, basis points



Source: Macrobond

Unemployment rate

seasonally adjusted, %



Sources: Macrobond, statistical authorities

Low interest rates in industrial countries have brought a growing flow of investment to developing economies and safe havens where the market for housing and other assets may have overheated. This risk is increased by stimulus measures focused on attracting investment and increasing credit supply to many developing countries. The end of unconventional monetary policy is now looming on the horizon, and the need to adjust will inevitably cause turbulence in the financial markets.

It is possible that developing countries will return to growth sooner that predicted, which would also lead to a faster rebound of world trade.

Gross domestic product

	2011	2012	2013	2014**	2015**	2016**
	change in volume, %					
World (PPP)	3.9	3.2	3.2	3.6	3.9	4.0
Euro area	1.5	-0.5	-0.5	0.7	1.2	1.7
EU	1.7	-0.4	0.1	1.0	1.5	2.0
Germany	3.3	0.7	0.4	1.8	2.5	1.5
France	2.0	0.0	0.3	1.0	1.2	1.5
Sweden	2.9	0.9	1.5	2.5	2.5	2.7
United Kingdom	1.1	0.3	1.9	2.5	2.5	2.2
United States	1.8	2.8	1.9	2.5	2.7	3.2
Japan	-0.4	1.4	1.6	1.7	1.2	1.2
China	9.6	7.8	7.6	7.2	7.0	7.0
Russia	4.3	3.4	1.5	2.0	2.5	2.5

Sources: Eurostat, statistical authorities, IMF, MoF

Background assumptions

	2011	2012	2013	2014**	2015**	2016**
World trade growth, %	6.2	1.9	2.7	3.6	5.2	5.7
EUR/USD	1.39	1.29	1.33	1.30	1.27	1.25
Industrial raw material price index, € (2010=100)	112.4	99.0	100.0	93	91	89
Crude oil (Brent), €/barrel	79.7	87.1	82.0	81.5	81	80
3-month Euribor, %	1.4	0.6	0.2	0.3	0.5	1.3
Government bonds (10-year), %	3.0	1.9	1.9	2.3	2.9	3.5
Export market share (2000=100) [1)]	82	81	79	79	78	78
Import prices, %	6.2	2.5	-1.0	0.7	0.7	0.6

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

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

Banking Union – what's it all about?

The Banking Union is one of the fastest progressing areas of EMU development. In the short term the aim of the Banking Union is to promote stability in the financial markets, and in the longer term to contribute to the healthy operation of those markets. Furthermore the Banking Union is intended to break the link between banks and sovereigns in the euro area.

The key elements of the Banking Union are the
1. Single Rulebook,
2. Single Supervisory Mechanism (SSM), and
3. Single Resolution Mechanism (SRM) and Single Resolution Fund (SRF)

Single Rulebook

The Single Rulebook includes capital requirements for banking institutions (CRD4), comprehensive tools for crisis recovery and resolution (BRRD), including investor bail in rules, and a harmonised Deposit Guarantee Scheme (DGS). The rules for banking capital regulation were updated in summer 2013 and took effect from the beginning of 2014. Agreement was reached with the European Parliament on the BRRD and the DSG Directive in December 2013. These directives will enter into force during 2015–2016.

ECB's comprehensive assessment and transition to common supervision

Negotiations have also been concluded on a single mechanism for banking supervision. The regulations on common banking supervision entered into force in November 2013, and in November this year 128 major banks in 18 Member States will come under direct ECB supervision.

Prior to assuming its new supervisory tasks the ECB shall conduct a comprehensive assessment of these banks. This assessment comprises three components:
i. A general risk assessment (including liquidity, leverage and funding and special risk exposures);
ii. A balance sheet assessment (in which any overvalued assets are removed from bank balance sheets); and
iii. A stress test conducted together with the European Banking Authority EBA.

It is expected that the assessment will be completed by October-November this year. It is impossible at this stage to anticipate the outcome of the assessment. However it is good to bear in mind that during the crisis some EUR 500 billion of public and private funds have been spent on the capitalisation of European banks. The median core solvency ratio of major European banks currently stands at around 12% of the risk-weighted balance sheet, well above the assessment's minimum target level of 8%. In other words there is some buffer for possible writedowns.

In the eventuality that the comprehensive assessment reveals any capital shortfalls, the Ecofin Council agreed in November 2013 on the following pecking order:

1. In a first instance, any capital required shall be raised from the private sector, either in the form of additional capital from the owners or from new market sources;
2. If this is not sufficient, national public backstop arrangements will enter the frame;
3. If even national backstops are not sufficient, instruments at the euro area/EU level might be considered. At the euro area level, options available include

a. ESM financial assistance for the recapitalisation of banking institutions in the form of a loan to a Member State
b. ESM direct recapitalisation instrument once it has been established in euro area and national decision-making procedures

EU State Aid rules shall always be applied as a minimum requirement whenever public funds are used. Furthermore any decisions on ESM financial assistance shall be made by ESM's decision-making bodies and according to their rules.

Single Resolution Mechanism and Fund

In December the Ecofin Council also reached a general approach on a Single Resolution Mechanism (SRM) and adopted a Terms of Reference for intergovernmental negotiations on the Single Resolution Fund (SRF). It is envisaged that SRM trilogue negotiations with the European Parliament and the SRF negotiations shall be concluded by March-April before the end of the Parliament's current legislature.

Most BRRD regulations will enter into force in Member States from the beginning of 2015. At the same time the Single Resolution Mechanism will go into effect. Bail in rules will enter into force no later than the beginning of 2016, at the same time as the de facto resolution authority will be handed over to the Single Resolution Board.

The Single Resolution Mechanism will thus be accompanied by a Single Resolution Fund (SRF). Member States participating in the Banking Union are currently expected to build the SRF over a 8 year transitional period, starting from 2016. In the first year of the transitional period the costs of crisis resolution will primarily be covered from national contributions to the fund. According to the draft agreement the primary responsibility of national compartments would progressively decrease each year at the same time as mutualisation between national compartments would increase accordingly. By the end of the transitional period national compartments would have been merged and the costs of resolving banks would be fully shared from the single fund. It is estimated that the Single Resolution Fund will be around EU 55 billion.

At the moment it is projected that the main Banking Union institutions will be up and running from the beginning of 2016. The Single Resolution Fund, on the other hand, will become operational during the transitional period.

Common backstop arrangement

The comment has been made in various contexts that the Single Resolution Mechanism needs to be backed up with an appropriate backstop arrangement that will guarantee adequate funding for crisis management even under exceptional conditions. However during the transitional period the SRM backstop will remain a national responsibility. After the transitional period the national compartments will be fully merged with the single fund. At this stage national sources will no longer be responsible for bridge financing, and the question will arise regarding the contribution of Member States participating in the Banking Union to developing a common backstop for the resolution fund. As yet there is no agreement on how a common backstop arrangement will be implemented, but this will be negotiated during the transitional period.

What if demand in Germany had been stronger?

During the 1990s Germany's current account deficit averaged 0.6% of GDP, but in 2002 the deficit turned to surplus. The surplus grew rapidly and from 2007 to 2013 averaged 6.8% of GDP. The German economy set aside an increasing share of its income for savings.

Household consumption trends have been very weak in Germany since 2000. In 2000 consumption as a proportion of disposable income was over 81%, but by 2013 the figure dropped to 66%. Since 2009 investment other than residential construction has progressed very slowly. Household investment has been slowed among other things by the Hartz reforms and other steps taken to bolster the country's poor competitiveness. The sluggishness of business investment is explained among other things by weak economic development and weak expectations.

What if demand in Germany had been stronger? A large current account surplus means resource underuse, and is not an optimal situation. On the other hand many of the proposed corrective measures to increase resource use, such as wage increases or stimulus measures, would stoke inflation and therefore undermine German competitiveness. Germany, after all, operates in the global economy and any policy measures compromising its competitiveness would in the longer term adversely impact its trade partners as well, for instance by increasing interest rates and reducing export demand in crisis countries (Spain, Portugal, Italy, Ireland, Greece)

We simulated a contra factual scenario where private demand in Germany did not decline during the 2000s using the NiGEM model developed by the British National Institute of Economic and Social Research.[1] NiGEM is a new Keynesian estimated econometric model of the global economy. In this framework output is demand-determined, agents' expectations can be varied and nominal wage and other rigidities hamper the economy's adaptation to shocks. The economies of most OECD countries, China and Russia have been modelled in NiGEM. The biggest economies have been modelled in most detail, the rest of the world is incorporated in the models as regional blocs. All models include domestic demand, export and import prices and volumes, current account and net external assets.

In our simulations we forced the 1996–2002 trends of German household consumption and business investment to remain on the same linear path in 2003–2013; see Figs 1 and 2. According to this scenario, average annual consumption in 2010–2013 would have been some EUR 93 billion and annual investment some EUR 33 billion higher than actual, representing around 3.8% and 1.3% of GDP, respectively. Furthermore, we assumed that agents' expectations are backward looking. Euro area interest rates were exogenised,[2] and euro area inflation accelerated just over 0.5 percentage points faster than actual inflation. Public sector deficits were allowed to be freely determined. All other world economy decision rules, such as demand equations and policy decision rules, remained unchanged.

According to the results, German GDP in 2002–2013 would have been 2.0–3.9 percentage points higher than actual. The stronger demand would have spilled over into other countries as well. The weighted GDP of the crisis countries would have been 0.2–0.6 and Finland's 0.4–0.9 percentage points higher than actual; see Fig 3. Germany's current account surplus would have shrunk, but still remained in the black throughout the period under analysis; see Fig 4. Stronger demand would have significantly improved Germany's budgetary position (by 3.0–3.2 percentage points in 2010–2013) and also strengthened the budgetary position of crisis countries (by 0.4–0.5 percentage points); see Fig 5. This effect is explained by the increase in tax revenue from higher GDP.

The favourable effects of the simulation require either a much looser interpretation of central bank inflation targets, for instance because of the large output gap and increasing unemployment following from the euro crisis, or an unusual price determination.

The results will be reported in more detail in a forthcoming report by Stenborg and Suni, to be published by the Research Institute of the Finnish Economy (ETLA) in 2014.

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[1] http://nimodel.niesr.ac.uk/

[2] A tighter monetary policy would clearly impact the results. See Stenborg, M. and Suni, P. (2014).

Figure 1. Germany, Constant Price Household Consumption, SA

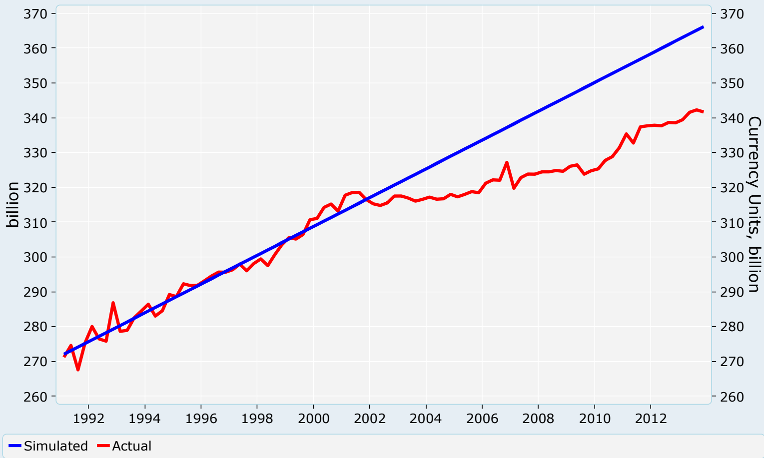


Figure 2. Germany, Constant Price Business Investment

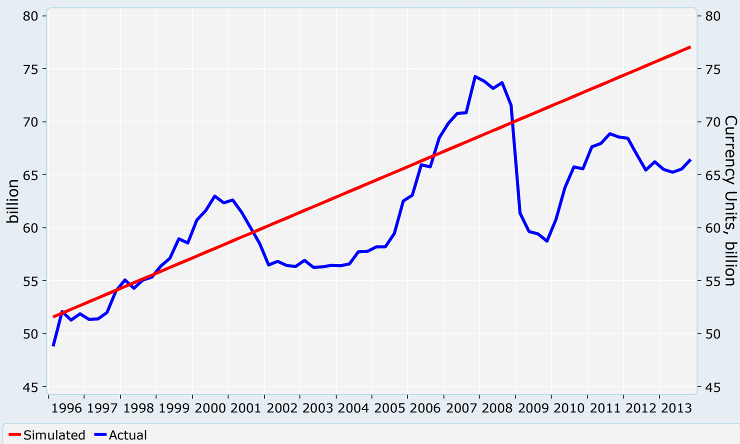


Figure 3. Simulated GDP Deviation from Actual, % GDP

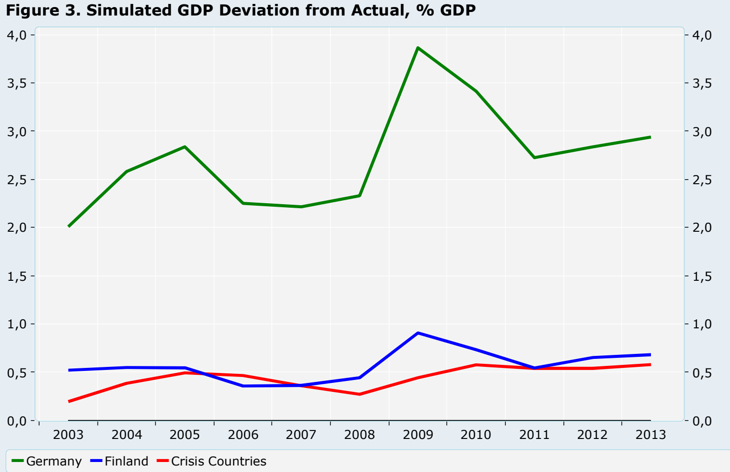


Figure 4. Current Account, % GDP

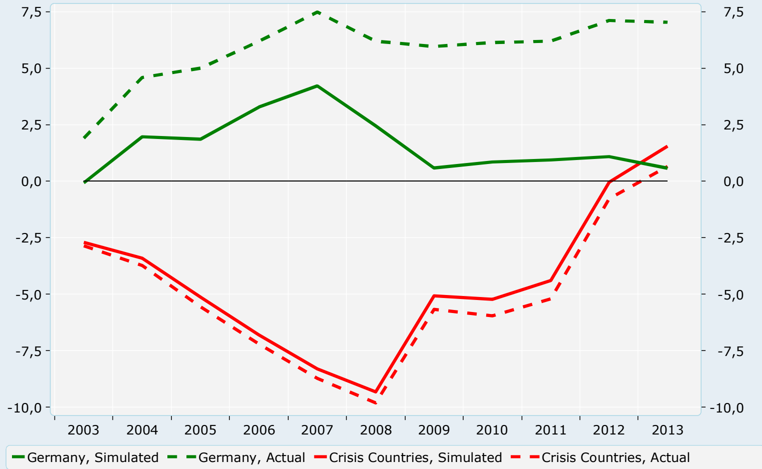
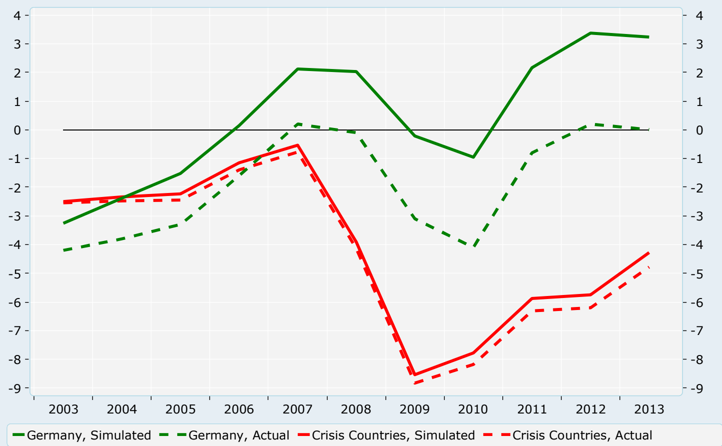


Figure 5. Public Sector Balance, % GDP



1.2 Foreign trade

Exports growing slowly, sluggish domestic demand slowing import growth

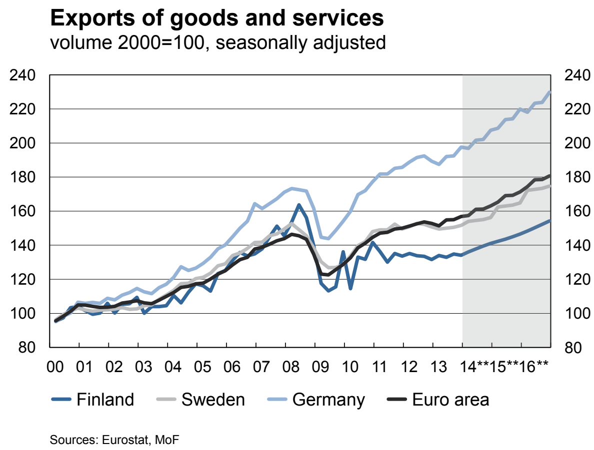
Finnish exports returned to a growth track in 2013. Although the rate of export growth was marginal, the contribution of net exports to GDP growth was 0.9 percentage points as imports also continued to fall last year.

In 2014 exports will continue to grow slowly, and the annual rate of exports volume growth will accelerate from 0.3% last year to 3.5% this year. This trend is driven by the rebound of economic growth in Finland's most important export markets and by the gradual acceleration of global trade after a few slower years. European economic growth will gather steam and investment will pick up around the world in 2015, which will create growing demand for Finnish goods and services. Exports growth will accelerate to over 4%. In 2015 exports growth will accelerate to almost 5% on the back of improving global trade. However this growth will still be modest compared to the pre-crisis period, and by 2016 the volume of exports will not yet recover to the levels recorded before the financial crisis. The rate of exports growth will be slower than world trade growth.

It is expected that exports growth will be broadly based, but in the short term the expectations are highest for the chemical industry and various service exports. With economic growth in the euro area remaining sluggish, the growth of export demand will be strongest outside Europe. If Finnish companies have significantly better success than earlier in breaking into the markets of developing countries, then exports may show stronger than predicted growth, which would also result in a stronger than predicted increase in imports.

Foreign trade

	2011	2012	2013	2014**	2015**	2016**
	change in volume, %					
Exports of goods and services	2.8	-0.2	0.3	3.5	4.1	4.8
Imports of goods and services	6.2	-0.7	-1.8	2.1	3.3	3.9
	change in price, %					
Exports of goods and services	4.3	1.2	-0.9	0.2	0.4	0.5
Imports of goods and services	6.2	2.5	-1.0	0.7	0.7	0.6



In 2014 imports will post growth of over 2% on the back of increasing exports, even though domestic demand is weak. The upturn in investment and accelerating exports will drive imports to growth of 3.3% in 2015. With consumption set to rise the following year, the rate of imports growth will climb further close to 4% in 2016. The contribution of net exports to GDP growth in the current year is around half a percentage point. That effect will diminish over the years ahead as the rate of imports growth comes closer to the figures for exports growth.

Export and import prices will rise very moderately over the outlook period with the downward trend of international market prices of crude oil and other raw materials. The significant deterioration of Finland's terms of trade has now ended as the share of falling-price electronic products as a proportion of Finnish exports has decreased considerably since the early 2000s.

Current account deficit continues to shrink

The national accounts trade balance returned to surplus in 2013 after two years of deficit. Underlying this turnaround is the continued fall last year of commodity imports in the wake of sluggish domestic demand. The trade balance surplus will grow over the outlook period with exports outpacing imports growth. In 2016 the trade balance surplus will reach over one billion euros. However this is still considerably smaller than the 10-billion-plus surpluses of the early 2000s.

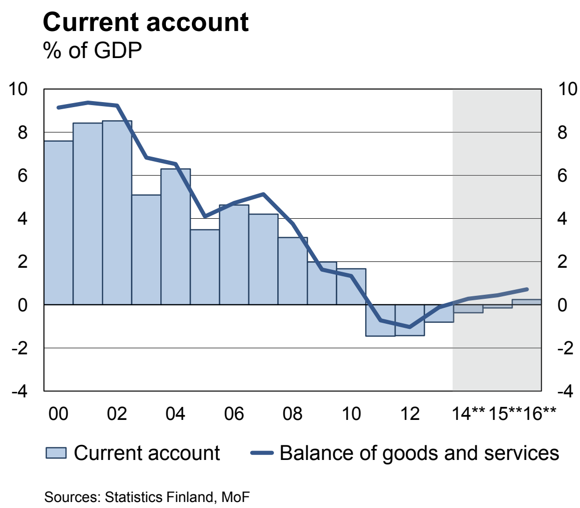
The services balance deficit also shrank last year with the fall in service imports. Last year the 2012 deficit of almost EUR 2 billion fell to just over half a billion. The services balance deficit will turn into a marginal surplus towards the end of the outlook period. Indeed over time it is projected that services trade will become the second pillar in strengthening the current account. At the end of the outlook period the balance of goods and services will show a surplus of EUR 1.5 billion.

Last year's deficit of around EUR 1.4 billion in the factor incomes and current transfers balance will shrink over the outlook period. This is attributable to the strengthening balance of capital payments. Capital payments into Finland will exceed the amount of payments out of Finland as economic growth gathers steam elsewhere in the world and foreign companies gradually begin to turn out increasing profits. The balance of capital payments has been positive since 2008. Indeed the balance of capital payments is the third pillar strengthening the current account apart from the trade of goods and services.

According to the latest national accounts figures the current account deficit peaked at EUR 2.8 billion in 2012 and narrowed to EUR 1.6 billion in 2013. The deficit will shrink over the outlook period as the goods and services balance strengthens and the surplus of capital payments increases. At the end of the outlook period the current account will turn into a slight surplus: in 2016 the current account surplus will stand at 0.2% of GDP.

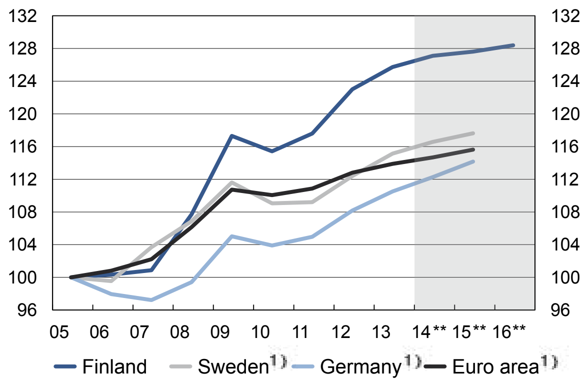
Current account

	2011	2012	2013	2014**	2015**	2016**
	EUR bn					
Balance of goods and services	-1.4	-2.0	-0.2	0.6	0.9	1.5
Factor incomes and income transfers, net	-1.4	-0.8	-1.3	-1.3	-1.2	-1.0
Current account	-2.7	-2.8	-1.6	-0.7	-0.3	0.5
Current account, % of GDP	-1.5	-1.4	-0.8	-0.4	-0.1	0.2



Finland's export performance depends not only on the quality of the goods and services sold, but also on product pricing. During the financial crisis unit labour costs in Finland rose far more sharply than in rival countries when compared to productivity growth, ultimately as a result of high pay rises. The wage settlement negotiated last autumn by the labour market organisations will significantly slow the rise of unit labour costs over the next few years, but those costs will not yet start falling. Projections are that in the near future unit labour costs in Finland will rise more slowly than in Sweden and Germany. This slight improvement in cost competitiveness is a step in the right direction, but it is crucial that any cost increases are moderate in the coming years as well.

Unit labour costs
2005=100, nominal



1) European Commission forecast

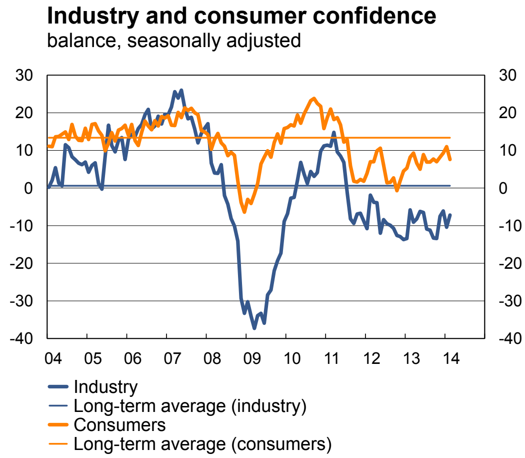
Sources: European Commission, Statistics Finland, MoF

1.3 Domestic demand

1.3.1 Private consumption

Consumption depressed by caution and weak real income development

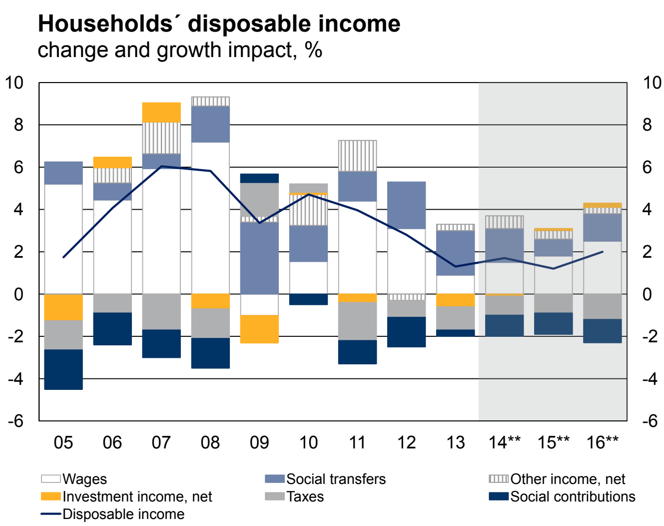
In recent years economic activity has been more dependent than usual on domestic demand. Private consumption accounts for more than half of domestic demand. Real disposable household income has shown modest gains over the past few years. In 2013 real income was at virtually the same level as three years earlier. Since the acute financial crisis private consumption has increased as a result of lowered household savings rates. This trend continued until last year, when private consumption fell by 0.8 %. Private consumption last showed negative growth in connection with the 2009 financial crisis. In 2013 private consumption declined in the wake of weak real income development and increasing consumer caution. The household savings rate turned up with the deteriorating employment situation and rising economic uncertainty.



Source: European Commission

Consumer expectations about their own financial situation have in recent months shown signs of improving, even though consumer survey data suggest that confidence remains below the long-term average. Expectations in retail trade have also improved from their exceptionally low level. Preliminary figures for January indicate that sales volumes in retail trade were up 1.2 % on last year's performance. However these early figures have tended to give a rather more positive picture of retail trade trends than the final statistics.

Wage and salary earnings are the single most important household income item. In 2014 it is predicted that the number of persons employed will continue to fall somewhat, albeit clearly less than last year. Real disposable household income will decline slightly in the current year. The recovery of the global economy will take some time to filter through to the consumer climate and to consumption propensity. The forecast is based on the assumption that household confidence will continue to strengthen through to the end of the outlook period. In 2014 private consumption will remain unchanged from last year's figures.



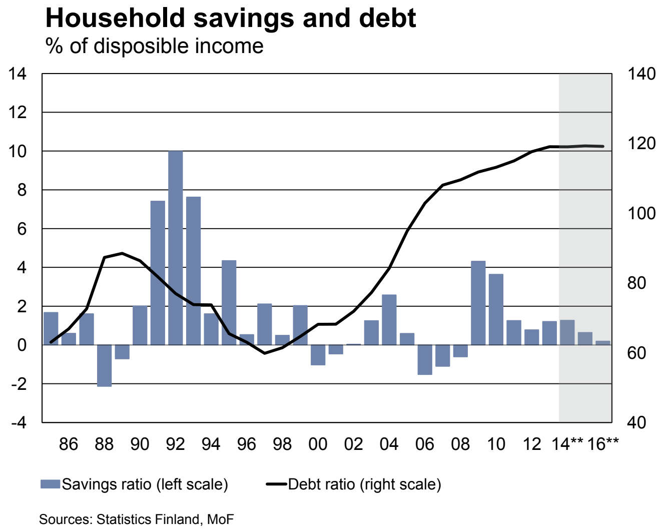
Sources: Statistics Finland, MoF

Gradual improvement in employment spurs consumption

Moderate wage increases contribute to strengthen the competitiveness and external balance of the national economy. The wage settlements now in place will have a delayed positive effect on employment and by the same token on household income. In 2015 the number of persons employed will start rising. At the same time overall tax rate will rise and growth of social transfers will slow down. Hence, despite of improving employment households real income will decrease slightly. In 2016 income tax scales will be adjusted to reflect the rise in earned income levels so as to prevent taxes from rising accordingly. However the increase in social security contributions will contribute to drive up the overall tax rate. Real disposable household income growth will accelerate towards the end of the outlook period, and private consumption growth will reach 1.1 % in 2016.

Interest rates have long been at an exceptionally low level. As the global economy continues to rebound and the economic situation in Europe improves, it is expected that interest rates will edge up over the next two years. In Finland these interest hikes filter through to impact household interest expenses with relatively little delay. Around 95 % of all households' housing loans are tied to 12-month or shorter reference rates. Rising interest rates also have the effect of increasing household property income. In recent years households' interest receipts have been slightly higher than their interest expenses. However interest receipts and interest expenses are unevenly divided between households. According to 2011 statistics on income distribution, the highest income decile received more than 40 % of all income receipts, at the same time as this same decile accounted for less than 20 % of all housing loan interest expenses. In the shorter term rising interest rates will therefore also dent the prospects for private consumption growth as the negative impacts of these interest hikes will be more keenly felt by households with lower than average incomes, whose short-term consumption propensity is higher than that of households in higher income brackets.

The impacts of the changing population age structure are seen in all sectors of society. As well as affecting economic growth and the general government budgetary position, population ageing is also reflected in private consumption and household savings behaviour. As a result of demographic change, the downward pressure on the savings rate increases in direct proportion to the growing number of pensioners who finance their consumption out of assets they have accumulated over their lifetime. In Japan, for instance, where the elderly population has long been growing, the savings rate has fallen appreciably. In Japan's case this trend has to do not just with population ageing, but it is thought that more general changes in savings behaviour are also at play.



Rising interest rates will drive down debt levels

Low interest rates have long fuelled the willingness of households to take on debt. The household indebtedness ratio has shown no signs of letting up. Despite only modest income growth, the indebtedness ratio climbed to 119 % in 2013. Housing loans account for almost three-quarters of all household debts. In 2013 it is estimated that the number of dwelling transactions fell by some 15 % as a result of household uncertainty. During the current year the number of transactions will continue to remain at a lower level than usual.

Compared to the demand for housing loans, the general economic slowdown has had an even greater impact on demand for consumer credit. In 2013 the number of consumer loans fell by around one per cent. In order to ensure a balanced development of the national economy, the growth of household indebtedness will be curbed by continuing to progressively limit tax deductions for interest paid on housing loans. At the same time the authorities have been paying ever closer attention to the credit conditions for housing loans. A legislative proposal is currently under preparation in order to introduce a ceiling on housing loans. Under the new rules housing loans would be capped at 90 % of the market value of the collateral pledged. It is proposed that the new loan ceiling rules will take effect from the beginning of July 2016.

1.3.2 Public consumption

The volume of public consumption increased by close to one per cent in 2013, less than the long-term average. In the next few years annual growth will remain even slower at around half a per cent.

Public consumption expenditure came to EUR 50 billion in 2013, accounting for over one-quarter of domestic demand. Welfare services, i.e. health care, social security and education account for two-thirds of public consumption. General public services, national defence, public order and safety account for one-fifth or some EUR 10 billion.

Central government consumption increased more than usual last year because from the beginning of 2013, with the introduction of the public broadcasting tax, the Finnish Broadcasting Company YLE is classified under the central government sector. The medium-term outlook for central government consumption is subdued because of the deficit in central government finances, and it is expected that the volume of consumption will fall slightly. Wages and salaries are anticipated to rise only very moderately, and therefore the price of consumption will rise less than earlier. Roughly half of central government consumption consists of compensation of employees, the other half consists of intermediate consumption, i.e. purchased inputs.

It is forecast that over the next few years, the volume of local government consumption will increase on average by just under 1% a year. Expenditure pressures are emanating from the growing demand for basic services in response to the changing population age structure. This is increasing the need for social and health care services in particular. On the other hand the growth of local government consumption is curbed by the stringent economic situation, which will force local governments to undertake adjustment measures during the current year. As yet nothing definitive is known about the adjustment measures that will be needed in the years ahead, and therefore they are not included in the forecast. In 2014–2016 it is forecast that nominal consumption expenditure will increase on average by over 2% a year. The main factor behind the slower growth rate is the moderate wage settlement negotiated in autumn 2013.

The expenditure of social security funds in 2013 came to EUR 3.4 billion, remaining at the same level as the year before. The biggest expense items were wages and salaries and social benefits in kind paid out by Kela (Social Insurance Institution), such as medicines and travel and rehabilitation benefits. Social benefits in kind decreased last year as a result of the savings decisions adopted in the Government Programme, but other consumption expenditure increased. It is predicted that expenditure will rise again over the outlook period, albeit more slowly than usual.

Consumption

	2013 share. %	2011	2012	2013	2014**	2015**	2016**
		Change in volume.%					
Private consumption	100.0	2.5	0.3	-0.8	0.0	0.3	1.1
Households	95.5	2.8	0.3	-0.8	0.0	0.3	1.1
Durables	8.0	8.2	-0.2	-0.9	1.3	1.6	2.3
Semi-durables	8.4	3.3	1.4	-1.5	0.5	0.5	1.3
Non-durable goods	28.0	0.5	-0.8	-1.8	-0.3	0.0	0.8
Services	51.3	3.5	0.8	-0.5	0.0	0.3	1.2
Consumption by non-profit institutions	4.5	-2.7	0.7	-0.5	0.0	0.5	1.0
Public consumption	100.0	0.5	0.5	0.8	0.3	0.4	0.7
Central government	27.8	-1.9	0.7	2.3	-0.5	-0.5	0.1
Local government	65.1	1.4	0.5	0.5	0.5	0.8	0.9
Social security funds	7.1	1.1	-0.3	-2.1	2.0	-0.2	0.8
TOTAL		**1.9**	**0.4**	**-0.3**	**0.1**	**0.3**	**1.0**
Individual consumption expenditure in general government		0.8	0.2	0.5	0.9	0.7	1.0
Total individual consumption expenditure		2.1	0.2	-0.3	0.2	0.5	1.1
Households´ disposable income		4.0	2.8	1.3	1.7	1.2	2.0
Private consumption deflator		3.5	2.9	1.7	1.7	1.5	1.3
Households´ real disposable income		0.4	-0.1	-0.4	0.1	-0.3	0.7
	%						
Consumption as proportion of GDP (at current prices)		80.1	81.5	82.3	82.0	81.2	80.6
Household savings ratio		1.3	0.8	1.2	1.3	0.6	0.2
Household debt ratio [1)]		114.9	117.6	119.0	119.0	119.3	119.1

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

1.3.3 Private investment

Investment down sharply towards the end of 2013

Investment fell by 4½% in 2013. The decline in private investment was sharper still, reaching almost 6½%. All investment items declined. Despite the ready availability of inexpensive funding, new investment in machinery, equipment and transport equipment in particular was disappointing: quarter-on-quarter figures were down throughout last year.

The total investment to GDP ratio was around 19% in 2013. Private investment to GDP fell by one percentage point from the previous year, coming in at around 16%. Reduced levels of private investment alone slowed GDP growth by more than one percentage point.

Investor activity last year was very much marked by caution, which was reflected both in household housing investment and in production-related investment by businesses. The stock of housing loans, for instance, fell in December 2013 from the previous month for the first time in 15 years. According to the Confederation of Finnish Industries investment survey, industrial companies have spent as much on their investments abroad as they have on their domestic investments when ownership arrangements are included.

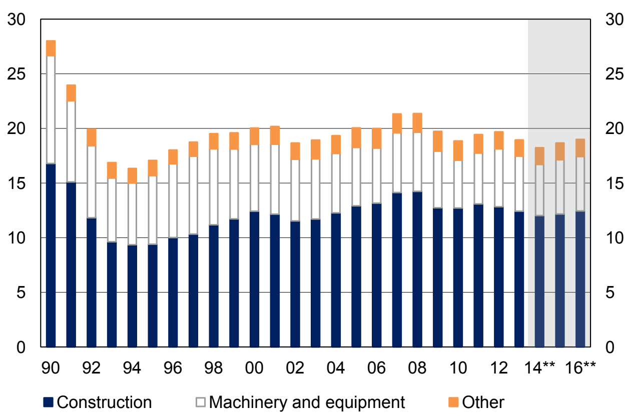
Private investment set for growth

In 2014 private investment will show robust quarter-on-quarter growth. Even so annual private investment will fall 3.5% short of last year's figure, as investment declined sharply towards the end of 2013.

The rate of investment will fall in 2014 because it is predicted that GDP will grow. The investment rate will start rising again from 2015. Investment growth is supported both by the steps taken in the euro area to curb public deficits and by the burgeoning rise of economic activity in high income countries. Furthermore the decisions taken by the Finnish Government on stimulus actions in 2013 and 2014 will increase both housing renovation activities and rental housing construction.

Private investment will provide a 1½% contribution to GDP growth in the final years of the outlook period in 2015 and 2016. Nonetheless investment will remain slightly below its 2012 level, falling some 10% short of the peak figures of 2007.

Investments
% of GDP



Sources: Statistics Finland, MoF

Housing investment to hit bottom this year

New housing investment is projected to fall sharply in 2014. On the one hand the number of started but incomplete projects is lower than last year, and on the other hand the number of new housing starts will also remain lower than earlier. It is anticipated that housing investment will hit rock bottom during the current year. The number of new housing starts in 2014 is estimated at around 25,000. The main reason for the declining trend lies in the weak cyclical situation and associated fears of increasing unemployment. However, conditions for rental housing development will improve with the increased investment earmarked for state-subsidised production and with the planned introduction from 1 January 2015 of new rules that would allow authorised pensions providers to use borrowed capital for investment in rental accommodation.

The climate of economic uncertainty coupled with often profound regional structural changes have particularly affected investment in low-rise housing. Housing starts will regain momentum in 2015, when investment is expected to show an annual growth rate of 3%. This will pick up further in 2016 when low-rise housing construction will also gather steam.

From individual projects to more broadly-based growth

Investment in non-residential buildings will show positive growth in 2014, but last year's sharp downturn affects annual comparisons and the forecast projects an increase of no more than 0.2%. For the time being this growth is entirely dependent on individual projects. Business construction was at a relatively low level last year when compared to the recent past, but it would now seem to be on the rise again. Investment in other commercial building construction is also at a modest level with the exception of individual warehouses, stations and agricultural production facilities.

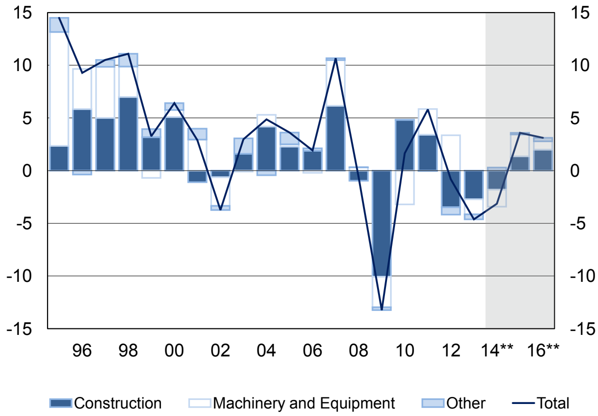
In 2015 and 2016 investment in non-residential building construction will increase on a broader basis. Even so the overall investment level in the last year of the outlook period will fall short of the 2012 figure. Similarly, as economic activity has developed less robustly than previously forecast, the need for commercial investment will also be lower than anticipated.

Renovation accounts for half of housing investment

Renovation investment is set to remain buoyant throughout the outlook period. Housing renovation investment is boosted by substantial stimulus measures as agreed by the Government in March 2013. These measures include the renovation start-up subsidy for housing corporations, which in the current year amounts to a total of EUR 100 million. In connection with its spring 2014 spending limits discussions the Government decided to increase home renovation subsidies paid out from the Housing Fund to older and disabled people, but at the same time made other, albeit smaller budget adjustments concerning renovation activities.

The volume of housing renovations is approaching the same level as investment in new housing construction. Renovation and new housing construction currently have more or less the same employment effect. In non-residential building construction renovation accounts for a smaller proportion of overall investment. In this sector demand is being boosted by the grants awarded to renovate schools with mould problems.

Investments
change in volume and growth impact, %



Sources: Statistics Finland, MoF

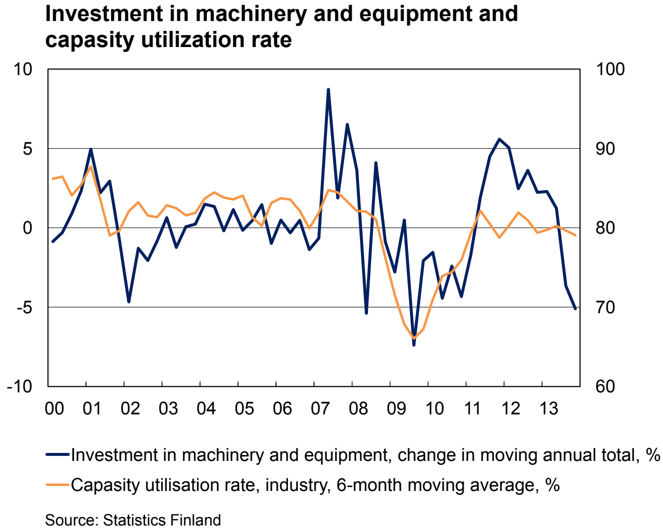
Infrastructure investment set for downturn

Civil engineering investment turnover and sales volumes have clearly fallen towards the end of last year. The cyclical situation is expected to deteriorate further with the slowdown of public investment, based on the Government's spring 2014 spending limits decision, for instance. At the same time diminishing housing construction will also spill over to affect the construction of roads and public utilities. Civil engineering investment is expected to fall both in 2014 and 2015. It is expected to decrease additionally by ½% in 2016 although both housing construction and non-residential building construction return to normal.

Machinery and equipment: from rollercoaster to slight uphill

Investment in machinery, equipment and transport equipment in 2013 saw both the highest peak since the financial crisis and an almost equally dramatic fall as was experienced at the turn of 2008 and 2009. Part of the reason for this was that some major vessel investments were recorded as investment in early 2013.

The forecast assumes that investment in transport equipment will turn to growth. This is supported among other things by the positive trends for first registrations towards the end of last year and in the early part of this year. Furthermore it is thought that the need for both new and replacement machinery and equipment will increase as exports gradually gather speed again. According to the Confederation of Finnish Industries survey, industry and energy investment are expected to increase by some 2% in the current year. Industry investment, including energy, accounts for close to 20% of total investment, while the service sector accounts for over 75%.



Fixed investment by type of capital asset

	2013 share, %	2011	2012	2013	2014**	2015**	2016**
		Change in volume,%					
Buildings	55.9	6.1	-5.1	-4.4	-2.7	2.7	3.6
Residential buildings	35.1	5.5	-4.0	-3.0	-4.5	2.9	4.0
Non-residential buildings	20.8	7.0	-6.8	-6.8	0.2	2.5	3.0
Civil engineering construction	9.7	-0.8	-5.5	-2.7	-2.7	-2.0	-0.4
Machinery and equipment	26.6	10.5	14.0	-5.3	-6.1	8.1	3.0
Other investment	7.8	-0.4	-8.0	-6.0	3.7	1.8	4.0
Total	100.0	**5.8**	**-0.8**	**-4.6**	**-3.1**	**3.6**	**3.1**
Private	85.1	6.3	-1.2	-6.4	-3.5	4.6	4.2
Public	14.9	2.6	1.7	6.8	-0.9	-1.9	-3.6
		%					
Investment to GDP ratio (at current prices)							
Fixed investment		19.4	19.7	18.9	18.2	18.7	19.0
Private		16.9	17.1	16.1	15.5	16.0	16.4
Public		2.5	2.6	2.8	2.8	2.7	2.6

Major revision of national accounts in July 2014

Finland, along with the other EU countries, is introducing a revision to the system of national accounts (ESA 2010). The updated system is based on the SNA 2008 system as developed by the United Nations. Statistics Finland will be publishing the new ESA 2010 national accounts figures on 11 July 2014: the figures released will include revised time series of annual national accounts (1975–2013) and quarterly national accounts (1990Q1–2014Q1).

ESA 2010 will bring changes to the methods of national accounting and expand the data contents of national accounts. The previous revision was made in 1999 when the national accounts system ESA 95 was adopted.

The new ESA 2010 system will among other things broaden the concept of assets and provide clearer guidance on how to handle global production methods. In addition the dividing line between general government and the private sector will be revised, and Member States will be obliged to provide data on liabilities related to pension systems. The changes with the greatest impacts on GDP will be the treatment of R&D expenditure and spending on national defence equipment as investment.

Statistics Finland has compiled material related to the revision of national accounts on its website at www.stat.fi/til/ekt2010. In connection with releasing the updated national accounts figures in July 2014, Statistics Finland will also be making other time series changes than those directly related to the ESA 2010 revision. Early indications from Statistics Finland are that the most significant time series revisions will probably concern data on renovation activities.

1.3.4 Public investment

Central government investment accounts for around one-quarter and local government investment for three-quarters of public investment. By type of capital goods, civil engineering investment accounts for over 40% of the total, investment in buildings for just under 40%, and the rest are mainly investment in machinery and equipment. The volume of public investment in 2012 was at the same level as 10 years ago. In the next few years ahead it is projected that, given the current financial difficulties, investment levels will continue to fall slightly.

Central government investment consists primarily of investment in transport infrastructure. Four major road projects will be launched in 2014. One of the biggest ongoing transport infrastructure projects is the upgrade of the Ostrobothnia rail line. It is estimated that the volume of central government investment will increase slightly from last year's low level.

There is considerable pressure to invest within the local government sector, among other reasons because of renovation needs and major infrastructure projects in population growth centres. However the realisation of these investment plans depends largely on the current situation in municipal finances and on the cost of borrowing. Indeed over the next few years it is anticipated that the annual volume of local government investment will fall somewhat in response to tightening local government finances.

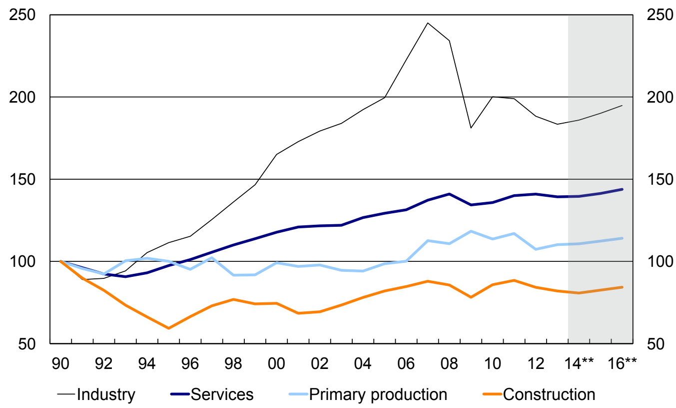
1.4 Domestic production

1.4.1 Total output

Return to growth postponed again

The economy did still not return to growth last year. Value added of the national economy declined by 1.5% in 2013. Total output has now fallen two years in succession. The economic slowdown last year was broadly based, with output falling in all main sectors of the economy except for the forest industry. The sharpest falls were recorded for industry and construction, where output was down 2½%. Output in services fell by over one per cent and in agriculture by half a per cent. Last year, services continued to account for a growing share of national value added – the figure now stands at well over 70% – at the same time as the share of secondary production has fallen to around one-quarter. Total value added still remains more than 6% lower than before the financial crisis in 2008.

Production
1990=100

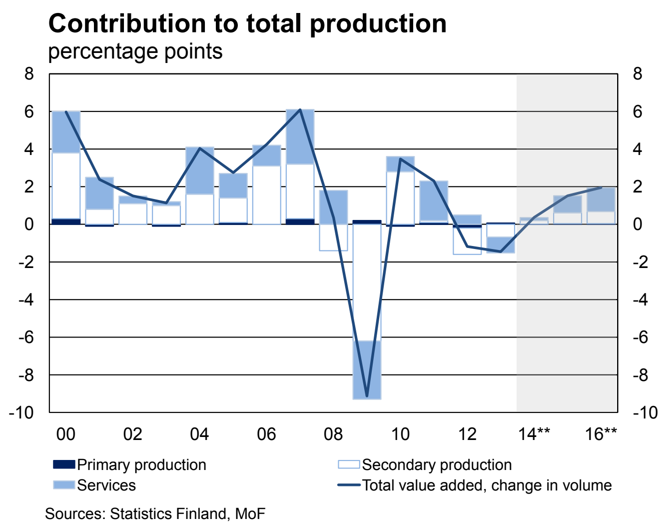


Sources: Statistics Finland, MoF

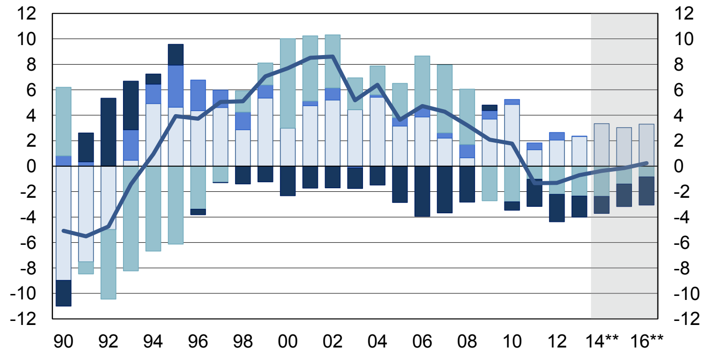
In 2013 the economy's productive resources remained largely underutilised. In manufacturing the capacity utilisation rate fell by around one percentage point to under 80%. Unemployment was up 6% and the unemployment rate climbed to 8.2%, even though the number of working aged people moving outside the labour force was a couple of per cent higher than the year before. Furthermore investment in production-related fixed assets has been falling for the past two years. The number of hours worked in the national economy fell more than value added, by 1.9%, and therefore labour productivity improved slightly, i.e. by 0.4%. Labour productivity has been poor since the financial crisis, continuing to remain 3½% lower than before the crisis. Part of the reason for this lies in the structural change in industry as the contribution of high-productivity sectors to total output has declined.

It is expected that the economy will gradually return to growth. This year national value added growth will come in at around ½%, but accelerate in 2015 to 1½ and in 2016 to 2%. The outlook in Europe, Finland's principal export market, is brighter than in the past few years, which will boost Finnish companies' export demand. It is expected that growth in developing markets will remain clearly stronger than in the main market areas. Overall businesses have an abundance of idle capacity that allows them to respond quickly to changes in demand. Inventory levels have been adjusted in recent years and therefore it is thought that an improvement in demand will be reflected in production more quickly than on average. It will take some time to counter the years of decline in cost competitiveness, but the moderate wage increases are a step in the right direction. Periods of economic stagnation provide an opportunity for businesses to focus on improving the competitiveness of their products so that they are better placed to take advantage of the eventual economic rebound.

Finland is a small and open economy whose cycles and trends are largely dependent on the development of its foreign trade. As before, it is expected that industrial output will recover with the rebound of export demand, as most of the country's industrial production is exported. The majority of services produced are used by the business sector, and therefore improving business output quickly improves the situation in services branches. Household purchasing power will show only moderate improvement over the outlook period, and therefore private consumption demand will not significantly increase service production either this year or next. Based on the number of planning permissions granted the volume of new building construction will remain quite low in 2014, but will pick up from next year with the revival of other economic activity. Building renovation activity, by contrast, will increase throughout the outlook period.



Net lending by sector
% of GDP



Households and non-profit institutions serving households
General government
Financial and insurance corporations
Non-financial corporations and housing corporations[1)]
Total economy

1) Including financial sector in 2014-2016

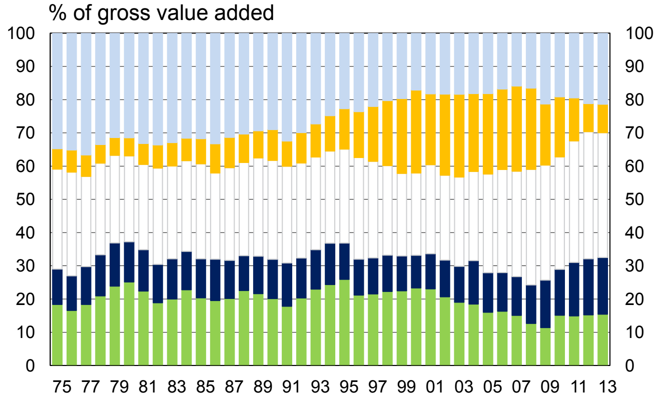
Sources: Statistics Finland, MoF

1.4.2 Secondary production

Industrial production past rock bottom?

The slide in industrial production slowed last year. Industry value added fell by 2.6% in 2013, half the figure in 2012. The decline in production cut across every main industry sector. The fall was sharpest in metal industry production at 5.1%. Production in the chemical industry declined by 0.4%. Energy production as well as water and waste management production were up by 0.7%. From spring to autumn the figures for industrial production showed signs of improving, but towards the end of the year they began falling again. Estimates are that export demand began to increase in 2013, but actual exports growth was more modest. It seems then that Finland's share of world industrial value added declined last year.

Manufacturing
% of gross value added



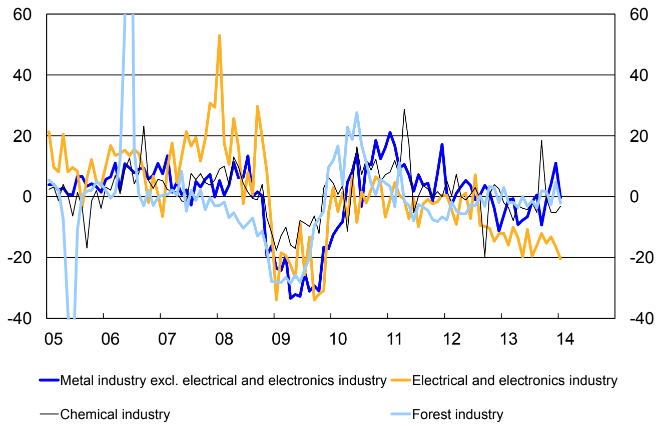
Forest industry
Chemical industry
Metal industry excluding electrical and elecronics industry
Electrical and electronics industry
Rest of manufacturing

Source: Statistics Finland

Indications are that the decline in industry performance has ended. Business tendency surveys show that the industry outlook no longer deteriorated towards the end of last year. In fact output expectations slightly improved. Almost half of the companies that responded to the Confederation of Finnish Industries questionnaire were constrained by inadequate demand, but that proportion no longer increased during the course of the year. Order books have still not started growing, so the turnaround looks set to remain muted, even though finished products inventories have recently been adjusted to reflect the lowered level of demand. Furthermore businesses feel that competition in the marketplace is intense, especially outside the main market area of Europe. Rebounding export demand will see industrial production return to growth this year. The outlook for growth is strongest in the forest and chemical industries, where inadequate demand is less of a problem than in other branches. In the technology industry, the single biggest branch, order books are being shortened by sluggish demand. Driven by the forest and chemical industries, industrial production will increase by 1½% this year, accelerating further to around 2% in 2015 and 2016 as other sectors gain steam. However it is expected that growth will be much slower than before the crisis, and production will still be 20% lower than production levels achieved during that period.

Volume index for industrial production

change yoy, per cent



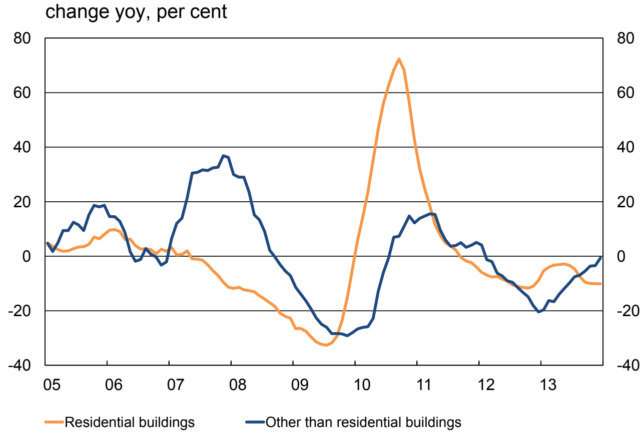
Source: Statistics Finland

From renovation to new building construction

The situation in construction remains sharply divided. The volume of new building fell by almost 8% last year, but it is estimated that renovation increased by a couple of per cent. Value added in the construction sector as a whole declined by 2.7% last year. New building construction declined across the board: the only exception showing an increase in 2013 was the development of public service premises. The sharpest falls were recorded for business, office, industrial and warehouse construction. Residential building construction declined less than other new building construction.

Growth expectations have increased in the area of new building construction. Business surveys indicate that the construction outlook has bottomed out and the number of planning permissions granted started rising towards the end of the year. Nonetheless inadequate demand has become an increasingly pervasive obstacle to growth, and in general more than three in four construction companies identify such obstacles. Furthermore the recovery of residential building construction is hampered by the growing number of unsold dwelling units. Indeed there is no quick and immediate turnaround in sight for the construction sector, but new building construction will continue to fall in 2014. It is thought that renovation will continue to increase, and therefore value added in the construction sector as a whole will decline by 1½% this year, less than in 2013. Increasing activity in the rest of the economy will push new building construction onto a growth path in 2015 and 2016, but even strong renovation performance will not be enough to achieve the average growth rate of the 2000s, i.e. around 2½%. The volume of construction output in 2016 will be some 4% lower than the peak figures of 2007.

Volume index for newbuilding
change yoy, per cent



Source: Statistics Finland

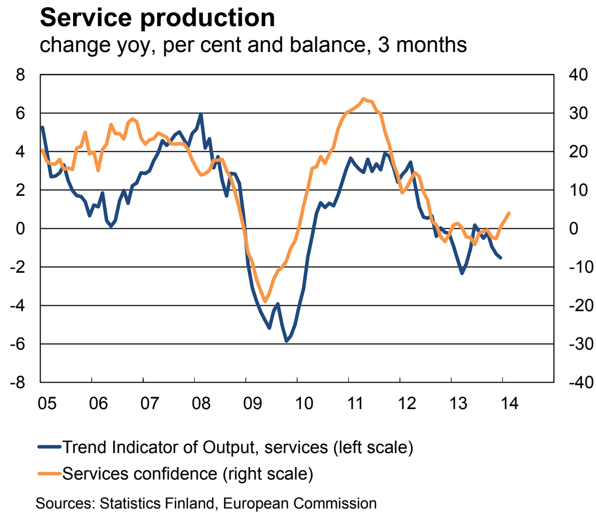
1.4.3 Services

Production structure continued to shift towards services

Private services were last year hit by the economic recession. Value added in services fell by 1.2% as output in private services started falling and dropped by 1.6%. Public service provision fell by 0.1%, less than in previous years. Figures for public services have not shown an increase since 2005. The decline has been broadly based, but the main downward thrust has come from the declining value added in public administration. The fall in private service provision was due to the decline in the production of business services. In addition the decrease in trade production deepened to 4%. Service production in 2013 accounted for 71.6% of the national value added. This share has increased by over 7 percentage points in the past 10 years.

The cyclical outlook in service industries has improved and sales expectations are cautiously improving. In service branches, too, inadequate demand is the biggest obstacle to production and sales growth, although not to the same extent or as widely as in industry and construction. In addition one in ten service companies answering the business survey said they were hampered by the lack of skilled labour, while the corresponding proportion in industry and building construction is much lower.

The majority of services produced go to the business sector, and therefore improving business output quickly improves the situation in services branches. According to the expectations of businesses themselves, growth prospects are strongest in information and communications as well as in financial services. These branches have a larger number of companies that expect to see an increase in sales than other service branches. On the other hand the lack of skilled labour in real estate and cleaning services is a more common obstacle to sales growth than inadequate demand. Furthermore growth prospects in wholesale and retail trade are depressed by the predicted slow improvement of purchasing power. Private service branches that provide business services will return to growth as demand picks up with rebounding economic activity, but in 2014 service production as a whole will post growth of no more than 0.2%. In 2015 and 2016 growth will gradually come close to 2%, the average growth rate in the 2000s. In contrast to other main sectors of the economy, service production will exceed the pre-crisis level in 2016.



Production by industry

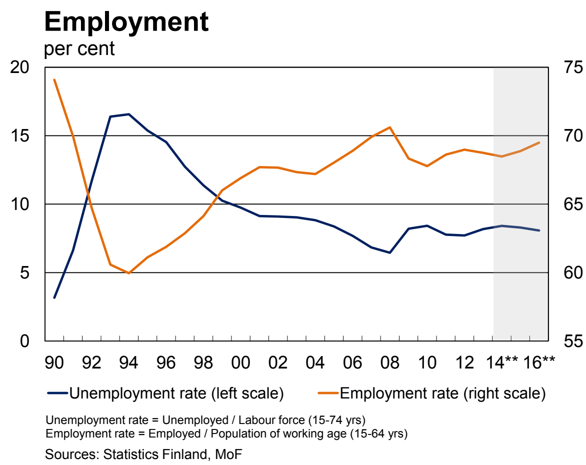
	2013* share, %[1)]	2011	2012	2013	2014**	2015**	2016**	Average 2013/2003
		change in volume, %						
Industry	18.7	-0.6	-5.3	-2.6	1.4	2.2	2.5	0.0
Manufacturing	14.9	-0.1	-8.4	-3.3	1.6	2.2	2.6	-0.4
Construction	6.8	3.1	-4.8	-2.7	-1.4	2.2	2.2	1.1
Agriculture and forestry	2.8	2.9	-8.2	2.6	0.5	1.4	1.5	1.5
Industry and construction	25.6	0.3	-5.2	-2.6	0.7	2.2	2.4	0.3
Services	71.6	3.1	0.7	-1.2	0.2	1.3	1.8	1.3
Total production at basic prices	100.0	2.3	-1.2	-1.5	0.4	1.5	2.0	1.1
GDP at market prices		2.8	-1.0	-1.4	0.5	1.4	1.8	1.2
Labour productivity in the whole economy		1.0	-1.4	0.4	0.1	0.7	0.7	0.8

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

1.5 Labour force

Employment situation continues to deteriorate

Employment started to fall in late 2012 and the same trend continued throughout 2013. The number of persons employed dropped most sharply in the third quarter of 2013, since which the annual rate of change slowed somewhat. In all the number of employed persons fell by 1.1% from the year before. The fall in employment was broadly based as the situation also began to deteriorate in services, which in the previous year still saw increasing employment. In industry, employment continued to fall for the fifth year in a row. Since 2008 the number of employed persons in industry has fallen by almost 70,000. The total number of hours worked by all employees in the economy decreased by 1.7% last year. However, the number of hours worked by wage earners declined at the same rate as the number of employed persons, which means that the number of hours worked by entrepreneurs has fallen dramatically.



Unemployment rate will continue to rise in 2014

According to Statistics Finland's Labour Force Survey (LFS) the unemployment rate increased last year by half a percentage point from 7.7% to 8.2%. The forecast is that the figure will rise further in the current year to 8.4%. In recent years the picture of unemployment derived from different statistical sources has been somewhat contradictory, making it difficult to give an accurate assessment of unemployment trends. The number of unemployed job seekers registered with employment offices (Ministry of Employment and the Economy figures) has risen much more sharply than the unemployment figures indicated by Statistics Finland's sample-based Labour Force Survey. This has been due to both structural and cyclical factors. One structural factor is the discontinuation of the unemployment pension, which has contributed to widen the statistical gap since 2010 as a result of older unemployed persons moving from the pension system into the unemployment security system. In the Labour Force Survey older unemployed persons registered with employment offices have only been counted as being unemployed if they have actively searched for a job.

Not all persons registered as unemployed actively search for work

The criterion of active job search might also contribute to explain why the two different measures of unemployment have behaved differently in the current cyclical environment. Unemployed persons in the LFS only comprise those who have actively searched for work. However at times of economic downturn there is also what is known as 'hidden unemployment': some unemployed people will decide to give up their active search for work because of the weak economic situation. These cases would still be counted as unemployed persons in the employment offices registers, but not in the numbers shown by the LFS. The difference between the unemployment statistics has continued to grow sharply until the very latest statistical publications. This differentiation involves the risk that Statistics Finland's official unemployment figures continue to grow or remain high even if the number of registered job seekers started to fall.

Labour market

	2011	2012	2013	2014**	2015**	2016**
	annual average, 1,000 persons					
Population of working age (15-74 yrs)	4 059	4 075	4 087	4 095	4 109	4 107
change	15	16	12	8	14	-1
Population of working age (15-64 yrs)	3 539	3 524	3 508	3 493	3 480	3 470
change	-16	-15	-16	-15	-13	-10
Employed (15-74 yrs)	2 474	2 483	2 457	2 449	2 457	2 474
of which 15-64 yrs	2 428	2 431	2 403	2 392	2 397	2 411
Unemployed (15-74 yrs)	209	207	219	225	222	217
	%					
Employment rate (15-64 yrs)	68,6	69,0	68,5	68,5	68,9	69,5
Unemployment rate (15-74 yrs)	7.8	7.7	8.2	8.4	8.3	8.1
aged under 25	19.8	18.9	19.7	..	..	..
	1,000 persons per annum					
Immigration, net	16.8	17.4	17.0	17.3	17.4	17.4

Although it seems that the worst of the deterioration of the employment situation is now over, there are no concrete signs that this deterioration will come to an end. During the current year it is predicted that the number of employed persons will again fall somewhat. Compared to output growth, employment after the financial crisis has still not declined to the extent one would have assumed based on quantitative interactions prior to the financial crisis. For instance, total output has fallen by 2.4% over the past two years, employment by no more than 0.7%. This raises the question as to whether there is still need for significant further adjustment in employment levels. The forecast works from the assumption that this is not the case. At the same time as the decline in employment has been slowing, it seems that the sharp but short-term fall in output after the financial crisis has involved factors that have nothing to do with domestic employment.

Outlook for coming years subdued

Employment trends will be very subdued over the coming years. Even though economic growth is set to slowly rebound, the effects on employment creation are expected to remain quite modest. It is expected that as the economy gathers speed, businesses will primarily want to focus on improving their profitability before we will see any large scale recruitment drive. Secondly, ongoing structural changes have created labour market mismatch problems between unemployed job seekers and job vacancies. In addition the forecast assumes that economic recovery in the coming years will be mainly driven by industry and that growth in labour-intensive services will remain slow. It is predicted that the employment situation will only begin to improve in 2015. However for the reasons just stated the number of persons employed will rise by no more than 0.4%. Even though production growth will be more broadly based in 2016, employment will continue to show only slow improvement, with the number of employed persons expected to increase by 0.7%.

The same reasons that are deterring employment growth in the coming years are also contributing to the slow decline of unemployment. The unemployment rate will remain at over 8% throughout the outlook period. The employment rate (15 to 64 yrs) dropped last year to 68.5%, the largest fall being recorded among people midway through their work careers (25 to 54 yrs). In the forecasting period, the employment rate will slowly climb to 69.5%, partly because its denominator, i.e. the working age population shrinks.

The effect on employment of the measures to adjust central government finances and the meas-ures to support growth , decided by the Government in the context of its decision on the budgetary framework, have been taken into account in the forecast.

1.6 Incomes, costs and prices

1.6.1 National income

Nominal net national income growth slowed to one half of a per cent last year. Among the national income components employee compensations increased by 0.9% from the year before. Wage bill growth slowed to one per cent. In the last three quarters of 2013, however, the wage bill showed growth of 1.3% compared to the year before. This was due to the one-off payment made in early 2012 under the framework agreement: because of that payment the wage bill showed hardly any year-on-year growth in the first quarter of 2013. Wage bill growth was clearly slowed by the deteriorating employment situation. Employee compensations as a proportion of national income climbed to 62%, which is explained by the relatively sharp rise in compensations and on the other hand by the lowered level of property and entrepreneurial income.

Operating surplus, a measure of corporate profits, declined by over 4% in Finland last year. When property and entrepreneurial income to and from other countries are taken into account, property and entrepreneurial income fell slightly less, by over 3%. Early estimates are that the amount of property income paid from foreign countries into Finland increased by over 4%. Taxes on production and imports net of subsidies increased by 4%, reflecting last year's increase in indirect taxes.

During the current year it is predicted that wage bill growth will pick up slightly from the previous year, despite moderate earnings growth, because the deterioration of employment is slowing. It is thought that social security contributions will rise more sharply than the wage bill because employer contributions were increased at the beginning of 2014 and agreed increases to earnings-related pension contributions will also tighten tax bases in 2015 and 2016. Wage bill growth will accelerate in 2015 and 2016 with the improving economy and strengthening employment, but still remain slower than the average rate for the 2000s.

Disposable income

	2013 share, %	2011	2012	2013	2014**	2015**	2016**	On average 2013/2003
		change, %						
Compensation of employees	62.0	4.6	3.3	0.9	1.6	1.9	2.6	3.7
Wages and salaries	50.3	4.5	3.2	1.0	1.4	1.8	2.5	3.9
Employers' contributions to social security schemes	11.6	5.3	3.9	0.7	2.6	2.3	2.8	2.8
Property and entrepreneurial income, net	22.0	-1.0	-3.7	-3.2	3.2	6.0	5.4	0.1
Taxes on production and imports minus subsidies	16.0	13.5	3.6	4.0	4.0	3.9	2.8	3.3
National income	100.0	4.5	1.7	0.5	2.4	3.1	3.2	2.7
Disposable income		4.6	1.8	0.0	2.4	3.2	3.3	2.7
Gross national income, EUR bn		189.2	193.3	194.6	198.6	204.3	211.1	

It is predicted that domestic operating surplus figures will turn to growth in 2014. In addition national income growth in 2014 and 2015 will be accelerated by increases in indirect taxation. In 2015 and 2016 national income growth will gather speed as property and entrepreneurial income in particular show faster growth than in recent years.

1.6.2 Wages and salaries

Nominal earnings, as measured by the index of wage and salary earnings, increased by 2% last year. In line with the framework agreement negotiated in November 2011, collectively agreed wages were up by 1.4%

In late November 2013 the labour market organisations observed that a sufficiently large number of sectoral wage settlements were compatible with the three-year Pact for Employment and Growth adopted by the confederations in August 2013. In the private sector 88% of wage earners come under the Pact for Employment and Growth, in the public sector the figure is 100%. In all some 93% of wage earners in the country are covered by the agreement. Among those that remained outside the agreement were employees in the construction industry, food industry and the communications and logistics sector. However some of these branches have reached a settlement whose cost effects are comparable to those under the Pact for Employment and Growth.

According to the Pact for Employment and Growth the first negotiated wage increase shall be 20 euros per month. This increase shall be implemented four months after the agreement start date. The second increase shall be 0.4%, and it shall be implemented 12 months after the first agreed increase. The labour market confederations shall meet by 15 June 2015 to negotiate on the third increase and its timing. If no agreement is reached on the second phase increases, individual branches can opt to cancel their agreements after the first phase.

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

	2011	2012	2013	2014**	2015**	2016**	On average 2013/2003
	change, %						
Index of negotiated wage rates	2.0	2.9	1.4	0.7	0.5	0.8	2.5
Wage drift, etc.	0.7	0.3	0.6	0.6	0.7	0.7	0.9
Index of wage and salary earnings	**2.7**	**3.2**	**2.0**	**1.3**	**1.2**	**1.5**	**3.4**
Real earnings[1]	-0.7	0.4	0.5	-0.2	-0.5	-0.4	1.6
Average earnings[2]	3.1	3.1	2.4	1.0	1.0	1.3	3.4
Labour costs per unit of output[3]							
whole economy	2.4	4.8	2.3	1.1	0.4	0.6	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 per employee divided by productivity per employed person.

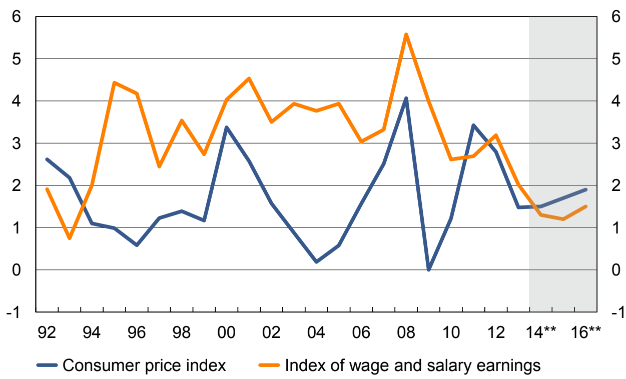
The first agreements under the Pact for Employment and Growth entered into force at the start of November 2013. This first wave included technology industry branches, which can agree locally on the timing and size of wage increases and on how they are to be implemented. In many other branches the new agreements take effect during spring 2014 with the expiry of current agreements. It follows that there are also differences in the timing of the wage increases.

In 2014 and 2015 earnings will develop in line with this new wage settlement. The Pact for Employment and Growth will in its first year push up collective wages by an average of 0.7%, and in the second year by around 0.5%. The forecast for the development of earnings works from the assumption that the contribution of factors other than collective wage increases will drive up earnings by over half a per cent in both years. Therefore it is predicted that nominal earnings will rise by 1.3% in 2014 and by 1.2% in 2015 as measured by the index of wage and salary earnings. This is well below the average of the 2000s, and well in line with the sluggish economy and slow employment trends. It is assumed that moderate earnings growth will continue in 2016, rising at a rate of 1.5%.

1.6.3 Consumer prices

Consumer prices rose on average by 1.5% last year, as measured by the national consumer price index. In early 2013 inflation remained at just over 1.5%, but from August it slowed to just over 1%. However in December inflation picked up again to 1.6%.

Consumer price index and index of wage and salary earnings
change from previous year, %



Sources: Statistics Finland, MoF

Average inflation in 2014 is forecast to remain unchanged from 2013 at 1.5%. The effect of indirect tax hikes will be almost the same as last year at around half a percentage point. In 2015 consumer prices are predicted to rise by 1.7% because it is expected that economic growth will gather some momentum and the planned indirect tax hikes will again push up consumer prices by some 0.4–0.5 percentage points. In 2016 it is predicted that consumer prices will increase at a rate of around 1.9%, as rising interest rates and the planned increase in the annual vehicle tax will push up inflation, although otherwise it is not thought there will be significant upward pressure on prices.

Sluggish economy slowed inflation

The slowdown of inflation in 2013 is explained by the sluggish development of the economy. Energy prices in particular were down as the price of crude oil fell on the international market. In addition lowered interest rates on housing loans and consumer loans slowed inflation significantly. It seems that the one percentage point increase in VAT rates from the beginning of 2013 did not immediately and with full effect pass through into consumer prices. Earlier it was forecast that higher indirect taxes would push up inflation in 2013 by some 0.6 percentage points. The fact that inflation in the early part of the year was higher than later in the year was due in part to the indirect tax increases introduced midway through 2012. For instance, the increases to the motor car tax and annual vehicle tax only began to have an impact on inflation in April 2012, and tobacco products were sold from existing stocks at the old tax rate until the beginning of May. Not only the economic cycle but also intense competition in mobile communication services contributed to slow inflation.

Inflation maintained by foodstuffs and services

In 2013 inflation was maintained by the development of foodstuffs and service prices. In the early part of the year prices of fresh foods – meat, fish, fruit and vegetables – peaked at almost 14%. Later in the year, however, the fresh food inflation rate eased to just over 4% with the arrival in the shops of a good domestic vegetable crop. Prices of processed foodstuffs developed more steadily and slowed from over 3% early in 2013 to around 2.5% towards the end of the year. Prices of services continued to rise steadily at around 3%, but service inflation also slowed marginally later in the year.

Economic situation and tax changes reflected in inflation

In the early part of 2014 the inflation rate was unchanged from the end of last year at around 1.5%. Even though it is expected that economic activity will pick up, the prediction is that international raw materials prices will remain on a slight downward trend throughout the outlook period. Domestic demand is forecast to remain subdued among other things because of the weak employment situation and historically moderate pay rises. Increased excise duties will have a significant impact on food prices this year as tax changes on sugar-containing soft drinks, alcohol and tobacco products will accelerate average annual inflation by some 0.4 percentage points. It is estimated that the planned increase in the tobacco tax in 2015 will drive up consumer prices by around 0.1 percentage points. At the same time taxes will also be increased on sweets, which will have a small, 0.1 percentage point effect on consumer prices. Otherwise it is thought that the development of food prices will return close to its normal path over the outlook period.

Energy prices falling, reference rates set to rise

Apart from food prices, another factor with often a major influence on the development of consumer prices is the fluctuation of energy product prices. Taxes on transport fuels and electricity were raised from the beginning of this year, creating upward price pressure of around 2%. It is estimated that the energy tax increases will push up the overall index by around 0.1 percentage point. Annual prices of energy commodities, however, are expected to increase only moderately, based on the assumption that the euro-denominated price of crude oil will continue to fall slightly in the international market throughout the outlook period. Likewise it is assumed that electricity prices will remain more or less unchanged at their current level in 2014–2016. The energy tax hikes taking effect from the beginning of 2015 will also have the effect of driving up the consumer price index by around 0.1 percentage points. Overall it is thought that the slight decrease in energy prices will significantly curb the rise in the consumer price index during the outlook period.

Rising reference rates, on the other hand, will stoke inflation in 2015 and especially in 2016. Furthermore the planned increase in the vehicle tax from the beginning of 2016 is estimated to push up consumer prices by a total of some 0.3–0.4 percentage points. It is thought that around half of this effect will materialise in 2015 because in practice, tax collection will slowly start from the beginning of 2015 as payments for the new 12-month tax term become due.

Service inflation slowing slightly

The consumer prices that have developed most steadily in recent history are the prices of goods and services. Overall goods prices have long been stagnant as home electronics prices have continued to fall. The contribution of goods to overall inflation has therefore remained quite marginal, and it is not thought there will be any significant change in this respect over the outlook period. The prices of services, by contrast, have risen at an annual average of 2.6% over the past ten years, and their contribution to inflation has come to around one percentage point. Wage and salary costs have great significance in services, and therefore it is assumed that the more moderate wage trends will reduce pressures to put up service prices during the outlook period. However it is noteworthy that the prevailing market situation may significantly impact the development of specific service items. For instance, intense competition in mobile communications services and in air transport has contributed to reduce prices in the recent past, but this will not necessarily be true in the future. On the other hand rents have been rising very sharply as demand for rental housing in population growth centres has outstripped supply.

Price indices

	2011	2012	2013	2014**	2015**	2016**	On average 2013/2003
	change, %						
Export prices[1]	4.3	1.2	-0.9	0.2	0.4	0.5	0.6
Import prices[1]	6.2	2.5	-1.0	0.7	0.7	0.6	2.2
Consumer price index	3.4	2.8	1.5	1.5	1.7	1.9	1.8
Harmonized index of consumer prices	3.3	3.2	2.2	1.7	1.4	1.3	2.0
Basic price index for domestic supply	6.4	3.1	0.2	0.9	1.3	1.6	2.9
Building cost index	3.3	2.4	1.0	1.3	1.6	2.4	2.6

[1] As calculated in the National Accounts.

Differences between national and EU indices come from owner-occupied housing

Finnish consumer prices, as measured by the EU harmonised consumer price index, rose on average by 2.2% in 2013. The difference between the national and the harmonised price index is quite large, 0.7 percentage points. The main source of this difference is the mean interest rate on housing loans, which is included in the commodity basket for the national but not for the harmonised price index. Furthermore the national index includes prices for flats, real estate and gambling as well as the annual vehicle tax.

During the current year the difference between the two price indices will narrow. It is predicted that on average, prices for commodities included in the national index will rise more slowly than the harmonised index, resulting in a more moderate increase in prices when measured on the national index. According to the forecast the situation will be reversed in 2015 and 2016 when the vehicle tax will be increased and when it is expected that reference interest rates will start rising with the improving economic situation.

Finnish inflation to remain higher than euro area inflation in 2014

Measured by the EU harmonised consumer price index, inflation in Finland has in recent years exceeded the average euro area rate. This is explained, on the one hand, by increases in indirect taxes and, on the other hand, by the persistently higher rate of inflation in services when compared to the euro area. Last year the euro area inflation rate of 1.4% was 0.8 percentage points slower than in Finland. In 2014, too, Finnish inflation will be clearly higher than in the euro area where the Commission forecast projects an increase in consumer prices of around one per cent. Next year, however, it is predicted that the difference will narrow considerably because inflation in Finland will slow moderately, whereas the annual change in consumer prices in the euro areas is expected to climb to over one per cent.

2 Economic policy and public finances

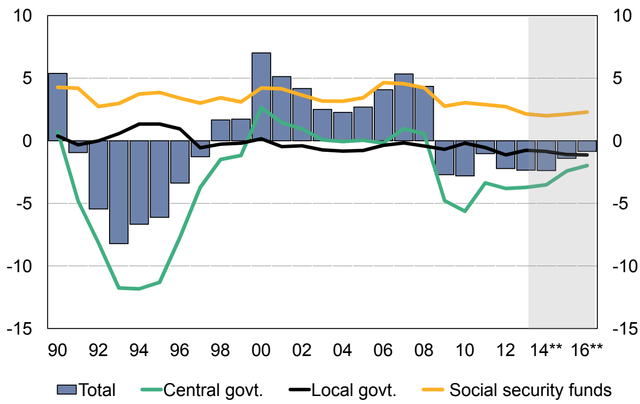
2.1 General government finances

The weak economy has obviously been reflected in the state of general government finances as well, which have been in deficit for years. In 2013 the general government deficit was 2.4% of GDP. It is expected that the general government budgetary position will slowly move closer to balance towards the end of the outlook period. Even though economic growth will temporarily pick up and adjustment measures will begin to take effect, the growth of public expenditure as a result of population ageing will place general government under increasing pressure.

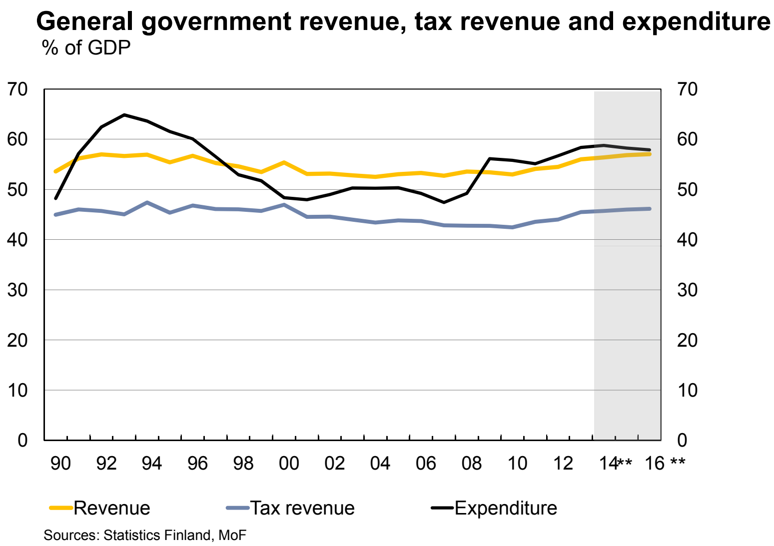
General government in Finland consists of central government, local government and social security funds, i.e. authorised pension providers that manage statutory earnings-related pension insurance and other social security funds. The sector that is most vulnerable to cyclical fluctuations is central government, mainly because of the high cyclical sensitivity of tax revenue.

Central government's budgetary position improved slightly in 2013. The central government deficit was 3.7% of GDP. Although economic growth and adjustment will contribute to reduce the deficit, central government's budgetary position will remain in the red over the forecast period. It is predicted that in 2018, the central government deficit will be 1% of GDP. In the medium term the debt-to-GDP ratio will begin to turn around.

The financial balance of general government subsectors
% of GDP



Sources: Statistics Finland, MoF



The local government deficit decreased in 2013. The budgetary position in local government improved on the back of comparatively strong tax revenue growth, mainly driven by one-off factors, coupled with slowing consumption expenditure growth. Increasing demand for social and health care services due to population ageing and cutbacks in central government transfers will place local governments under increasing financial pressure. In the medium term it is expected that local government finances will remain in deficit.

In 2013 the surplus in earnings-related pension funds decreased from the year before. Increasing pension expenditure in the coming years will burden the financial position of earnings-related pension funds. Other social security funds are expected to remain close to balance.

The tax rate, i.e. the ratio of taxes and social security contributions levied by general government to GDP, increased in 2013. The tax rate stood at 45.5%. Several tax base changes contributed to drive up the tax rate. The tax rate is expected to average 46 % in 2015–2018.

In 2013 the expenditure rate, i.e. general government spending to GDP, was over 58%. The expenditure rate will remain at an historically very high level over the medium term. Since the introduction of the public broadcasting tax from the beginning of 2013, the Finnish Broadcasting Company YLE has been classified under general government. This change pushed up the tax rate and the expenditure rate by around 0.3 percentage points.

Even though it shows a deficit, Finland's general budgetary position is one of the strongest in the European Union. Under the EU Stability and Growth Pact it is required that the budgetary deficit must not exceed 3% and the general government debt-to-GDP ratio must not be higher than 60%. So far Finland has managed to stay well within these targets. However Finland's public debt to GDP will breach the 60% limit in the near future, although the debt ratio will turn to a slight downward trend after 2016.

The Finnish Stability Programme update in spring 2013 set a new medium-term objective (MTO) for public finances in Finland, i.e. a structural balance of –¬0.5% or better. The Fiscal Compact between EU Member States that took effect from the beginning of 2013 and the national legislation required by that compact provide the legal framework for MTOs. Legislation also specifies the corrective action that shall be taken in the event of any significant deviation from the MTO or the adjustment path to the MTO. It seems that the general government structural balance[1] will remain close to target in the medium term.

General government finances [1)]

	2011*	2012*	2013**	2014**	2015**	2016**
	EUR billion					
Current taxes	30.9	30.9	32.7	32.9	34.1	35.7
Taxes on production and imports	26.9	27.8	28.7	29.8	30.8	31.6
Social security contributions	24.0	25.5	26.0	26.9	27.7	28.7
Taxes and contributions, total [2)]	82.2	84.6	88.0	90.2	93.3	96.7
Other revenue [3)]	20.3	20.7	21.0	21.7	22.7	23.6
of which interest receipts	3.3	3.0	2.9	3.0	3.4	4.0
Total revenue	**102.1**	**104.8**	**108.3**	**111.3**	**115.4**	**119.6**
Consumption expenditure	46.2	48.3	49.7	50.6	51.6	52.8
Subsidies	2.7	2.8	2.7	2.9	2.8	2.7
Social security benefits and allowances	33.9	36.1	38.2	39.8	40.7	42.1
Other current transfers	5.7	5.8	6.0	6.0	6.0	6.2
Subsidies and current transfers, total	42.3	44.7	46.9	48.6	49.5	50.9
Capital expenditure [4)]	5.4	5.6	6.0	6.1	6.1	6.0
Other expenditure	10.1	10.5	10.3	10.6	11.0	11.7
of which interest expenses	2.7	2.8	2.5	2.7	2.8	3.2
Total expenditure	**104.0**	**109.1**	**112.9**	**116.0**	**118.2**	**121.3**
Net lending (+) / net borrowing (-)	**-2.0**	**-4.3**	**-4.6**	**-4.7**	**-2.9**	**-1.8**
Central government	-6.4	-7.3	-7.2	-7.0	-4.9	-4.2
Local government	-1.0	-2.2	-1.5	-1.7	-2.2	-2.4
Employment pension schemes	5.4	4.8	4.1	4.2	4.4	4.8
Other social security funds	0.1	0.4	0.0	-0.2	-0.1	0.0
Primary balance [5)]	-2.4	-4.4	-4.9	-4.9	-3.4	-2.4

1) As calculated in the national accounts, ESA95.

2) Incl. capital taxes.

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

4) Gross fixed capital formation and capital transfers.

5) Net lending before net interest expenses.

1 EDP structural budgetary position as used in the multilateral surveillance of economic policies.

General government fiscal plan

The Government adopted the fiscal plan in the spending limits discussions on 24-25 March 2014. This box briefly describes what the fiscal plan is.

EU Member States are required to prepare a credible and effective medium-term budgetary framework that provides a sound foundation for a three-year or longer fiscal planning horizon in order to ensure that national fiscal planning is based on a multiannual approach. Each year Member States are to make public their national medium-term fiscal plans in line with their medium-term budgetary framework . The national medium-term fiscal plan is intended to support national-level decision-making and its aim is to improve national ownership of fiscal policy strategies.

The fiscal plan is based on Government Decree 120/2014 and other relevant national legislation. The fiscal plan meets both the requirements for budgetary frameworks as set out in Council Directive 2011/85/EU and Regulation (EU) 473/2013 on the medium-term fiscal plan.

The purpose of the fiscal plan is to support budgetary decision-making and the achievement of the medium-term objective (MTO) set for the structural balance. The fiscal plan covers every branch of general government, including central government finances, local government finances, statutory pension institutions and other social security funds. The Government prepares the fiscal plan for the electoral term and revises the plan for the following four-year period by the end of April.

The fiscal plan includes

- A description of EU regulations and national legislation governing the preparation of the plan; the targets set for the management of public finances overall and by sector; and the fiscal policy pursued by the Government in seeking to achieve these targets.
- A macroeconomic forecast and an assessment of the public finances outlook over the electoral term and beyond. The public finances outlook is based on independent, up-to-date and realistic assessments of real economic prospects during the electoral term, the prospects for growth in the economy and the long-term impacts of population ageing on the economy.
- A proposal on key measures targeting public revenues and expenditures and an assessment of progress made with structural reforms and their fiscal and economic impacts.
- The central government spending limits decision, which remains unchanged both in terms of its content and its role as a tool of government budget preparation.
- Local government macroeconomic steering. This is based on a new system the purpose of which is to ensure that the duties and obligations of local governments are compatible with the target of fiscal balance. In the first fiscal plan in spring 2014 this component of the plan will be replaced by a summary of the Basic Public Services Programme.

The aim is to draw up a fiscal plan annually following the same schedule and procedures used in the preparation of spending limits. The 2014 fiscal plan is part of the Finnish Stability Programme for 2014–2018.

Main economic indicators in general government

	2011*	2012*	2013**	2014**	2015**	2016**
	% of GDP					
Taxes and social security contributions	43.6	44.0	45.5	45.7	46.0	46.1
General government expenditure [1]	55.1	56.7	58.4	58.8	58.2	57.9
Net lending	**-1.0**	**-2.2**	**-2.4**	**-2.4**	**-1.4**	**-0.9**
Central government	-3.4	-3.8	-3.7	-3.5	-2.4	-2.0
Local government	-0.5	-1.1	-0.8	-0.9	-1.1	-1.1
Employment pension institutions	2.8	2.5	2.1	2.1	2.2	2.3
Other social security funds	0.0	0.2	0.0	-0.1	-0.1	0.0
Primary balance [2]	-1.3	-2.3	-2.5	-2.5	-1.7	-1.1
General government debt	**49.3**	**53.6**	**56.9**	**59.8**	**61.0**	**61.4**
Central government debt	42.2	43.6	46.4	48.7	49,3	49,2
General government employment. 1000 person	614	612	615	614	613	612
Central government	141	139	141	140	139	138
Local government	463	462	464	464	464	464
Social security funds	11	11	11	11	11	11

[1] EU-harmonized definition.

[2] Net lending before net interest expenses.

Fiscal balance and debt ratios in some EU economies

	2013*	2014**	2015**	2013*	2014**	2015**
	Fiscal balance			Debt		
	% of GDP					
Finland	-2.4	-2.4	-1.4	56.9	59.8	61.0
United Kingdom	-6.3	-5.2	-4.2	91.4	93.4	94.5
Sweden	-1.1	-1.5	-0.8	41.5	41.8	40.8
Denmark	-0.3	-1.3	-2.7	42.4	41.6	43.1
Ireland	-7.2	-4.8	-4.3	122.3	120.3	119.7
Spain	-7.2	-5.8	-6.5	94.3	98.9	103.3
Netherlands	-3.1	-3.2	-2.9	74.3	75.3	75.6
Luxembourg	-0.2	-0.5	-2.4	24.3	25.5	28.1
Portugal	-5.9	-4.0	-2.5	129.4	126.6	125.8
Austria	-1.7	-2.1	-1.8	74.6	74.3	73.7
Germany	-0.1	0.0	0.0	79.6	77.3	74.5
France	-4.2	-4.0	-3.9	93.9	96.1	97.3
Belgium	-2.7	-2.6	-2.7	99.8	100.5	100.0
Italy	-3.0	-2.6	-2.2	132.7	133.7	132.4
Greece	-13.1	-2.2	-1.0	177.3	177.0	171.9

Source: EU Commission forecast 2014, Finland MoF.

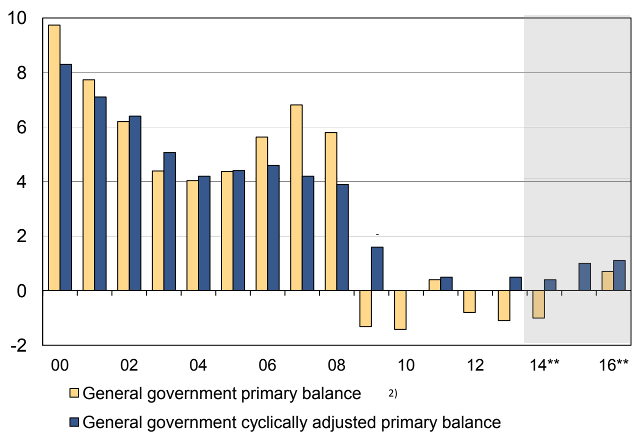
2.1.1 Estimates of fiscal policy impact

At the general government level the fiscal policy stance in 2014 will be almost neutral. As regards central government finances, the tax base changes in 2014 will contribute to ease taxation somewhat. On the other hand increases to pension contributions and the municipal tax rate hike will have the effect of driving up the tax rate in 2014. The adjustment measures agreed by the Government in its discussions on 25 March 2014 will significantly tighten fiscal policy in 2015–2016, and pension contributions will be increased by 0.4 percentage points in both years. By 2016 the tax rate will climb by 0.6 percentage points to 46.1% of GDP. The general government expenditure rate will fall by 0.5 percentage points to 57.9% of GDP in 2016.

Another way to assess the fiscal policy stance is to look at changes in the structural primary balance. The structural primary balance will show very little change in 2014, supporting the same assessment of a neutral fiscal policy stance as does a detailed examination of the changes in tax and expenditure bases. In 2015–2018 it is forecast that the structural balance will improve on average by 0.3 percentage points a year as adjustment slows the growth of expenditure and increases taxes. The effects of fiscal policy on economic growth will be greatest in 2015, which is when most of the adjustment measures will be put in place.

Changes in the structural primary balance do not necessarily reflect the effects of discretionary fiscal policy because of the growth of public expenditure due to population ageing. Age-related social and health care expenditure will rise even without any active decisions and cause the structural primary balance to deteriorate if fiscal policy otherwise is neutral. Fiscal policy only becomes contractionary when the volume of discretionary measures exceeds the growth of age-related expenditure.

Primary balance and cyclically adjusted primary balance [1]
% of GDP



1) Based on the European Commission's production function approach.
2) Primary balance before grossinterest expenses.

Sources: Statistics Finland, MoF

2.1.2 General government debt

General government debt increased by EUR 7 billion last year, climbing to over EUR 110 billion. The public debt to GDP ratio increased by over 3 percentage points to 57%. The debt ratio has only ever been this high on a couple of occasions in the 1990s. It is anticipated that as economic growth continues to remain sluggish, the debt ratio will continue to rise in the coming years and breach the 60% limit. However the growth of the debt ratio will level out in the medium term.

The general government debt forecast is based on central government's net borrowing needs, and the forecast for central government debt is derived from those figures. In addition the forecast takes account not only of on-budget debt, but also the debt accrued by units that in the national accounts are included in central government. These units include universities, Solidium and the public service broadcaster YLE. The general government debt figure is also impacted by local government deficits and the need for borrowing in local government. Social security funds effectively have no debt at all.

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 public–private partnership projects, the capital assets of the State Nuclear Waste Management Fund and coins in circulation. By the end of 2013 Finland's public debt was listed as including EUR 3.4 billion in EFSF loans to crisis countries. Taken together these other debt items increased the 2013 debt figure by almost EUR 10 billion, or almost 8% of GDP.

Debt statistics furthermore reflect internal general government debt, which is consolidated out of the measure of public debt. The most important internal general government debt item are investments by pension funds in government debt securities. The stock of these securities is down to EUR 3 billion. In recent years these investments have no longer had a major impact on changes in general government debt.

Change in general government debt ratio and related factors

	2012*	2013**	2014**	2015**	2016**	2017**	2018**
Debt ratio. % of GDP	53.6	56.9	59.8	61.0	61.4	61.3	61.2
Change in debt ratio	4.3	3.3	2.8	1.2	0.4	-0.1	-0.1
Factors impacting change in debt ratio							
Primary budgetary position	0.8	1.1	1.0	0.0	-0.7	-1.4	-1.8
Interest expenditure	1.4	1.3	1.3	1.4	1.5	1.7	1.8
Change in GDP volume	0.5	0.8	-0.3	-0.8	-1.1	-0.9	-0.8
Change in GDP price	-1.6	-1.1	-0.9	-0.9	-0.9	-1.1	-1.1
Acquisition of financial assets (net)	2.5	2.1	2.1	2.2	2.3	2.2	2.1
Other factors [1]	0.6	-0.8	-0.5	-0.7	-0.8	-0.6	-0.2

[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.

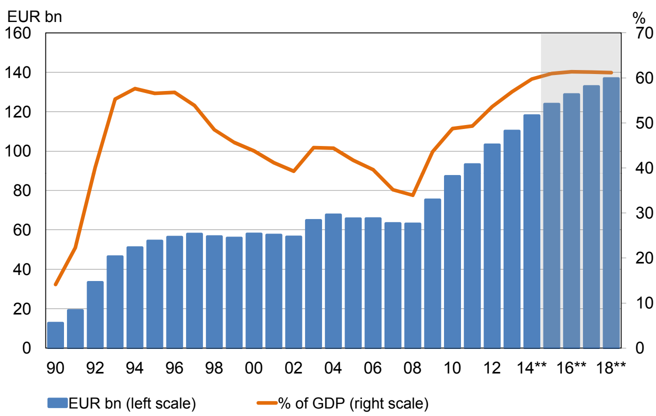
The Table below provides an overview of general government debt dynamics. It illustrates the relationship between the general government budgetary position and debt ratio change in the national accounts. A plus sign indicates that the factor has the effect of increasing the debt ratio, a minus sign that it decreases the debt ratio.

The general government primary budgetary position was in deficit last year, which pushed up the debt ratio by 1.1 percentage points. Rising interest expenditure accounted for 1.3 percentage points of debt ratio growth. When debt is measured relative to GDP, GDP growth has the effect of reducing the debt ratio. In 2013 the fall in GDP volume increased the debt ratio, but rising GDP price lowered it by 1.1 percentage points.

The definition of general government as comprising earnings-related pension funds has a major impact on how the annual general government budgetary position is reflected in changes in general government debt. Part of the earnings-related pension contributions collected from employees and employers in Finland is prefunded. For this reason earnings-related pension funds show a surplus. In 2013 that surplus was 2.1% of GDP. 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 0.8 percentage points in 2013.

General government debt



Sources: Statistics Finland, MoF

2.2 Central government

Despite the fall in GDP last year, central government's national accounts deficit narrowed slightly to EUR 7.2 billion. The Government's adjustment efforts contributed to prevent the deficit from growing. Tax revenue increased by close to 4%. This increase came from various changes to tax bases, most notably the one percentage point increase in the general VAT rate. Expenditure increased by 3%. Central government interest outlays decreased and current transfers to other general government subsectors increased.

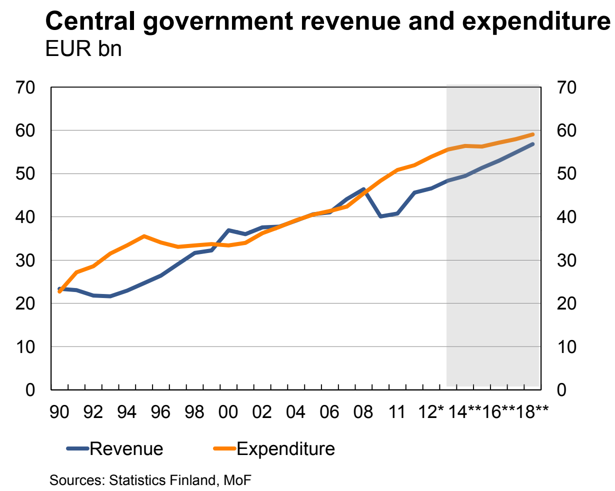
Economic growth will remain subdued in 2014, restricting the growth of tax revenue. In contrast to last year, changes to tax bases will no longer drive up tax revenue. It is expected that during the current year tax base changes will have the effect of slightly reducing overall tax revenue. Central government's budgetary position will improve somewhat because of very slow expenditure growth. The number of people on central government's payroll will decrease, which will reduce consumption expenditure. Interest outlays on central government debt are historically at a relatively low level despite the large volume of debt.

The progressive recovery of economic activity will improve central government's budgetary position in the coming years, and the deficit will shrink towards the end of the budget planning period. The adjustment decisions taken by the Government in its spring 2014 discussions on spending limits will contribute to reduce the deficit. It is projected that from 2015 to 2018, revenue will increase on average by 3.5% and expenditure by 1.2%. The central government deficit projection for 2018 is 1 % of GDP. If this forecast proves to be accurate, central government will have been in deficit for 10 years.

Central government debt at year-end 2013 stood at EUR 90 billion. Since the State Budget shows a deficit each year throughout the planning period, central government debt is set to increase over the medium term despite adjustment efforts. The Government Programme target of reducing the central government debt-to-GDP ratio by the end of the parliamentary term will not be achieved. However in the medium term the debt-to-GDP ratio will begin to fall.

The euro crisis has recently been showing some signs of easing. The crisis has added to the Finnish Government's debt burden and financial commitments. Finland has granted a total of some EUR 1.1 billion in bilateral loans to crisis-hit countries, contributed EUR 1.4 billion to the capitalisation of the ESM, and guaranteed loans taken out by the EFSF worth EUR 3.4 billion.

State guarantees include all guarantees issued by central government, state enterprises, state-owned joint stock companies and special credit institutions ultimately backed by central government. These guarantees are not an expenditure item and do not show up in the State Budget, unless they are called upon. The number of state guarantees issued has been increasing in recent years. In all, central government loan guarantees at year-end 2013 amounted to EUR 33 billion.



Central government [1)]

	2011*	2012*	2013**	2014**	2015**	2016**
	EUR billion					
Current taxes	11.8	11.5	12.0	11.8	12.4	13.4
Taxes on production and imports	26.9	27.8	28.7	29.8	30.8	31.6
Taxes and contributions, total [2)]	39.0	39.8	41.3	42.2	43.9	45.8
Other revenue [3)]	6.0	6.3	6.6	6.8	6.9	6.7
of which interest receipts	0.5	0.5	0.4	0.5	0.5	0.5
Total revenue	**45.1**	**46.1**	**47.9**	**49.0**	**50.8**	**52.5**
Consumption expenditure	12.7	13.2	13.8	14.0	14.2	14.4
Subsidies and current transfers, total	34.1	35.5	36.9	37.2	36.8	37.3
to general government	22.6	23.7	24.8	25.0	24.6	25.0
Interest expenses	2.5	2.6	2.4	2.5	2.6	2.8
Capital expenditure [4)]	2.1	2.1	2.0	2.2	2.2	2.1
Total expenditure	**51.4**	**53.4**	**55.1**	**55.9**	**55.7**	**56.7**
Net lending (+) / net net borrowing (-)	**-6.4**	**-7.3**	**-7.2**	**-7.0**	**-4.9**	**-4.2**
Primary balance[5)]	-4.3	-5.2	-5.3	-4.9	-2.8	-1.9

[1)] As calculated in the national accounts.
[2)] Incl. capital taxes.
[3)] Incl. capital transfers (excl. capital taxes) and consumption of fixed capital.
[4)] Gross fixed capital formation and capital transfers.
[5)] Net lending before net interest expenses.

2.2.1 Central government expenditure

Central government's national accounts expenditure increased by 3% last year. Close to one percentage point of this was due to the assignment of the Finnish Broadcasting Company YLE from the beginning of 2013 to the central government sector following the introduction of the public broadcasting tax. Over the previous 10 years central government expenditure increased on average by 4% a year.

Transfers to local governments and social security funds account for 45% of total central government expenditure and consumption expenditure for 25%. The former figure has increased steadily: in 2000 it was 10 percentage points less than it is now. Other major expenditure items include subsidies, transfers to non-profit organisations, EU fees and interest outlays. In recent years the national accounts expenditure figure has on average been EUR 1.5 billion higher than expenditure shown by central government accounts.

In the medium term central government expenditure growth will be relatively slow and the ratio of expenditure to GDP will fall, but still remain higher than before the financial crisis. Expenditure growth will be constrained by central government adjustment measures and reduced price changes to on-budget spending limits expenditure.

Interest expenses have remained quite moderate because of low interest rates and the country's strong credit rating, even though central government debt has risen appreciably for five years in a row. In 2013 national accounts interest expenses amounted to 4.3% of total expenditure, compared to the peak figure of 16% in 1997. Despite the increasing level of central government debt, interest expenditure will remain moderate both this year and next. However interest expenses will then begin to accelerate with the growing amount of debt and the eventual rise in interest rates.

Central government spending limits for 2015–2018

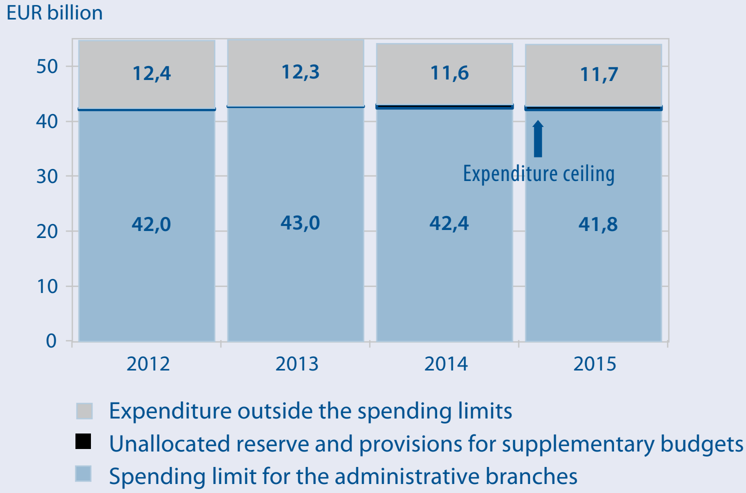
The Government is committed to a responsible long-term expenditure policy through a spending limits system that covers approximately 80% of on-budget expenditure. The spending limits system contributes to stable and credible management of central government finances.

The April 2014 spending limits decision for 2015–2018 is based on the fiscal policy objectives laid down in the Government Programme and on the earlier spending limits decisions taken during the current parliamentary term. The Government has announced new adjustment measures that will reduce central government expenditure and increase revenue by EUR 2.3 billion at an annual level in 2018. Most of these measures will be put in place during 2015. The net effect of all central government adjustment measures adopted during the parliamentary term comes to EUR 6.8 billion, or around 3% of GDP at an annual level in 2018.

The new adjustment measures on the expenditure side mainly concern spending in 2015: the 2015 additional adjustment amounts to almost EUR 1 billion, rising to around EUR 1.4 billion in 2018. The expenditure cuts affect a wide range of spending categories in all administrative branches.

New decisions on tax adjustment mainly consist of increases to excise duties as well as changes in earned income and capital income tax that will have the effect of narrowing income differentials. The new tax policy measures will increase central government tax revenue by a net total of around EUR 0.5 billion in 2015 and by around EUR 0.9 billion in 2018.

On-budget expenditure and Government term expenditure ceiling[1]



[1] Government term expenditure ceiling according to Spending Limits Decision, 2014. Expenditure at nominal prices. Government term expenditure ceiling consists of expenditure allocated to administrative branches and of unallocated reserve.

Source: Ministry of Finance

The decisions taken by the Government will reduce 2015 spending limits expenditure by around EUR 810 million. Indexation savings account for around EUR 120 million of this, reducing the spending limits price adjustment. The overall spending limits for the parliamentary term are thus reduced by EUR 690 million in 2015. Spending limits can be revised downwards mid-term without undermining the credibility of the spending limits system.

According to the spending limits decision total appropriations under the administrative branches' spending limits for 2015 come to EUR 41.7 billion. This will drop back to EUR 41.4 billion in 2018 (at 2015 price and cost levels). At the moment the 2015 unallocated reserve is technically negative, i.e. EUR –65.8 million. This is because the Government has decided to cover part of the costs of the so-called growth package from proceeds generated from share sales. EUR 150 million of the additional spending limits expenditure due to the growth package will be covered from proceeds from share sales recognized in 2014 in compliance with the spending limits rules in the Government Programme. Assuming that these proceeds are recognized as planned, the proposed negative reserve corresponds in reality to a positive unallocated reserve of some EUR 84 million.

Items excluded from the spending limits include cyclically variable expenditure, such as unemployment security expenditure, pay guarantee, housing allowances, and the central government contribution to the cost of basic social assistance. 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. Total expenditure outside the spending limits in 2015 comes to an estimated EUR 11.7 billion, of which interest payments account for around EUR 1.9 billion. It is estimated that interest payments will increase to around EUR 2.9 billion by 2018. The projected increase in interest expenditure is attributable to an assumed rise in interest rates during the spending limits period and to an increased debt stock due to central government deficit trends.

Central government budget balance: estimate 2014–2018, current prices, EUR billion 2014, Budget

	2014 Budget	2015	2016	2017	2018
Total estimated expenditure (current prices[1])	54.1	53.5	53.7	54.6	55.9
Total estimated revenue	46.9	49.6	50.4	52.0	53.4
Estimated on-budget balance	**-7.1**	**-3.9**	**-3.3**	**-2.6**	**-2.5**

[1] Expenditure converted into current prices using the MoF price index forecast for central government expenditure. The index provides a rough estimation of price trends over the budget planning period.

During the planning period it is estimated that central government on-budget expenditure will come to EUR 52.9–53.5 billion (estimated at 2015 price level). In real terms, central government expenditure will fall on average by around ½ per cent a year. In nominal terms expenditure will increase on average by around one per cent a year. Factors driving up on-budget expenditure include the growth of age-related expenditure, additional investments agreed under the Government Programme, indexations and increasing interest payments on central government debt. On the other hand expenditure will be decreased by the expenditure savings announced by the Government.

It is estimated that over the budget planning period, on-budget ordinary revenue will show an annual average increase of 3.3%. Tax revenue is forecast to increase by 3.6%. The revenue estimates are based on medium-term projections for the national economy. Projected economic growth will be slow in the medium term, which will also hamper the growth of tax bases. The revenue forecasts reflect not only the new adjustment decisions, but also the Government's tax policy priorities and other earlier Government decisions.

The central government deficit will contract from around EUR 7.1 billion in 2014 to an estimated EUR 2.5 billion in 2018. Central government finances are faced by a much lower macro forecast than last spring. On the other hand the Government has announced additional adjustment measures that will improve central government finances.

Central government debt will increase over the budget planning period by some EUR 12 billion to around EUR 108 billion in 2018. The central government debt to GDP ratio will continue to rise in 2015, but start to fall before the end of the planning period.

In 2018 it is estimated that the central government debt to GDP ratio will be around 48%.

Factors impacting change in central government budget balance compared to the spending limits decision of March 2013, EUR billion

	2014	2015	2016
Estimated balance, spending limits decision 8 April 2013	**-3.8**	**-2.4**	**-2.3**
New expenditure savings decisions, net	1.0	1.1	1.3
New changes to tax bases, net	0.5	0.8	0.9
Growth package	-0.3	-0.1	0.0
Income from changes in Government ownership	1.0	0.0	0.0
Decrease in projected interest payments on central government debt	0.0	0.0	0.0
Change due to macroeconomic forecast	-2.9	-3.3	-3.3
Other change including revised price adjustment	0.6	0.6	0.8
Change total	***-0.1***	***-0.9***	***-0.3***
Estimated balance, spending limits decision 3 April 2014	**-3.9**	**-3.3**	**-2.6**

2.2.2 Central government revenue

Over 85% of central government revenue consists of taxes. The most significant tax revenue items are taxes on earned and capital income, value added tax and corporate income tax. The development of tax revenue depends largely on the broader development of the economy and its structure. Furthermore the Government can take decisions that will impact tax accrual and the structure of taxation. Changes to the apportionment of tax receipts between central government, local government and parishes also influence the amount of tax revenue raised by central government.

Tax revenue growth has been variable in recent years. In the past two years output has declined, but tax revenue increased by 2% in 2012, and last year tax revenue growth accelerated to almost 4% on the back of tax base changes. The sharpest growth was recorded for VAT revenue following the tax base hike. The introduction of the bank tax and public broadcasting tax also drove up tax revenue.

GDP will see slow growth in 2014, which will contribute to restrict the growth of tax bases. The most significant tax base changes are the decision to lower the corporate income tax rate by 4.5 percentage points to 20% from the beginning of the year and the reform of dividend income taxes. All in all the tax base changes will slightly slow tax revenue growth in 2014. It is estimated that national accounts tax revenue will increase by 2% this year.

In 2015 it is predicted that many tax bases will grow more rapidly, which will boost the growth of central government tax revenue. In 2015 taxes will be eased by the reduction by one-half of waterway charges and the removal of the rail goods transport tax. In its spring 2014 spending limits discussions the Government decided on several tax base changes as part of a broader drive to adjustment in central government finances. Tax base changes will be made to several excise duties and to earnings and capital income taxes. The tax base changes will strengthen tax revenue growth in 2015. It is predicted that tax revenue in 2015 will increase by over 4%.

Forecasts for certain revenue and demand items impacting taxable income and the tax base in 2012-2018. annual change

	2012	2013	2014	2015	2018/2015**
	change. % per year				
Taxable earned income and capital income	3.2	3.1	2.4	2.4	3
Wage and salary earnings and other income	3.7	1.0	1.3	1.8	2
Pensions and other social security benefits	5.9	6.8	3.9	3.2	3 1/2
Capital income	-14.7	9.7	1.8	3.4	4
Index of wage and salary earnings	3.2	2.0	1.3	1.2	1 1/2
Operating surplus	-4.7	-4.1	3.5	5.6	5
Value of household consumption expenditure	3.3	0.8	1.7	2.0	3
VAT base	5.7	-0.2	1.8	2.0	3
Petrol consumption	-3.6	-2	-1½	-2.0	-2
Diesel consumption	-0.4	-0.8	1	1	1½
Electricity consumption	- 3/4	-5.1	4	1½	1½
Duty-paid alcohol consumption	-1.8	-4.3	-2	-2	-½
New passenger cars	-11.5	-7.2	2.7	3.9	4
Consumer price index	2.8	1.5	1.5	1.4	1 1/2

From 2016 through to the end of the outlook period it is estimated that tax revenue will increase on average by just under 4%. During this period some tax base changes will be introduced, and some of the temporary measures adopted by the Government will expire.

As for other sources of central government revenue, the single biggest items are property income and transfers from the State Pension Fund. Transfers from the State Pension Fund cover 40% of central government's annual pension expenditure. In its spring 2014 spending limits discussions the Government decided to draft a legislative amendment that will allow for increased State Pension Fund revenue recognition in 2014 and 2015. It is expected that other central government property income will also increase more than usual in 2014 and 2015 because as part of its adjustment measures, the Government decided on additional revenue recognitions from public enterprises. Furthermore more dividend incomes than usual will be withdrawn from state-owned corporations.

Taxes on earned and capital income

Revenue from earned and capital income taxes consists of receipts from progressive income tax, capital income tax and withholding tax paid by people with limited tax liability. The most significant source of revenue is progressive income tax. Almost 70% of the earned income tax base consists of wage and salary earnings, over one-quarter of taxable social benefits and less than 5% of other revenue.

Earned income and capital income tax revenue will increase in 2014 despite sluggish economic activity and falling employment. The tax base changes introduced include both steps that will increase tax revenue and those that will reduce tax revenue. As part of the Pact for Employment and Growth signed by the labour market confederations in autumn 2013, central government took the step to raise income thresholds in the earned income tax scales by 1.5%, with the exception of the highest income bracket. On the other hand dividend income tax rates were increased from the beginning of the year.

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	380 of which central govt. 129 and local govt. 169 sosial security funds 70
	Pension incomes	1-pp	119, of which central govt. 32 and local govt. 76
Capital income tax	Investment income	1-pp	28
Corporate tax	Operating surplus	1-pp	43, of which central govt. 27 and local govt. 15
VAT	Value of private consumption	1-pp	118
Car tax	Sales of new cars	thousands	7
Energy tax	Electricity consumption	1%	8
	Petrol consumption	1%	13
	Diesel consumption	1%	14
Duty on alcoholic beverages	Alcohol consumption	1%	14
Duty on cigarettes	Cigarette consumption	1%	7

In 2015 the employment situation will show some improvement with the recovery of economic activity, and wage bill growth will accelerate. It is estimated that revenue from earned income and capital taxes will increase at an annual rate of 4%. In its spring 2014 spending limits discussions the Government took the decision to increase 2015 earned income taxes by deciding not to adjust tax scales for real earnings growth and inflation. The lower limit of the highest income bracket in the progressive income tax scale is lowered to EUR 90,000, with the validity of the income category extended to 2018. On the other hand taxes are eased by increasing the basic and earned income deduction.

It is predicted that unemployment will improve towards the end of the outlook period, and wage bill growth is expected to increase on average by around 2½% a year in 2016–2018. Revenue from earned income and capital income taxes will grow slightly more rapidly than the wage bill. The forecast assumes that in the years following the current electoral term, the earned income tax scale will be revised to reflect rising earnings levels or inflation.

Corporate income tax

In recent years corporate income tax as a proportion of total tax revenue has fallen, primarily because of the sluggish economy, the lowered corporate income tax rate and, to some extent, international tax competition. Revenue from corporate income tax paid by businesses on their profits is shared between central government, local government and parishes. The forecast for corporate income tax revenue assumes that the tax base loosely follows the development of the national accounts operating surplus, and the forecast for the current year also takes account of tax revenue data for the early part of the year.

During the Government's term in office the corporate income tax rate has been lowered in total by 6.5 percentage points. This represents a significant loss of tax revenue. However the thinking is that in the long term, the reduction of the corporate income tax rate will significantly contribute to boosting economic growth. It is expected that the lowered tax rate will influence choices of business form, the company financing structure, the transfer of profits, and the amount and direction of investments made. The aim of lowering the corporate income tax rate is to improve Finland's position in the tightening environment of international tax competition. Central government will compensate local government for the tax revenue losses resulting from the lowered corporate income tax rate.

The operating surplus will increase moderately in 2014. Revenue from corporate income tax will fall sharply from last year because of the lowered tax rate. However the moderate wage settlement and lowered tax rate will contribute to bolster business profits.

In 2015 the growth of operating surplus will gather pace and revenue from corporate income tax will increase. It is estimated that corporate income tax revenue will increase more or less in line with the operating surplus throughout the outlook period. In 2015–2018 it is projected that the operating surplus will increase on average by 5% a year and revenue from corporate income tax by an average of around 6% a year.

Central government revenue from corporate income tax may differ from the overall development of corporate income tax revenue, for several reasons. Corporate income tax revenue for the calendar year may accumulate more slowly or more rapidly than the corporate income tax for the tax year. Taxes for a given tax year accumulate over many years, and the level of supplementary prepayments made in the year following the tax year, for instance, varies widely. It is expected that central government revenue from corporate income tax will fall considerably during the current year. As local governments are compensated in full for the effects of corporate income tax rate changes, this year's reduction in the corporate income tax rate will only be reflected in central government tax revenue. The share of corporate income tax revenue going to central government will increase in 2016, which is the final year of the increased apportionment paid to local governments.

Indirect taxes

The single most important source of indirect tax revenue is VAT, which accounts for around one-third of total tax revenue in the budget. In 2014 it is projected that VAT revenue will fall because there were no significant tax base changes at the start of the year and because private consumption will remain effectively unchanged. One tax base change that has only minor significance is that rents paid by universities of applied sciences will be subject to VAT from the beginning of 2014. It is estimated that national accounts VAT revenue will increase by just over 2%. In 2015 VAT revenue growth will accelerate. It is projected that VAT revenue will increase steadily over the budget planning period by 3% a year.

Private consumption accounts for around 60% of the VAT tax base. In recent years private consumption growth has been historically sluggish. During the outlook period household consumption will be constrained by the slow improvement in the employment situation and the moderate growth of wage and salaries.

Some 60% of energy tax revenue consists of excise duties on petrol and diesel, 20% comes from electricity and the rest from other energy products. Energy taxes have been put up considerably in recent years. The energy tax hikes set out in the Government Programme are focused on transport fuels, taxes on which were raised in two stages. The first increase was implemented in 2012 and the second from the beginning of this year. A new tax on power plants was introduced from the beginning of 2014. On the other hand electricity tax reliefs were granted to IT centres. The Government decided to increase energy taxes in its spring 2014 spending limits discussions by increasing the tax rate in electricity tax band I. In addition the carbon dioxide tax on heating, power plant and machinery fuels will be increased, as will the tax on transport fuels.

Revenue from other excise duties will grow more steadily than energy taxes. Tax bases for tobacco, alcoholic beverages, sweets, ice cream and soft drinks were revised at the beginning of the year, bringing a marked increase in tax revenue. This year's revenue from the tobacco tax will remain relatively small because of tax planning in response to the tax base change last year. The growth of non-taxable travellers' imports and grey imports constitute a significant threat that may dent revenue from alcohol and tobacco tax over the outlook period. The tobacco tax will be further increased in 2015.

Revenue from the motor car tax fluctuates sharply. Passenger cars account for around 90% of total revenue from the motor car tax. It is estimated that in the coming years demand for cars will remain lower than over the past few years. Revenue from the motor car tax will increase with the reduction of tax subsidies in 2015 because the reduced car tax rate will no longer be applied to taxis (excluding specially equipped taxis) or motor vehicles imported into Finland as removal goods. The forecast is that the car tax will rise on average by 3,5% a year over the outlook period. The vehicle tax is a time-based tax that is levied in 12-month periods on passenger cars, vans and heavy goods vehicles. The annual vehicle tax was increased in keeping the Government Programme at the beginning of 2013, and a further increase will be introduced from the beginning of 2016 as part of the tax base changes adopted by the Government in spring 2014.

Central government on-budget revenue: estimates for 2012-2018, EUR billion

	2013 provisional financial accounts	2014 budget	2015	2016	2017	2018	2018/2015 annual change, %
Total tax revenue estimates	38.7	39.8	41.0	42.8	44.3	45.9	3
Income and wealth taxes [1]	12.1	12.1	12.7	13.8	14.7	15.5	4 1/2
Taxes based on turnover	17.3	17.9	18.1	18.7	19.3	19.9	3
Excise duties	6.6	6.9	7.2	7.3	7.2	7.2	1
Other taxes	2.8	2.9	3.0	3.1	3.2	3.3	2
Miscellaneous revenue	5.1	4.7	5.4	5.1	5.2	5.1	0
Interest income and profit entered as income	2.0	2.0	2.7	2.0	2.0	2.0	- 1/2
Total revenue estimates	**46.2**	**46.9**	**49.6**	**50.4**	**52.0**	**53.4**	**3**

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

Impact of discretionary tax measures on general government tax revenue

	2013	2014	2015	2016	2017	2018
	EUR million					
Earned income taxes	90	-33	27	-78	-76	-94
Average increase in municipal tax rate	135	360	0	0	0	0
Investment income tax	108	74	84	41	0	0
Corporate tax	-50	-921	113	0	0	0
YLEtax	440	77	-6	7	5	0
Other direct taxes	166	162	65	29	0	0
Value-added tax	742	151	2	0	0	0
Energy taxes	76	169	256	35	1	0
Other indirect taxes	177	167	281	101	0	0
Social security contributions	11	580	306	279	205	155

2.2.3 On-budget accounts and National Accounts

In 2014 the State Budget net financing requirement is about EUR 6.5 billion in accordance with the budget approved by Parliament, supplemented with updated tax revenue estimates and the new adjustment decisions made by the Government on 25 March 2014. The national accounts forecast for state sector net borrowing amounts to about 0EUR 7 billion. In recent years the national accounts budgetary position has tended to be stronger than the on-budget balance.

On-budget accounts comprise a total of some 70 separate accounting units. In the national accounts, central government finances are defined as comprising all on-budget entities as well as 10 extra-budgetary funds. Universities are not included in the State Budget, although they do still come under the national accounts central government concept. The state-owned investment company Solidium and the Finnish Broadcasting Company YLE are also classified as part of central government in the national accounts. In connection with this year's national accounts reform other new extra-budgetary units will also be classified under the central government sector.

The concepts and classifications applied in on-budget accounts and in the national accounts differ in many respects. For instance, the content of consumption expenditure items in on-budget accounts differs quite considerably from national accounts consumption expenditure, and on-budget investment expenditure covers only a small part of expenditure classified as investment in the national accounts. 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.

Perhaps the single most significant source of differences between the on-budget net financing requirement and national accounts net lending comes from financial investments. Financial investments such as central government loans, capitalisations 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.

Every EU country is required to report twice a year to Eurostat on the differences between their on-budget and national accounts figures in connection with their EDP reporting. Published on the Eurostat website, these reports describe the differences between on-budget accounting and national accounts not only for central government, but also for other general government subsectors.

On-budget balance and central government net lending[1]

	2012	2013*	2014**	2015**	2016**
	EUR billion				
On-budget surplus (+)/deficitT (-) [2]	**-7.8**	**-8.4**	**-6.5**	**-4.0**	**-3.3**
Privatization proceeds (net proceeds from equity sales)	-0.1	-0.1	-1.1	-1.1	-0.5
Financial investment, net	0.7	0.9	0.5	0.5	-0.2
Rvenue surplus in off-budget units (e.g. State Pension Fund)	-0.5	-0.6	0.0	0.0	0.0
Cash/accrual basis adjustment	0.0	0.3	0.2	0.2	0.2
Other adjustment items [3]	0.3	0.6	0.0	-0.5	-0.4
Central government net lending (+) /-borrowing (-)	**-7.3**	**-7.2**	**-7.0**	**-4.9**	**-4.2**

[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 2013 the local government deficit contracted to 0.8% of GDP, and the local government financial position improved by some EUR 700 million from the previous year. This was due to increased tax revenue growth and slowing expenditure growth. The amount of local government debt increased to 7½% of GDP.

Local government tax revenue showed exceptionally strong growth last year given the sluggish economy, reaching around 7%. The average municipal tax rate rose by 0.1 percentage point to 19.38%. However most of the increase in tax revenue was attributable to one-off items. Local government revenue was pushed up most particularly by the adjustment of earned income and capital income tax apportionments between local and central government in favour of local governments. The growth of local government expenditure slowed from the previous year to around 2½% primarily as a result of adjustment measures. Investment expenditure, on the other hand, continued to grow apace.

In 2014 it is predicted that the local government deficit to GDP ratio will remain more or less unchanged from the previous year. The growth of both overall expenditure and income will slow. Local government debt to GDP will increase to over 8%.

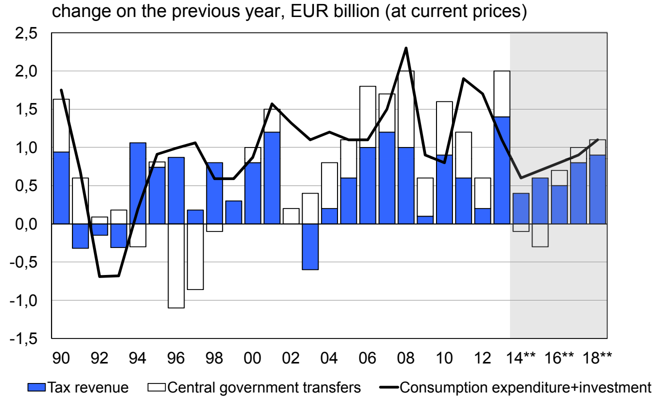
Local government revenue growth will come in at just over one per cent. Tax revenue is predicted to increase by 2%. Revenue from real estate tax in particular will increase strongly following the revision of the criteria for real estate evaluations and the decision by some local authorities to put up their real estate tax rates from the beginning of the year. Revenue from municipal tax will also increase as almost half of all local authorities increased their tax rates. The average municipal tax rate increased by 0.36 percentage points. Central government transfers to local governments, on the other hand, will fall as a result of central government adjustments.

Local governments’ nominal consumption will increase by just under 2%. Personnel costs account for the majority of local government expenditure, and the moderate wage settlement agreed for 2014–2015 will contribute to slow their growth. Active adjustment efforts by local authorities themselves will also slow the growth of consumption expenditure.

Local government investment spending has increased sharply in recent years and now stands at an exceptionally high level. There remains considerable pressure to invest within the local government sector, both in renovation and new construction projects. However it is thought that the long-standing downturn will begin to restrict new investment starts by local governments. Therefore it is predicted that over the outlook period the volume of investment will begin slightly to fall.

Local government taxes, central government transfers, consumption expenditure and investment

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



Sources: Statistics Finland, MoF

Municipal finances to remain tight in the coming years

It is predicted that local government finances will continue to remain firmly in deficit in 2015-2018. Even though economic growth is gradually rebounding, the economic outlook in general is subdued, and therefore the growth of tax bases and local government tax revenue will be slower than usual.

In 2015–2018 local government tax revenue will increase on average by just over 3% a year. The temporary 5 percentage point increase in the apportionment of corporate income tax revenue to local governments will expire in 2016, which will reduce local government tax revenue in that year.

The local government tax revenue estimate includes several tax base changes decided by the Government, but those changes have no effect on the development of local government revenue because central government transfers to local government have been revised accordingly to offset the effects on tax revenue. These include increases to the basic and earned income deduction as well as increased lower and higher real estate tax limits in 2015. In addition the deduction for commuting expenses will be reduced and the maximum amount deductible on housing loan interest will be progressively scaled back in 2015–2018. For 2016–2017 it is assumed that the central government tax scales for earned income will be adjusted for inflation.

Central government transfers to local government will still fall in 2015 and then start moderately to increase, on average by close to 1½ % a year. Central government adjustment measures will reduce central government transfers by a total of EUR 1.4 billion at an annual level in 2017. In all, therefore, local government tax revenue growth and the increase in central government transfers to local government will average 2,3%.

It is predicted that overall local government expenditure growth will slightly outpace overall revenue. The volume of local government consumption is expected to follow the increasing demand for services resulting from the changing population structure and to increase by less than one per cent a year. It is assumed that earnings in the local government sector will develop in line with general earnings trends.

The current outlook does not assume any increases in municipal income tax rates, despite significant upward pressure. It also makes no assumptions regarding as-yet-unspecified local government measures in 2015–2018 to adjust expenditure levels and to increase operational efficiency. The forecast for the local government sector therefore is in essence a scenario exercise, indicating the general scale of the deficit that will open up in local government finances if the local authorities take no balancing actions.

Without effective measures, local government finances are on an unsustainable path

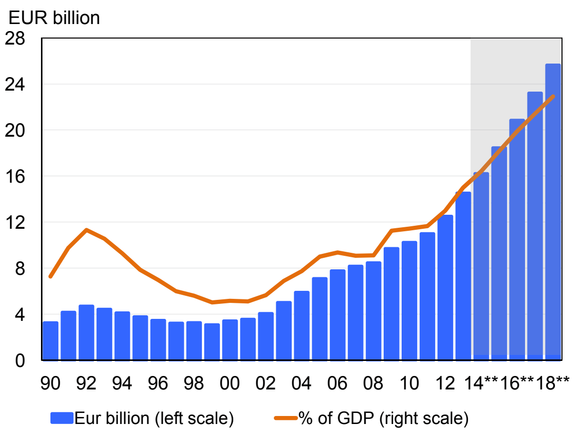
The state of local government finances gives cause for concern. If the revenue and expenditure projections outlined here are accurate, the local government sector will remain firmly in deficit through to 2018. This will drive up the volume of local government debt to EUR 25 billion by 2018, over EUR 11 billion more than in 2013. The debt to GDP ratio will climb to over 11%. The outlook is further clouded by the steadily escalating expenditure pressures beyond the outlook period as a result of population ageing. For this reason the local government debt ratio risks to accelerate further unless timely steps are taken to address the sustainability gap in local government finances.

In its structural policy programme the Government has set the target of achieving balance in local government finances. Under this programme the Government has committed itself to reducing the duties and obligations of local authorities so that the operational expenditure of local and joint municipal authorities is reduced by one billion euros at an annual level in 2017. Further savings of one billion euros at an annual level in 2017 should be achieved through tax financing and interventions by local governments themselves, among other things by improving productivity. On the other hand the structural policy programme includes measures that have the effect of increasing local government expenditure. This forecast only takes account of those components in the package of measures whose details (including scale) have already been specified and decided. It is estimated that the measures included in the Government spending limits decision will reduce net local government expenditure by around EUR 280 million at an annual level in 2017.

In line with the Government's structural policy programme steps will be taken to reform the system of macroeconomic local government steering with a view to securing balanced finances. The EU directive on requirements for budgetary frameworks (2011/85/EU) requires Member States to strengthen the fiscal governance of the public sector and its all sub-sectors . In keeping with this directive the Government decree on fiscal planning (120/2014) requires that a target is also set for the local government budgetary position in 2015 and that a ceiling is specified for the maximum amount that measures taken by central government may affect local government finances. This will help to integrate local government macroeconomic steering more closely with the control and planning of general government finances. Furthermore the economic provisions of the Local Government Act will be revised so that they are more supportive of maintaining balance in local government finances.

The scenario calculation presented clearly underscores the importance of the effective implementation of measures designed to strengthen local government finances from the point of view of local government sustainability. In recent years local governments have taken active adjustment efforts among other things by increasing their tax rates, but the achievement of balance will still require substantial further input. The macroeconomic steering reform will take full effect in 2015 and provide a range of new tools for improving the stability of local government finances. This will require a firm commitment to the objectives set on the part of both central government and local governments.

Local government debt



Sources: Statistics Finland, MoF

Local government [1)]

	2011	2012*	2013**	2014**	2015**	2016**
	EUR billion					
Taxes and social security contributions	19.2	19.4	20.7	21.1	21.8	22.3
of which municipal tax	16.3	16.8	17.9	18.3	18.8	19.4
corporate tax	1.6	1.5	1.5	1.3	1.4	1.3
real estate tax	1.2	1.3	1.4	1.5	1.6	1.6
Other revenue [2)]	16.1	16.7	17.3	17.3	17.1	17.4
of which interest receipts	0.3	0.3	0.3	0.3	0.3	0.3
of which transfers from central government	12.2	12.6	13.3	13.2	12.9	13.1
Total revenue	**35.3**	**36.0**	**38.0**	**38.4**	**38.9**	**39.6**
Consumption expenditure	30.1	31.5	32.4	33.0	33.7	34.6
of which compensation of employees	19.9	20.7	21.0	21.0	21.2	21.5
Income transfers	2.8	3.0	3.0	3.2	3.4	3.6
of which social security benefits and allowances	1.1	1.2	1.3	1.3	1.3	1.4
subsidies and oher transfers	1.4	1.5	1.6	1.6	1.8	1.8
interest expenses	0.2	0.2	0.2	0.2	0.3	0.5
Capital expenditure [3)]	3.4	3.7	4.1	4.0	4.0	3.9
Total expenditure	**36.3**	**38.2**	**39.5**	**40.1**	**41.1**	**42.0**
Net lending (+) / net borrowing (-)	**-1.0**	**-2.2**	**-1.5**	**-1.7**	**-2.2**	**-2.4**
Primary balance [4)]	-1.1	-2.3	-1.6	-1.8	-2.3	-2.3

[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.

2.4 Social security funds

2.4.1 Earnings-related pension funds

In 2013 the surplus of earnings-related pension funds narrowed to 2.1% of GDP, down from 2.5% in 2012. In the past five years the surplus of earnings-related pension funds has decreased by more than 2 percentage points.

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 the slower rise in earnings have in turn dampened the growth of incomes from contributions. Low interest rates have in turn reduced interest revenue on pension assets. Another factor contributing to reduce interest revenue is the shift in investment focus to stocks. However the total value of pension assets had climbed to EUR 162 billion by year-end 2013.

The growing number of pensioners and the rise in the average pension will continue to drive pension expenditure growth throughout the outlook period. Slower inflation means that annual indexations of pensions will remain at less than 2% over the outlook period, which will slow the growth of pension expenditure. The Government decided in its spending limits discussions on 25 March 2014 to lower the pension index increment to 0.4% in 2015. The Government also decided to transfer EUR 500 million from the State Pension Fund into the Budget. Pension expenditure will increase at around 5% throughout the forecast period. Pension expenditure to GDP will climb to over 13% in 2018, compared to less than 9% in 2008.

The earnings-related pension contribution was increased by 0.8% from the beginning of 2014, returning to the previously agreed track after the decision last year to suspend the increase. Earnings-related pension contributions will be increased by 0.4 percentage points in 2015 and 2016, with the burden shared equally by employees and employers. Wage bill growth will remain sluggish both this year and next as a result of weak employment growth and moderate pay rises. It is expected that proceeds from pension assets will increase during the outlook period with higher interest rates. In 2014 it is expected that the earnings-related pension funds surplus will be 2.1 % of GDP. In 2015 and 2016 contribution hikes and increased interest receipts will be enough to keep pace with the growth of expenditure, and the surplus of earnings-related pension funds will improve moderately.

Based on the contribution hikes and the growth of interest and capital income it is predicted that the surplus of earnings-related pension funds will remain at over 2% of GDP in 2017–2018[1]. Pension expenditure will continue to increase rapidly in the medium term, too, even though the life expectancy coefficient will cut new pensions by as much as 4.4% in 2018. The financial position of earnings-related pension funds excluding net interest expenditure will weaken by 0.7% over the outlook period, even though their headline balance will remain unchanged from 2013. This reflects the key importance of the interest rate assumption in the forecast.

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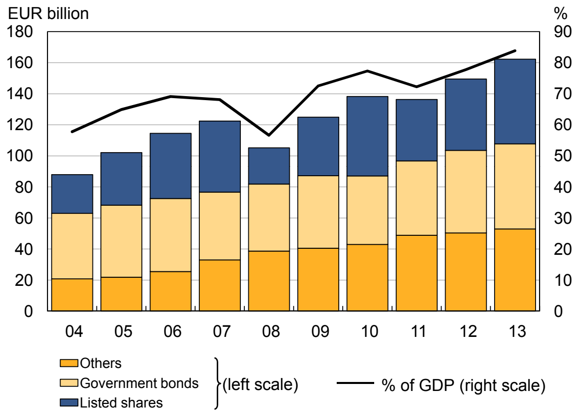
1 The medium-term forecast assumes that pension contributions will increase by 0.3 pecentage points in 2017 and by 0.2 percentage points in 2018.

Investment portfolio of pension funds by type of investment (all members)



Source: The Finnish Pension Alliance

Finances of social security funds[1)]

	2011*	2012*	2013*	2014**	2015**	2016**
	EUR billion					
Investment income	4.0	3.8	3.7	4.2	4.7	5.2
Social security contributions	24.0	25.5	25.9	26.9	27.7	28.7
of which contibutions paid by employers	16.9	17.7	17.9	18.4	18.8	19.4
contributions paid by insured	7.1	7.8	8.0	8.5	8.8	9.3
Transfer from general government	11.6	12.3	12.9	13.2	13.2	13.3
Other revenue	0.6	0.5	0.5	0.6	0.6	0.6
Revenue	**40.2**	**42.1**	**43.1**	**44.9**	**46.1**	**47.8**
Consumption expenditure	3.4	3.6	3.6	3.7	3.7	3.8
Social security benefits and allowances	28.7	30.6	32.5	34.0	34.8	36.0
Other outlays	2.6	2.7	2.9	3.3	3.3	3.1
Expenditure	**34.7**	**36.8**	**38.9**	**40.9**	**41.8**	**43.0**
Net lending (+) / net borrowing (-)	**5.4**	**5.2**	**4.1**	**3.9**	**4.3**	**4.8**
Earnings-related pension schemes	5.4	4.8	4.1	4.2	4.4	4.8
Other social security funds	0.1	0.4	0.0	-0.2	-0.1	0.0
Primary balance [2)]	3.0	3.1	2.0	1.7	1.7	1.7

[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 include 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 5.5% in 2013. This sharp growth was attributable to rising earnings-related unemployment security expenses, which were up by 16.7%, and the growth of basic unemployment security, up 18.2%. The costs of unemployment exceeded EUR 4 billion. Sickness insurance expenditure fell marginally last year as a result of reduced reimbursements of medicines and travel expenses as set out in the Government Programme. Transfers from central and local government to other social security funds increased by EUR 400 million from the previous year, allowing these funds to maintain financial balance in 2013.

It is predicted that unemployment-related expenditure will still rise in 2014, but then begin to fall as unemployment eases towards the end of the outlook period. Unemployment expenditure will be reduced by the decisions taken by the Government on 25 March 2014 to cut earnings-related unemployment expenditure by EUR 50 million from the beginning of 2015. Furthermore the Government decided on savings of EUR 51 million in sickness insurance expenditure. Despite these savings sickness insurance expenditure is projected to increase on average by 3% a year over the outlook period. The Government also decided to increase the national pension index by 0.4% in 2015, around one percentage point less than the normal index adjustment. As a result of these savings decisions the growth of expenditure by other social security funds will slow appreciably from the beginning of next year.

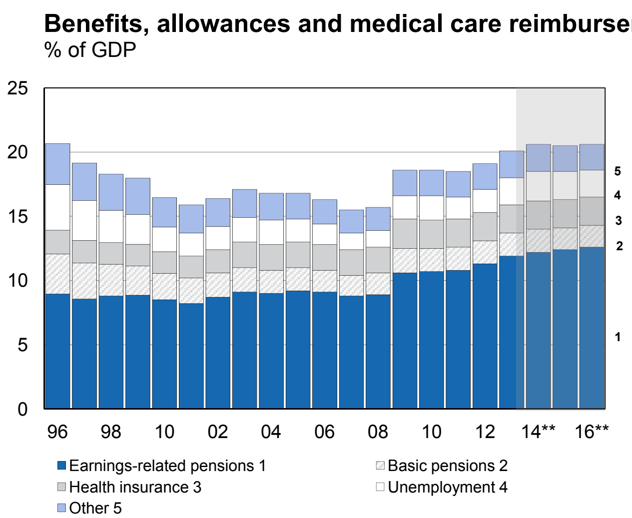
Employees' sickness insurance contribution increased by 0.12% and employers' income security contribution by 0.1% from the beginning of this year. Employees' and employers' unemployment insurance contribution, on the other hand, fell by 0.1%. As a result of the lowered unemployment security contribution and the growth of unemployment expenditure, the financial position of other social security funds will show a deficit of 0.1% of GDP this year. From 2015 other social security funds will be close to balance.

The relative contributions of the local government sector and central government to Kela financing will be revised in 2015 as local governments take more responsibility for the financing of long-term unemployment. In 2012 more than two-thirds or 69% of Kela's financing came from central government, 26% from social security contributions and 5% from local governments.

Social security contributions rates and pension indices

	2011	2012	2013	2014**	2015**	2016**
SOCIAL INSURANCE CONTRIBUTIONS [1)]						
Employers						
Sickness insurance	2.12	2.12	2.04	2.14	2.15	2.15
Unemployment insurance	2.32	2.32	2.32	2.20	2.20	2.20
Earnings-related pension insurance	17.10	17.35	17.35	17.75	17.95	18.15
Local government pension insurance	23.60	23.60	24.00	23.70	23.70	23.50
Employees						
Sickness insurance	2.01	2.04	2.04	2.16	2.18	2.20
Unemployment insurance	0.60	0.60	0.60	0.50	0.50	0.50
Earnings-related pension insurance	4.92	5.45	5.45	5.85	6.05	6.25
Pensioners						
Sickness insurance	1.36	1.39	1.47	1.49	1.50	1.53
Pension indices						
Earnings-related index (over 65)	2 323	2 407	2 475	2 509	2 519	2 558
National pension index	1 508	1 565	1 609	1 630	1 637	1 664

[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.



Sources: Statistics Finland, MoF

2.5 Long-term sustainability of public finances

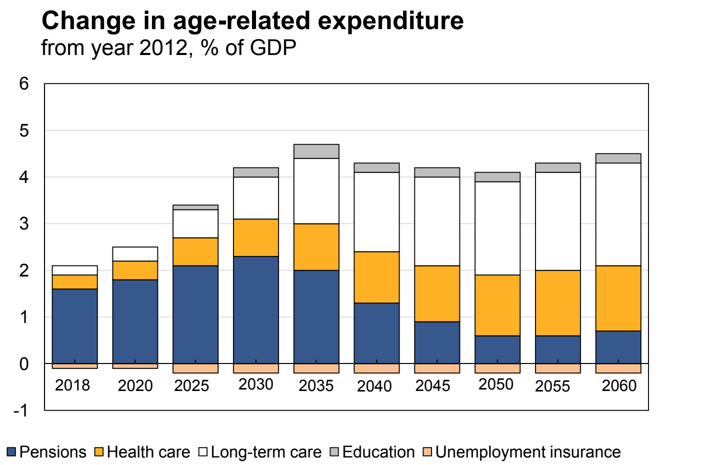
Public finances are not on a sustainable basis in the long term, but with the economy returning to normal and adjustment measures taking effect, general government will move closer to balance in the medium term. The changing population age structure has begun to push up age-related expenditure and reduce the number of people in working age. The fiscal pressures of population ageing will remain high for the next two decades.

The Ministry of Finance assesses the impacts of population ageing on public spending using a model developed by the Ministry of Social Affairs and Health. Using this social expenditure model it is possible to forecast the development of age-related expenditure through to 2060. The estimates are based on Statistics Finland's 2012 population projection, age group breakdowns for social and health care expenditure and long-term projections of macroeconomic development. The model provides an insight into how pension, health care, long-term care and unemployment expenditure are expected to develop with the changing population structure. In addition the current projections include an assessment of the development of education expenditure. In 2012 age-related expenditure accounted for around half of all public spending.

By 2030, with the population aged 65 or over estimated to increase by more than 400,000 people, it is forecast that pension expenditure will increase by around 2.3 percentage points to 15% of GDP. The growth of the elderly population will also drive up health care and long-term care expenditure, both of which will increase by around one percentage point relative to GDP by 2030. It is expected that unemployment and education expenditure will remain close to their current levels throughout the outlook period. Age-related expenditure is expected to increase by over 4% relative to GDP by 2030. Pension expenditure is expected to decrease moderately after 2030 as the life expectancy coefficient cuts new beginning pensions in correlation with the rising life expectancy. However it is expected that health care and long-term care expenditure will continue to grow throughout the outlook period with the ageing population structure, even though it is thought that the improving health of the elderly population will reduce the age-group standardised need for care. Age-related expenditure will rise by 4.4% from 2012 to 2060.

Age-related expenditure provides a guide for assessing long-term adjustment needs in public finances, i.e. the so-called sustainability gap. According to the Ministry of Finance's estimate the sustainability gap in general government finances stands at 3.0% of GDP at 2018 level. The structural deficit of base year 2018 accounts for -1.8 percentage points of the sustainability gap, future interest expenditure on existing debt for 0.9 percentage points, reduced property income for 1.7 percentage points and increasing age-related expenditure for 2.2 percentage points. The sustainability gap estimate does not take account of the measures that have not yet been rubberstamped. The calculation is based on existing legislation and measures already decided upon.

The sustainability projection is in essence a scenario calculation that projects 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 forecast, the greater the uncertainty, which is why the forecast is highly sensitive to the assumptions on which it is based.



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

General government finances 2012–2060, % of GDP

	2012	2018	2030	2040	2060	2060-2012
	% of GDP					change, %
Total expenditure	56.7	57.5	59.6	59.7	59.9	3.2
of which age-related and unemployment expen-diture	28.4	30.4	32.5	32.6	32.8	4.4
Pensions	12.7	14.2	15.0	14.0	13.4	0.7
Old-age pensions	11.3	13.0	13.8	12.9	12.4	1.1
Other pensions	1.3	1.2	1.1	1.1	0.9	-0.4
Health care	6.0	6.3	6.8	7.1	7.4	1.4
Long-term care	2.1	2.3	3.0	3.8	4.3	2.2
Education	5.9	5.9	6.1	6.1	6.1	0.2
Unemployment	1.8	1.7	1.6	1.7	1.6	-0.2
Interest expenditure	1.4	1.8	3.8	5.1	9.7	8.3
Total revenue	54.5	57.4	57.8	56.9	56.4	1.9
of which: property income	3.7	4.5	4.8	4.0	3.5	-0.2
Net lending *)	-2.2	0.0	-3.9	-6.0	-11.4	-9.2
of which: transfer to pension funds	2.5	2.0	0.5	0.8	1.1	-1.4
General government debt	53.6	61.2	78.1	104.3	199.3	145.7
General government assets	123.8	135.0	122.6	106.4	97.3	-26.5
Pension funds`financial assets, gross	77.5	89.0	85.0	74.5	72.3	-5.2

*) Cyclically-adjusted net lending as of 2017.

Underlying assumptions

	Assumptions, %			
	2018	2030	2040	2060
Labour productivity growth	1.0	1.4	1.4	1.4
Real GDP growth	1.4	1.4	1.6	1.5
Participation rate				
males (15-64)	76.6	78.4	78.5	78.6
females (15-64)	75.6	74.6	75.1	75.6
total (15-64)	75.9	76.6	76.7	77.0
Unemployment rate	7.6	7.0	7.0	7.0
Old-age dependency ratio*	35	44	45	50
Inflation	1.8	2.0	2.0	2.0
Real interest rate	1.0	3.0	3.0	3.0
Real return of asset	2.0	3.5	3.5	3.5

*** the ratio of people aged over 64 to those aged 15–64**

Souce: Ministry of Social Affairs, Statistics Finland, Ministry of Finance.

Appendix 1

Changes from the previous forecast

Table 1. Evolution of forecasts over time[1]

	2013*				2014**				2015**				2016**
	eb1	es2	eb2	es1	eb1	es2	eb2	es1	eb1	es2	eb2	es1	es1
GDP at market prices, change in volume, %	-0.4	-0.5	-1.2	-1.4	1.2	1.2	0.8	0.5	1.9	1.9	1.8	1.4	1.8
Consumption, change in volume, %	0.6	0.4	-0.1	-0.3	0.8	0.8	0.4	0.1	1.2	1.2	0.9	0.3	1.0
Exports, change in volume, %	0.0	-0.5	-0.8	0.3	3.7	3.7	3.6	3.5	4.2	4.2	4.1	4.1	4.8
Unemployment rate, %	8.3	8.3	8.2	8.2	8.1	8.2	8.4	8.4	7.8	7.9	8.2	8.3	8.1
Consumer price index, change, %	1.7	1.6	1.5	1.5	2.1	2.1	1.5	1.5	2.0	2.0	1.6	1.7	1.9
Central government net lending, % of GDP	-3.7	-3.8	-3.8	-3.7	-3.0	-3.3	-3.6	-3.5	-2.5	-3.0	-3.2	-2.4	-2.0
General government net lending, % of GDP	-2.5	-2.6	-2.6	-2.4	-2.1	-2.3	-2.5	-2.4	-1.6	-1.9	-2.0	-1.4	-0.9
Central government debt, % of GDP	46.5	47.5	46.6	46.4	48.0	49.3	49.3	48.7	48.3	50.1	50.7	49.3	49.2

[1] Release date: Economic Bulletin 19.6.2013 (eb1), Economic Survey 16.9.2013 (es2), Economic Bulletin 19.12.2013 (eb2) and Economic Survey 3.4.2014 (es1).

Sources: Statistics Finland, MoF

Table 2. Outturn data for 2013 and forecasts used in budget process, change %

	Forecast for 2013			Average forecast errors	
	Spring 2012	Autumn 2012	Outturn 2013	Forecast under-/over-estimation[1], pp.	Magnitude of forecast error[2], pp.
GDP (volume)	1.5	1.0	-1.4	2.3	4.1
GDP (value)	4.0	3.4	0.6	2.6	4.5
Private consumption (value)	3.8	3.6	0.8	1.1	3.3
Current account, % of GDP	-0.3	-1.4	-0.8	1.5	1.8
Inflaation	2.6	2.4	1.5	0.6	1.0
Wage bill	2.6	2.5	1.0	1.5	2.0
Unemployment rate	7.9	8.1	8.2	0.0	1.1
Central governmnet debt, % of GDP	45.4	47.2	47.6	-1.1	3.6
Central government net lending, % of GDP	-2.5	-2.8	-3.7	1.2	1.8
General government net lending, % of GDP	-0.5	-1.2	-2.4	1.3	2.2

Forecasts are compared with March 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.

Appendix 2

Recent policy measures August 2013-December 2013

30 August 2013

The labour market confederations reached a settlement on a collective bargaining agreement in line with the national Pact for Employment and Growth with a view to supporting employment and economic growth in Finland. The national labour market confederations propose a revision of collective agreements in two stages. The first phase of the agreement period will be 24 months if the current agreement ends no later than 31 December 2013; otherwise the first phase will continue for 22 months. The second phase of the agreement period will end on a date to be determined by the collective bargaining parties between 1 November 2016 and 31 January 2017.

The first agreed increase for the first agreement phase shall be 20 euros per month. The agreed increase shall be implemented four months after the starting date of the first agreement phase. The second agreed increase shall be 0.4%, and it shall be implemented 12 months after the first agreed increase. The labour market confederations shall meet in June 2015 to review the general economic climate, progress achieved with structural reforms, employment, the development of exports and competitiveness, and related factors. Based on these discussions the labour market confederations shall agree upon the cost effects and timing of the second phase wage settlement.

5 September 2013

The Government submitted to Parliament the second supplementary budget proposal for 2013. The second supplementary budget proposal for 2013 increases the need for net borrowing by EUR 10 million. Central government net borrowing is estimated at around EUR 7.8 billion.

12 September 2013

The Government submitted to Parliament the third supplementary budget proposal for 2013. The proposed net reduction in revenue estimates is EUR 899 million and the net increase in appropriations EUR 389 million. The third supplementary budget proposal for 2013 thus shows an overall deficit of EUR 1.3 billion. Proposed central government net borrowing for 2013 is estimated at EUR 9.1 billion.

16 September 2013

The Government submitted to Parliament its proposal for the 2014 State Budget. Excluding net borrowing, ordinary revenue comes to EUR 47.2 billion and appropriations total EUR 53.9 billion. The Budget projects a deficit of EUR 6.7 billion, which under the proposal will be covered by increased government borrowing. At year-end 2014 it is estimated that government debt will stand at around EUR 100 billion, or 49% of GDP. It is projected that on-budget revenue will increase by nearly 3% compared to the amount budgeted for 2013 (including supplementary budget proposals). The growth of tax bases will be constrained by the decline in total output and modest economic growth in 2014. In terms of scale, the single most significant tax policy decision concerns the reform of corporate and dividend income taxes. In 2014 the corporate income tax rate will be lowered by 4.5 percentage points to 20%, and the structure of dividend taxes will be overhauled. The tax base from business and industry will be expanded among other things by withdrawing the right of businesses to deduct entertainment expenses and by limiting the tax deductibility of interest charges. Local governments and parishes will continue to receive an increased percentage of corporate income tax revenue. Tax adjustments in 2014 consist mainly of increases in excise duties: the duty on alcoholic beverages, tobacco products and soft drinks will be increased, as will taxes on transport fuels and electricity. The earned income deduction and basic deduction will be increased in earned income taxation. Interest deductions on housing loans will be further reduced by 5 percentage points. Tax rules for mileage allowance payments will be revised. The maximum amount of domestic help credit will be increased to EUR 2,400. Earned income tax scales will not be adjusted for inflation and income growth. When the increase in price levels is taken into account, appropriations to administrative branches will be down by 2.9% in real terms compared to the 2013 ordinary budget and by 3.8% compared to final 2013 budget amounts. Decisions taken by the Government to adjust central government finances will curb expenditure growth and reduce net central government spending by some EUR 0.6 billion compared to savings made in 2013. In line with earlier decisions, the savings will affect central government transfers to local governments for the provision of basic public services, for instance. Interest outlays on central government debt will be unchanged from 2013. Proposed spending limits appropriations amount to EUR 42.5 billion. Under the Government's proposal there would remain an unallocated reserve of around EUR 83 million in addition to the EUR 200 million supplementary budget provision.

20 September 2013

Parliament decided that the second supplementary budget for 2013 will be put into effect as of 1 October 2013.

11 October 2013

Parliament decided that the third supplementary budget for 2013 will be put into effect as of 21 October 2013.

24 October 2013

The Government submitted to Parliament the fourth supplementary budget proposal for 2013. The proposed net revenue increase comes to EUR 48 million, while net appropriations are up by EUR 189 million. The fourth supplementary budget proposal for 2013 thus shows a deficit of EUR 141 million. Proposed central government new borrowing for 2013 is EUR 9.2 billion.

25 October 2013

The labour market confederations confirmed they had reached a settlement on a Pact for Employment and Growth. The contracting parties in different branches have reported on the outcomes of their respective negotiations to the confederations. The sectors where an agreement has been reached in line with the Pact for Employment and Growth cover 93% of all wage earners.

7 November 2013

The ECB Governing Council decided to lower the interest rate for the Eurosystem's main refinancing operations to 0.25%, with effect from the operation to be settled on 13 November 2013.

21 November 2013

The Government submitted to Parliament its proposal for an amendment to the 2014 budget proposal. It is proposed that appropriations be increased by a net total of EUR 108 million and that ordinary revenue be decreased by a net total of EUR 261 million. The supplementary proposal therefore increases central government borrowing needs by EUR 369 million. Proposed central government net borrowing for 2014 is EUR 7.1 billion. As a consequence it is estimated that central government debt will rise to around EUR 100 billion by the end of 2014. It is proposed that net tax revenue estimates are revised downwards by EUR 265 million. As part of the Pact for Employment and Growth it is proposed that earned income tax scales be revised so that income thresholds are increased by 1.5% with the exception of the highest income bracket. In addition the proposed revision of the rules for computing the tax-free mileage allowance in 2014 will be cancelled. It is proposed that appropriations be increased by a net total of EUR 108 million.

27 November 2013

Parliament decided that the fourth supplementary budget for 2013 will be put into effect as of 1 December 2013.

12 December 2013

The Government submitted to Parliament its proposal the fifth supplementary budget proposal for 2013. The fifth supplementary budget proposal increases net borrowing needs by EUR 31 million. Central government net borrowing is estimated at around EUR 9.2 billion.

20 December 2013

Parliament decided that the fifth supplementary budget for 2013 will be put into effect as of 30 December 2013.

Parliament decided that the 2014 Budget will be put into effect as of 1 January 2014.

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