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Subject: Finland's Stability Programme 2014

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Delegations will find attached the fourth part of Finland's Stability Programme for 2014.

## 5.4 On-budget revenue 2015—2018

Actual on-budget revenue is expected to grow in the spending limits period on average by 3.3 per cent per year. Tax revenue is expected to grow by 3.6 per cent per year. Tax revenue accounts for on average 85 per cent of actual on-budget revenue. In 2018 on-budget revenue (excluding borrowing) is expected to be EUR 53.4 billion.

Central government on-budget revenue estimates are based on an estimate of the medium-term development of the economy. Economic growth is expected to be slow in the medium term, and as a result growth of taxes bases will also be slow. Compared with the economic growth forecast that formed the basis of the previous year's spending limits decision, the economic growth projections for 2014—2017 have been cumulatively reduced by nearly 2 percentage point.

As well as new decisions, the revenue estimates also take into account the tax policy positions outlined in the Government Programme and other decisions taken by the Government, most of which have been put into effect in connection with the 2012—2014 Budgets.

As new decisions, adjustment measures on the taxation side consist mainly of increases in excise duties as well as measures taken in the taxation of earned and capital income that narrow income differences. On the other hand, it is estimated that tax changes included in the spending limits decision with respect to indirect taxes will, in a static evaluation, increase income differences.

No earnings-level or inflation adjustment will be made to earned income taxation thresholds in 2015, which is expected to increase central government tax revenue by around EUR 110 million. Taxation of those on low incomes will be eased by increasing the earned income deduction and the basic deduction in municipal income tax. The limit of the highest income class of the progressive income tax scale will be lowered from EUR 100,000 to EUR 90,000 and this will remain in effect until 2018. This will increase earned income tax revenue by EUR 54 million.

The right to deduct the interest on home loans will be reduced by a further 5 percentage points per year, and as a result only 50 per cent of the interest on home loans will be deductible in 2018. This measure will increase tax revenue by EUR 83 million at the 2018 level. In addition, the right to deduct commuting expenses will be reduced, such that the co-payment portion for commuting expenses will rise to EUR 750.

The changes made to capital income taxation will increase tax revenue by EUR 28 million while at the same time narrowing income differences. Taxation of capital income will be increased such that the income limit of the higher tax rate will be lowered by EUR 10,000 to EUR 30,000 and the higher rate increased by one percentage point to 33 per cent.

Inheritance and gift taxation will be increased by raising all marginal rates in tax scales by one percentage point. In addition, the tax class for the proportion of gifts and inheritances over EUR 1,000,000, which was previously prescribed as temporary, will be made permanent from 2016. The measures will increase tax revenue by a total of EUR 60 million.

In energy taxation, a number of measures increasing tax revenue will be made. Tax increases will be made to class I of the electricity tax (impact on central government tax revenue EUR 120 million in 2018), to the carbon dioxide tax on heating, power plant and

working machine fuels (EUR 90 million) and to the tax on transport fuels (EUR 42 million). On the other hand, the 2015 tax increase on peat, decided earlier, will be cancelled (EUR -8 million). In addition, energy tax subsidies for mining activity will be abolished (EUR 20 million), and the previously tax-free liquefied petroleum gas will be made taxable (EUR 10 million). The measures taken in energy taxation will increase tax revenue by EUR 274 million in 2018.

The tobacco tax will be tightened by EUR 50 million. The annual motor vehicle tax on cars and vans will be increased by EUR 150 million. The car tax reductions on taxis (excluding specially equipped taxis) and on cars imported as removal goods will be abolished.

The adopted new tax policy measures will increase central government tax revenue on a net basis by around EUR 0.5 billion in 2015 and around EUR 0.9 billion in 2018.

The tightening of taxation in the next few years is also explained by earlier decisions of the Government in respect of taxation. The right to deduct interest on home loans will also be reduced on the basis of earlier decisions, the right to deduct interest on study loans will be abolished and an increase of the excise duty on sweets will be made in 2015. Under an earlier decision, the R&D tax incentive in corporate income tax will end after 2014, as will the right to increased depreciation of production-related investments. After 2015 the temporary tax incentive for investors will end, as will the increased corporate income tax apportionment for municipalities and parishes.

On the other hand, in respect of decisions made earlier by the Government, tax revenue will be reduced by measures outlined by the central government to support a labour market settlement in autumn 2013, namely the halving of fairway dues and the removal of the rail goods transport tax in 2015—2017.

#### Tax revenue

Corporate income tax revenue is expected to grow in the spending limits period on average by around 6 per cent per year. In 2014 corporate income tax revenue is expected fall significantly as a result of the reduction of the corporate income tax rate that came into force in 2014. Thereafter tax revenue is expected to grow at the same rate as the operating surplus forecast according to national accounts. By tax beneficiary, it is expected that the central government's corporate income tax revenue will grow faster than revenue overall, on average by around 9 per cent per year, due to the expiry in 2016 of the temporary increase in the apportionment of corporate income tax to municipalities and parishes.

Earned income is expected to grow in the spending limits period by an average of just over 2.7 per cent and capital income by an average of 3.8 per cent per year. Central government revenue from earned income and capital income tax is expected to grow in the spending limits period more quickly than the tax base, on average by around 5 per cent per year, because no adjustments corresponding to the rise in earnings level will be made to tax thresholds. In 2014 a 1.5 per cent adjustment was made to income tax thresholds. With respect to 2015, no adjustment to tax thresholds will be made for earnings level or inflation. For the years after the parliamentary term, i.e. 2016—2018, it is assumed that inflation adjustments will be made to the central government income tax scale.

Value-added tax revenue is projected to grow in the spending limits period on average by around 2.7 per cent per year. Projected tax revenue growth is derived from the estimated increase in household consumption expenditure.

Total revenue from excise duties is projected to grow in the spending limits period by an average of around 1 per cent per year. Revenue from the excise duties on sweets, ice cream and soft drinks as well as the tobacco tax is expected to grow, but revenue from the excise duty on alcoholic beverages is expected to fall due to an anticipated decline in taxable consumption.

Annual revenue from the bank tax in the spending limits period is assumed to be EUR 133 million per year according to tax receipts for 2013. A power plant tax was introduced at the beginning of 2014, but significantly lighter than stated in the Government Programme. The annual revenue from the tax is assumed to be EUR 50 million per year in the spending limits period.

#### Other on-budget revenue

Miscellaneous revenues are expected to grow by an average of around 2 per cent per year.

As regards other on-budget revenue, dividend revenue is expected to be around EUR 1 billion on an annual basis. Annual proceeds from the sale of state-owned shares are expected to generate on-budget revenue on average by around EUR 620 million per year in the spending limits period. This estimate takes into account the new policy on the sale of central government assets in 2014—2015, as a result of which projected proceeds from the sales of shares in 2015 will be around EUR 0.6 billion greater than previously projected. The estimate of central government interest revenue is slightly lower than the estimate made in connection with the spring 2013 spending limits decision. This is explained by a lowering of market interest rates due to a slower than expected strengthening of the euro area economy. The lower market interest rates are reflected particularly in the estimate of interest earned on central government deposits.

Fees levied by central government will be increased as part of adjustment measures so as to achieve EUR 30 million in additional revenue.

## Ministry of Finance estimate of ordinary on-budget revenue in 2014—2018, EUR billion

	2014 B	2015	2016	2017	2018	2014— 2018 average annual change, %
Total tax revenue	39.8	41.0	42.8	44.3	45.9	3.6
— taxes on earned and capital income	8.7	9.0	9.5	9.9	10.5	4.8
— corporate income tax	2.5	2.6	3.1	3.3	3.5	8.7
— value-added tax	17.0	17.2	17.8	18.3	18.9	2.7
— excise duties	6.9	7.2	7.3	7.2	7.2	1.0
— other tax revenue	4.7	4.9	5.2	5.5	5.9	5.7
Miscellaneous revenue	4.7	5.4	5.1	5.2	5.1	2.0
Interest income, income from share sales and profit entered as income	2.0	2.7	2.0	2.0	2.0	-0.3
— Dividend income and income from sales of shares	1.5	2.1	1.5	1.5	1.4	-1.6
<b>Total revenue<sup>1</sup></b>	<b>46.9</b>	<b>49.6</b>	<b>50.4</b>	<b>52.0</b>	<b>53.4</b>	<b>3.3</b>

<sup>1</sup> Including repayment of loans granted by central government

## 5.5 Central government on-budget funding requirement and debt 2015—2018

Taking into account the development of appropriations in line with the spending limits as well as revenue estimates, the central government on-budget deficit is expected to be around EUR 4 billion, i.e. around 2 per cent of GDP, in 2015. The deficit is expected to fall to EUR 2.5 billion, i.e. 1.1 per cent of GDP, in 2018.

The slowing of the reduction of the deficit in 2018 will be to a large extent due to the fact that debt interest expenditure and age-related expenditure will rise. Revenue growth will also slow slightly from the previous year due to a projected slowing of GDP growth.

It is assumed that central government debt will grow to around EUR 100 billion in 2015. The central government debt-to-GDP ratio will rise in 2014—2015, but growth in the debt ratio will turn later in the spending limits period. Central government debt is expected to be around EUR 108 billion in 2018, which is around 48 per cent of GDP.

In national accounting terms, central government finances are projected to be in deficit during the entire spending limits period (see Section 3.1).

**Ministry of Finance estimate of on-budget balance in 2014—2018, EUR billion, at current prices**

	2014	2015	2016	2017	2018
On-budget revenue estimate, total <sup>1</sup>	46.9	49.6	50.4	52.0	53.4
On-budget expenditure estimate, total, at current prices <sup>2</sup>	54.1	53.5	53.7	54.6	55.9
<b>On-budget balance estimate</b>	-7.1	-3.9	-3.3	-2.6	-2.5
Central government debt-to-GDP ratio, %	49	49	49	49	48

<sup>1</sup> Including repayment of loans granted by central government.

<sup>2</sup> Expenditure converted into current prices using the Ministry of Finance central government expenditure price index projection, which provides a rough estimate of price trends over the spending limits period.

## 5.6 Off-budget central government finances

In the national accounts, the central government sector includes, alongside central government on-budget finances, the central government funds that are outside budget finances (excluding the State Pension Fund, which is classified in the national accounts under the pension provider sector) as well as the Finnish Broadcasting Company YLE, the universities and Solidium Oy.

The central government has 11 off-budget funds. Over the spending limits period, it is estimated that their combined annual revenue will be around EUR 5.5 billion and expenditure around EUR 5.1–5.3 billion. The annual net surplus of off-budget entities will therefore be around EUR 0.2–0.4 billion. The annual net surplus of off-budget funds, excluding the State Pension Fund, is estimated at EUR 0.1–0.2 billion.

From the beginning of 2013, the YLE tax was introduced to cover the costs of the public service broadcaster, the Finnish Broadcasting Company YLE. Revenue from the YLE tax is transferred to the State Television and Radio Fund. The amount of funds transferred will be revised annually to reflect changes in cost levels. The revisions will be based on a weighted index in which the weighting of the Cost-of Living Index is one third and that of the Index of Wage and Salary Earnings two thirds. Parliament groups decided that no index adjustment will be made in 2015.

With respect to the State Pension Fund, a legislative amendment will be prepared, on the basis of which revenue recognition from the fund into the budget will be increased in 2014–2015 by an estimated total of EUR 500 million. A revenue recognition into the budget will be made from the State Guarantee Fund, totalling EUR 100 million in the 2014 autumn supplementary budget.

The oil damage duty, paid into the Oil Pollution Compensation Fund, is levied on crude oil and petroleum products imported into and transported through Finland. The fixed-term increase of the duty will be continued in line with an objective stated in the Government Programme. The increased duty is EUR 1.50 per tonne of oil and it will be applied in 2013–2015.

Expenditure payable from the National Housing Fund will be increased by reducing the interest contribution payable on youth and student housing temporarily until the end of 2015 and through temporary start-up assistance, which will be targeted in connection

with loan guarantees. In addition, renovation grants for the homes of the elderly and the disabled will be increased for 2014 and 2015. Investment grants for special groups will be increased in 2016—2018.

**Off-budget central government funds, EUR million (at 2015 price and cost level)**

	2015	2016	2017	2018
Taxes and tax-like revenue, total	87	71	71	71
Miscellaneous revenue	315	258	186	176
Pension contributions	1 727	1 757	1 789	1 818
Interest income and profit entered as income	490	508	497	488
Transfers from budget	511	511	511	511
Revenue excluding financial transactions	3 131	3 105	3 054	3 065
Repayments of loans granted	2 383	2 415	2 429	2 436
<b>Total revenue</b>	<b>5 513</b>	<b>5 520</b>	<b>5 483</b>	<b>5 501</b>
Consumption expenditure	283	238	210	181
Current transfers	870	889	959	947
Interest expenditure	2	1	1	2
Transfers to budget	2 109	1 912	1 978	2 048
Expenditure excluding financial transactions	3 264	3 041	3 148	3 176
Loans granted and other financial investments	2 034	2 034	2 037	2 044
<b>Total expenditure</b>	<b>5 297</b>	<b>5 075</b>	<b>5 185</b>	<b>5 220</b>
<b>Net financial surplus</b>	<b>216</b>	<b>445</b>	<b>297</b>	<b>280</b>

Overall funding of universities comprises appropriations allocated to universities in the budget and supplementary funding (e.g. paid services, donations, and sponsoring). In 2012 funding of universities totalled around EUR 2.8 billion, of which the central government share was around 75 per cent. Central government funding is expected to remain at around the same level in the next few years.

The investment company Solidium Oy is a limited company wholly owned by the state. In the central government budget, EUR 800 million in revenue was recognised from Solidium Oy in 2012 and also EUR 800 million in 2013.

#### State enterprises

For 2014 a total of EUR 220 million, of which Metsähallitus accounts for EUR 120 million, is budgeted for revenue recognitions into the central government budget from the state enterprises Metsähallitus and Senate Properties. In the spending limits period, annual revenue recognitions are expected to grow slightly. As part of the Government's growth package, revenue recognitions into the budget totalling EUR 175 million will be made in 2014—2015, in addition to the annual revenue recognitions. The additional recognition for 2015 is EUR 105 million, of which Senate Properties will account for EUR 90 million.

## 6 Steering of local government finances 2015—2018

### Outlook for local government finances

An imbalance between expenditure and revenue has arisen in local government finances in recent years. Last year the budgetary position of local government finances improved temporarily due to non-recurring factors. Sluggish growth as well as adjustment measures in central government finances will keep municipalities' revenue growth slow in the next few years. Expenditure growth is also projected to slow compared with recent years but to be faster than growth of revenue over the entire outlook period. In the forecast, municipal income tax rates have been kept at the 2014 level, and expenditure growth has not been balanced with revenue. Local government finances will remain clearly in deficit, and growth of debt threatens to continue.

The state of and outlook for local government finances are comprehensively assessed in the Basic Public Services Programme.

### Government's policy outlines for local government finances

The Government Programme did not set a target for the budgetary position of local government finances. In local government finances, however, it is natural to aim for a structural balance of revenue and expenditure, and in the implementation of the Structural Policy Programme, the Government is committed to implementing measures to balance local government finances.

Municipalities' duties and obligations will be reduced, such that local government operating expenditure is reduced by EUR 1 billion by 2017. In addition, the goal is achieve a EUR 1 billion saving at the 2017 level through tax funding and municipalities' own measures. The Government's decision on the implementation of the Structural Policy Programme includes a programme to reduce municipalities' duties and obligations, which will be implemented, for example, in the central government spending limits decision for 2015—2018.

The Government will refrain from giving new tasks and obligations that increase local government expenditure without deciding at the same time to cut tasks and obligations of corresponding size or fully funding the new tasks or obligations that are given. This principle will be applied to new projects with respect to the spending limits decision of 2014—2017. In addition, projects already included in the spending limits that will increase local government expenditure will be critically assessed.



In accordance with the Government Programme, the municipalities will be compensated in full for changes in tax criteria.

In its decision on the implementation of the Structural Policy Programme, the Government also decided to introduce a new steering system for local government finances, with the objective of securing the sustainability of local government finances. The new system will ensure that municipalities' tasks and obligations are consistent with the goal of balancing local government finances. The macroeconomic steering of local government finances will be implemented as part of the General Government Fiscal Plan and its annual revision. From 2015, the part of the General Government Fiscal Plan relating to local government finances will set a maximum limit for changes of expenditure arising to local government finances from central government measures. This maximum will be consistent with the target set for the budgetary position of local government finances.

In the comprehensive reform of the Local Government Act that will come into force from the beginning of 2015, the intention is to reform provisions relating to the financial management of individual municipalities. The changes will support the balancing of the whole of local government finances.

The Government will implement a nationwide municipal reform with the objective of creating a thriving municipal structure built on economically robust municipalities. The Local Government Structure Act came into force of 1 July 2013 and an amendment proposal relating to it, which concerns the Government's authority to decide on municipal mergers against the will of a municipality, will be submitted in spring 2014. It is intended that the new municipalities could start operating from the beginning of 2017.

The system of central government transfers to local government will be reformed from the beginning of 2015, with the objective being a funding model that incentivises economic activity and the effective arrangement of services. The objective is for the system to be mainly neutral in municipal merger situations and to function in a changing municipal and service structure. The rapporteur's preliminary Government proposal on the reform was circulated to municipalities for comment in February 2014.

In connection with the local government reform, the reform of the social and health care service structure will be taken forward. The Government has decided on a reform of the arrangement of social and health care services, such that arrangement responsibility would be transferred to five specific catchment areas.

Central government measures directed at local government finances

#### ***Central government transfers and grants in the spending limits period***

Central government transfers within the scope of the municipalities' basic public services budget analysis will total around EUR 9.6 billion in 2015, which is around EUR 840 million less than in 2014. A large part of the change is explained by the fact that responsibility for the basic funding of universities of applied sciences will be transferred completely to central government from the beginning of 2015. In 2016—2018 central government transfers and grants will rise nominally by 1.2–1.7 per cent per year.

Most of the central government transfers and grants are notional central government transfers, including equalisation items, within the sphere of the central government transfer system. Excluding the funding of the universities of applied sciences, the level of central government transfers in the administrative branch of the Ministry of Finance is around EUR 8.5 billion and in the administrative branch of the Ministry of Education and Culture around EUR 0.6 billion.

Expenditure on social welfare and health care resulting from changes in population age structure and numbers is expected to grow notionally in the spending limits period by around EUR 1,127 million. Pre-school and basic education expenditure will grow notionally by EUR 87 million in the spending limits period.

Indexation of central government transfers will increase central government transfers for basic public services by around EUR 47 million in 2015. In the administrative branch of the Ministry of Education and Culture, indexation will increase central government transfers by a total of around EUR 9.5 million, of which EUR 6.4 million is the estimated share of municipalities and joint municipal authorities.

The central government transfer for basic public services takes into account changes that have taken place in tax revenue compensation compared with the spring 2013 spending limits decision. These changes will reduce central government transfers for municipalities' basic public services by EUR 93.5 million v. 2015, EUR 77.5 million in 2016 and EUR 50.5 million in 2017. In addition, an adjustment rising from EUR -12 million (in 2015) to EUR -85 million (in 2018) is taken into account for the impact of new tax criteria changes in spring 2014. The central government transfer for basic public services will also be reduced by the increases decided in the lower and upper limits of real-estate tax rates, correspondingly by EUR -54 million from 2015.

A technical assumption is that in the next parliamentary term's tax criteria changes will be compensated for in full in local government finances.

**Central government transfers and grants to local government within the basic public services budget analysis, EUR million** (spending limits period 2015—2018 at 2015 prices)

	2013 <sup>1</sup>	2014 <sup>1</sup>	2015	2016	2017	2018
<b>Imputed transfers including equalisation items within the system of central government transfers to local government</b>						
Ministry of Finance	8 677	8 613	8 476	8 501	8 456	8 453
Ministry of Education and Culture	979	782	645	639	595	591
Transfer for funding of universities of applied sciences <sup>2</sup>			-455	-455	-455	-455
<b>Total</b>	<b>9 657</b>	<b>9 395</b>	<b>8 666</b>	<b>8 685</b>	<b>8 596</b>	<b>8 590</b>
<b>Other government aid included in the basic public services budget<sup>3</sup></b>						
Ministry of Finance	67	35	56	105	173	133
Ministry of Education and Culture	272	231	136	136	133	133
Ministry of Employment and the Economy	178	175	174	153	155	153
Ministry of Social Affairs and Health	562	523	490	487	507	508
<b>Total</b>	<b>1 079</b>	<b>963</b>	<b>856</b>	<b>881</b>	<b>967</b>	<b>926</b>
Specified government transfer for helicopter medical emergency service (33.60.40) <sup>4</sup>	26	33	29	29	0	0
<b>Central government transfers and grants included in the basic public services budget analysis, total</b>	<b>10 762</b>	<b>10 391</b>	<b>9 551</b>	<b>9 595</b>	<b>9 563</b>	<b>9 516</b>

<sup>1</sup> Budgeted (budget and supplementary budgets)

<sup>2</sup> Responsibility for funding universities of applied sciences will be transferred to central government from the beginning of 2015 and they will no longer fall within the analysis of the basic public services programme. The share of central government transfers for universities of applied sciences received by municipalities has been estimated notionally.

<sup>3</sup> EUR 15 million has been earmarked in 2015 and EUR 25 million in 2016 as a discretionary government transfer for start-up costs of a new children's hospital providing public health care. Since the funding would go to a foundation, the appropriations are not entered in the table.

<sup>4</sup> The specified government transfers do not include the local government funding share up to 2016. A reduction from 2017 relating to operational funding reform has been taken into account in the central government transfers of the main title of the Ministry of Finance.

During the spending limits period, the level of central government transfers takes into account the general reduction in central government transfers to local government decided earlier in this parliamentary term, which will reduce the 2015 central government transfers by just under EUR 200 million compared with 2014. Cuts in central government transfers decided during the parliamentary term total around EUR 1.3 billion at 2015 prices.

An overall increase of EUR 126 million at 2015 prices for the development of social and health care services will be made to central government transfers for municipalities' basic public services, when reductions of EUR 19 million, made as savings decisions, have been taken into account. Most of the increase in central government transfers, EUR 82 million at 2015 prices, will be allocated to implementing the Act on Care Services for the Elderly. An appropriation of EUR 9.4 million has been earmarked for the development of other social and health care services, which will be allocated to the implementation of the new Social Welfare Act. An annual EUR 13.1 million will be allocated to developing student care.

Certain reductions will be directed at the central government transfer appropriation for municipalities' basic public services as part of adjustment measures in central government finances. EUR 10 million earmarked as an increase in the discretionary central government transfer for municipalities will be cancelled from 2015.

The central government transfer appropriation for municipalities' basic public services will be reduced by an additional EUR 40 million from 2015. In respect of this, however, proposals will be made on increasing social and health customer fees such that a corresponding increase in payment receipts will be achieved, in which case the arrangement will be cost neutral overall from the perspective of local government finances.

Discretionary government transfers granted for the costs of establishing libraries will be transferred to central government transfers for municipalities' basic public services, as will the payment of ex-post funded discretionary government transfers granted before 2015 for the costs of projects setting up educational establishments. As part of savings measures, discretionary government transfers for the setting up of educational establishments will be abolished from 2015, as a result of which the appropriation saving is EUR 12.1 million in 2015 and will rise gradually to EUR 22 million in 2018.

Discretionary government transfers for general education will be cut by EUR 60 million and discretionary government transfers for vocational education by EUR 2.6 million.

Savings decisions directed earlier in this parliamentary term at liberal adult education, museums, theatres and orchestras, vocational upper secondary and further education, and general upper secondary have also been taken into account. One criterion taken into account in targeting savings is securing the implementation of the youth guarantee. From 2014 student places in vocational upper secondary education and training will be increased with the aid of EUR 5.2 million in order to implement the youth guarantee.

Young people's apprenticeship training will be strengthened and for young people there will a preliminary period in apprenticeship training. From 2014 additional funding will be allocated to apprenticeship training and the development of on-the-job learning.

The curricula of pre-school and basic education as well as the general objectives, allocation of lesson hours and curriculum criteria of general upper secondary education will be revised. The minimum number of lesson hours in basic education will be increased by three weekly lessons per year from 2016, as result of which central government transfers to local government will be raised by EUR 3.9 million in 2016 and EUR 9.4 million from 2017. Half of the increase will be covered by transfers from general education appropriations.

Municipalities' role and responsibility in the active care of long-term unemployment be emphasised. In accordance with the spending limits decision for 2014—2017, part of the funding responsibility for the labour market support of long-term unemployed people who have been on labour market support for over 300 days will be transferred to the municipalities from the beginning of 2015. The aim of the funding reform of labour market support is to create opportunities for those who are on labour market support to participate in activation measures.

To reduce long-term unemployment, a trial lasting until the end of the parliamentary term is under way, in which, after 12 months' unemployment at the latest, the main responsibility for managing unemployment is transferred to the municipality or municipalities jointly. A central government grant of EUR 20 million has been allocated to the trial still for 2015.

In the context of the reform of social and health care services, municipal mergers are expected to decline and slow down to some extent. On this basis, funding for municipali-

ties' merger grants and for compensation of central government transfer losses has been reduced by EUR 5 million in 2015, EUR 10 million in 2016 and EUR 20 million from 2017. Financial support for the merging of municipalities (merger grants, compensation for central government transfer losses, feasibility studies) will accordingly be allocated as follows: around EUR 51 million in 2015, around EUR 95 million in 2016, around EUR 153 million in 2017 and around EUR 113 million in 2018.

#### Measures of the Structural Policy Programme

The impacts of the Government's Structural Policy Programme are described in Section 5.3.

#### Tax criteria changes

Tax criteria changes are outlined in Sections 4.2 and 5.4. Central government transfers to local government will be reduced so that the decided tax criteria changes have no impact on local government finances.

#### Impacts of central government measures

Central government measures will weaken local government finances in 2015 by an estimated net amount of around EUR 200 million compared with 2014. The biggest factors weakening local government finances are cuts to central government transfers and the shifting to municipalities of responsibility for funding the labour market support of the long-term unemployed. Central government measures will change to supporting local government finances in 2017, when there will be no new cuts to central government transfers and, moreover, the measures of the Structural Policy Programme will begin to have an impact. It should be noted, however, that the central government measures decided for 2015—2018 and their cost and impact assessments will be reviewed in further preparations.

## 7 Financing criteria of earnings-related pension funds 2015—2018

The earnings-related pension system consists of a number of different pension acts, in which pensions are generally determined, however, on the same criteria. The funding of pension expenditure varies by pension act, as a result of which the financing criteria of earnings-related pension funds cannot be described by a single rule. The financing criteria of the earnings-related pension sector can be examined, however, by looking separately at the financing criteria of the largest pension funds (TyEL, YEL, VaEL and KuEL) and the outcomes implied by them.

Finland's earnings-related pension system is a partially prefunded system in which pensions are financed, mainly annually, with pension contributions collected from employers and employees as well as partially prefunded pension assets and the income obtained from them. In addition, part of the pensions of central government employees and of entrepreneurs, agricultural entrepreneurs and seafarers is financed from the central government budget. Employees' pension contributions are the same in all pension acts. Pensions accrue in all pension acts in nearly the same way from earnings during the whole of working careers, with the accrual percentages being 1.5 per cent (18–52 year-olds), 1.9 per cent (53–62 year-olds) and 4.5 per cent (63–67 year-olds). Starting old-age pensions are reduced by a life expectancy coefficient, in which the starting pensions of each age class is reduced in proportion to the change in life expectancy of a 62 year-old compared with the 2010 level. Pensions being paid are increased annually by the Employee Pension Index, in which inflation has a 80 per cent weighting and change of earnings level has a 20 per cent weighting.

**The Private-sector Employees' Pensions Act (TyEL)** covers around 2/3 of the labour force. Of TyEL earnings-related pension contributions, part are prefunded individually and the remainder goes to finance current pensions in a pay-as-you-go system. With respect to 18–54 year-olds, an amount corresponding to an annual pension accrual of one half of one per cent is funded for old-age pensions. In addition, the parts of pensions placed in funds are supplemented by increase coefficients confirmed by the Ministry of Social Affairs and Health, which are based on the investment income received by the pension providers. The private earnings-related pension sector's EMU buffer is located in the pay-as-you-go system's buffer fund, which is termed the equalisation fund (equalisation liability). The target level of the EMU buffer has been agreed at a figure corresponding to 2.5 per cent of the private sector's annual wage bill, in which case the target level is around EUR 1.4 billion at the 2011 level. Pensions institutions jointly pay for the unfunded parts of pensions in due

course using the equalisation part of insurance contributions. Around 17 per cent of TyEL and MEL (Seafarer's Pension Act) old-age pensions paid in 2012 were prefunded. Disability and unemployment pensions are not financed by the pension institutions in the same way as old-age pensions with annual prefunding; only as each pension starts does the pension institution allocate a sum calculated by actuarial principles for the payment of the starting pension. Around 55 per cent of TyEL and MEL disability pensions and around 52% of unemployment pensions were prefunded in 2012. Part-time and survivors' pensions are not prefunded; they are financed with a pay-as-you-go system. The pension expenditure of entrepreneurs (9 per cent of those insured), agricultural entrepreneurs and seafarers is financed from contribution income and the part exceeding this from the central government budget.

Criteria relating to level of the TyEL contribution are prepared in working groups established by the Finnish Pension Alliance TELA based on statistics and calculations produced by the earnings-related pension insurance companies and the Finnish Centre for Pensions. In addition, the contribution level is discussed in the pension negotiation group of social partners, in which a uniform increase of the TyEL contribution (0.4 percentage points per year) has been agreed right up to 2016. The aim is to set the TyEL contribution in such a way that pensions being paid and the prefunded part of pensions are covered by contributions. If no agreement is reached in the pension negotiation group on the level of the pension contribution, the act sets a minimum level for pension contributions. Pension contributions must be at a level that guarantees the payment of pensions and the funding required by law. According to the latest long-term calculations of the Finnish Centre for Pensions, the pension contribution increase requirement after 2016 is around one percentage point to ensure that the TyEL system is on a sustainable foundation.

The financial position of private earnings-related pension funds is influenced by how much of the pension contributions is placed in funds annually and how much is paid out in the form of prefunded pensions. The amount of fund assets paid out will grow in future and at the same time the amount of fund assets collected in relation to the wage bill will remain close to the current level. This will reduce the surplus of the TyEL system in future. Based on current long-term calculations, private pension assets (EUR 96 billion in 2012) in relation to the wage bill of those insured will grow until 2020, after which the ratio will remain nearly stable (assuming one per cent pension contribution increases after 2016). Maintaining the level of fund assets stable in relation to the wage bill will require that fund assets accrue at the annual growth rate of the wage bill.

Pensions earned within the scope of the Local Government Pensions Act (KuEL) (21 per cent of those insured) are financed through KuEL contributions, which are collected each year at the level required for pension costs. The contributions also cover the system's administration expenses and in addition they are placed in a pension liability fund for future pensions. The part of contributions placed in funds have no corresponding link to increasing pension liabilities as in the TyEL system. The investment assets of KEVA (Local Government Pensions Institution) stood at EUR 34 billion at the end of 2012.

In the KuEL system, the financing of earnings-related pensions is based mainly on pension contributions, for which KEVA's member organisations are jointly responsible. The level of municipal sector pension contributions is decided by KEVA's Council. In the KuEL

system, the aim is to set pension contributions in such a way that the pension system is on a sustainable foundation and the level of pension contributions remains stable in future. KuEL contributions are determined on the basis of wages paid in the municipal sector and also on the basis of pension expenditure. Both employers and employees pay KuEL's wage-based pension contributions. The contribution percentages of employees are the same as in the TyEL system. When pension expenditure exceeds pension contributions, the difference is covered by fund income or by selling off fund assets. In the light of current forecasts, fund assets will nominally not be sold off, so the KuEL system is projected to remain in surplus also in the long term. In the event of the anticipated financial balance changing, the system's balance will be restored by changing pension contributions or by selling off fund assets.

Employees ensured under the **State Pension Act (VaEL)** (6.5 per cent of those insured) and central government employees pay their pension contributions into the State Pension Fund (VER). Funds are transferred from the State Pension Fund annually into the central government budget to cover VaEL pension expenditure. The transferred amount is currently 40 per cent of the expenditure arising from central government pensions, the rest of pension expenditure is covered by tax revenue. A total of EUR 1,604 million was transferred into the central government budget in 2012. In the event the transferred amount exceeding pension contribution income, the difference is balanced out from pension fund income. State Pension Fund assets are projected to continue to grow nominally in the future, so the VaEL balance will not, in the light of current forecasts, go into deficit, despite growth in pension expenditure. The State Pension Fund aims to increase prefunded assets until their level exceeds one quarter of the central government's pension liabilities. At the end of 2012, pension liabilities totalled EUR 92.6 billion and over 65% of the prefunding target (EUR 15.4 billion) had been achieved. The State Pension Fund does not cover pension liabilities individually as in the private sector; it is a buffer fund. The State Treasury approves the actuarial criteria according to VaEL, excluding the administration expense part of the contribution, which is confirmed by the Ministry of Finance.

Other, smaller public sector pension acts and provisions include the Evangelical-Lutheran Church Pensions Act (KiEL) as well as the pension provisions of the Social Insurance Institution of Finland, the Bank of Finland and the Provincial Government of Åland.

**In summary**, it can be said that the earnings-related pension funds do not have any single rule by which financing criteria are determined. Due to the prefunding of pensions, the earnings-related pension sector has been significantly in surplus historically. Demographic change will cause growth of pension expenditure growth, which will be reflected in a reduction of surpluses. Due to prefunding, property income is substantial, however, so pension funds will nominally not have to sell off assets, even if pension expenditure exceeds contributions. Pension funds are also here to stay in the public sector, even though they were originally established to balance the pension expenditure of the baby-boom generation. It is possible, however, that pension funds will partially sell off assets in some circumstances, for example should the entire earnings-related pension fund sector fall into deficit, although in the light of current information this will not happen. Pay-as-you-go pension systems are by definition annually in balance.



Overall, the surplus of pension funds has reduced from four per cent of GDP at the beginning of the millennium to 2.1 per cent of GDP in 2013. The surplus is projected to fall to two per cent of GDP in the medium term as pension expenditure grows faster than income. The continuation of prefunding will keep pension funds in surplus by an estimated one per cent of GDP also in the future. In the national accounts, private sector pension funds are also included in general government finances and as general government finance assets. The earnings-related pension system surplus is not seen in general government gross debt.

## 8 Financing criteria of other social security funds 2015—2018

**Other social security funds** include other public sector entities implementing social security duties, such as the Social Insurance Institution of Finland (KELA) and entities handling the earnings-related unemployment insurance system.

KELA's activities are financed statutorily by the sickness insurance contributions of the insured and employers as well as by public sector contributions. The central government's share of KELA's funding in 2012 was 69 per cent, while insurance contributions accounted for 26 per cent and municipalities for 5 per cent. KELA's total expenditure was EUR 13.5 billion in 2012. Of total expenditure, benefit expenditure accounts for 97 per cent and operating expenditure for around 3 per cent. KELA's benefit funds are the National Pension Insurance Fund, the National Health Insurance Fund and the General Fund for Social Security.

The earnings-related unemployment insurance system is managed by the Unemployment Insurance Fund (TVR) and unemployment benefit societies. Earnings-related unemployment expenditure is financed from unemployment insurance contributions collected from employees and employers, central government contributions and the membership fees of unemployment benefit societies. In 2012 the benefits paid by unemployment benefit societies totalled around EUR 2.1 billion. Of this expenditure, the central government funded around 42 per cent, the Unemployment Insurance Fund 53 per cent and the unemployment benefit societies around 5 per cent.

To safeguard liquidity and to balance out changes in unemployment insurance contributions resulting from foreseeable fluctuations in the economy, the Unemployment Insurance Fund has a cyclical buffer, consisting of the difference of the fund's assets and liabilities. The forecast of the maximum amount of the assets and liabilities of the buffer when determining unemployment insurance contributions may be at most the magnitude of expenditure corresponding to an unemployment rate of 5.0 per cent.

The financing of other social security funds is in balance in the medium term, but the financial balance may vary slightly on an annual basis, with the buffer fund providing flexibility. In the 2000s the other social security funds have deviated from balance annually by at most 0.3 per cent of GDP.

