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REPORT FROM THE COMMISSION

FINLAND

Report prepared in accordance with Article 126(3) of the Treaty

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1. LEGAL BACKGROUND

Article 126 of the Treaty on the Functioning of the European Union (TFEU) lays down the excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure"[1], which is part of the Stability and Growth Pact. Specific provisions for euro area Member States under EDP are laid down in Regulation (EU) No 473/2013[2].

According to Article 126(2) TFEU, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3% (unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value); and (b) whether the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

Article 126(3) TFEU stipulates that, if a Member State does not fulfil the requirements under one or both of the above criteria, the Commission has to prepare a report. The Commission may also prepare a report if, notwithstanding the fulfilment of the requirements under the criteria, it is of the opinion that there is a risk of an excessive deficit, the latter understood as the situation defined in Article 126(2) TFEU. This report also has to "take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State".

This report, which represents the first step in the EDP, analyses the reasons for Finland being non-compliant with the debt criterion of the Treaty, with due regard to the economic background and other relevant factors.

Following the amendments to the Stability and Growth Pact in 2011, the debt requirement has been put on an equal footing with the deficit requirement in order to ensure that, for countries with a debt-to-GDP ratio above the 60% reference value, the ratio is brought below (or sufficiently declining towards) that value.

According to the Stability Programme, communicated to the Commission on 17 April 2014, the general government deficit for 2015 is expected to reach 1.1% of GDP while the gross debt ratio would reach 61.0% by the end of 2015, above the 60% of GDP reference value. According to the Commission 2014 Spring Forecast, the debt ratio would reach 61.2% of GDP.

The planned figure, both in the Commission forecast and in the 2014 Stability Programme debt provides *prima facie* evidence on the risk of the existence of an excessive deficit based on the debt criterion in Finland in the sense of the Treaty and the Stability and Growth Pact. The Commission has therefore prepared the following report in order to comprehensively

1 OJ L 209, 2.8.1997, p. 6. The report also takes into account the "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 3 September 2012, available at: http://ec.europa.eu/economy_finance/economic_governance/sgp/legal_texts/index_en.htm .

2 OJ L 140, 27.5.2013, p. 11: Regulation (EU) No 473/2013 of the European Parliament and of the Council on "common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area".

assess the excess over the reference value, in order to conclude whether the breach of the debt criterion merits the launch of an EDP. This report is an update of the report issued on 15 November 2013[3]. Section 2 examines the debt criterion and section 3 the relevant factors influencing the debt developments. The report takes into account the Commission 2014 Spring Forecast, released on 5 May 2014.

2. DEBT CRITERION

The general government gross debt ratio has increased rapidly over the last years, growing from 48.8% of GDP in 2010 to 57.0% in 2013. According to the Commission 2014 Spring Forecast, the debt will reach 59.9% of GDP in 2014 and 61.2% of GDP in 2015. Finland's Stability Programme forecasts the debt to increase to 59.8% of GDP in 2014 and to 61.0% of GDP in 2015. The difference is due to the fact that for 2015, the Commission forecasts a lower primary balance and a smaller positive effect from GDP growth. It is forecast that the debt ratio would increase also in 2016, reaching 61.4% according to the national forecast.

Table 1: Debt dynamics

	2010	2011	2012	2013	2014	2015
Government gross debt ratio	48.8	49.3	53.6	57.0	59.9	61.2
Change in debt ratio [b] (1 = 2+3+4)	5.2	0.6	4.3	3.3	2.9	1.4
Contributions:						
• Primary balance (2)	1.4	-0.4	0.8	1.2	1.3	0.4
• “Snowball” effect (3)	-0.5	-1.4	0.1	0.6	0.0	-0.4
of which:						
Interest expenditure	*1.1*	*1.1*	*1.0*	*1.0*	*1.0*	*1.0*
Real GDP growth	*-1.4*	*-1.3*	*0.5*	*0.7*	*-0.1*	*-0.6*
Inflation (GDP deflator)	*-0.1*	*-1.2*	*-1.4*	*-1.1*	*-0.9*	*-0.8*
• Stock-flow adjustment (4)	*4.3*	2.4	3.4	1.5	1.6	1.4

Notes:

[a] In percent of GDP.

[b] The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t}\right) + \frac{SF_t}{Y_t}$$

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the “snow-ball” effect, measuring the combined effect of interest expenditure and economic growth on the debt ratio.

Source: Eurostat and Commission 2014 spring forecast

3. RELEVANT FACTORS

Article 126(3) of the TFEU provides that the Commission report “shall also take into account whether the government deficit exceeds government investment expenditure and take into account other relevant factors, including the medium-term economic and budgetary position of the Member State in order to decide whether the breach of the criterion merits the launch of an EDP for the Member State in question." These factors are further clarified in Article 2(3) of Council Regulation (EC) No 1467/97, which also specifies that “any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess in

[3] COM(2013) 912 final.

qualitative terms the excess over the reference value and which the Member State has put forward to the Commission and to the Council" need to be given due consideration.

In view of the above provisions, the following subsections consider in turn (1) the medium-term economic position; (2) the medium-term budgetary position (including public investment); (3) the developments in the medium-term government debt position, its dynamics and sustainability; (4) other factors put forward by the Member State; and (5) other factors considered relevant by the Commission.

3.1. Medium-term economic position

Cyclical conditions and potential growth. After Finland's GDP decreased by 8.5% in 2009, the country recovered at satisfactory pace over 2010 and 2011, but has experienced a new recession over 2012 and 2013. The crisis has negatively affected Finland's potential growth. Before the crisis, in 2007, potential growth was estimated at 2.2% but has decreased to 0% in 2013. Capital accumulation remains the only positively contributing element for potential output growth. Potential growth is forecast to remain at 0% in 2014 and to improve only slightly, to 0.4% in 2015.

Real GDP declined in 2012 and 2013, opening up an output gap of -2.7% of GDP in 2013. Growth is forecast to exceed potential growth over 2014-15, but this will not be sufficient to close the output gap which is expected to narrow to -1.9% by 2015.

Table 2: Macroeconomic and budgetary developments [a]

	2010	2011	2012	2013		2014		2015	
	COM	COM	COM	COM	National authorities	COM	National authorities	COM	National authorities
Real GDP (% change)	3.4	2.8	-1.0	-1.4	-1.4	0.2	0.5	1.0	1.4
Potential GDP (% change)	0.3	0.4	0.2	0.0		0.0		0.4	
Output gap (% of potential GDP)	-2.5	-0.1	-1.4	-2.7	-2.9	-2.6	-2.6	-1.9	-1.7
General government balance	-2.5	-0.7	-1.8	-2.1	-2.0	-2.3	-2.0	-1.3	-1.1
Primary balance	-1.4	0.4	-0.8	-1.2	-1.1	-1.3	-1.0	-0.4	0.0
One-off and other temporary measures	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.1	0.0	0.1
Government gross fixed capital formation	2.5	2.5	2.6	2.8	2.8	2.9	2.8	2.8	2.7
Cyclically-adjusted balance	-1.2	-0.7	-1.1	-0.7	-0.6	-0.9	-0.6	-0.3	-0.2
Cyclically-adjusted primary balance	-0.1	0.4	-0.1	0.3	-0.5	0.1	-0.6	0.6	-0.2
Structural balance [b]	-1.1	-0.6	-1.0	-0.6	-0.5	-0.9	-0.7	-0.3	-0.3
Structural primary balance	0.0	0.5	0.0	0.3	0.4	0.1	0.3	0.6	0.8

Notes:

[a] In percent of GDP unless specified otherwise.

[b] Cyclically-adjusted balance excluding one-off and other temporary measures.

Source: Eurostat and Commission 2014 spring forecasts, Finland's 2014 Stability Programme.

When taking into account the influence of the cycle, it seems that the negative cyclical developments over the recent years have had a significant impact on the debt ratio. Indeed, if corrected for the cycle over the last three years, the debt ratio in 2015 would remain below the Treaty reference value.

Table 3. General government deficit and debt (% of GDP)[4]

		2010	2011	2012	2013		2014		2015	
					COM	National authorities	COM	National authorities	COM	National authorities
Deficit criterion	General government balance	-2.5	-0.7	-1.8	-2.1	-2.0	-2.3	-2.0	-1.3	-1.1
Debt criterion	General government gross debt	48.8	49.3	53.6	57.0	56.9	59.9	59.8	61.2	61
	General government gross debt adjusted for the effect of the cycle	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	57.2	56.7
Source: Eurostat and Commission 2014 spring forecast, Finland's 2014 Stability Programme, Finland's Ministry of Finance calculations										

Recent structural reforms. Assessment of the reforms undertaken by the Finnish authorities in response to the recommendations issued by the Council in July 2013 in the context of the EU semester is generally positive. Comprehensive reforms of the municipal structure, healthcare and social services are being prepared, the youth guarantee has been extended, early exit pathways from the labour market are being reduced and the national competition authority has been strenghtened. Finland reformed the corporate income tax system effective as from 2014, reducing the corporate income tax rate and increasing dividend taxation. The aim is to increase the growth-friendliness of the tax system.

In 2013, Finland adopted a broad structural policy programme for improving growth conditions and reducing the sustainability gap[5]. The government is foreseeing measures to balance local government finances, to increase the efficiency of the public sector, to extend working careers by 2 years and to improve competition and competitiveness. More specific steps have been announced in the context of the latest expenditure ceilings decision in March 2014[6] and in the National Reform Programme 2014[7].

Political parties have reached a consensus regarding the direction of the healthcare and social care reforms. All social welfare and healthcare services are to be delivered by five regional providers, based on current, specific catchment areas. This is confirmed in the the National Reform Programme. Municipalities would continue to participate in the provision of services, but a significant share of their obligations is transferred to these five regions. Local services,

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4 The cyclically-adjusted debt is computed as:

$$\left(\frac{B_t}{Y_t}\right)^{3-years\ -adjusted} = \left(\frac{B_t + \sum_{j=0}^{2}\left(C_{t-j}\right)}{Y_{t-3}\prod_{h=0}^{2}(1+y^{pot}_{t-h})(1+p_{t-h})}\right)$$

where B_t stands for debt, Y_t for GDP at current price, y^{pot} for potential growth, pt for the price deflator of GDP, C_t for the cyclical part of the budget balance. The cyclical components and potential growth are calculated according to commonly agreed methodologies.

5 A structural policy programme to strengthen conditions for economic growth and bridge the sustainability gap in general government finances is available at: http://valtioneuvosto.fi/etusivu/rakenneuudistus395285/tiedostot/rakennepoliittinen-ohjelma-29082013/fi.pdf

6 Hallituksen päätös rakennepoliittisen ohjelman toimeenpanosta osana julkisen talouden suunnitelmaa http://valtioneuvosto.fi/tiedostot/julkinen/kehysneuvottelut-2014/paatos/fi.pdf

7 http://www.vm.fi/vm/en/04_publications_and_documents/01_publications/02_economic_surveys/20140415Europe/Europa_2020_Spring_2014_NETTI.pdf

such as healthcare services, home help services for the elderly and social welfare services, should still be provided close to home. The legislative proposal is due to be submitted to the parliament in autumn 2014 and it is expected that the new structures will be effective by 2017.

The municipal reform is built on voluntary mergers of the municipalities, which are currently preparing detailed studies on the benefits of the mergers. Municipalities that will take merger decisions within the deadline will be entitled to grants and compensation. According to the National Reform Programme, the government has decided to appoint special rapporteurs for the 12 larger metropolitan regions to study the potential mergers. The outcome of the voluntary mergers appears uncertain at this stage. However, the government has set in the structural policy programme targets to reduce the duties and obligations and to cut the overlapping activities in order to increase the efficiency. At the same time, the municipalities are expected to improve productivity and to increase tax revenues, thus closing the deficit (1% of GDP) currently persistent in the local government sector.

A pension reform is part of the reform agenda social partners are expected to arrive at the agreement in autumn 2014. The target is to implement it from 2017.

Depending on the implementation details still to be decided, these measures could have a strong positive impact on public finances in the medium term through increased growth and expenditure reduction.

3.2. Medium-term budgetary position

Structural deficit and fiscal consolidation. During the recovery of 2010-11, Finland improved the structural balance significantly, reaching -0.6% by end 2011. With the economic decline over 2012-13 the structural balance started to deteriorate, falling to -1.0% in 2012. Finland had a MTO of +0.5% of GDP until 2013, when it was adjusted to -0.5%. According to the Commission 2014 Spring Forecast, Finland reached the MTO in 2013. In all years, Finland's headline deficit has been below 3% of GDP and is forecast to remain so over the forecast horizon.

With growth expected to return in 2014, Finland's Stability Programme aims to stay sufficiently close to the MTO. However, according to the Commission 2014 Spring Forecast the structural balance deteriorates to -0.9% in 2014. Still, the risk of significant deviation highlighted in the assessment of the 2013 Draft Budgetary Plan appears to be reduced. For 2015, Finland plans to improve the structural balance to -0.1%, above the MTO, due to the consolidation measures decided in March 2014. The Commission 2014 Spring Forecast confirms that the structural balance is likely to exceed the MTO in 2015, albeit with a lower margin.

The Commission forecast shows that debt will remain on the upward trend over 2014-15. National authorities also forecast that the debt level will increase over 2014-16, but assuming no change in policies, the stability programme expects that the debt ratio will start to decline in 2017.

3.3. Medium-term government debt position

Long-term sustainability of public finances. Finland is assessed to be at low risk of fiscal stress in the short term but is at medium sustainability risk in the medium term and at high risk in the long term due to the budgetary impact of the cost of ageing. The focus, therefore, should be on containing age-related expenditure growth further so as to contribute to the sustainability of public finances in the medium and long term.

According to the 2012 Ageing Report reference scenario, Finland's public healthcare expenditure is set to increase significantly from 6.0% of GDP to 7.0% of GDP by 2060. Among the many measures being proposed is the consolidation of reform efforts already being made by, for example, increasing hospital efficiency, enhancing the supply of follow-up care for long-term care patients so as to reduce the unnecessary use of acute care settings for these patients, improving the organisation and management of health care or introducing medical best practices systematically.

Stock-flow adjustment. The stock-flow adjustment has a large effect on the changes in the general government debt in Finland. This is driven by the fact that the earnings-related pension system included in the general government sector is partially pre-funded and is showing surpluses. The surplus was at 2.1% of GDP in 2013 and is forecast at 2.0% for 2014. It is included in the general government balance but is not used to pay off gross general government debt. These funds show up as net accumulation of financial assets in the stock-flow adjustment. Therefore, Finland's general government net financial assets position is forecast to amount to 47.1% of GDP in 2014[8]. Among the OECD countries, it is one of the highest positive net financial asset positions.

Sale of assets. The government has decided to sell properties belonging to government-owned Senate Properties and Metsähallitus. Balance sheet management of the central government's company ownerships will be enhanced by expanding the ownership base of state-owned unlisted companies and, if necessary, withdrawal from company ownership. In addition, sales of shares of state-owned listed companies as well as other measures will be implemented to increase proceeds transferred to central government. The total amount of dividends of unlisted companies will be increased. The additional recognition of revenue arising from the measures compared with that outlined earlier will be around EUR 1.9 billion in 2014–2015. Most of the proceeds will be directed to the repayment of central government debt, but EUR 0.6 billion will be dedicated to investments for 2014 and 2015.

Total stock of debt guaranteed by government. Finland had central government guarantees amounting to 17.1% of GDP in 2013. Guarantees linked to the financial sector amounted to 0.6% of GDP in 2013. Therefore, risks related to contingent liabilities, guarantees, financial rescue operations and debt assumptions are limited.

3.4. Other factors considered relevant by the Commission

Financial stabilisation operations. Among the other factors considered relevant by the Commission, particular consideration is given to financial contributions to fostering international solidarity and achieving the policy goals of the Union, the debt incurred in the form of bilateral and multilateral support between Member States in the context of safeguarding financial stability, and the debt related to financial stabilisation operations during major financial disturbances (Article 2(3), Regulation (EC) No 1467/97).

In assessing compliance with the debt criteria, financial assistance to euro-area Member States with a debt-increasing impact has been taken into account. At the end of 2013, the cumulative impact of participation in the financial stabilisation operations amounted to 2.9% of GDP. According to the Commission 2014 Spring Forecast, the cumulative impact would amount to 2.3% of GDP in 2015. Thus, Finland's general government gross debt would be 58.9% of GDP in 2015, if the debt related to financial stabilisation operations was removed from the total.

[8] OECD Economic Outlook no 93, Annex Table 33.

3.5. Other factors put forward by the Member State

In the letter received by the Commission on 14 May 2014, Finland emphasised the role of solidarity operations in the debt buildup, deviations in the growth forecast between Finland and the Commission, the governemnt Structural Policy programme agreed in August 2013 (further specified in November 2013 and March 2014), consolidation measures decided for 2015 and beyond and the sale of government assets (2014 and 2015) in order to reduce debt and to stimulate the economy as the factors to be considered. According to Ministry of Finance calculations, the debt level corrected for business cycle effects would be 56.7% of GDP in 2015.

The implications of solidarity operations are discussed in section 3.4 of the current report. Section 3.1 addresses the recent structural reforms including the Structural policy programme. Consolidation measures are covered in section 3.2 and asset sales in section 3.3. While the Commission 2014 Spring Forecast expects growth in 2014 and 2015 to be lower than the national forecasts, the debt to GDP ratio exceeds the reference value also in the national forecast for 2015 despite the slightly more positive growth scenario. Thus the finding on the planned breach is not based exclusively on the Commission's more negative growth forecast.

4. CONCLUSIONS

General government gross debt is planned to reach 61.0% of GDP in 2015, above the 60% of GDP reference value. The risk of breaching the reference value is confirmed by the Commission forecast, which projects gross debt at 61.2% of GDP. However, as explained above, the planned breach is fully explained by Finland's financial support in the context of the safeguarding financial stability in the euro area. Finally, the debt level has been influenced by large purchases of financial assets by the social security funds, resulting in the build-up of assets in parallel to the increase of debt.

Overall, the analysis presented in the report suggests that the debt criterion of the Treaty is fulfilled.