EUROPEAN
COMMISSION

Brussels, 16.11.2015
COM(2015) 803 final

REPORT FROM THE COMMISSION

Finland

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

REPORT FROM THE COMMISSION

Finland

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

1. INTRODUCTION

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 (SGP). 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 question of Finland's compliance with the deficit and 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.

[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".

The report updates the previous Commission's assessment of the excess of the deficit and debt ratio over the Treaty reference values of 12 May 2015[3]. The May report concluded that overall neither the deficit nor the debt criterion in the Treaty was considered to be complied with. However, no further steps under the EDP were taken as, following the May report, the incoming government had announced new consolidation measures in the government programme. On the basis of this announcement, the Commission services published an addendum to the assessment of the Stability Programme[4] which concluded that when the new measures are accounted for, the headline deficit would remain below the reference value in 2016 and the debt-to-GDP ratio would grow less than anticipated in the spring forecast. On 28 September 2015, Finland submitted an update of the Stability Programme together with the Draft Budgetary Plan (DBP).

The general government deficit in Finland reached 3.3% of GDP in 2014, thus exceeding the 3%-of-GDP reference value. In its DBP Finland plans the deficit to increase further to 3.4% of GDP in 2015, but to decrease to 2.8% in 2016. According to the Commission 2015 autumn forecast, the deficit is forecast to decline to 3.2% of GDP in 2015, 2.7% of GDP in 2016 and further to 2.3% in 2017. The notified deficit for 2014 and the planned deficit ratio for 2015 provide prima facie evidence of the existence of an excessive deficit in Finland in the sense of the Treaty and the Stability and Growth Pact, before, however, considering all relevant factors as set out below.

General government debt amounted to 59.3% of GDP in 2014, below the 60%-of-GDP reference value. Both the DBP and the Commission 2015 autumn forecast indicate that the gross debt ratio would be above the 60%-of-GDP reference value of the Treaty in 2015 and 2016 (62.5% of GDP in 2015 and 64.5% in 2016 based on the Commission forecast and 62.6% in 2015 and 64.3% in 2016 based on the DBP). The planned and projected debt ratio for 2015 and 2016 provide evidence that there appears to be *prima facie* a risk of the existence of an excessive deficit in Finland in the sense of the Treaty and the Stability and Growth Pact, before, however, considering all relevant factors as set out below.

The Commission has therefore prepared the following report to comprehensively assess the excess over the Treaty reference values, in order to examine whether they are complied with after all relevant factors have been considered. Section 2 of the report examines the deficit criterion, Section 3 discusses debt developments. Section 4 deals with relevant factors. The report takes into account the Commission 2015 autumn forecast released on 5 November 2015.

2. DEFICIT CRITERION

According to Finland’s September 2015 fiscal data notification, validated by Eurostat on 21 October 2015, its general government deficit amounted to 3.3% of GDP in 2014, against 2.5% of GDP in 2013.

3 COM(2015) 246 final, http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/126-03_commission/2015-05-13_fi_126-3_en.pdf

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

Based on the DBP, the deficit will reach 3.4% of GDP in 2015 and decline to 2.8% in 2016 (see table 2). According to the Commission 2015 autumn forecast, the deficit will reach 3.2% in 2015 and 2.7% in 2016.

Although in excess of 3% of GDP, the deficit is close to the Treaty reference value in 2014 and is forecast by both the national authorities and the Commission to remain so in 2015.

The excess over the 3%-of-GDP reference value in 2014 can be considered exceptional, as the 2014 deficit was negatively affected by the changeover to the ESA2010 methodology, and in particular the change in the treatment of swaps. The specific "EDP deficit" concept which existed under ESA 95 has been discontinued with the transition to ESA 2010. The “EDP deficit” defined under ESA 95 included the net impact of interest flows on swaps and forward rate agreements. Since the introduction of ESA 2010 in 2014, this special treatment for swaps under EDP statistics has disappeared and these are treated as financial transactions directed at derivatives and not as interest. As a result, the 2013 deficit was revised upwards by 0.3% of GDP. Finland continues to use the swap agreements and in 2014, the income from those was 0.3% of GDP. According to the previously-used concept, the deficit would have remained at 3%-of-GDP in 2014.

For 2015, the effect of the changeover to ESA 2010 was fully known and could be incorporated in the budget preparation process. Therefore, the excess is no longer exceptional in 2015. According to the Commission 2015 autumn forecast the general government balance is expected to improve slightly on the back of the positive contribution from cyclical conditions in 2015 while the structural balance remains unchanged.

In 2016, the narrowing of the deficit is mainly due to discretionary fiscal measures, especially on the expenditure side. Planned expenditure cuts reduce the spending on development cooperation, education and training and the subsidies to enterprises. Interest expenditure is decreasing, but this is more than offset by a decline in revenue from government assets. Labour market partners have decided to increase the unemployment insurance contributions as of 2016, helping to reduce the deficit in social security funds.

Therefore, the excess over the 3%-of-GDP reference value is temporary in the sense of the Treaty and the Stability and Growth Pact. In particular, the budgetary forecasts as provided by the Commission and the DBP indicate that the deficit will fall below the reference value in 2016.

In sum, the deficit in 2014 and 2015 remains close to, but above the 3%-of-GDP reference value. The existing and planned excess over the reference value is also temporary in the sense of the Treaty and the Stability and Growth Pact. In 2014 the deficit could also be considered to be exceptional. However, given that the deficit is not considered to be exceptional in 2015, the deficit criterion in the sense of the Treaty and Council Regulation (EC) No 1467/97 appears not to be fulfilled before analysing the relevant factors.

3. DEBT CRITERION

The general government gross debt-to-GDP ratio has increased rapidly over the recent years, growing from 32.7% of GDP in 2008 to 59.3% in 2014, on the back of deficits (as revenue shrank during the severe economic downturn and expenditure remained elevated) and stock-flow adjustments arising from the financial investments of the earnings-related social security funds. The deficit and the stock-flow adjustment contributed roughly equally to the growth of nominal debt over these years.

Finland's DBP envisages public debt to increase to 62.6% of GDP in 2015 and to continue increasing to 64.3% of GDP in 2016. Also according to the Commission 2015 autumn forecast, public debt is expected to exceed the 60%-of-GDP reference value, reaching 62.5% of GDP in 2015 and 64.5% of GDP in 2016 (Table 1).

According to the Commission forecast, the projected nominal growth is insufficient to offset the impact of interest expenditure on the debt ratio in 2015, resulting in a debt-increasing snowball effect. In 2016 however, the snowball effect would disappear. The role of stock-flow adjustments declines over the forecast horizon, as the surplus of the social security funds is expected to diminish.

The analysis above thus suggests that, before consideration is given to all relevant factors, the debt criterion in the sense of the Treaty and Council Regulation (EC) No 1467/97 appears not to be fulfilled based on the 2016 draft budgetary plan as well as the Commission 2015 autumn forecast.

Table 1: Debt dynamics

	2012	2013	2014	2015	2016
Government gross debt ratio	52.9	55.6	59.3	62.5	64.5
Change in debt ratio [b] (1 = 2+3+4)	4.4	2.7	3.8	3.2	2.0
Contributions:					
• Primary balance (2)	0.7	1.3	2.1	2.0	1.5
• “Snowball” effect (3)	0.7	0.5	0.6	0.2	0.0
of which:					
Interest expenditure	1.4	1.3	1.2	1.2	1.1
Real GDP growth	*0.7*	*0.6*	*0.2*	*-0.2*	*-0.4*
Inflation (GDP deflator)	-1.4	-1.4	-0.9	-0.8	-0.7
• Stock-flow adjustment (4)	3.0	0.9	1.1	1.0	0.5

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 2015 autumn forecast

4. Relevant factors

Article 126(3) of the TFEU stipulates that the Commission's 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 qualitative terms the excess over the reference value and which the Member State has put forward to the Council and the Commission*" need to be given due consideration.

When assessing compliance on the basis of the deficit criterion, if the ratio of the government debt to GDP exceeds the reference value, relevant factors shall be taken into account in the steps leading to the decision on the existence of an excessive deficit, as the double condition of the overarching principle — that, before these relevant factors are taken into account, the general government deficit remains close to the reference value and its excess over the reference value is temporary — is met. Relevant factors shall be taken into account also when assessing compliance on the basis of the debt criterion.

The following subsections consider in turn: (1) the medium-term economic position; (2) the medium-term budgetary position including an assessment of compliance with the required adjustment towards the MTO and the development of public investment; (3) the developments in the medium-term government debt position, its dynamics and sustainability; (4) other factors considered relevant by the Commission; and (5) other factors put forward by the Member State.

The report reflects the factors mentioned above based on the notified data and the Commission 2015 autumn forecast.

4.1. Medium-term economic position

Cyclical conditions and potential growth

After Finland's real GDP collapsed by 8.3% in 2009, the country recovered gradually in 2010 and 2011, but experienced a new recession over 2012-14. In 2014, GDP contracted by 0.4%. The growth outlook is slowly improving for 2015 and 2016 (Table 2). The crisis has negatively affected Finland's potential growth, having averaged 0% over the last four years and being negative (at -0.1%) over 2013 and 2014, as according to estimates by the Commission based on the commonly-agreed methodology. In 2015 potential output growth is estimated at -0.1% whereas in 2016 it is estimated at 0.1%. The contraction of potential output is caused by declining contributions of labour inputs and the estimated negative contribution of total factor productivity, which reflects the ongoing restructuring of the economy. Moreover, the positive contribution of capital also declined over the crisis period, due to low investment. Overall, real GDP in 2014 was 5.9% below the level recorded in 2008, whereas potential output has grown by just 0.6% over this period.

As real GDP declined over 2012-14, the output gap widened to -2.9% of potential GDP in 2014 and it is expected to start closing gradually in 2015 to -2.5% as GDP is estimated to grow slightly above potential. In 2016, GDP growth is also forecast to remain above potential growth, reducing the output gap to -2.0% of GDP.

Table 2: Macroeconomic and budgetary developments[a]

	2012	2013	2014	2015		2016		2017
	COM	COM	COM	COM	National authorities	COM	National authorities	COM
Real GDP (% change)	-1.4	-1.1	-0.4	0.3	0.2	0.7	1.3	1.1
Potential GDP (% change)	0.0	-0.1	-0.1	-0.1	0.0	0.1	0	0.5
Output gap (% of potential GDP)	-1.6	-2.6	-2.9	-2.5	-2.6	-2.0	-1.6	-1.4
General government balance	-2.1	-2.5	-3.3	-3.2	-3.4	-2.7	-2.8	-2.3
Primary balance	-0.7	-1.3	-2.1	-2.0	-2.2	-1.5	-1.7	-1.2
One-off and other temporary measures	-0.1	-0.1	0.1	0.0	0.0	0.0	0.0	0.0
Government gross fixed capital formation	4.0	4.1	4.1	3.9	4.1	3.9	4.1	3.9
Cyclically-adjusted balance	-1.2	-1.1	-1.7	-1.7	-1.9	-1.5	0.0	-1.5
Cyclically-adjusted primary balance	0.2	0.2	-0.4	-0.6	-0.7	-0.4	-0.8	-0.4
Structural balance [b]	-1.1	-1.0	-1.8	-1.7	-1.9	-1.5	-1.9	-1.5
Structural primary balance	0.3	0.3	-0.5	-0.6	-0.7	-0.4	-0.8	-0.4

Notes:

[a] In percent of GDP unless specified otherwise.

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

Source: Eurostat and European Commission 2015 autumn forecast, 2016 Draft Budgetary Plan

These negative cyclical developments have had a significant impact on the public deficit and the debt-to-GDP ratio, but looking forward, the economy is expected to grow above its potential growth rate. If corrected for the cycle over the last three years, the debt ratio in 2015 would remain below the Treaty reference value both according to the Commission and the DBP, but this would no longer be the case in 2016. Based on the Commission 2015 autumn forecast, cyclically-adjusted debt would be 57.5% of GDP in 2015 and 60.7% in 2016 (Table 3).

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

		2012	2013	2014	2015		2016		2017
					COM	National authorities	COM	National authorities	COM
Deficit criterion	General government balance	-2.1	-2.5	-3.3	-3.2	-3.4	-2.7	-2.8	-2.3
Debt criterion	General government gross debt	52.9	55.6	59.3	62.5	62.6	64.5	64.3	65.7
	General government gross debt adjusted for the effect of the cycle						57.5		60.7

Sources: Eurostat, European Commission 2015 autumn forecast, 2016 Draft Budgetary Plan, data communicated by the national authorities

Recent structural reforms

The most important recent reform is the pension reform agreed by the social partners in September 2014. The reform links the retirement age to life expectancy as recommended by the Council in July 2014. According to the national authorities, the reform is expected to improve long-term fiscal sustainability by approximately 1% of GDP. However, this reform remains to be enacted. The adoption of the legal acts by the Parliament is expected for later this year, with the objective to implement the reform from 2017 onwards. Consequently, also the budgetary effect would not be apparent before 2017. Also, a decision regarding the extended unemployment benefits for workers close to the retirement age ("the unemployment tunnel") has not been taken under the current pension reform. This could limit the positive impact that the pension reform is expected to have on the labour supply, as older unemployed will remain eligible for unemployment benefits until reaching the pension age.

The government is envisaging further reforms, which, once enacted and implemented, could contribute towards fiscal sustainability. The government's Strategic Programme of 27 May 2015 foresees structural reforms that are generally in line with the findings of the 2015 Country Report and the country specific recommendations (CSRs). To improve non-cost competitiveness, the government is planning measures that foster start-ups, fast-growth companies and change-of-generation in businesses. The government has committed not to increase the operating costs for the industry during its parliamentary term. The government has set an ambitious goal for reducing unit labour costs by 15%. This is envisaged by applying continued wage-moderation (5 pps), structural labour market reforms (5 pps) and one-off reduction of labour costs (5 pps). To achieve the reduction of labour costs, the government has, in September 2015, made a proposal that includes the reduction of public sector holidays, reduction of overtime pay and Sunday's supplementary pay as well as reduction of employers' contribution to social security. These proposed measures are being debated, and the government has agreed to implement any other measures agreed by the social partners if the same result (5% reduction of labour costs) is achieved.

Regarding the labour market, the government plans to reform social and unemployment benefits to increase incentives to work, to shorten periods of unemployment, to reduce structural unemployment and to save public resources. The government published its proposal regarding the social- and healthcare services reform on 9 November 2015. One of the government's strategic goals over the next four years is to simplify legislation and regulation in order to improve the business environment. The task and service provision obligations of the municipalities are planned to be reduced.

On 28 September 2015 the Governemnt published the implementation plan for the key projects and reforms of the Government's strategic programme[5]. The implementation plan includes the deadlines for the preparation of necessary legislation for reforms and implementation phases. Most of the deadlines for providing legislative proposals to the parliament are in early 2016.

4.2. Medium-term budgetary position

Structural deficit and fiscal consolidation

Based on the Commission's current calculations, Finland’s structural balance was -1.8% of GDP in 2014. In 2015, the structural balance is expected to remain unchanged[6] and in 2016 to improve by 0.2% of GDP, so that in 2016 the structural balance reaches -1.5% of GDP.

---

[5] http://valtioneuvosto.fi/documents/10184/321857/Toimintasuunnitelma+strategisen+hallitusohjelman+k%C3%A4rkihankkeiden+ja+reformien+toimeenpanemiseksi.pdf

[6] While according to the figures in table 2 the structural balance seems to improve by 0.1% of GDP, this is only due to rounding.

Based on the relevant forecast vintages of the Commission forecast, Finland was subject to exceptionally bad economic conditions in 2014, namely a real GDP contraction, and therefore exempt from delivering any fiscal effort. Finland was assessed to be at its MTO (-0.5% of GDP) in the beginning of 2014, but deviated from it in the course of 2014 on the back of a deterioration of the structural balance by 0.8% of GDP.

In 2015, the structural balance is expected to remain unchanged, pointing to a risk of some deviation (gap of -0.1% of GDP) from the required fiscal effort of 0.1% of GDP. The expenditure benchmark is forecast to be respected. However, over the years of 2014 and 2015 taken together, there is a risk of a significant deviation based on the structural balance pillar (average gap of -0.4% of GDP compared to the threshold of significant deviation of 0.25% of GDP on average over two years), while the expenditure benchmark points to compliance (positive average gap of 0.5% of GDP). This calls for an overall assessment. The difference between the two pillars is explained by revenue shortfalls negatively affecting the structural-balance pillar and the difference in the potential growth benchmarks used. On the one hand, the current estimate of potential GDP growth underlying the structural balance estimate is lower than the medium-term average used in the expenditure benchmark (frozen based on the Commission 2013 winter forecast). The former seems to provide a more adequate estimate of medium-term potential growth rate at the current juncture because the macroeconomic outlook in Finland has changed negatively compared to the one expected in 2013. On the other hand, the difference in growth benchmarks also captures the effects of lower-than-expected inflation. Whereas the expenditure benchmark uses the deflator from the relevant vintages of the forecast, the structural balance reflects actual inflation which turned out much lower than previously forecast, suggesting that in this specific respect the expenditure benchmark seems to be a better indicator of the fiscal effort at the current juncture. On balance, the overall assessment points to a risk of some deviation from the required adjustment towards the MTO over 2014-15 taken together, which will need to be reassessed ex post taking into consideration whether the economic situation of the country in 2014 (i.e. negative real growth) justifies the observed loosening of the structural balance.

In 2016, the structural balance is projected to improve by 0.2% of GDP, pointing to a risk of some deviation (gap of -0.3% of GDP) from the required adjustment of 0.5% of GDP. Over 2015-16 taken together, the deviation based on the structural balance is 0.2% of GDP. There is a projected deviation of 0.1% of GDP in 2016 based on the expenditure benchmark, which is however respected over 2015 and 2016 taken together. The difference in the potential growth rates used has a considerable positive effect (0.4% of GDP) on the expenditure benchmark. On that basis, the overall assessment based on the Commission 2015 autumn forecast points to a risk of some deviation from the required adjustment path towards the MTO in 2016.

Government expenditure and investment

Government investment as a share of GDP has been increased compared with the start of the crisis. In 2008, gross fixed capital formation by the government sector amounted to 3.6% of GDP. In 2013 it reached 4.2% of GDP and in 2014 4.1% of GDP. According to the DBP, investment is expected to amount to 4.1% of GDP in 2015 and 2016. Throughout the period, the general government deficit ratio in both headline and structural terms is lower than the government investment-to-GDP ratio. Overall, general government investment, as a share of GDP, is among the highest in the euro area.

Finland's general government sector has recorded primary deficits since 2012 and is expected to remain in primary deficit also in 2015 and 2016. The effective interest rate paid on debt has decreased significantly in recent years. Interest expenditure, as a share of GDP, is forecast by both the Commission as well as by the national authorities to fall over the forecast horizon.

Current expenditure, excluding interest, has been on an increasing trend. In fact, it increased by 9 pps. of GDP since 2004. It should be noted that 5.7 pps. of the change occurred in 2009, when nominal GDP contracted by 6.5%. At 58.3% of GDP, it was the highest in the EU in 2014. Expenditure has increased in all sub-sectors of the general government over the years 2004 to 2014, but the increase has proportionally been the highest in the earnings-related pension funds sector. When considering general government expenditure by function, it appears that expenditure growth is mainly driven by healthcare and pension expenditure, reflecting the ageing society. Expenditure has also increased for general public services, despite the fact that expenditure related to public debt transactions (i.e. interest expenditure), which is taken into account under this category, has fallen as a share of GDP.

Quality of public finances

Finland has enacted, in national law, the structural-budget-balance rule foreseen by the Fiscal Compact and enshrined specific implementing provisions in secondary legislation. Finland’s fiscal framework is tied to multiannual expenditure ceilings and has recently been strengthened by a provision obliging the central government to consider the impact of its policy measures on the fiscal balance of local authorities and social-security funds. However, there seems to be limited flexibility to react to challenges arising during the running year. If a growth forecast is revised significantly downwards during the year, as happened in 2013 and 2014, there is no process to adjust the expenditure limits accordingly.

4.3. Medium-term government debt position

Long-term sustainability of public finances

The general government gross consolidated debt-to-GDP ratio stood at 59.3% of GDP in 2014. Based on medium-term projections building on the Commission's spring 2015 forecast, the debt is expected to rise to close to 80% of GDP by 2025 (based on the no-policy-change scenario, under the assumption that the structural primary balance position evolves according to the Commission's spring 2015 forecast until 2016), remaining above the 60%-of-GDP Treaty threshold. The increase would be mostly driven by the costs of ageing.

Finland is assessed to be at low risk of fiscal stress in the short term, but is at high sustainability risk in the medium term and medium 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 run. However, the latest pension reform, agreed by the social partners in autumn 2014, is not included in these assessments, as the necessary legislation should be finalised by end-2015 and the reform laws are expected to enter into force as of 2017.

Stock-flow adjustment

The stock-flow adjustment has a large effect on changes in general government debt in Finland. In 2012, the stock-flow adjustment accounted for 70% of the increase in the debt-to-GDP ratio. Thereafter, in 2013 and 2014, it accounted for roughly 30% of the change in the debt ratio. A similar impact is forecast for 2015, while in 2016 the stock-flow adjustment is projected to account for one fourth of the change in the debt-to-GDP ratio. This is because the earnings-related pension system, included in the general government sector, is partially pre-funded and is in surplus. The surplus stood at 1.9% of GDP in 2013 and at 1.4% of GDP in 2014. In 2015, the DBP projects the surplus to diminish to 0.5% of GDP and grow to 0.8% of GDP in 2016. The surplus is included in the general government balance but is not used to pay off general government debt. These funds show up as a net accumulation of assets in the stock-flow adjustment. Finland's general government net-financial-assets position is forecast at 51.0% of GDP in 2015, down from 54.7% of GDP in 2014[7]. The OECD projects net assets to amount to 47.2% of GDP by the end of 2016. Among OECD countries, this is one of the highest positive net-financial-asset positions.

Total stock of debt guaranteed by the government

Finland had central-government guarantees amounting to 17.4% of GDP in 2014. Among those, guarantees linked to the financial sector amounted to 0.9% of GDP in 2014. The bulk of the guarantees (12% of GDP) are issued to a wide group of non-financial corporations, mainly through the Finnvera corporation - a specialised state-owned financing company. Taking into account the strong position of the financial sector[8] and the low observed pay-outs from the guarantees, the risks associated with the debt guaranteed by the government do not appear to be significant.

Impact of the cycle

As Finland has experienced difficult economic times over 2012-13 and a large negative output gap, estimated at -2.9 % of GDP in 2014, has opened, the debt-to-GDP ratio is also influenced by the cyclical developments. When corrected for the effects of the cycle, the Commission forecast for general government debt is estimated at 57.5% of GDP in 2015, but above the reference value in 2016 (60.7% of GDP).

4.4. 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) of Regulation (EC) No 1467/97).

In assessing compliance with the debt criterion, financial assistance to euro-area Member States with a debt-increasing impact has been taken into account. According to the Commission 2015 autumn forecast, the cumulative impact of this assistance would amount to 2.8% of GDP in 2015. Thus, Finland's general government gross debt would be 59.7% of GDP in 2015 and 61.8% in 2016 if the debt related to financial-stabilisation operations was deducted.

[7] OECD Economic Outlook no 97, Annex Table 33.

[8] As discussed in the 2015 Country Report http://ec.europa.eu/europe2020/pdf/csr2015/cr2015_finland_en.pdf

4.5. Other factors put forward by the Member State

In a letter received by the Commission on 3 November 2015, the Finnish authorities emphasised that the government has taken the measures foreseen in the May Strategic Programme. The authorities make reference to the updated Stability Programme (submitted on 28 September 2015) which provides information about the plans to reduce the general government deficit until 2019[9]. They note also that the September Stability Programme uses a conservative estimate of the Government's plans, including only the sufficiently detailed measures while the government in fact plans an even higher consolidation effort.

Finland also argues that the excess of the deficit over the 3% of GDP reference value was exceptional due to negative annual real GDP growth at -0.4% of GDP in 2014. The government does not point to currently known factors which would allow considering the deficit exceptional in 2015. However, the authorities argue that expenditure associated with the refugee crisis should be taken into account as a relevant factor under both the deficit and the debt criterion and provide information regarding the projected costs associated with the increased number of asylum seekers in 2015, noting that this could be an event outside the control of the government that could, ex post, be ground to consider exceptional circumstances also in 2015. Whereas the costs are currently difficult to estimate, the currently known additional expenditure based on the data provided amounts to 0.06% of GDP in 2015, thus not sufficient to explain the breach over the 3%-of-GDP reference value of the Treaty in 2015. The authorities foresee that in 2016 the immigration-related additional costs could amount to 0.3% of GDP.

Among the other relevant factors that should be taken into account when considering compliance with the deficit criterion, the government emphasizes the broad compliance with the preventive arm requirements. In addition, the Finnish authorities note that the low inflation and low interest rate environment has had a negative influence on the deficit. The outturn of the 2015 inflation is now estimated to be 1½ pps lower than forecast during the 2015 budget preparation, resulting in lower revenues. A low interest rate environment has a negative effect on the general government budget, as the loss of revenue from Finland's assets exceeds the gains from the lower interest expenditure.

Among the other relevant factors that should be taken into account when considering compliance with the debt criterion, the Finnish authorities point out that the debt-to-GDP ratio would remain below the 60% reference value in 2015 if adjusted for the effects of the cycle as well as when taking into account the solidarity operations. Among the relevant factors in 2016, the authorities emphasize the broad compliance with the preventive arm requirements and the accumulation of financial assets.

5. CONCLUSIONS

Deficit criterion

The general government deficit in Finland reached 3.3% in 2014 and is planned to increase further to 3.4% of GDP in 2015. Both the draft budgetary plan and the Commission 2015 autumn forecast expect the general government balance to fall below the 3%-of-GDP reference value of the Treaty in 2016. On this basis, the excess over the 3%-of-GDP

[9] The updated Stability Programme is briefly discussed in the Staff Working Document accompanying the Commission opinion on Finland's 2016 Draft Budgetary Plan.

reference value of the Treaty can be considered close and temporary. The excess over the reference value can be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact in 2014. This report examined relevant factors, notably medium-term economic position, structural reforms and progress towards the MTO. Especially, as Finland's budgetary position is strongly affected by the effects of the cycle and is broadly compliant with the required progress towards the MTO, the analysis presented in this report suggests that the deficit criterion as defined in the Treaty and in Regulation (EC) No 1467/97 should be considered as currently complied with.

Debt criterion

While general government gross debt was below 60% in 2014, the 2015 DBP envisages it to reach 62.6% of GDP in 2015, i.e. above the 60%-of-GDP reference value. Similarly, the Commission 2015 autumn forecast projects gross debt above the reference value at 62.5% of GDP in 2015 and 64.5% in 2016. As demonstrated in this report, while the planned breach of the debt criterion is fully explained by Finland's financial support to safeguard financial stability in the euro area in 2015, this would no longer be the case in 2016. The debt level has been influenced by large purchases of financial assets by the social security funds, resulting in the accumulation of assets in parallel to the increase of debt. Additionally, it should be noted that the debt ratio reflects the effects of Finland's current cyclical position, but also this factor cannot, by itself, explain the excess over the 60%-of-GDP reference value in 2016. This report also examined other relevant factors, notably finding that Finland is expected to broadly comply with the required adjustment path towards the MTO in 2015 and 2016, which should help ensure – in the medium term – that debt decreases at a sufficient pace. On this basis, the analysis presented in this report suggests that the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/97 should be considered as currently complied with. However, as Finland's debt-to-GDP ratio has been on an increasing trend, and it is forecast to continue rising over the medium term under a no-policy-change assumption, the pension reform and other structural reforms increasing productivity and supply of labour are key to enhance Finland's growth prospects in the medium term. Their swift adoption and implementation would contribute to address the CSRs and improve fiscal sustainability.