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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. 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 (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 debt criterion of the Treaty, with due regard to the economic background and other relevant factors before drawing a final conclusion on compliance

Following the amendments to the SGP 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.

On 13 January 2015 the Commission presented a Communication on Flexibility, providing new guidance on how to apply the existing rules of the Stability and Growth Pact, in order to

[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] 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 (OJ L 140, 27.5.2013, p. 11).

strengthen the link between effective implementation of structural reforms, investment, and fiscal responsibility in support of jobs and growth. The Communication does not amend any provision of the Pact, but aims to further reinforce the effectiveness and understanding of its rules and to develop a more growth-friendly fiscal stance in the euro area by ensuring the best use of the flexibility enshrined within the Pact while preserving its credibility and effectiveness in upholding fiscal responsibility. In particular, the Communication clarified that – in line with the provisions of Article 2(3) of Council Regulation (EC) No 1467/97 - the Commission, when examining whether an EDP needs to be opened (in the context of a report according to Article 126(3) TFEU), will analyse carefully all relevant medium-term developments regarding the economic, budgetary and debt positions. It has also clarified that the implementation of structural reforms in the context of the European Semester is to be considered among these relevant factors[3].

According to the 2015 Draft Budgetary Plan of Finland, communicated to the Commission on 2 October 2014 the general government deficit for 2015 was expected to reach 2.4% of GDP while the gross debt ratio would reach 61.2% by the end of 2015, which is above the 60% reference value. According to the Commission 2015 winter forecast, the general government deficit will be at 2.5% of GDP in 2015, while the projection for the debt ratio is in line with that of the authorities in the Draft Budgetary Plan.

The projected figure, both in the Commission forecast and in the Draft Budgetary Plan provides evidence that there appears to be *prima facie* a risk of the existence of an excessive deficit based on the debt criterion in the sense of the SGP before however considering all relevant factors as set out below.

This report therefore updates the previous Commission assessment of the excess of the debt ratio over the reference value of 2 June 2014[4], in order to examine whether the launch of an EDP is warranted after all relevant factors have been considered.

Section 2 examines the deficit criterion, Section 3 the debt criterion and section 4 the relevant factors influencing the debt developments. The report takes into account the Commission 2015 winter forecast, released on 5 February 2015. Compared to the report of 2 June 2014, the deficits are forecast to be higher for 2014 as well as for 2015 due to the weaker growth outlook. Expenditure on interest is forecast to be lower. The current report is based on ESA 2010 data. The switch to ESA 2010 lowered the debt-to-GDP ratio (for the last statistical year, 2013, debt-to-GDP ratio is reduced from 57.0% under ESA 95 to 56.0%).

2. DEFICIT CRITERION

According to the Draft Budgetary Plan as well as the Commission 2015 winter forecast, Finland's general government deficit will remain below the Treaty reference value during the period 2014 until 2016. According to the Commission forecast, the deficit reached 2.7% of GDP in 2014 and is projected to decline thereafter to 2.5% of GDP in 2015 and 2.2% of GDP in 2016 based on the no-policy change assumption. According to the Draft Budgetary Plan,

[3] Article 2 of Regulation (EC) No 1467/97 provides that *"[…] The report shall reflect, as appropriate […] the implementation of policies in the context of the prevention and correction of excessive macroeconomic imbalances, the implementation of policies in the context of the common growth strategy of the Union […]"*.

[4] COM(2014) 432 final.

the deficit would have been 2.7% of GDP in 2014 and was forecast to decline to 2.4% of GDP in 2015. Hence, the deficit criterion in the Treaty is fulfilled.

3. DEBT CRITERION

The general government gross debt ratio has increased rapidly over the last years, growing from its low point of 32.7% of GDP in 2008 to 56.0% in 2013. According to the Commission 2015 winter forecast, the debt is expected to have reached 58.9% of GDP in 2014 and to grow to 61.2% of GDP in 2015 and 62.6% in 2016. Finland's Draft Budgetary Plan forecasted the debt to increase to 59.6% of GDP in 2014 and to 61.2% of GDP in 2015. The winter forecast debt figure for 2014 takes into account the slower growth of central government debt in the second half of the year.

Table 1: Debt dynamics

	2011	2012	2013	2014	2015	2016
Government gross debt ratio	48.5	53.0	56.0	58.9	61.2	62.6
Change in debt ratio [b] (1 = 2+3+4)	1.4	4.5	2.9	2.9	2.3	1.4
Contributions:						
• Primary balance (2)	-0.4	0.7	1.1	1.4	1.2	1.0
• "Snowball" effect (3)	-0.9	0.9	0.7	0.6	0.1	-0.4
of which:						
Interest expenditure	1.4	1.4	1.3	1.3	1.2	1.2
Real GDP growth	*-1.2*	*0.7*	*0.6*	*0.0*	*-0.5*	*-0.8*
Inflation (GDP deflator)	-1.2	-1.3	-1.2	-0.6	-0.7	-0.8
• Stock-flow adjustment (4)	2.7	2.9	1.1	0.9	1.1	0.8

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 winter forecast

4. 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 all other relevant factors, including the medium-term economic and budgetary position of the Member State*." 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 compliance with the deficit and debt criteria and which the Member State has put forward to the Council and the Commission*" 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.

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 - 2013. In 2014, Finland's output is estimated to have remained broadly unchanged compared to the previous year. Recently, productivity growth has been low and export market share losses have accumulated, reflecting the ongoing restructuring of the economy. The crisis has negatively affected Finland's potential growth. Based on the winter forecast, potential growth is estimated to have declined from 2.2% in 2007 to almost a standstill in 2014. In 2015, potential growth is expected to improve only slightly, supported by capital accumulation and hours worked, while no positive contribution is expected to come from the total factor productivity. The sharp decline in potential growth has a negative impact on debt sustainability.

As real GDP declined in 2012 and 2013, the output gap widened to -3.1% of potential GDP in 2013 where it is expected to remain in 2014 as GDP is estimated to have stayed unchanged. In 2015, growth is forecast to exceed potential growth, reducing the output gap somewhat to -2.6% of potential GDP.

Table 2: Macroeconomic and budgetary developments [a]

	2011	2012	2013	2014		2015		2016	
	COM	COM	COM	COM	National authorities	COM	National authorities	COM	National authorities
Real GDP (% change)	2.6	-1.5	-1.2	0.0	0	0.8	1.2	1.4	n.a.
Potential GDP (% change)	0.2	0.1	0.1	0.0		0.3		0.3	n.a.
Output gap (% of potential GDP)	-0.3	-1.8	-3.1	-3.1	-3.0	-2.6	-2.2	-1.5	n.a.
General government balance	-1.0	-2.1	-2.4	-2.7	-2.7	-2.5	-2.4	-2.2	n.a.
Primary balance	0.4	-0.7	-1.2	-1.4	-1.4	-1.2	-1.1	-1.0	n.a.
One-off and other temporary measures	-0.1	-0.1	-0.1	0.1	0.0	0.0	0.0	0.0	n.a.
Government gross fixed capital formation	3.8	4.0	4.2	4.1	4.1	4.1	4.0	4.1	n.a.
Cyclically-adjusted balance	-0.8	-1.1	-0.6	-0.9	-1.0	-1.0	-1.2	-1.3	n.a.
Cyclically-adjusted primary balance	0.5	0.4	0.6	0.4	0.3	0.3	0.1	-0.1	n.a.
Structural balance [b]	-0.8	-1.0	-0.6	-1.0	-1.0	-1.0	-1.2	-1.3	n.a.
Structural primary balance	0.6	0.4	0.7	0.3	0.3	0.3	0.1	-0.1	n.a.

Notes:

[a] In percent of GDP unless specified otherwise.

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

Source: Eurostat and Commission 2015 winter forecasts, Draft Budgetary Plan 2015

These negative cyclical developments have had a significant impact on the debt ratio. 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 national authorities. Based on the Commission winter forecast, cyclically adjusted debt would be 55.8% of GDP in 2015. The national authorities agree with this calculation.

Table 3. General government deficit and debt (% of GDP)[5]

		2011	2012	2013	2014		2015		2016	
					COM	National authorities	COM	National authorities	COM	National authorities
Deficit criterion	General government balance	-1.0	-2.1	-2.4	-2.7	-2.7	-2.5	-2.4	-2.2	n.a.
Debt criterion	General government gross debt	48.5	53.0	56.0	58.9	59.6	61.2	61.2	62.6	n.a.
	General government gross debt adjusted for the effect of the cycle						55.8	55.8		

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

5 The cyclically-adjusted debt is computed as:

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

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.

Recent structural reforms

In 2013, Finland adopted a broad structural policy programme for improving growth conditions and reducing the sustainability gap[6]. The government foresees measures to balance local government finances, increase the efficiency of the public sector, extend working careers by 2 years and improve competition and competitiveness. More specific steps have been announced in the context of the latest expenditure ceilings decision in March 2014[7] and laid out in the National Reform Programme 2014[8]. Further implementing decisions were taken in August 2014[9], these decisions are currently being carried out by the government.

The Commission's assessment of the reforms undertaken by the Finnish authorities in response to the recommendations issued by the Council in July 2013 and in July 2014 in the context of the EU semester is generally positive. The 2015 Country Report notes that Finland is making some progress with the implementation of the 2014 Country Specific Recommendations. Comprehensive reforms for increasing the size of municipalities, improvements of 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. A reform of the corporate income tax system aimed at increasing the growth-friendliness of the tax system has entered into force in 2014, reducing the corporate income tax rate and increasing dividend taxation.

A pension reform has been agreed by the social partners in late September 2014. The reform links pension age to life expectancy as recommended by the Council in July 2014. The target is to implement the reform from 2017 onwards. According to the national authorities, the reform will improve fiscal sustainability by approximately 1% of GDP.

Political parties have reached a consensus regarding the direction of the healthcare and social care reforms. According to the 2014 National Reform Programme, the main principle of the reform is the integrated provision of all social welfare and healthcare services by five regional providers. Municipalities would continue to participate in the provision of services, but a significant share of their competencies is transferred to these five regions. Local services, such as healthcare services, home help for the elderly and social welfare, can still be provided close to home. At the end of 2014, legislative proposals related to this reform were presented to the parliament 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 decide to merge within the deadline will be entitled to grants and compensation. According to the

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6 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

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

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

9 Government decision on strengthening the implementation of the structural policy programme http://valtioneuvosto.fi/tiedostot/julkinen/pdf/2014/budjettineuvottelut-2014/rakennepoliittinen-ohjelma/government-decision-280814.pdf

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. Although it is planned not to force mergers, the government has set targets for the reduction of 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 of the local government sector (which currently stands at 1% of GDP).

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.

4.2. Medium-term budgetary position

Structural deficit and fiscal consolidation

Finland's headline deficit is below 3% of GDP and is forecast to remain so until 2016. During the recovery of 2010-11, Finland's structural balance improved significantly, reaching -0.8% of GDP by end-2011. In 2012 the structural balance deteriorated to -1.0% of GDP. Finland had a medium-term objective (MTO) of +0.5% of GDP until 2013, when it was adjusted to -0.5% of GDP. According to the Commission 2015 winter forecast, Finland reached the MTO in 2013, as the structural balance was -0.6% of GDP, sufficiently close to the MTO.

According to both national and Commission forecasts, Finland is expected to have moved away from the MTO in 2014. With growth expected to return in 2015, Finland would be expected to improve the structural balance by 0.1% of GDP. However, the Draft Budgetary Plan foresees a continued deterioration of the structural balance also in 2015, and, according to the winter forecast, the structural balance would not change in 2015. While the Commission at this stage does not project a significant deviation from the MTO in 2014 and/or 2015, the forecast implies some deviation which, when repeated over time, could result in a significant deviation in the future.

The ratio of general government expenditure to GDP is increasing. While the average over the period 2006-2010 amounted to 50.6%, the ratio reached 57.8% in 2013 and is projected to remain high in the Commission 2015 winter forecast; the ratio is among the highest in the EU.

4.3. 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. However, the latest pension reform is not yet included in these assessments.

The debt would continue to increase according to the current projections also beyond 2016. According to the baseline scenario (relying on Commission forecasts, Economic Policy Committee agreed long-run convergence assumptions of underlying macroeconomic variables (real interest rate, real GDP growth, inflation) and the assumption of constant fiscal policy beyond the forecast horizon), the debt level would be relatively stable until 2019-2020 and continue to increase thereafter. The increase would be driven by the costs of ageing.

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 stood at 1.9% of GDP in 2013 and is estimated by the national authorities at 1.5% for 2014. In 2015, the surplus is projected to diminish to 1.3% of GDP and to start growing thereafter. The surplus is included in the general government balance but is not used to pay off general government gross debt. These funds show up as net accumulation of assets in the stock-flow adjustment. Therefore, Finland's general government net financial assets position is forecast to amount to 56.5% of GDP in 2014[10]. 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 the government in order to reduce debt. Balance-sheet management of the central government's company ownerships is envisaged to 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 shall be implemented to increase revenues transferred to the government. The total amount of dividends of unlisted companies is intended to be increased. The additional recognition of revenue arising from these measures compared with that outlined earlier will be around EUR 1.9 billion in 2014–15. Most of the proceeds will be directed to the repayment of central government debt, but EUR 0.6 billion will be dedicated to investments in 2014 and 2015[11].

Total stock of debt guaranteed by the government

Finland had central-government guarantees amounting to 16.5% of GDP in 2013. Guarantees linked to the financial sector amounted to 0.5% of GDP in 2013. Therefore, risks related to contingent liabilities, guarantees, financial-rescue operations and debt assumptions are limited.

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 criteria, financial assistance to euro-area Member States with a debt-increasing impact has to be taken into account. According to the Commission 2015 winter forecast, the cumulative impact of this assistance would amount to 2.9% of GDP in 2015. Thus, Finland's general government gross debt would be 58.3% of GDP in 2015 if the debt related to financial stabilisation operations was removed from the total and thus below the reference value in the Treaty.

[10] OECD Economic Outlook no 93, Annex Table 33.
[11] General Government Fiscal Plan 2015 – 2018.

4.5. Other factors put forward by the Member State

In the letter received by the Commission on 13 February 2015, Finland emphasised the role of the cyclical situation and the solidarity operations in the accumulation of debt. Finland also drew attention to the government's Structural Policy programme agreed in August 2013, consolidation measures decided for 2015 and beyond, and the sale of government assets in order to reduce debt and to stimulate the economy as factors to be considered. The implications of solidarity operations are discussed in Section 4.4 of the current report. Section 4.1 addresses the recent structural reforms including the Structural policy programme. Consolidation measures are covered in Section 4.2 and asset sales in Section 4.3.

According to Ministry of Finance calculations (based on the Commission's 2015 winter forecast), the debt level corrected for business-cycle effects would be 55.8% of GDP in 2015 and 59.7% of GDP in 2016.

5. CONCLUSIONS

General government gross debt is planned to reach 61.2% of GDP in 2015, above the 60% of GDP reference value. The risk of breaching the reference value is confirmed by the Commission's 2015 winter forecast, which projects gross debt also at 61.2% of GDP. However, as demonstrated in this report, the planned breach is fully explained by Finland's financial support to safeguard financial stability in the euro area without which government debt would be below 60% of GDP. Additionally, 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. Finally, it should be noted that the debt ratio reflects the effects of Finland's current cyclical position.

Overall, the analysis presented in the report including the assessment of all relevant factors suggests that the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/97 should be considered as currently complied with.