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COMMISSION STAFF WORKING DOCUMENT

Analysis of the draft budgetary plan of Finland

Accompanying the document

COMMISSION OPINION

on the draft budgetary plan of Finland

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1. INTRODUCTION

Finland submitted its Draft Budgetary Plan for 2018 on 5 October 2017 in compliance with Regulation (EU) No 473/2013 of the Two-Pack. Finland is subject to the preventive arm of the Pact and should preserve a sound fiscal position which ensures compliance with the medium-term budgetary objective (MTO) taking into account the allowances linked to unusual events, to the implementation of structural reforms and to investments for which a temporary deviation is granted. As the debt ratio was 63.1% of GDP in 2016 Finland also needs to comply with the debt reduction benchmark.

Section 2 of this document presents the macroeconomic outlook underlying the Draft Budgetary Plan and provides an assessment based on the Commission 2017 autumn forecast. The following section presents the recent and planned fiscal developments, according to the Draft Budgetary Plan, including an analysis of risks to their achievement based on the Commission 2017 autumn forecast. In particular, it also includes an assessment of the measures underpinning the Draft Budgetary Plan. Section 4 assesses the recent and planned fiscal developments in 2017-2018 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. A box on the application of constrained judgement is contained in this section, given that the plausibility tool indicated that the estimate for the output gap in Finland is subject to uncertainty. Section 5 provides an analysis of the implementation of fiscal-structural reforms in response to the latest country-specific recommendations adopted by the Council in July 2017. Section 6 summarises the main conclusions of the present document.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

In 2016 Finland came out of a period of recession that had lasted four years, and output grew by 1.9%. While the Stability Programme submitted in April 2017 had forecast growth to reach 1.2% in 2017 and to accelerate to 1.8% in 2018, the Draft Budgetary Plan has revised growth expectations upwards to 2.9% in 2017 and to 2.1% in 2018.

According to the Commission 2017 autumn forecast, the Finnish economy is expected to grow by 3.3% in 2017 and by 2.7% in 2018. In the Commission forecast the key growth drivers are the same as in the Draft Budgetary Plan forecast, investment and net exports.

For 2017, the Commission forecasts a higher growth contribution from investment and net exports, but a smaller contribution from private consumption. For 2018, the Commission projects higher growth in all demand components, especially in exports of goods and services on the back of higher expectations for external demand, than does the Draft Budgetary Plan.

There are no significant differences between the inflation projections of the Commission and the Draft Budgetary Plan. Overall, the macroeconomic scenario underlying the Draft Budgetary Plan is plausible.

Risks to the macroeconomic scenario are broadly balanced. Based on the Commission 2017 autumn forecast, the Finnish economy could benefit from a higher-than-expected increase in world trade and stronger-than-anticipated recoveries in the euro area and Russia.

Box 1: The macroeconomic forecast underpinning the budget in Finland

The macroeconomic forecast underpinning the budget has been prepared by the Economics department of the Ministry of Finance. Finland is the only euro area Member State that has designated a Ministry of Finance department as the independent forecast producer in the meaning of Regulation 473/2013 of the Two-pack. The management of the Economics department is separated from the Budget department and according to the law adopted in spring 2015, the Economics department is independent in its forecasting activities.

Table 1. Comparison of macroeconomic developments and forecasts

	2016	2017			2018		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	1,9	1,2	2,9	3,3	1,8	2,1	2,7
Private consumption (% change)	1,8	1,1	2,4	2,0	1,4	1,4	1,8
Gross fixed capital formation (% change)	7,2	2,8	4,7	6,9	3,1	3,7	4,4
Exports of goods and services (% change)	1,3	2,9	4,7	9,0	5,7	3,7	5,7
Imports of goods and services (% change)	4,4	3,1	2,9	6,6	4,4	2,6	4,1
Contributions to real GDP growth:							
- Final domestic demand	2,8	1,1	2,3	2,8	1,3	1,7	2,1
- Change in inventories	-0,2	0,1	0,0	-0,2	0,1	0,0	-0,2
- Net exports	-1,2	-0,1	0,6	0,8	0,4	0,4	0,6
Output gap[1]	-2,4	-1,6	-0,8	-0,7	-0,8	-0,2	0,4
Employment (% change)	0,5	0,4	0,7	0,5	1,9	0,8	0,7
Unemployment rate (%)	8,8	8,5	8,6	8,6	7,2	8,1	8,3
Labour productivity (% change)	1,4	0,8	2,2	2,8	-0,2	1,3	2,0
HICP inflation (%)	0,4		1,0	0,9		1,5	1,3
GDP deflator (% change)	0,9	1,2	0,9	0,5	1,6	1,6	1,7
Comp. of employees (per head, % change)	1,0	-1,0	-0,4	-1,1		0,6	1,3
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-1,3	-1,4	-1,5	-1,1	-1,1	-1,6	-0,3

Note:

[1]In percent of potential GDP, with potential GDP growth recalculated by the Commission on the basis of the programme scenario using the commonly agreed methodology.

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

The Draft Budgetary Plan projection for the headline deficit in 2017, 1.2% of GDP, is significantly smaller than the projection in the 2017 Stability Programme, 2.3% of GDP (see table 2). This improvement owes to the revised macroeconomic forecast (see table 1). The Commission 2017 autumn forecast predicts the deficit at 1.4% of GDP, marginally higher than the Draft Budgetary Plan. The difference between the Commission forecast and the Draft Budgetary Plan is explained in particular by the slightly more cautious revenue projections of the Commission forecast.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2016	2017			2018			Change: 2016-2018
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**54.0**	**52.9**	***52.9***	**52.5**	**52.3**	***51.7***	**51.1**	**-2.4**
of which:								
- Taxes on production and imports	14.4	14.2	*14.0*	14.4	13.9	*13.8*	14.2	-0.6
- Current taxes on income, wealth, etc.	16.5	16.2	*16.6*	16.2	16.2	*16.2*	15.4	-0.4
- Capital taxes	0.2	0.3	*0.4*	0.2	0.3	*0.3*	0.2	0.1
- Social contributions	13.0	12.4	*12.2*	12.2	12.2	*11.9*	11.9	-1.0
- Other (residual)	9.9	9.8	*9.7*	9.6	9.7	*9.5*	9.3	-0.4
Expenditure	**55.8**	**55.2**	**54.1**	**53.9**	**53.9**	**53.1**	**52.3**	**-2.7**
of which:								
- Primary expenditure	54.7	54.3	53.1	53.0	53.0	52.2	51.4	-2.5
of which:								
Compensation of employees	13.3		12.4	12.6		12.0	12.1	-1.3
Intermediate consumption	10.8		10.6	10.7		10.5	10.4	-0.3
Social payments	22.5	22.6	22.1	21.9	21.9	21.8	21.3	-0.7
Subsidies	1.2	1.2	1.2	1.2	1.2	1.2	1.1	-0.1
Gross fixed capital formation	4.0	3.9	3.9	3.9	4.0	4.0	3.9	0.0
Other (residual)	2.9	n.a.	2.9	2.7	n.a.	2.7	2.6	-0.2
- Interest expenditure	1.1	0.9	1.0	1.0	0.9	0.9	0.9	-0.2
General government balance (GGB)	**-1.7**	**-2.3**	**-1.2**	**-1.4**	**-1.6**	**-1.4**	**-1.2**	**0.3**
Primary balance	**-0.7**	**-1.4**	**-0.2**	**-0.4**	**-0.7**	**-0.5**	**-0.3**	**0.1**
One-off and other temporary measures	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.1	-0.1
GGB excl. one-offs	**-1.7**	**-2.3**	**-1.2**	**-1.4**	**-1.5**	**-1.4**	**-1.2**	**0.4**
Output gap[1]	-2.4	-1.6	-0.8	-0.7	-0.8	-0.2	0.4	2.0
Cyclically-adjusted balance[1]	-0.4	-1.4	-0.7	-1.0	-1.1	-1.3	-1.4	-0.8
Structural balance (SB)[2]	**-0.4**	**-1.4**	**-0.7**	**-1.0**	**-1.0**	**-1.2**	**-1.4**	**-0.7**
Structural primary balance[2]	0.7	-0.5	0.3	-0.1	-0.1	-0.3	-0.4	-0.9

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the DBP/programme as recalculated by Commission on the basis of the DBP/programme scenario using the commonly agreed methodology.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

According to the Draft Budgetary Plan, the nominal deficit is projected to increase narrowly in 2018, to 1.4% of GDP. The planned deficit is again smaller than in the Stability Programme, which projected the deficit at 1.6% of GDP. In the Draft Budgetary Plan, the projected decline in public consumption explains the lower forecast for the expenditure-to-GDP ratio in 2018 than expected in the Stability Programme. This seems plausible as the government has a consolidation strategy which concentrates mainly on reducing government expenditure. In addition, the upward revision of nominal GDP reduces the deficit-to-GDP ratio. The Commission 2017 autumn forecast predicts a slightly smaller deficit at 1.2% of GDP than the Draft Budgetary Plan on the back of a more positive economic outlook.

Euro area sovereign bond yields remain at historically low levels, with 10-year rates in Finland currently standing at 0.5[1]. As a consequence, total interest payments by the general government have continued to decrease as a share of GDP. Based on the information included in the Draft Budgetary Plan, interest expenditure is expected to fall from 1.1% of GDP in 2016 to 1.0% in 2017 and to decrease further next year, to 0.9% of GDP. These levels are well below the 1.4% of GDP recorded in 2012 at the peak of the euro area sovereign debt crisis. However, the low interest rate environment lowers the revenues from government assets. In 2016, government assets amounted to 130% of GDP, largely owing to the statutory pension funds that are included in the general government sector. As government debt amounted to 63.1% of GDP in 2016, the loss in revenues from assets due to low interest rates more than outweighs the savings on government interest payments. This development has weakened also Finland's structural balance over the last years.

The structural balance, as recalculated by DG ECFIN using the commonly agreed methodology on the basis of the Draft Budgetary Plan's macroeconomic scenario, is expected to deteriorate by 0.5% of GDP to -1.2% of GDP in 2018.[2] The recalculated structural balance in 2018 was projected at -1.0% of GDP on the basis of the Stability Programme. Similarly, the Commission 2017 autumn forecast predicts a deterioration of the structural balance in 2017-2018. According to the Commission, the structural balance would be -1.4% of GDP in 2018.

Against the background of falling interest expenditure and revenue, since 2013, the structural primary balance has deteriorated more (or improved less) than the structural balance. In 2017 the projected deterioration in the structural balanceis still accompanied by a more pronounced deterioration in the structural primary balance with a difference estimated at 0.1 percentage point of GDP .

The Finnish authorities indicated in the 2017 Stability Programme that the budgetary impact of the additional costs related to the exceptional inflow of refugees is significant and should be considered as an unusual event outside the control of the government, as defined in Article 5.1 and Article 6.3 of Regulation (EC) No 1466/97.

In the 2017 Stability Programme, Finland stated that the expenditure was 0.34% of GDP in 2016 and would decline to 0.19% of GDP in 2017 while Finland’s Draft Budgetary Plan for 2018 does not present any information on expenditure related to the inflow of refugees.

On the basis of the information in the Stability Programme, the Commission's provisional assessment indicates that the three-year carry-forward effect of expenditure in relation to costs considered to have a clear and direct link to refugee inflows would merit for an allowance of 0.22% of GDP in 2017.and 0.17% of GDP in 2018. However, if the projected decline in the expenditure as reported in the Stability Programme would materialise fully, the allowance would be reduced to 0.07% of GDP in 2017 and very close to zero in 2018. The Commission

[1] 10-year bond yields as of 6 November 2017. Source: Bloomberg

[2] Cyclically-adjusted balance net of one-off and temporary measures, recalculated by the Commission on the basis of the information provided in the Draft Budgetary Plan, using the commonly agreed methodology.

will make a final assessment, including on the eligible amounts, in spring 2018 on the basis of observed data as provided by the authorities.

The 2017 Draft Budgetary Plan presented a formal request to avail of the flexibility available under the preventive arm for 2017 pursuant to the "Commonly agreed position on Flexibility within the Stability and Growth Pact" endorsed by the ECOFIN Council in February 2016. Finland requested a temporary deviation of 0.6% of GDP from the adjustment path towards the MTO in view of the planned implementation of major structural reforms with a positive impact on the long-term sustainability of public finances (0.5% of GDP) and national investment expenditures on projects co-financed by the EU under the European Structural and Investment Funds (0.1% of GDP). In July 2017, Finland was granted the flexibility as requested and therefore the carry-forward effect of these allowances in 2018 is 0.6% of GDP.

3.2. Debt developments

According to the revised estimate as validated by Eurostat, Finland's gross public debt was 63.6% of GDP in 2015 and declined to 63.1% of GDP in 2016. The Draft Budgetary Plan expects the debt ratio to decline further to 62.5% in 2017 and 61.9% in 2018. This constantly declining path for the debt ratio is somewhat different from that in the Stability Programme which projected a stabilisation of the debt ratio in 2018 and a decline thereafter. The Commission 2017 autumn forecast confirms the declining path of the debt-to-GDP ratio and projects debt at 62.1% of GDP in 2018.

Earlier, Finland's debt increased due to the relatively high primary deficits but also due to the stock-flow adjustments. These adjustments were driven by the statutory earnings-related pension system, which is included in the general government sector and is partly pre-funded.[3] The pension funds are in surplus, but this surplus has declined over the recent years due to lower interest revenues on the funds' interest-bearing assets. In 2016, the surplus was 1.1% of GDP and would be included in table 3 as net accumulation of financial assets under stock-flow adjustment, as the surplus is not used to pay off central government or local government debt.

However, in 2016, the debt-to-GDP ratio declined owing to factors other than the primary balance (in deficit), interest expenditure (increases the nominal deficit) or the net accumulation of financial assets as described above. Government debt declined due to a reduction of central government cash funds and the reduced volume of security deposits related to derivative contracts.[4] These factors were larger than the net accumulation of financial assets and therefore exceptionally the stock-flow adjustment reduced the debt ratio.

[3] Reflecting the assets of the pension funds, Finland's general government net financial assets amounted to 53.4% of GDP in 2016, second highest among the OECD countries (most countries have large net liabilities). OECD Economic Outlook, June 2017.

[4] Ministry of Finance, Economic Survey, Autumn 2017

Table 3. Debt developments

(% of GDP)	2016	2017			2018		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**63.1**	**64.7**	**62.5**	**62.7**	**64.5**	**61.9**	**62.1**
Change in the ratio	-0.5	1.6	-0.5	-0.4	-0.2	-0.6	-0.6
Contributions[2] *:*							
1. Primary balance	**0.7**	**1.4**	**0.2**	**0.4**	**0.7**	**0.5**	**0.3**
2. "Snow-ball" effect	**-0.7**	**-0.6**	**-1.4**	**-1.3**	**-1.2**	**-1.3**	**-1.7**
Of which:							
Interest expenditure	1.1	0.9	1.0	1.0	0.9	0.9	0.9
Growth effect	-1.2	-0.7	-1.7	-2.0	-1.1	-1.3	-1.6
Inflation effect	-0.6	-0.7	-0.6	-0.3	-1.0	-1.0	-1.0
3. Stock-flow adjustment	**-0.5**	**0.8**	**0.6**	**0.5**	**0.3**	**0.2**	**0.9**
Of which:							
Cash/accruals difference							
Net accumulation of financial							
of which privatisation proceeds							
Valuation effect & residual							

Notes:

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

3.3. Measures underpinning the draft budgetary plan

Table 4 A describes the main discretionary revenue measures that are reported in the Draft Budgetary Plan. Table 4 B presents the total of expenditure measures, as reported in the Draft Budgetary Plan, without a detailed breakdown into national accounts items.

The cuts in the taxation of earned income and lowered social security contributions in 2017 and 2018 reduce planned government revenues. The government decided on these tax cuts to compensate employees for the increase in their share of overall social security contributions, as agreed in the Competitiveness Pact in 2016 (while the total amount of contributions were lowered to reduce wage costs to employers. Besides reducing the taxation of earned income, the government has increased indirect taxation on items such as fuel, tobacco and alcohol and it has increased the lower and upper limits of real estate taxes from which the revenue is allocated to the municipalities. This gradual shift from labour to indirect taxation lowers the tax wedge on labour income.

The government consolidates public finances mainly through cuts in central government expenditure cuts. These cuts will continue in 2018 and 2019. Savings arise in particular from social transfers, which are not adjusted to the increase in the consumer price index. The planned size of savings is deemed plausible in 2018.

Table 4. Main discretionary measures reported in the Draft Budgetary Plan

A. Discretionary measures taken by General Government - revenue side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2017	**2018**	**2019**
Taxes on production and	0.0	0.0	0.0
Current taxes on income,	-0.3	-0.2	0.0
Capital taxes			
Social contributions	-0.5	-0.1	0.1
Property Income			
Other			
Total	-0.8	-0.3	0.1

Note:
The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that revenue increases as a consequence of this measure.
Source: Draft Budgetary Plan for 2018

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2017	**2018**	**2019**
Compensation of employees			
Intermediate consumption			
Social payments			
Interest Expenditure			
Subsidies			
Gross fixed capital formation			
Capital transfers			
Other			
Total	-0.9	-0.2	0.2

Note:
The DBP does not present expenditure measures by national account components.
The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that expenditure increases as a consequence of this measure.
Source: Draft Budgetary Plan for 2018

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Finland is subject to the preventive arm of the Pact and should ensure sufficient progress towards its MTO, -0.5% of GDP. Box 2 reports the latest country-specific recommendations in the area of public finances. Finland is also subject to the debt reduction benchmark.

Box 2. Council recommendations addressed to Finland

On 11 July 2017, the Council addressed recommendations to Finland in the context of the European Semester. In particular, in the area of public finances the Council recommended Finland to pursue its fiscal policy in line with the requirements of the preventive arm of the Stability and Growth Pact, which entails achieving its medium-term budgetary objective in 2018, taking into account the allowances linked to unusual events, the implementation of the structural reforms and investments for which a temporary deviation is granted.

The Council recalled that based on the Commission 2017 spring forecast Finland should ensure that the nominal growth rate of net primary government expenditure in 2018 does not exceed 1.6%, corresponding to an improvement in the structural balance by 0.1% of GDP. However, in view of the Commission 2017 autumn forecast that Finland will be closer to its MTO in 2017 and in line with the arrangements in place for updating the fiscal requirements contained in the country-specific recommendations[5], the nominal growth rate of net primary government expenditure should not exceed 2.1%, corresponding to an allowed deterioration in the structural balance by 0.2% of GDP.

4.1. Compliance with the debt criterion

As its public debt exceeds the 60% of GDP reference value of the Treaty, Finland needs to comply with the debt reduction benchmark. On 22 May 2017, the Commission issued a report in accordance with Article 126(3) of the Treaty in which it concluded that the debt criterion should be considered as currently complied with following an assessment of the relevant factors, such as compliance with the preventive arm requirements and effects of the cycle to the debt ratio. The Commission stated in the conclusions that the swift adoption and implementation of structural reforms increasing productivity and the supply of labour would be key to enhance Finland's growth prospects in the medium term, which would contribute to improve fiscal sustainability.

The Draft Budgetary Plan projects the debt-to-GDP ratio to decline in 2017 and 2018. The Commission 2017 autumn forecast has a similarly declining, but slightly more cautious path for the debt. Nonetheless, Finland is projected to comply with the debt reduction benchmark in 2017 and 2018 according to the Commission forecast and therefore the Draft Budgetary Plan projection with slightly steeper decline should also fulfil the debt reduction benchmark.

[5] These arrangements, known as the 'unfreezing' principle, are referred to in the Opinion of the Economic and Financial Committee of the Council on "Improving the predictability and transparency of the SGP: A stronger focus on the expenditure benchmark in the preventive arm", of 29 November 2016, and have been specified further in subsequent discussions with the Member States.

Table 6. Compliance with the debt criterion*

	2016	2017			2018		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio	63.1	64.7	62.5	62.7	64.5	61.9	62.1
Gap to the debt benchmark [1,2]				-1.5			-1.1
Structural adjustment [3]	0.3	-0.4	-0.2	-0.7	0.3	-0.5	-0.3
To be compared to:							
Required adjustment [4]							

Notes:

[1] Not relevant for Member Sates that were subject to an EDP procedure in November 2011 and for a period of three years following the correction of the excessive deficit.

[2] Shows the difference between the debt-to-GDP ratio and the debt benchmark. If positive, projected gross debt-to-GDP ratio does not comply with the debt reduction benchmark.

[3] Applicable only during the transition period of three years from the correction of the excessive deficit for EDP that were ongoing in November 2011.

[4] Defines the remaining minimum annual structural adjustment over the transition period which ensures that – if followed – Member State will comply with the debt reduction benchmark at the end of the transition period, assuming that COM (SP) budgetary projections for the previous years are achieved.

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

* An ex-ante assessment of planned compliance with the debt criterion can be based on the Draft Budgetary Plan only for the concerned countries providing extended data series (i.e. covering years up to t+4) in the DPB on a voluntary basis, as agreed at the EFC-A on 22 September 2014 and reflected in the updated Code of Conduct of the two-pack..

4.2. Adjustment towards the MTO

The Council recommended on 12 July 2016 that Finland should achieve an annual fiscal adjustment of at least 0.6 % of GDP in 2017. In the light of the Commission 2017 autumn forecast, it appears that the required adjustment for 2017 is negative, meaning that Finland is allowed to worsen its fiscal position in structural terms by 1% of GDP. This allowed deterioration takes into account the temporary allowances linked to the structural reform clause and the investment clause, as well as the previously granted allowance on the basis of unusual event (inflow of refugees), which are carried forward for a period of three years, and an estimated structural balance in the previous year that was slightly above the MTO. The 1% of GDP deterioration corresponds to a growth rate of government expenditure, net of discretionary revenue measures and one-offs, of 1.9% (in real terms). According to the information provided in the Draft Budgetary Plan, the real growth rate of government expenditure, net of revenue measures and one-offs, will not exceed the applicable expenditure benchmark rate. The structural balance pillar on the basis of the recalculated output gap also points to compliance. The Commission forecast confirms these projections, as both pillars similarly point to compliance. This conclusion would not change in case the expected drop in refugee related costs, as reported in the Stability Programme, was to be taken into account in the assessment.

Box 3. Implementation of the "constrained judgement" approach and its impact on fiscal surveillance

The April 2016 Amsterdam Informal ECOFIN Council requested that improvements be made to the commonly agreed methodology for the estimation of potential growth and the output gap. In response, it was agreed, alongside a revision of the methodology for the estimation of the non-accelerating wage rate of unemployment, to introduce a "constrained judgement" approach for cases where the commonly agreed methodology appears to produce "counterintuitive" output gap results for individual Member States. This has already been implemented in the assessment of the 2017 Draft Budgetary Plans and the 2017 Stability and Convergence Programmes.

The objective of the "constrained judgement" approach is to have a transparent and economically grounded tool to statistically test the plausibility of the output gap estimates for individual Member States estimated on the basis of the common method. To this end, the Commission developed an objective screening tool - based on a set of cyclically relevant indicators as well as thresholds/ranges - to signal cases where the outcomes of the commonly agreed methodology could be interpreted as being subject to a large degree of uncertainty and therefore deserving of further investigation on the part of the Commission. If this plausibility tool flags the estimate of a Member State's output gap using the common methodology, the Commission carries out an "in depth" analysis which could lead to the application of a "constrained" degree of judgement in conducting Member States' budgetary assessments.

Regarding Finland, the plausibility tool provided indications that the output gap for 2017, estimated on the basis of the common methodology, is subject to uncertainty. The plausibility tool suggests that the output gap could be estimated at -1.5% of potential GDP instead of -0.7% as estimated on the basis of the common methodology. The factors underlying the plausibility tool are capacity utilisation, short-term unemployment rate, slack in the economy, (lagged) GDP growth and wage developments. Three of these factors seem to reach values above their long-run averages in 2017 while the indicator for short-run unemployment would end up only marginally below its long-run average. The nominal wage indicator is projected to decline in 2017 which would point to a larger negative output gap. However, in 2017, it is difficult to separate the cyclical and structural drivers for wage developments due to the implementation of the Competitiveness Pact, and therefore the indicator for wages could be considered as an outlier from the other four factors.

On the basis of these considerations the Commission does not see sufficient ground to deviate from the output gap estimated on the basis of the commonly agreed methodology. This estimate coincides with the latest output gap estimate of the IMF (-0.7%) while the OECD has recently projected a somewhat larger estimate for the gap (-1.4%).

In 2018, Finland is required to respect its MTO (-0.5% of GDP) taking into account the temporary deviations on the basis of unusual event clause, the structural reform clause and the investment clause, which are carried forward for three years. In addition, on the basis of the Commission 2017 autumn forecast, the structural balance in the previous year is estimated closer to the MTO than before. This would translate into an allowed deterioration of 0.2% of

GDP which corresponds to a reference rate of 2.1% for nominal growth of government expenditure, corrected for discretionary revenue measures and one-offs.

According to the information provided in the Draft Budgetary Plan, the nominal growth rate of government expenditure in 2018[6], net of discretionary revenue measures and one-offs, will not exceed the applicable expenditure benchmark rate. The recalculated structural balance is projected to deviate by 0.3% of GDP from the required adjustment. This calls for an overall assessment. It appears that the change in the structural balance pillar in 2018 is negatively impacted by significant revenue shortfalls, of about 0.6 % of GDP, driven by less tax-rich growth than suggested by standard elasticities. Taking this factor into account, the Draft Budgetary Plan for 2018 is found to be compliant with the required adjustment.

Based on Commission 2017 autumn forecast, the nominal growth rate of government expenditure in 2018, net of discretionary revenue measures and one-offs, will not exceed the applicable expenditure benchmark rate, while the change in the structural balance would deviate by 0.1% of GDP from the required adjustment. As above, the expected change in the structural balance is negatively impacted by significant revenue shortfalls. If corrected for those, the structural balance would point to compliance. Therefore, the Draft Budgetary Plan for 2018 is compliant with the preventive arm requirements in 2018. This conclusion would not change in case the expected drop in refugee related costs as reported in the Stability Programme was to be taken into account in the assessment.

Following an overall assessment based on the Draft Budgetary Plan and the Commission 2017 autumn forecast, the adjustment path towards the MTO seems to be in line with the requirement of the preventive arm of the Pact in 2017 and 2018.

[6] As part of the agreement on the EFC Opinion on "Improving the predictability and transparency the SGP: a stronger focus on the expenditure benchmark in the preventive arm", which was adopted by the EFC on 29 November 2016, the expenditure benchmark, that is the maximum allowable growth rate of expenditure net of discretionary revenue measures, is expressed in nominal terms as from 2018.

Table 7: Compliance with the requirements of the preventive arm

(% of GDP)	2016	2017		2018	
Initial position[1]					
Medium-term objective (MTO)	-0.5	-0.5		-0.5	
Structural balance[2] (COM)	-0.4	-1.0		-1.4	
Structural balance based on freezing (COM)	-0.4	-1.0		-	
Position vis-a -vis the MTO[3]	At or above the MTO	At or above the MTO		Not at MTO	
(% of GDP)	**2016**	**2017**		**2018**	
	COM	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.0	0.0		0.5	
Required adjustment corrected[5]	0.2	-1.0		-0.2	
Change in structural balance[6]	0.3	-0.2	-0.7	-0.5	-0.3
One-year deviation from the required adjustment [7]	-0.1	0.7	0.3	-0.3	-0.1
Two-year average deviation from the required adjustment [7]	0.1	0.3	0.1	0.2	0.1
Expenditure benchmark pillar					
Applicable reference rate[8]	0.4	1.9		2.1	
One-year deviation adjusted for one-offs [9]	0.5	0.8	1.0	0.0	0.3
Two-year average deviation adjusted for one-offs [9]	0.7	0.6	0.7	0.4	0.6
PER MEMORIAM: One-year deviation [10]	0.6	0.8	1.0	-0.1	0.2
PER MEMORIAM: Two-year average deviation [10]	0.6	0.7	0.8	0.3	0.6
Conclusion					
Conclusion over one year	Overall assessment	Compliance	Compliance	Overall assessment	Overall assessment
Conclusion over two years	Compliance	Compliance	Compliance	Compliance	Compliance

Notes

[1] The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance = cyclically-adjusted government balance excluding one-off measures.

[3] Based on the relevant structural balance at year t-1.

[4] Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 38.).

[5] Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[6] Change in the structural balance compared to year t-1. Ex post assessment (for 2016) was carried out on the basis of Commission 2017 spring forecast.

[7] The difference of the change in the structural balance and the corrected required adjustment.

[8] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.

[9] Deviation of the growth rate of public expenditure net of discretionary revenue measures, revenue increases mandated by law and one-offs from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

[10] Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

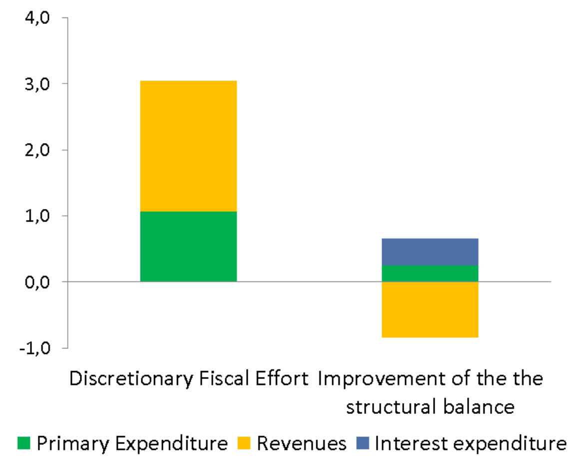
Source :

Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations.

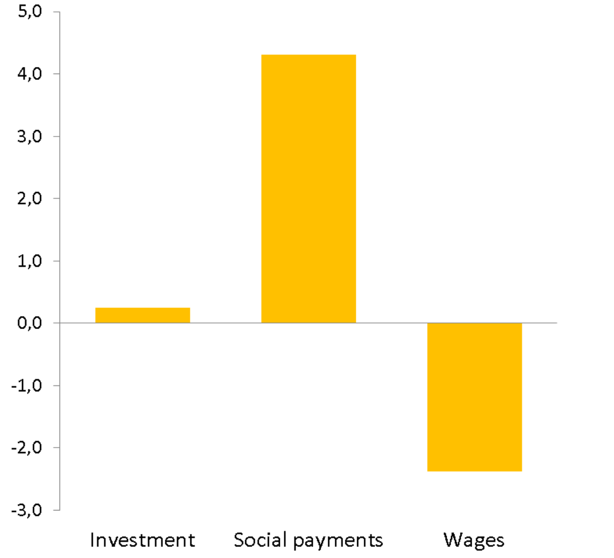
5. Composition of public finances and Implementation of fiscal structural reforms

The current government, which took office in 2015, has consolidated public finances mainly by reducing central government expenditure. At the same time, taxes on earned income have been reduced, and indirect taxes and excise duties have been increased. Over the 2011-2017 period, the discretionary fiscal effort is mainly driven by increased revenues (graph 1). However, the 2017 structural balance is broadly at the same level as it was in 2011: Falling tax revenues and falling property income of the pension funds have offset the structural improvement on the expenditure side, where in addition to discretionary expenditure cuts, low interest rates have reduced interest expenditures. The spending on social payments has increased over the past years, as population ageing has increased pension spending and the 2012-2015 economic downturn increased unemployment insurance expenditure (graph 2). The public wage bill has come down gradually over time and more recently also due to the measures in the Competitiveness Pact (wage freeze in 2017 and a temporary reduction in annual holiday bonuses).

Graph 1: Composition of the fiscal effort (2011-2017), Finland (% GDP)



Graph 2: Change in the share in total expenditure of selected expenditure items (2011-2017), Finland (% change)



Source:

Draft Budgetary Plans 2018, European Commission 2017 autumn forecast. Graph 1 shows the Discretionary Fiscal Effort (DFE) which combines a top-down approach on the expenditure side with a bottom-up or narrative approach on the revenue side. In a nutshell, the DFE consists of the increase in primary expenditure net of cyclical components relative to economic potential on the one hand, and of discretionary revenue measures on the other hand. See European Commission (2013): Measuring the fiscal effort, Report on Public Finances in EMU, part 3 http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee-2013-4.pdf

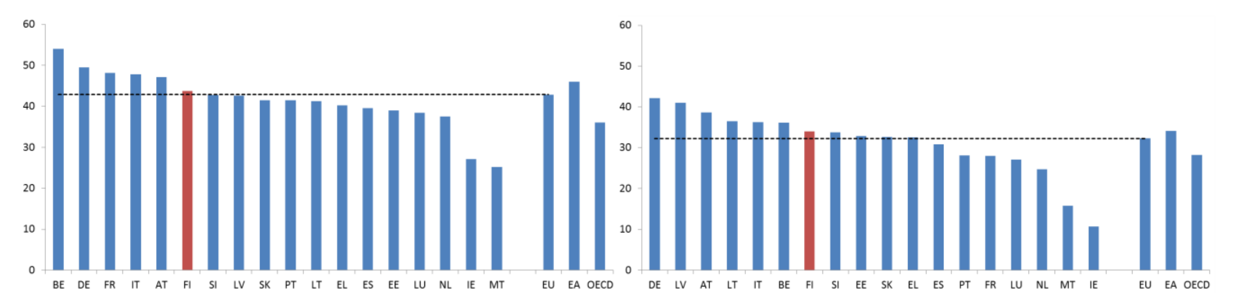
Besides the gradual tax shift away from taxation of earned income (favouring small income earners) towards indirect taxes on items such as energy, tobacco and alcohol, as well as real estate tax, Finland is currently not pursuing any ambitious tax reform nor has it been given any fiscal structural country-specific recommendation.

Box 4 – Addressing the tax burden on labour in the euro area

The tax burden on labour in the euro area is relatively high, which weighs on economic activity and employment. Against this background, the Eurogroup has expressed a commitment to reduce the tax burden on labour. On 12 September 2015, the Eurogroup agreed to benchmark euro area Member States' tax burden on labour against the GDP-weighted EU average, relying in the first instance on indicators measuring the tax wedge on labour for a single worker at average wage and a single worker at low wage. It also agreed to relate these numbers to the OECD average for purposes of broader comparability.

The tax wedge on labour measures the difference between the total labour costs to employ a worker and the worker’s net earnings. It is made up of personal income taxes and employer and employee social security contributions. The higher the tax wedge, the higher the disincentives to take up work or hire new staff. The graphs below show the tax wedge in Finland for a single worker earning respectively the average wage and a low wage (50% of the average) compared to the EU average.

The tax burden on labour in Finland at the average wage and at low wage (2016)



Notes: No recent data is available for Cyprus. EU and EA averages are GDP-weighted. The OECD average is not weighted.

Source: European Commission Tax and Benefit Indicator database based on OECD data.

Benchmarking is only the first step in the process towards firm country-specific policy conclusions. The tax burden on labour interacts with a wide variety of other policy elements such as the benefit system and the wage-setting system. A good employment performance indicates that the need to reduce labour taxation may be less urgent while fiscal constraints can dictate that labour tax cuts should be fully offset by other revenue-enhancing or expenditure-reducing measures. In-depth country-specific analysis is necessary before drawing policy conclusions.

Finland's Draft Budgetary Plan contains the following measures that affect the tax wedge on labour: reduction of personal income tax and changes to social security contributions. The measures follow from the Competitiveness Pact which came in force in 2017 (see the more detailed discussion in the staff working document[1] of the Draft Budgetary Plan for 2017. According to the Pact, employers' contributions to social security will be shifted towards employees in 2018. In addition, it's been decided that unemployment insurance contributions will be reduced by 0.2 percentage point as of 2018 as the number of unemployed is projected to decrease. The government will compensate employees for the shift through a cut in personal income tax. As customary, the government also will adjust the central government labour income tax-brackets according to expected increases in wages in 2018. These measures are not financed and will therefore lower general government revenues.

[1] C(2016) 8006 final

Finland was granted in 2017 the use of the structural reform clause mainly on the basis of the Competitiveness Pact. The aim of the Pact was to reduce labour costs to employers to regain cost competitiveness by reducing employers' contributions to social security, by freezing wages for 12 months, and by increasing annual working time without additional compensation. In the public sector, the annual holiday bonus is temporarily lowered by 30% in 2017-2019. The Pact has improved cost competitiveness: salaries have increased only marginally in 2017 in the private sector, while in the public sector, wages have come down.

6. OVERALL CONCLUSION

Following an overall assessment of the Draft Budgetary Plan for 2018, the planned structural adjustment is concluded to be in line with the required adjustment path towards the MTO both in 2017 and 2018. Similarly, following an overall assessment based on the Commission 2017 autumn forecast, Finland is not projected to deviate from the adjustment path towards the MTO recommended by the Council both in 2017 and 2018. Finland's debt-to-GDP ratio is projected to decline in line with the debt reduction benchmark in 2017 and 2018.