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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**

{C(2018) 8017 final}

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## 1. INTRODUCTION

Finland submitted its Draft Budgetary Plan for 2019 on 4 October 2018 in compliance with Regulation (EU) No 473/2013 of the Two-Pack. Finland is subject to the preventive arm of the Pact and should ensure sufficient progress towards its medium-term budgetary objective (MTO).

Section 2 of this document presents the macroeconomic outlook underlying the Draft Budgetary Plan and provides an assessment based on the Commission 2018 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 2018 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 2018-2019 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. 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 2018. Section 6 summarises the main conclusions of the present document.

## 2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

Finland is experiencing a third year of robust economic growth as output grew by 2.5% in 2016 and 2.8% in 2017. While the Stability Programme submitted in April 2018 had forecast growth to reach 2.6% in 2018 and to slow down to 2.2% in 2018, the Draft Budgetary Plan has revised growth expectations upwards to 3.0% in 2018 and downwards to 1.7% in 2019.

According to the Commission 2018 autumn forecast, the Finnish economy is expected to grow by 2.9% in 2018 and by 2.2% in 2019. In the Commission forecast growth is expected to be broad based, driven mainly by private consumption and investment, similar to the forecast that is the basis of the Draft Budgetary Plan.

For 2018, the Commission forecasts a higher growth contribution from private consumption, but a smaller contribution from net exports. Contribution from investment is the same in both forecasts. For 2019, the Commission projects higher growth in all domestic demand components, which explains the more optimistic outlook, but is remains more pessimistic on net exports.

There are no significant differences between the HICP inflation projections of the Commission and the Draft Budgetary Plan, while the GDP deflator for 2018 is lower in the

Commission forecast Overall, the macroeconomic scenario underlying the Draft Budgetary Plan is plausible for 2018 and cautious for 2019.

Risks to the macroeconomic scenario are tilted to the downside. In both the Commission 2018 autumn forecast and the Draft Budgetary Plan the main risks lie in the worsening external environment.

**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**

| | 2017 | 2018 | | | 2019 | | |
|---|---|---|---|---|---|---|---|
| | COM | SP | DBP | COM | SP | DBP | COM |
| Real GDP (% change) | 2.8 | 2.6 | 3.0 | 2.9 | 2.2 | 1.7 | 2.2 |
| Private consumption (% change) | 1.3 | 1.8 | 2.1 | 2.4 | 1.5 | 1.6 | 2.1 |
| Gross fixed capital formation (% change) | 4.0 | 3.6 | 4.1 | 4.1 | 3.8 | 1.5 | 2.2 |
| Exports of goods and services (% change) | 7.5 | 6.1 | 4.9 | 4.2 | 4.8 | 3.9 | 3.9 |
| Imports of goods and services (% change) | 3.5 | 4.3 | 3.5 | 3.2 | 3.9 | 3.0 | 3.1 |
| *Contributions to real GDP growth:* | | | | | | | |
| - Final domestic demand | 1.5 | 1.9 | 2.2 | 2.7 | 1.8 | 1.3 | 2.1 |
| - Change in inventories | 0.1 | 0.0 | 0.3 | -0.2 | 0.0 | 0.0 | -0.3 |
| - Net exports | 1.4 | 0.7 | 0.6 | 0.4 | 0.4 | 0.3 | 0.3 |
| Output gap[1] | -0.8 | 0.1 | 0.9 | 0.3 | 0.5 | 1.1 | 0.6 |
| Employment (% change) | 1.2 | 1.8 | 2.6 | 2.2 | 1.0 | 0.9 | 1.1 |
| Unemployment rate (%) | 8.6 | 8.1 | 7.4 | 7.8 | 7.5 | 6.9 | 7.2 |
| Labour productivity (% change) | 1.6 | 0.8 | 0.4 | 0.6 | 1.2 | 0.7 | 1.1 |
| HICP inflation (%) | 0.8 | 1.2 | 1.1 | 1.2 | 1.4 | 1.4 | 1.6 |
| GDP deflator (% change) | 0.8 | 1.5 | 1.6 | 0.9 | 2.0 | 1.8 | 1.6 |
| Comp. of employees (per head, % change) | -1.2 | 1.1 | 0.8 | 1.4 | 2.1 | 1.8 | 2.2 |
| Net lending/borrowing vis-à-vis the rest of the world (% of GDP) | 0.7 | 0.8 | 0.5 | 0.6 | 0.9 | 0.7 | 1.0 |

Note:

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

*Source:*

*Stability Programme 2018 (SP); Draft Budgetary Plan for 2019 (DBP); Commission 2018 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 2018 is 0.7% of GDP, slightly bigger than the projection in the 2018 Stability Programme of 0.6% of GDP (see table 2). This deterioration is estimated against the up-side revision of the macroeconomic forecast (see table 1). The Commission 2018 autumn forecast predicts the deficit at 0.8% of GDP, marginally higher than the Draft Budgetary Plan. The difference between the Commission forecast and the Draft Budgetary Plan is explained mainly by the lower Commission projection of nominal GDP.

**Table 2. Composition of the budgetary adjustment**

| (% of GDP) | 2017 | 2018 | | | 2019 | | | Change: 2017-2019 |
|---|---|---|---|---|---|---|---|---|
| | COM | SP | DBP | COM | SP | DBP | COM | DBP |
| **Revenue** | **53.3** | **52.1** | **51.9** | **52.2** | **51.8** | **51.8** | **51.9** | **-1.5** |
| *of which:* | | | | | | | | |
| - Taxes on production and imports | 14.1 | 13.8 | 13.9 | 14.0 | 13.6 | 13.8 | 13.9 | -0.3 |
| - Current taxes on income, wealth, etc. | 16.6 | 16.4 | 16.0 | 16.1 | 16.5 | 16.3 | 16.5 | -0.3 |
| - Capital taxes | 0.4 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | -0.1 |
| - Social contributions | 12.2 | 12.0 | 12.0 | 12.0 | 11.9 | 11.7 | 11.7 | -0.5 |
| - Other (residual) | 10.0 | 9.6 | 9.7 | 9.7 | 9.5 | 9.7 | 9.5 | -0.3 |
| **Expenditure** | **54.0** | **52.7** | **52.6** | **52.9** | **52.0** | **51.9** | **52.1** | **-2.1** |
| *of which:* | | | | | | | | |
| - Primary expenditure | 53.0 | 51.8 | 51.7 | 52.1 | 51.1 | 51.1 | 51.3 | -1.9 |
| *of which:* | | | | | | | | |
| Compensation of employees | 12.5 | | 12.1 | 12.2 | | 11.9 | 12.1 | -0.6 |
| Intermediate consumption | 10.7 | | 10.5 | 10.6 | | 10.5 | 10.4 | -0.2 |
| Social payments | 21.9 | 21.5 | 21.3 | 21.5 | 21.1 | 21.1 | 21.2 | -0.8 |
| Subsidies | 1.2 | 1.1 | 1.2 | 1.2 | 1.1 | 1.1 | 1.1 | -0.1 |
| Gross fixed capital formation | 4.1 | 3.9 | 4.0 | 4.0 | 3.9 | 3.8 | 3.8 | -0.3 |
| Other (residual) | 2.6 | n.a. | 2.6 | 2.6 | n.a. | 2.7 | 2.6 | 0.1 |
| - Interest expenditure | 1.0 | 0.9 | 0.9 | 0.9 | 0.8 | 0.8 | 0.8 | -0.2 |
| **General government balance (GGB)** | **-0.7** | **-0.6** | **-0.7** | **-0.8** | **-0.2** | **-0.1** | **-0.2** | **0.6** |
| **Primary balance** | **0.3** | **0.3** | **0.2** | **0.1** | **0.7** | **0.7** | **0.6** | **0.4** |
| One-off and other temporary measures | 0.0 | -0.1 | -0.1 | -0.1 | 0.1 | 0.1 | 0.1 | 0.1 |
| **GGB excl. one-offs** | **-0.7** | **-0.5** | **-0.6** | **-0.7** | **-0.3** | **-0.2** | **-0.3** | **0.5** |
| Output gap[1] | -0.8 | 0.1 | 0.9 | 0.3 | 0.5 | 1.1 | 0.6 | 1.6 |
| Cyclically-adjusted balance[1] | -0.2 | -0.6 | -1.2 | -0.9 | -0.5 | -0.7 | -0.5 | -0.3 |
| **Structural balance (SB)[2]** | **-0.2** | **-0.6** | **-1.1** | **-0.8** | **-0.6** | **-0.8** | **-0.6** | **-0.4** |
| Structural primary balance[2] | 0.8 | 0.3 | -0.2 | 0.0 | 0.3 | 0.0 | 0.2 | -0.6 |

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 2018 (SP); Draft Budgetary Plan for 2019 (DBP); Commission 2018 autumn forecast (COM); Commission calculations*

According to the Draft Budgetary Plan, the nominal deficit is projected to decrease substantially in 2019, to 0.1% of GDP. The planned deficit is marginally smaller than in the Stability Programme, which projected the deficit at 0.2% of GDP. This difference is explained by the projected small reduction in public investment in the Draft Budgetary Plan compared to the Stability Programme. The Commission 2018 autumn forecast predicts a slightly bigger deficit than the Draft Budgetary Plan, of 0.2% of GDP, despite a more positive economic outlook. This is mainly explained by the Commission's more cautious assumptions on revenue elasticities.

Euro area sovereign bond yields remain at low levels, with 10-year rates in Finland currently standing at 0.7%[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% of GDP in 2016 to 0.9% in 2018 and to decrease further next year, to 0.8% 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 also lowers the revenues from government assets. In 2017, government assets amounted to 135% 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 2017, the loss in revenues from assets due to low interest rates more than outweighs the savings on government interest payments. This development has weakened Finland's structural balance over the last years.

The structural balance, as recalculated by the Commission using the commonly agreed methodology on the basis of the Draft Budgetary Plan's macroeconomic scenario, is expected to improve by 0.3% of GDP compared to 2018 to -0.8% of GDP in 2019[2] (-0.6% of GDP on the basis of the Stability Programme). Similarly, the Commission 2018 autumn forecast predicts an improvement of the structural balance in 2019. According to the Commission, the structural balance will be -0.6% of GDP in 2019.

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 2019 still, the projected improvement in the structural balance is accompanied by a more subdued improvement in the structural primary balance estimated at 0.2 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 (0.05% of GDP in 2015 and an additional 0.17% of GDP in 2016) 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.

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 1) the planned implementation of major structural reforms, in particular the 2017 pension reform and the Competitiveness Pact, with a positive impact on the long-term sustainability of public finances (0.5% of GDP) and 2) national investment expenditures on projects co-financed by the EU under the European Structural and Investment Funds (0.1% of GDP).

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[1] 10-year bond yields as of 24 October 2018. 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.

As regards the investment clause, however, the eligibility criteria require an increase in public investment. Outturn data for 2017 available in spring 2018 showed a decrease in public investment in 2017 compared to the previous year while the investment linked to Union funds is estimated to have remained stable. Thereby, Finland was no longer considered eligible for a temporary deviation of 0.1% of GDP in relation to national investment expenditure in projects co-financed by the EU.

A Member State that is at, or close to, its MTO is allowed to depart from it for three years and therefore the flexibility granted in a given year is carried forward for the next two years. This is the case of Finland, for which the temporary deviations from the adjustment path towards the MTO granted in relation to costs considered to have a clear and direct link to refugee inflows and implementation of structural reforms are carried forward so that they cover a period of three years. The cumulated allowed deviations amount to 0.72% of GDP in 2017, 0.67% of GDP in 2018 and 0.5% of GDP in 2019.

### 3.2. Debt developments

According to the revised estimate as validated by Eurostat, Finland's gross public debt was 63.0% of GDP in 2016 and declined to 61.3% of GDP in 2017. The Draft Budgetary Plan expects the debt ratio to decline further to 59.9% in 2018 and 59.1% in 2019. This constantly declining path for the debt ratio is somewhat more optimistic from that in the Stability Programme, which projected a smaller decrease of the debt ratio in 2018 and a bigger decline in 2019, eventually bringing the debt ratio to similar level. The Commission 2018 autumn forecast confirms the declining path of the debt-to-GDP ratio and projects debt at 58.5% of GDP in 2019.

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, which, however, has declined over recent years due to lower interest revenues on the funds' interest-bearing assets. In 2017, the surplus was 0.9% of GDP[4] and was 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.

In 2017, the debt-to-GDP ratio declined owing mainly to the growth effect and inflation effect. Primary balance and stock-flow adjustments were also positive factors against the negative effect of interest expenditure.

[3] Reflecting the assets of the pension funds, Finland's general government net financial assets amounted to 59% of GDP in 2017, second highest among the OECD countries (most countries have large net liabilities). OECD Economic Outlook, May 2018.

[4] Finish Ministry of Finance (2018) Economic Survey Autumn 2018, September 2018

**Table 3. Debt developments**

| (% of GDP) | 2017 | 2018 | | | 2019 | | |
|---|---|---|---|---|---|---|---|
| | | SP | DBP | COM | SP | DBP | COM |
| **Gross debt ratio[1]** | **61.3** | **60.4** | **59.9** | **59.8** | **58.9** | **59.1** | **58.5** |
| Change in the ratio | -1.7 | -0.9 | -1.4 | -1.5 | -1.5 | -0.8 | -1.4 |
| *Contributions[2] :* | | | | | | | |
| **1. Primary balance** | **-0.3** | **-0.3** | **-0.2** | **-0.1** | **-0.7** | **-0.7** | **-0.6** |
| **2. "Snow-ball" effect** | **-1.2** | **-1.6** | **-1.8** | **-1.4** | **-1.6** | **-1.2** | **-1.3** |
| *Of which:* | | | | | | | |
| Interest expenditure | 1.0 | 0.9 | 0.9 | 0.9 | 0.8 | 0.8 | 0.8 |
| Growth effect | -1.7 | -1.6 | -1.8 | -1.7 | -1.3 | -1.0 | -1.3 |
| Inflation effect | -0.5 | -0.9 | -0.9 | -0.5 | -1.2 | -1.0 | -0.9 |
| **3. Stock-flow adjustment** | **-0.2** | **1.0** | **0.6** | **0.0** | **0.8** | **1.1** | **0.6** |
| *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 2018 (SP); Draft Budgetary Plan for 2019 (DBP); Commission 2018 autumn forecast (COM); Commission calculations*

### 3.3. Measures underpinning the draft budgetary plan

Table 4 A describes the main discretionary revenue measures and Table 4 B presents the main discretionary expenditure measures as reported in the Draft Budgetary Plan.

The cuts in the taxation of earned income and lowered social security contributions in 2018 and 2019[5] reduce the 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 was lowered to reduce wage costs to employers). Beside reducing the taxation of earned income, the government has increased indirect taxation on items such as fuel, tobacco and alcohol as well as 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.

[5] Regarding 2019, the cuts in the taxation of earned income have been overcompensated by one-off measures increasing government revenues (cf. positive value in Table 4).

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

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

**A. Discretionary measures taken by General Government - revenue side**

| Components | Budgetary impact (EUR millions) (as reported by the authorities) | | |
|---|---|---|---|
| | **2018** | **2019** | **2020** |
| Taxes on production and imports | 128.9 | 392.8 | 0 |
| Current taxes on income, wealth, etc. | -332.5 | 64.4 | -227 |
| Capital taxes | | | |
| Social contributions | -443.3 | -627.2 | 0 |
| Property Income | | | |
| Other | | | |
| Total | -646.9 | -170.0 | -227.0 |

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 2019*

**B. Discretionary measures taken by general Government- expenditure side**

| Components | Budgetary impact (EUR millions) (as reported by the authorities) | | |
|---|---|---|---|
| | **2018** | **2019** | **2020** |
| Compensation of employees | | | |
| Intermediate consumption | -175.7 | -181.8 | -251.0 |
| Social payments | -351.4 | -363.6 | 0.0 |
| Interest Expenditure | | | |
| Subsidies | | | |
| Gross fixed capital formation | | | |
| Capital transfers | | | |
| Other | -175 | -181.0 | 0 |
| Total | -702.0 | -726.4 | -251.0 |

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 expenditure increases as a consequence of this measure.

*Source: Draft Budgetary Plan for 2019*

## 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.

**Box 2. Council recommendations addressed to Finland**

On 13 July 2018, the Council addressed recommendations to Finland in the context of the European Semester.[6] In particular, in the area of public finances the Council recommended Finland to achieve the medium-term budgetary objective (-0.5% of GDP) in 2019, taking into account the allowances linked to the implementation of the structural reforms for which a temporary deviation is granted. The Council recalled that based on the Commission 2018 spring forecast Finland should ensure that the nominal growth rate of net primary government expenditure in 2019 does not exceed 2.9%, corresponding to an allowed deterioration in the structural balance by 0.2% of GDP.

### 4.1. Compliance with the debt criterion

The Draft Budgetary Plan projects the debt-to-GDP ratio to decline below the reference value of the Treaty of 60% of GDP in 2018 and decline further in 2019. The Commission 2018 autumn forecast has a similarly declining path for the debt. Finland is therefore projected to comply with the 60% of GDP reference value in 2018 and 2019.

**Table 5. Compliance with the debt criterion***

| | 2017 | 2018 | | | 2019 | | |
|---|---|---|---|---|---|---|---|
| | | SP | DBP | COM | SP | DBP | COM |
| Gross debt ratio | 61.3 | 60.4 | 59.9 | 59.8 | 58.9 | 59.1 | 58.5 |
| Gap to the debt benchmark [1,2] | | -2.8 | | | | | |
| Structural adjustment [3] | 0.3 | -0.4 | -0.7 | -0.6 | 0.0 | 0.3 | 0.2 |
| *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 2018 (SP); Draft Budgetary Plan for 2019 (DBP); Commission 2018 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

[6] Council Recommendation of 13 July 2018 on the 2018 National Reform Programme of Finland and delivering a Council opinion on the 2018 Stability Programme of Finland, OJ C 320, 10.9.2018, p. 112–115.

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

For 2018, the Council's fiscal recommendation, based on the Commission 2017 spring forecast, invited Finland to achieve the medium-term budgetary objective in 2018, taking into account the allowances linked to unusual events and the implementation of structural reforms. At the time, this was deemed consistent with the nominal growth rate of net primary government expenditure[7] in 2018 not not exceeding 1.6%, corresponding to an improvement in the structural balance by 0.1% of GDP. Subsequently, the Commission 2017 autumn forecast indicated that Finland would be closer to its MTO in 2017 than expected in spring. Taking into account the revised outlook[8], the applicable growth rate of government expenditure was set at 2.1%, corresponding to an allowed deterioration in the structural balance by 0.2% of GDP. Finally, taking into account the fiscal impact of the withdrawal of the investment clause, the applicable growth rate for the expenditure benchmark is considered at 1.9%, corresponding to an allowed deterioration in the structural balance by 0.1% of GDP.

According to both the information provided in the Draft Budgetary Plan and the Commission 2018 autumn forecast, the projected distance of the (recalculated) structural balance to the MTO in 2018 is below what is allowed when considering the temporary deviation granted related to unusual events and the implementation of structural reforms. Thus, the current assessment for 2018 points to compliance.

In 2019, Finland is required to respect its MTO taking into account the allowed temporary deviation. According to both the information provided in the Draft Budgetary Plan and the Commission 2018 autumn forecast, the projected distance of the (recalculated) structural balance to the MTO in 2019 is below what is allowed when considering the temporary deviation granted related to the implementation of structural reforms. Thus, the current assessment for 2019 also points to compliance.

At the same time, according to the Draft Budgetary Plan, the nominal growth rate of government expenditure in 2018 of 2.9%, net of discretionary revenue measures and one-offs, will exceed the applicable expenditure benchmark rate by 1 percentage point, or 0.5% of GDP, pointing to a risk of some deviation. The Commission 2018 autumn forecast data confirm this risk. Similarly, according to the Draft Budgetary Plan, the nominal growth rate of government expenditure in 2019 of 3.3%, net of discretionary revenue measures and one-offs, will exceed the applicable expenditure benchmark rate of 2.9% by 0.4 percentage point or 0.2% of GDP, pointing to some deviation. The two-year average deviation will exceed the

[7] As part of the agreement on the Economic and Financial Committee 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 Economic and Financial Committee 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.

[8] Following the Opinion of the Economic and Financial Committee of 29 November 2016 and the subsequent discussion and endorsement by the Committee, the "unfreezing" of the required adjustment for year t may only take place in two occasions: in autumn t-1, which in principle allows the change to be taken into account in the Member State's budget for year t before it is finally adopted, and in spring t+1, at the time of the ex post assessment of compliance with the preventive arm.

benchmark rate leading to a risk of a significant deviation (gap of 0.3% of GDP). The Commission forecast data confirm this risk. If compliance with the MTO taking into account the allowances linked to unusual events and the implementation of structural reforms can no longer be established in future assessments for 2018 or 2019, the overall assessment of compliance will need to take into account a possible deviation from the above-mentioned benchmark rates..

**Table 6: Compliance with the requirements of the preventive arm**

| (% of GDP) | 2017 | 2018 | | 2019 | |
|---|---|---|---|---|---|
| **Initial position**[1] | | | | | |
| Medium-term objective (MTO) | -0.5 | -0.5 | | -0.5 | |
| Structural balance[2] (COM) | -0.2 | -0.8 | | -0.6 | |
| Structural balance based on freezing (COM) | -1.0 | -0.8 | | - | |
| **Position vis-a -vis the MTO**[3] | At or above the MTO | At or above the MTO | | Not at MTO | |
| (% of GDP) | **2017** | **2018** | | **2019** | |
| | **COM** | **DBP** | **COM** | **DBP** | **COM** |
| **Structural balance pillar** | | | | | |
| Required adjustment[4] | 0.0 | 0.5 | | 0.3 | |
| Required adjustment corrected[5] | -0.9 | -0.1 | | -0.2 | |
| Change in structural balance[6] | 0.5 | -0.7 | -0.6 | 0.3 | 0.2 |
| *One-year deviation from the required adjustment* [7] | 1.4 | -0.6 | -0.5 | 0.4 | 0.4 |
| *Two-year average deviation from the required adjustment* [7] | 0.6 | 0.4 | 0.4 | -0.1 | -0.1 |
| **Expenditure benchmark pillar** | | | | | |
| Applicable reference rate[8] | 1.7 | 1.9 | | 2.9 | |
| *One-year deviation adjusted for one-offs* [9] | 1.1 | -0.5 | -0.4 | -0.2 | -0.2 |
| *Two-year average deviation adjusted for one-offs* [9] | 0.8 | 0.3 | 0.3 | -0.3 | -0.3 |

*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 20XX-1) was carried out on the basis of Commission 20XX 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.

*Source* :

*Draft Budgetary Plan for 2019 (DBP); Commission 2018 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. 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 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). This trend, however, may reverse in next years as wage growth pressures are increasing amidst favourable cyclical conditions.

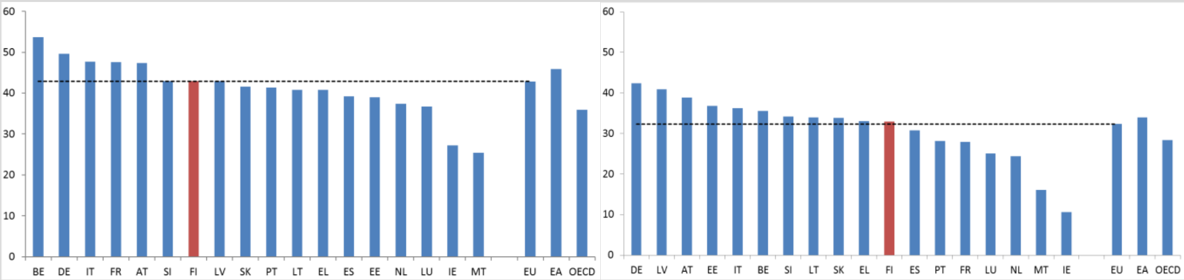
Besides the gradual tax shift away from taxation of earned income (favouring small income earners) towards indirect taxes on items such as energy, tobacco and alcohol, as well as real estate tax, Finland is currently not pursuing any ambitious tax reform.

**Box 3. 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 (2017)**




*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 (see Table 4). 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 were shifted towards employees in 2018. In addition, unemployment insurance contributions have been reduced by 0.2 percentage point as of 2018 as the number of unemployed is projected to decrease. The government compensated 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 and 2019. These measures are financed by reduction in the government intermediate consumption and cuts of other expenditures.

[1] C(2016) 8006 final

For 2019, the Council's fiscal-structural recommendation invited Finland to ensure the adoption and implementation of the administrative reform to improve cost-effectiveness and equal access to social and healthcare services. The ageing population and the rising age-related expenditure remain concerns for the long-term sustainability of Finnish public finances. The Draft Budgetary Plan highlights the SOTE (i.e. social and healthcare reform) and Regional Reform that are to come into effect as of the beginning of 2021. The prepared administrative reform and the reform of the social and healthcare services aim at reducing expenditure growth in this area and ensuring equal access to healthcare. The reforms are currently under discussion in the Parliament but, contrary to what had been initially announced, will likely not be adopted by the end of 2018. With elections expected in April next year, this might be the last opportunity for the current coalition government to pass these reforms.

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

Finland's debt-to-GDP ratio is projected to decline below the 60% reference value in 2018 and 2019.

Based on both the information contained in the Draft Budgetary Plan and the Commission 2018 autumn forecast, the structural balance is expected to meet the medium-term objective both in 2018 and 2019, taking into account the relevant allowances. If such achievement of the medium-term objective is not confirmed in future assessments, the overall assessment of compliance will need to take into account the extent of the deviation from the requirement set by the Council.