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**Assessment of the 2016 Stability Programme for
Finland**

(Note prepared by DG ECFIN staff)

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1. INTRODUCTION

This document assesses Finland's April 2016 Stability Programme (hereafter called Stability Programme), which was submitted to the Commission on 14 April 2016. The programme covers the years 2016 to 2020. It was approved by the government as part of the general government fiscal plan, which serves as Finland's medium-term budgetary framework. This ensures full consistency between the Stability Programme and the medium-term budgetary framework. This document will serve as a basis for the 2017 budget.

Finland is subject to the preventive arm of the Stability and Growth Pact and should ensure sufficient progress towards its MTO. As the debt ratio was 63.1% of GDP in 2015 exceeding the 60% of GDP reference value, on 18 May 2016, the Commission issued a report under Article 126(3) TFEU investigating the reasons for the *prima facie* lack of compliance with the debt criterion¹. The report concluded that, after the assessment of all the relevant factors, the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 should be considered as currently complied with.

This document complements the Country Report published on 26 February 2016 and updates it with the information included in the Stability Programme.

Section 2 presents the macroeconomic outlook underlying the Stability Programme and provides an assessment based on the Commission 2016 spring forecast. The following section presents the recent and planned budgetary developments, according to the Stability Programme. In particular, it includes an overview on the medium term budgetary plans, an assessment of the measures underpinning the Stability Programme and a risk analysis of the budgetary plans based on the Commission forecast. Section 4 assesses compliance with the rules of the SGP, including on the basis of the Commission forecast. Section 5 provides an overview of long-term sustainability risks and Section 6 on recent developments and plans regarding the fiscal framework and the quality of public finances. Section 7 provides a summary.

2. MACROECONOMIC DEVELOPMENTS

Finland's economy came out of a 3-year recession in 2015 with real GDP increasing by 0.5 % on the back of higher private consumption. As real exports increased slightly while imports decreased, net exports improved. Investment declined in 2015 compared to 2014 but a turnaround was registered in the course of 2015.

The output gap, as recalculated by the Commission based on the information in the programme, following the commonly-agreed methodology, was -2.4 % of potential GDP in 2015.

In 2016, GDP growth is expected to accelerate to 0.9% according to the Stability Programme. Investment is expected to increase while private consumption is projected to grow slightly less dynamically than in 2015. Real exports are expected to increase but - due to increased imports - net-exports are expected to decrease. The recalculated output gap is expected to

¹ COM(2016) 292 final: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/126-03_commission/2016-05-18_fi_126-3_en.pdf

narrow and is estimated at -1.7% of potential GDP in 2016. Therefore, in 2016, Finland is still experiencing bad economic times, as the negative output gap is relatively large.

The Stability Programme projects GDP to grow by 1.2% in 2017 and by roughly the same rate over the years 2018-2019. Growth is expected to be driven by domestic demand. Overall, as the labour force is not expected to grow much and productivity growth has declined, the expectations for growth are rather modest, around 1% per year over the forecast horizon. Nonetheless, the projected growth rate of actual GDP is about twice as high as the estimated growth of potential GDP. The negative output gap is set to shrink to 1.1% in 2017 and to close in 2020.

The macroeconomic outlook in the Stability Programme is somewhat weaker than the one presented in last year's programme. The latter had forecast real GDP growth at 1.4% in 2016 and at 1.5% in 2017. The 2016 Stability Programme also revised downwards the growth projection of the 2016 Draft Budgetary Plan (DBP), where growth was forecast at 1.3% for 2016. The difference is due to lower net-exports, which more than offset the increased contribution of domestic demand.

The Commission's 2016 spring forecast projects lower growth for 2016 and 2017 compared to the Stability Programme, mainly on account of weaker consumption and investment projections. The Commission forecasts GDP to grow by 0.7% in 2016 and 2017. This is expected to lead to a 0.1 pp slower reduction in the output gap than presented in the Stability Programme projection.

Table 1: Comparison of macroeconomic developments and forecasts

	2015		2016		2017		2018	2019	2020
	COM	SP	COM	SP	COM	SP	SP	SP	SP
Real GDP (% change)	0.5	0.5	0.7	0.9	0.7	1.2	1.2	1.1	1.1
Private consumption (% change)	1.4	1.4	0.7	1.0	0.5	0.8	0.9	0.8	0.9
Gross fixed capital formation (% change)	-1.1	-1.1	2.5	5.2	2.1	3.3	3.0	2.8	2.0
Exports of goods and services (% change)	0.6	0.6	1.2	1.3	2.5	2.9	3.6	3.4	3.4
Imports of goods and services (% change)	-0.4	-0.4	2.0	2.6	2.4	3.0	3.5	3.4	3.4
<i>Contributions to real GDP growth:</i>									
- Final domestic demand	0.4	0.4	0.9	1.6	0.7	1.2	1.2	1.1	1.0
- Change in inventories	-1.1	-0.2	0.1	-0.2	0.0	0.0	0.0	0.0	0.0
- Net exports	0.4	0.4	-0.3	-0.5	0.0	0.0	0.1	0.0	0.0
Output gap ¹	-2.3	-2.4	-1.6	-1.7	-1.2	-1.1	-0.7	-0.4	
Employment (% change)	-0.3	-0.4	0.2	0.3	0.3	0.4	0.4	0.3	0.3
Unemployment rate (%)	9.4	9.4	9.4	9.3	9.3	9.0	8.7	8.4	8.1
Labour productivity (% change)	0.9	1.0	0.5	0.6	0.4	0.8	0.8	0.8	0.8
HICP inflation (%)	-0.2	-0.2	0.0	0.1	1.3	1.1	1.4	1.6	1.7
GDP deflator (% change)	0.4	0.4	0.8	0.7	1.0	1.1	1.4	1.8	2.0
Comp. of employees (per head, % change)	1.6	1.3	1.2	1.2	1.2	1.0	1.1	1.6	2.0
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	0.2	0.2	0.3	0.1	0.2	0.2	0.3	0.3	0.3
<i>Note:</i>									
¹ In % of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.									
<i>Source:</i>									
Commission 2016 spring forecast (COM); Stability Programme (SP).									

The projections for nominal GDP in 2016 are rather similar as 0.2 pp lower real GDP growth in the Commission's forecast is compensated by 0.1 pp larger change in the GDP deflator. In the Stability Programme, nominal GDP growth accelerates in 2017 thanks to accelerating real GDP growth, while the projection for the deflator is similar in both forecasts, close to 1%.

Overall, the differences between the growth projections in the Commission's forecast and the Stability Programme remain small and the macroeconomic assumptions underlying the programme are plausible.

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. Deficit developments in 2015

The general government deficit decreased in 2015 to 2.7% of GDP, an improvement of 0.5 pp. compared to the previous year. This is also an improvement compared to the target of -3.2% for 2015 set in the 2015 Stability Programme².

Total revenues reached 55.5% of GDP in 2015, in line with the 2015 Stability Programme. The composition of revenue items (direct and indirect taxes, social contributions and other revenue) was very close to the 2015 Stability Programme forecast.

Government expenditures amounted to 58.3% of GDP, 0.5pp lower than planned in the 2015 Stability Programme. The largest difference comes from the lower intermediate consumption and lower social transfers. Higher growth – real GDP was 0.3% and nominal GDP 0.4% higher than expected in the 2015 Stability Programme – served to contain the increase in social payments. Unemployment did not reach 9.6% as forecast in the 2015 Stability Programme but ended up slightly lower at 9.4%. Also government investment and compensation of employees were both 0.1 pp lower than expected.

There are no windfall gains for the Finnish public sector from the low interest rate environment, because the lower interest expenditure is more than offset by the lower interest revenues received by the social security funds.

The government did not take any additional measures beyond those specified in the draft budgetary plan for 2015 to lower the deficit in 2015. No one-off measures were implemented.

² In 2015, Finland submitted a Stability Programme in April and updated it in October. The April Stability Programme was submitted just before the general elections and was therefore based fully on the no policy change assumption, with no measures foreseen at that time. The government submitted an updated Stability Programme in October, together with its draft budgetary plan for 2016. The updated Stability Programme and the draft budgetary plan were based on the same macroeconomic forecast and were fully coherent. If a reference is made to the 2015 Stability Programme in this document, it refers to the October update.

3.2. Medium-term strategy and targets

The objective of the 2016 Stability Programme is to reduce the deficit from 2.7% of GDP in 2015 to 1.3% of GDP by 2020. The structural deficit, recalculated by the Commission on the basis of the information in the programme according to the commonly agreed methodology, is planned to reach 1.2% by the end of the programme period.³ This is not sufficient to reach the medium-term objective (MTO) of 0.5% structural deficit. The MTO reflects the objectives of the Pact and remains unchanged compared to the previous programme. The planned structural deficit path of the Stability Programme is based on a no-policy-change assumption, but takes into account the measures which have already been sufficiently specified.

Finland's Stability Programme foresees a nominal budgetary adjustment that is divided rather equally over the programme years. During 2017-2019, the headline balance adjustment would average 0.4pp per year. However, based on the Stability Programme scenario, the recalculated structural balance improves on average by 0.1pp per year, as the output gap is expected to close by 2020. The targets of the 2016 Stability Programme are more ambitious than the targets of the previous Stability Programme, which is explained mainly by the better outcome in 2015.

Based on the Stability Programme, Finland plans revenues to remain stable in relation to GDP and foresees expenditure-restraining measures. The Stability Programme does not account for the possible impact of the Competitiveness Pact, which is currently being negotiated by the social partners. The Pact would enter into force in 2017 and is expected to improve cost-competitiveness and the general government deficit.

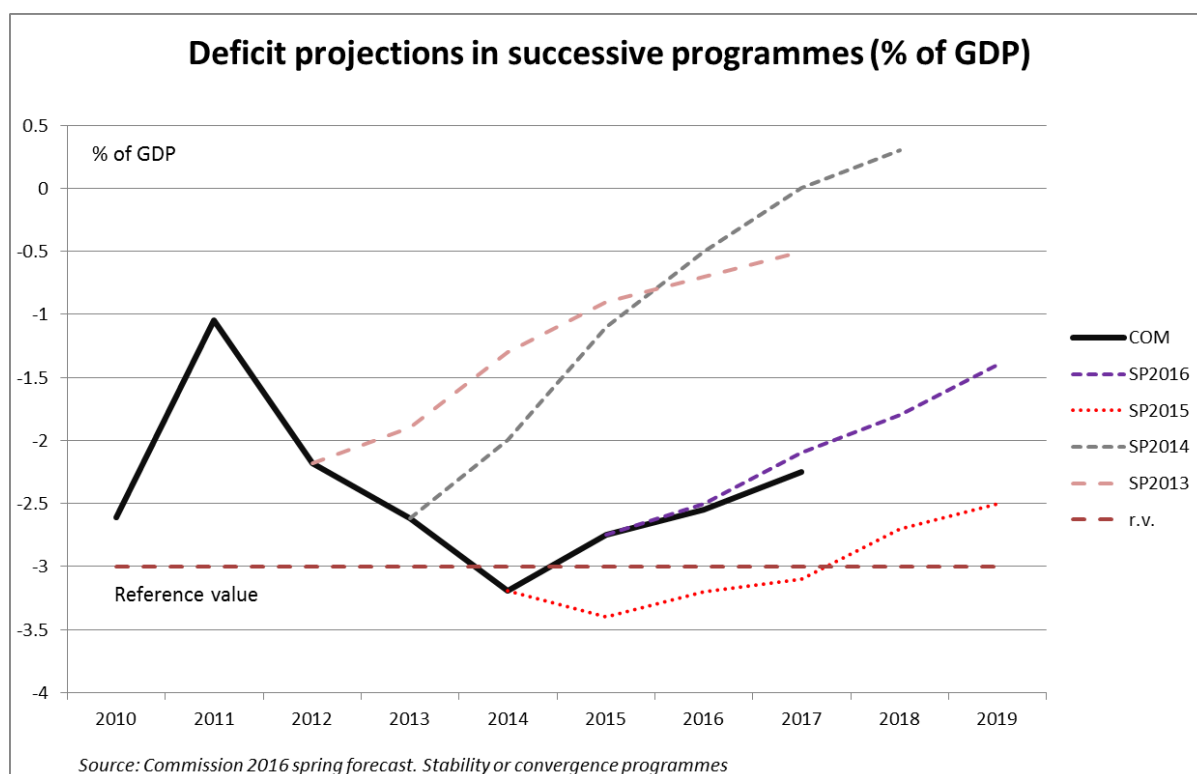
The deficit projections were optimistic in the 2013 and 2014 Stability Programmes (Figure 1). However, in the 2015 Stability Programme, the projection for the 2015 deficit outcome was pessimistic and in reality the deficit was below the Treaty reference value.

³ The government remains committed to reaching the MTO by 2019 but the planned measures are currently not sufficiently detailed in order to be included in the Stability Programme.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2015	2016		2017		2018	2019	2020	Change: 2015-2020
	COM	COM	SP	COM	SP	SP	SP	SP	SP
Revenue	55,5	55,8	55,6	55,9	55,5	55,3	55,3	55,0	-0,5
<i>of which:</i>									
- Taxes on production and imports	14,4	14,4	14,4	14,4	14,3	14,1	14,0	13,9	-0,5
- Current taxes on income, wealth, etc.	16,8	16,6	16,6	16,6	16,5	16,6	16,6	16,6	-0,2
- Social contributions	13,0	13,3	13,3	13,3	13,2	13,1	13,0	12,9	-0,1
- Other (residual)	11,3	11,5	11,3	11,6	11,5	11,5	11,7	11,6	0,3
Expenditure	58,3	58,3	58,2	58,1	57,6	57,0	56,7	56,4	-1,9
<i>of which:</i>									
- Primary expenditure	57,0	57,1	57,0	57,0	56,5	55,9	55,5	55,2	-1,8
<i>of which:</i>									
Compensation of employees	14,0	14,0	13,8	13,8	13,6	13,3	13,0	12,8	-1,2
Intermediate consumption	11,5	11,6	11,7	11,8	11,7	11,8	11,8	11,9	0,4
Social payments	22,9	23,1	23,1	23,0	23,0	22,9	22,8	22,8	-0,1
Subsidies	1,4	1,3	1,3	1,3	1,2	1,2	1,1	1,1	-0,3
Gross fixed capital formation	4,0	4,1	4,1	4,1	4,1	4,1	4,1	3,9	-0,1
Other (residual)	3,2	3,1	3,1	2,9	2,8	2,7	2,6	2,6	-0,9
- Interest expenditure	1,2	1,2	1,2	1,1	1,1	1,1	1,2	1,2	0,0
General government balance (GGB)	-2,7	-2,5	-2,5	-2,3	-2,1	-1,8	-1,4	-1,3	1,4
Primary balance	-1,5	-1,4	-1,4	-1,1	-1,0	-0,6	-0,3	-0,1	1,4
One-off and other temporary measures	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
GGB excl. one-offs	-2,7	-2,5	-2,5	-2,3	-2,1	-1,8	-1,4	-1,3	1,4
Output gap ¹	-2,3	-1,6	-1,7	-1,2	-1,1	-0,7	-0,4		n.a.
Cyclically-adjusted balance ¹	-1,4	-1,6	-1,5	-1,5	-1,5	-1,4	-1,2		n.a.
Structural balance²	-1,4	-1,6	-1,5	-1,5	-1,5	-1,4	-1,2		n.a.
Structural primary balance ²	-0,2	-0,5	-0,3	-0,4	-0,4	-0,3	0,0	n.a.	n.a.
<i>Notes:</i>									
¹ Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.									
² Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.									
<i>Source :</i>									
Stability Programme (SP); Commission 2016 spring forecasts (COM); Commission calculations.									

Figure 1: Government balance projections in successive programmes (% of GDP)



3.3. Measures underpinning the programme

The Stability Programme foresees that the measures presented in 2016 draft budgetary plan will be implemented but no additional measures are foreseen. Most important among the measures taken for 2016 are expenditure cuts which, based on the Stability Programme, amount to 0.4% of GDP. Measures increasing general government revenues include the increase in unemployment insurance contribution and increase of tobacco, waste and energy taxes. The threshold where the highest central government income tax rate applies was temporarily reduced from 90 000 euros to 72 300 euros for 2016 and 2017 and the tax deductibility of mortgage interest payments was reduced. The tax rate for capital income exceeding 30,000 euros has been raised from 33% to 34%. On the other hand, the taxation of low and medium wage incomes was eased by increasing the earned income tax credit.

For 2017 and beyond, the improvement of the general government deficit outlined in the Stability Programme relies mainly on expenditure cuts. The Stability Programme foresees to reduce administrative expenditures, but also expenditures related to transfers and the provision of services. Savings are planned from loosening the requirements on some of the services that the municipalities have to provide, therefore reducing the expenditure needs by the municipalities. In 2017, the Stability programme foresees a 0.85% cut in the CPI-indexed benefits (excluding basic social assistance). According to the Stability Programme, the already decided measures will reduce general government expenditure by 3.8 bn euros (1.9% of GDP) by 2019, compared to the expenditure at the time when the government took office in 2015.

On the revenue side in 2017 and beyond, the main aim continues to be to increase the growth friendliness of taxation without increasing the overall tax rate. The taxation of new vehicles will be gradually reduced and the revenue loss is compensated by increasing the annual road

tax and by extending the tax on new vehicles to new vehicle types. The Stability Programme plans reducing the tax deductibility of mortgage interest payments further. The fuel excise duty is going to be increased in 2017 but simultaneously the tax on sugar-containing products is eliminated. Real estate tax, which is collected by the municipalities, is expected to be increased gradually during the Stability programme horizon. Regarding the social security contributions, the earnings-related pension contributions is set to be increased by 0.4 percentage points in 2017, after which these will be frozen for 2017–2019.

Main budgetary measures

Revenue	Expenditure
2016	
<ul style="list-style-type: none"> • Reduction of direct taxes (-0.15% of GDP) • Increase of indirect taxes (0.1% of GDP) • Increase of social security contributions (0.3% of GDP) 	<ul style="list-style-type: none"> • Expenditure cuts, net (-0.4% of GDP)
2017	
<ul style="list-style-type: none"> • Reduction of direct taxes (-0.1% of GDP) • Increase of indirect taxes (0.1% of GDP) • Increase of social security contributions (0.15% of GDP) 	<ul style="list-style-type: none"> • Expenditure cuts, net (-0.7% of GDP)
2018	
<ul style="list-style-type: none"> • Reduction of direct taxes (-0.1% of GDP) • Reduction of indirect taxes (-0.05% of GDP) • Increase of social security contributions (0.05% of GDP) 	<ul style="list-style-type: none"> • Expenditure cuts, net (-0.2% of GDP)
2019	
<ul style="list-style-type: none"> • Reduction of direct taxes (-0.1% of GDP) • Increase of indirect taxes (0.05% of GDP) • Increase of social security contributions (0.05% of GDP) 	<ul style="list-style-type: none"> • Expenditure cuts, net (-0.3% of GDP)
2020	
<ul style="list-style-type: none"> • Reduction of direct taxes (-0.15% of GDP) 	<ul style="list-style-type: none"> • Expenditure cuts, net (-0.05% of GDP)
<p><u>Note:</u> The budgetary impact in the table is the impact reported in the programme, i.e. by the national authorities. A positive sign implies that revenue / expenditure increases as a consequence of this measure.</p>	

3.4. Debt developments

The general government gross debt-to-GDP ratio increased rapidly over the recent years, from 32.7% of GDP in 2008 to 63.1% of GDP in 2015, on the back of high deficits and stock-flow adjustments arising mainly from the financial investments of the earnings-related social security funds. The deficit and the stock-flow adjustment contributed roughly equally to the growth of nominal debt over these years.

In 2015, the impact of the stock-flow adjustment amounted to ca. 40% of the increase in debt-to-GDP ratio. This was caused by employment pension funds selling their holdings of central government bonds, thereby reducing the amount of intra-government sector debt that is taken into account in the general government debt consolidation process.

Finland's Stability Programme envisages public debt to increase to 65.0% of GDP in 2016 and to continue increasing to 66.7% of GDP in 2017. The debt-to-GDP ratio is planned to peak in 2018-19 at 67.4%. Thereafter, it is planned to decline marginally to 67.2% in 2020. According to the Commission 2016 spring forecast, public debt is expected to reach 65.2% of GDP in 2016 and grow to 66.9% of GDP in 2017 (Table 3).

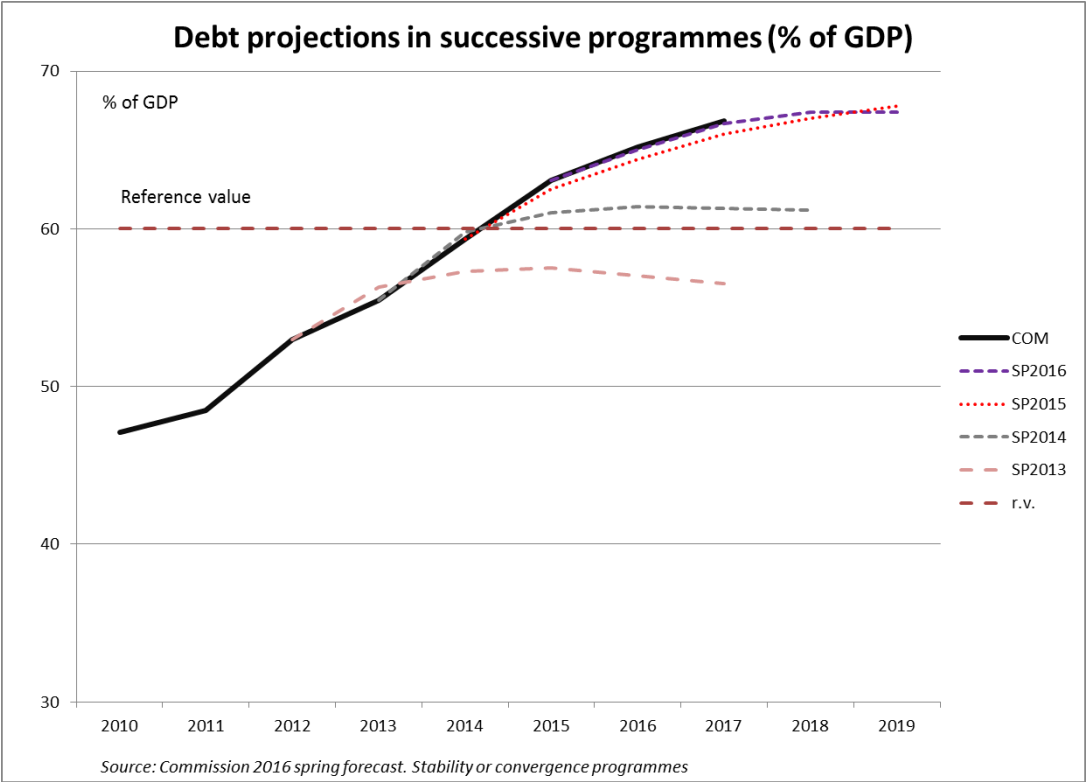
According to the Commission 2016 spring forecast, the projected nominal GDP growth is insufficient to offset the impact of interest expenditure on the debt ratio in 2016, resulting in a small debt-increasing "snowball-effect". By 2017 however, the "snowball-effect" is set to fade out as inflation, measured by the GDP deflator, is expected to accelerate. The role of stock-flow adjustments declines over the forecast horizon, as the surplus of the social security funds is expected to diminish.

Table 3: Debt developments

(% of GDP)	Average 2010-2014	2015	2016		2017		2018	2019	2020
			COM	SP	COM	SP	SP	SP	SP
Gross debt ratio¹	52,7	63,1	65,2	65,0	66,9	66,7	67,4	67,4	67,2
Change in the ratio	3,5	3,8	2,1	1,9	1,7	1,7	0,7	0,0	-0,2
<i>Contributions² :</i>									
1. Primary balance	1,0	1,5	1,4	1,4	1,1	1,0	0,6	0,3	0,1
2. "Snow-ball" effect	0,2	0,7	0,2	0,1	0,0	-0,4	-0,5	-0,8	-0,7
<i>Of which:</i>									
Interest expenditure	1,3	1,2	1,2	1,1	1,1	1,1	1,2	1,1	1,2
Growth effect	-0,2	-0,3	-0,4	-0,6	-0,5	-0,8	-0,8	-0,7	-0,7
Inflation effect	-1,0	-0,2	-0,5	-0,4	-0,6	-0,7	-0,9	-1,2	-1,2
3. Stock-flow adjustment	2,4	1,6	0,5	0,4	0,5	1,1	0,6	0,5	0,5
<i>Of which:</i>									
Cash/accruals diff.				0,0		0,0	0,0	0,0	0,0
Acc. financial assets				1,3		1,2	1,0	0,9	0,8
<i>Privatisation</i>				-0,4		-0,2	-0,2	-0,2	-0,2
Val. effect & residual				-1,9		-1,6	-2,0	-2,3	-2,3
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 effects.									
<i>Source :</i>									
Commission 2016 spring forecast (COM); Stability Programme (SP), Commission calculations.									

The debt projections have been overly optimistic in the earlier Stability Programmes (Figure 2). However, compared to the 2015 Stability Programme, the 2016 programme does not introduce substantial differences.

Figure 2: Government debt projections in successive programmes (% of GDP)



3.5. Risk assessment

For 2016, the Stability Programme macroeconomic scenario is relatively close to the Commission 2016 spring forecast.

In 2017 the Stability Programme foresees 0.5pp higher GDP growth than the Commission spring forecast. Related to this, both the deficit and debt are projected to be lower in 2017 in the Stability Programme than in the Commission 2016 spring forecast.

The main uncertainty surrounding the 2017 macroeconomic forecasts (both of the Commission and the Stability Programme) is related to labour market developments. On 29 February 2016, the central labour market organisations reached an agreement, referred to as the Competitiveness Pact, to increase, from 2017, annual working time by 24 hours without additional compensation, not to carry out any centrally agreed wage increases in 2017 and to shift social security contributions more towards the employees, so that the costs for employers would be lower. Public sector employees' holiday bonuses would be temporarily reduced by 30%.

Employer and employee organisations have started sectoral collective agreement negotiations on introducing the terms of the Competitiveness Pact into industry level agreements. By the end of May 2016 these negotiations are expected to be completed. In case the coverage in terms of employees is not sufficient, it is possible that the Pact will not be implemented. In addition to increasing cost-competitiveness and increasing exports, a wide endorsement of the Pact by the social partners could also have an uncertainty-reducing impact on the economy,

which could encourage investment and growth. Neither the Stability Programme nor the Commission 2016 spring forecast have taken the Competitiveness Pact into account.

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

4.1. Compliance with the debt criterion

On the basis of the validated budgetary data for 2015, the general government gross debt ratio increased to 63.1% of GDP last year, above the 60%-of-GDP reference value in the Treaty. The Commission has therefore prepared a report under Article 126(3) TFEU investigating the reasons for the *prima facie* lack of compliance with the debt criterion.

Moreover, the 2016 Stability Programme plans the general government gross debt to reach 65.0% of GDP in 2016 and 66.7% of GDP in 2017. Similarly, the Commission 2016 spring forecast projects gross debt above the reference value, at 65.2% of GDP in 2016 and at 66.9% of GDP in 2017.

The report concluded that, after the assessment of all the relevant factors, the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 should be considered as currently complied with. However, the Commission noted that Finland's debt-to-GDP ratio has been on an increasing trend, and that it is forecast to continue rising over the medium term under a no-policy-change assumption. Therefore, the Commission urged Finland to swiftly adopt and implement the structural reforms targeted at increasing productivity and supply of labour in order to enhance its growth prospects in the medium term.

4.2. Compliance with the MTO or the required adjustment path towards the MTO

Box 1. Council recommendations addressed to Finland

On 14 July 2015, the Council addressed recommendations to Finland in the context of the European Semester. In particular, in the area of public finances the Council recommended to Finland to achieve a fiscal adjustment of at least 0.1 % of GDP towards the medium-term budgetary objective in 2015 and of 0.5 % of GDP in 2016. The Council also recommended to Finland to continue the efforts to reduce the fiscal sustainability gap and to strengthen the conditions for growth.

Assessment of eligibility to the "unusual events" provision

In its 2016 Stability Programme, Finland requested that expenditure linked to additional immigration, amounting to 0.05% of GDP for 2015 and 0.2% of GDP in 2016, would be taken into account when assessing the progress towards the MTO. While the inflow of asylum seekers was higher in 2015, the budgetary impact is higher in 2016, as the expenditure on reception centre operation and reception allowances increases rapidly due to the need to cater for the already arrived asylum seekers. Also education and integration costs, as well as social transfers increase in 2016.

The provisions defined in Article 5(1) and Article 6(3) of Regulation (EC) No 1466/97 allow catering for this additional expenditure, in that the inflow of refugees is an exceptional event, its impact on Finland's public finances is significant and sustainability would not be compromised by allowing for a temporary deviation from the adjustment path towards the medium-term budgetary objective. The amounts mentioned above appear plausible. Therefore, the required adjustment towards the medium-term budgetary objective for 2015 has been reduced to take into account these costs. Regarding 2016, a final assessment, including on the eligible

amounts, will be made in spring 2017 on the basis of observed data as provided by Finland's authorities.

Adjustment towards the MTO

In 2015, the structural balance improved by 0.2% of GDP, exceeding the recommended adjustment towards the MTO, and the expenditure benchmark was met with a margin of 0.7% of GDP. Therefore, Finland was in line with the requirements of the preventive arm in 2015.

In 2016, the required adjustment towards the MTO is 0.5% of DGP. The Stability Programme plans a worsening of the structural balance by 0.1pp, pointing to a risk of a significant deviation (gap of -0.6% of GDP) from the required adjustment of 0.5% of GDP. According to the information provided in the Stability Programme, the real growth rate of government expenditure, net of discretionary revenue measures, in 2016 is planned to be 0.2% below the applicable expenditure benchmark rate (0.8%). This calls for an overall assessment. The current estimate of potential GDP growth underlying the structural balance estimate (0.0% growth) is lower than the medium-term average growth used for the expenditure benchmark (0.8%, frozen based on the Commission 2013 winter forecast). The plausibility of the latter may be questioned given that the prolonged downturn has durably affected Finland's medium-term growth prospects. Indeed, if the medium-term potential growth rate underlying the expenditure benchmark were to be updated based on the data in the Commission 2015 spring forecast (as will be the approach from 2017 onwards, whereby the requirements will be set on the basis of the Commission's spring forecast of the previous year), the expenditure benchmark would not be fully met but would indicate some deviation from the adjustment path towards the MTO.

The difference between the signals given by the two pillars also reflects the effects of lower than expected inflation. In the draft budgetary plan for 2016, submitted in November 2015, the GDP deflator was forecast at 1.2%. A similar forecast was made by the Commission in autumn 2015. In the 2016 Stability Programme, the GDP deflator is forecast at 0.7%. This negatively affects public revenues through reduced tax collection. Although most of the social security transfers are indexed to the CPI, for 2016 there was already a previous decision to freeze the index adjustments. Therefore the lower-than-expected inflation had less of an impact on the public expenditures.

Taking into account these factors, the structural balance pillar would still indicate some deviation in 2016 from the adjustment path towards the MTO. Considering these factors, the overall assessment based on the Stability Programme points to some deviation from the recommended adjustment path towards the MTO in 2016. In case the budgetary impact of the exceptional inflow of refugees was excluded from the assessment, the conclusion of the overall assessment would remain unchanged.

The overall assessment on the basis of the results of the Commission spring forecast confirms the risk of some deviation from the recommended adjustment path towards the MTO.

In 2017, Finland is recommended to improve the structural balance by 0.6% of GDP, as the economy enters into normal times and the debt-to-GDP ratio exceeds 60%. Based on the Stability Programme, the recalculated structural balance as well as the expenditure benchmark pillar point to a significant deviation from the adjustment path towards the MTO. This indicates the risk of significant deviation from the adjustment path towards the MTO in 2017. This risk is also confirmed by the Commission 2016 spring forecast, relying on the usual no-policy change assumption.

Table 4: Compliance with the requirements under the preventive arm

(% of GDP) ¹	2015	2016				2017	
Initial position¹							
Medium-term objective (MTO)	-0.50	-0.50				-0.5	
Structural balance ² (COM)	-1.4	-1.6				-1.5	
Structural balance based on freezing (COM)	-1.4	-1.6				-	
Position vis-a-vis the MTO³	Not at MTO	Not at MTO				Not at MTO	
(% of GDP)	2015	2016				2017	
	COM	SP		COM		SP	COM
		Vis-à-vis the CSR	Including additional clauses	Vis-à-vis the CSR	Including additional clauses	Vis-à-vis the CSR	
Structural balance pillar							
Required adjustment ⁴	0.1	0.5				0.6	
Required adjustment corrected ⁵	0.1	0.5	0.3	0.5	0.3	0.6	
Change in structural balance ⁶	0.2	-0.1		-0.2		0.1	0.1
<i>One-year deviation from the required adjustment⁷</i>	0.2	-0.6	-0.4	-0.7	-0.5	-0.5	-0.5
<i>Two-year average deviation from the required adjustment⁷</i>	-0.3	-0.2	-0.1	-0.3	-0.2	-0.6	-0.6
Expenditure benchmark pillar							
Applicable reference rate ⁸	0.7	-0.1	0.2	-0.1	0.2	-0.8	
<i>One-year deviation⁹</i>	0.7	0.2	0.4	0.0	0.2	-0.7	-0.7
<i>Two-year average deviation⁹</i>	0.5	0.5	0.6	0.3	0.4	-0.3	-0.4
Conclusion							
Conclusion over one year	Compliance	Overall assessment	Overall assessment	Overall assessment	Overall assessment	Significant deviation	Significant deviation
Conclusion over two years	Overall assessment	Overall assessment	Overall assessment	Overall assessment	Overall assessment	Significant deviation	Significant deviation
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 2014) is carried out on the basis of Commission 2015 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 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.							
<i>Source:</i> Stability Programme (SP); Commission 2016 spring forecast (COM); Commission calculations.							

5. FISCAL SUSTAINABILITY

The general government gross consolidated debt-to-GDP ratio stood at 63.1% of GDP in 2015. Medium-term projections building on the Commission's 2016 spring forecast expect debt to rise to close to 76% of GDP by 2026 (based on the no-policy-change scenario and under the assumption that the structural primary balance evolves according to the Commission's 2016 spring forecast until 2017). The debt ratio therefore remains above the 60%-of-GDP Treaty threshold. The increase in debt would be mostly driven by the costs of ageing. Based on the Stability Programme scenario, which assumes that the budgetary plans in the programme are fully implemented, the debt-to-GDP ratio would increase more slowly, reaching ca 72% by 2026.

Finland is assessed to be at low risk of fiscal stress in the short term, but at high sustainability risk in the medium term and medium risk in the long term due to the budgetary impact of the cost of ageing. Based on the Stability Programme scenario, the medium term sustainability risk would be medium, narrowly under the threshold of high risk. The policy focus should be on containing age-related expenditure growth further so as to contribute to the sustainability of public finances in the medium and long run. The impact of the latest pension reform, which was legislated in autumn 2015, will be included in the assessment once the Economic Policy Committee has conducted its peer review, following Finland's request.

Table 5: Sustainability indicators

<i>Time horizon</i>	No-policy Change Scenario		Stability / Convergence Programme Scenario	
Short Term	LOW risk			
S0 indicator ^[1]	0.2			
Fiscal subindex (2015)	0.2	LOW risk		
Financial & competitiveness subindex (2015)	0.2	LOW risk		
Medium Term	HIGH risk			
DSA ^[2]	HIGH risk			
S1 indicator ^[3]	2.7	HIGH risk	2.4	MEDIUM risk
<i>of which</i>				
IBP	0.6		0.3	
Debt Requirement	0.5		0.7	
CoA	1.6		1.4	
Long Term	MEDIUM risk		MEDIUM risk	
S2 indicator ^[4]	3.3		2.6	
<i>of which</i>				
IBP	1.6		1.3	
CoA	1.7		1.3	
<i>of which</i>				
Pensions	-0.4		-0.7	
HC	0.5		0.5	
LTC	1.6		1.5	
Other	0.0		0.1	
Source: Commission services; 2016 stability/convergence programme.				
Note: the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2016 forecast until 2017. The 'stability/convergence programme' scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented over the period covered by the programme. Age-related expenditure as given in the 2015 Ageing Report.				
[1] The S0 indicator reflects up to date evidence on the role played by fiscal and financial-competitiveness variables in creating potential fiscal risks. It should be stressed that the methodology for the S0 indicator is fundamentally different from the S1 and S2 indicators. S0 is not a quantification of the required fiscal adjustment effort like the S1 and S2 indicators, but a composite indicator which estimates the extent to which there might be a risk for fiscal stress in the short-term. The critical threshold for the overall S0 indicator is 0.43. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.35 and 0.45.				
[2] Debt Sustainability Analysis (DSA) is performed around the no fiscal policy change scenario in a manner that tests the response of this scenario to different shocks presented as sensitivity tests and stochastic projections. See Fiscal Sustainability Report 2015.				
[3] The medium-term sustainability gap (S1) indicator shows the upfront adjustment effort required, in terms of a steady adjustment in the structural primary balance to be introduced over the five years after the forecast horizon, and then sustained, to bring debt ratios to 60% of GDP in 2030, including financing for any additional expenditure until the target date, arising from an ageing population. The following thresholds were used to assess the scale of the sustainability challenge: (i) if the S1 value is less than zero, the country is assigned low risk; (ii) if a structural adjustment in the primary balance of up to 0.5 p.p. of GDP per year for five years after the last year covered by the spring 2015 forecast (year 2017) is required (indicating an cumulated adjustment of 2.5 pp.), it is assigned medium risk; and, (iii) if it is greater than 2.5 (meaning a structural adjustment of more than 0.5 p.p. of GDP per year is necessary), it is assigned high risk.				
[4] The long-term sustainability gap (S2) indicator shows the immediate and permanent adjustment required to satisfy an inter-temporal budgetary constraint, including the costs of ageing. The S2 indicator has two components: i) the initial budgetary position (IBP) which gives the gap to the debt stabilising primary balance; and ii) the additional adjustment required due to the costs of ageing. The main assumption used in the derivation of S2 is that in an infinite horizon, the growth in the debt ratio is bounded by the interest rate differential (i.e. the difference between the nominal interest and the real growth rates); thereby not necessarily implying that the debt ratio will fall below the EU Treaty 60% debt threshold. The following thresholds for the S2 indicator were used: (i) if the value of S2 is lower than 2, the country is assigned low risk; (ii) if it is between 2 and 6, it is assigned medium risk; and, (iii) if it is greater than 6, it is assigned high risk.				

6. FISCAL FRAMEWORK

Finland's fiscal framework is built around the system of central government expenditure ceilings which can be considered national numerical fiscal rules. Also, the framework aims to ensure progress towards the MTO. At the beginning of the government term, the government sets the expenditure ceilings for its expected term in office. In later years, expenditure growth must comply with the ceilings put in place, adjusted for inflation developments. Cyclically sensitive expenditure falls outside the expenditure ceilings. Compliance with the expenditure ceilings does not, in itself, ensure compliance with the SGP.

The National Audit Office supervises the compliance with the expenditure ceilings and the progress towards the MTO. In its latest report⁴, the Audit Office finds that the government complied with the expenditure ceiling requirement 2015. It found, however, that the spending limits system was opaque and difficult for outsiders to monitor as the spending limits are set in real terms and therefore price level adjustments have to be made. Based on the information provided in the Stability Programme, the past, planned and forecast fiscal performance in Finland appears to comply with the requirements of the applicable national numerical fiscal rules.

Finland has also grounded in its legislation a structural structural-balance rule arising from the Fiscal Compact. Based on the legislation, the activation of the correction mechanism is linked to the significant deviation procedure at EU level.

The macroeconomic forecast underlying the Stability Programme has been prepared by the Economics department of the Ministry of Finance. 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. . The forecast is not endorsed by any other third party. Finland is the only euro area country that has chosen this type of arrangement.

The 2016 Stability Programme indicates that it is the national medium-term fiscal plan in the sense of Two-Pack Regulation 473/2013. Neither the Stability Programme nor the National Reform Programme includes indications on the expected economic returns on non-defence public investment projects that have a significant budgetary impact.

⁴ Fiscal policy monitoring report, Spring 2016: http://www.vtv.fi/files/5174/Finanssipolitiikan_valvonnan_raportti_kevat_2016.pdf

7. CONCLUSIONS

In 2015, Finland achieved an improvement of the structural balance of 0.2% of GDP, which exceeded the required adjustment towards the MTO. Also the growth rate of government expenditure, net of discretionary revenue measures, was below the applicable expenditure benchmark rate by 0.7% of GDP.

Finland's debt exceeded the 60%-of-GDP reference value in 2015 and will continue to grow until 2018 according to the programme. On 18 May 2016, the Commission issued a report under Article 126(3) TFEU investigating the reasons for the *prima facie* lack of compliance with the debt criterion. The report concluded that, after the assessment of all the relevant factors, the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 should be considered as currently complied with.

Finland plans a worsening of the structural balance of 0.1% of GDP in 2016 and an improvement of 0.1% of GDP in 2017. This path implies a deviation of 0.6% of GDP from the required adjustment path towards the MTO in 2016 and a deviation of more than 0.5% in 2017. In 2016, the growth rate of government expenditure, net of discretionary revenue measures, is planned to be equal to the applicable expenditure benchmark rate. The overall assessment shows that there is a risk of some deviation from the adjustment path towards the MTO. This risk is confirmed by the Commission forecast. In 2017, the growth rate of government expenditure, net of discretionary revenue measures, is planned to be 0.6% above the applicable expenditure benchmark rate. Therefore, there is a risk of significant deviation from the adjustment path towards the MTO. This risk is also confirmed by the Commission 2016 spring forecast results.

8. ANNEX

Table I. Macroeconomic indicators

	1998-2002	2003-2007	2008-2012	2013	2014	2015	2016	2017
Core indicators								
GDP growth rate	4.0	3.6	-0.7	-0.8	-0.7	0.5	0.7	0.7
Output gap ¹	1.5	1.0	-1.2	-2.3	-2.8	-2.3	-1.6	-1.2
HICP (annual % change)	2.1	1.0	2.7	2.2	1.2	-0.2	0.0	1.3
Domestic demand (annual % change) ²	3.1	3.6	0.1	-1.1	0.2	-0.7	0.9	0.7
Unemployment rate (% of labour force) ³	9.9	8.2	7.7	8.2	8.7	9.4	9.4	9.3
Gross fixed capital formation (% of GDP)	22.5	22.8	22.7	21.2	20.6	20.3	20.6	21.0
Gross national saving (% of GDP)	29.6	28.4	23.3	19.5	19.6	19.5	20.0	20.5
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	3.8	3.3	-0.8	-2.6	-3.2	-2.7	-2.5	-2.3
Gross debt	42.9	39.5	44.6	55.5	59.3	63.1	65.2	66.9
Net financial assets	30.6	54.8	54.1	53.8	54.4	55.2	n.a	n.a
Total revenue	53.3	51.9	52.8	54.9	54.9	55.5	55.8	55.9
Total expenditure	49.4	48.6	53.7	57.5	58.1	58.3	58.3	58.1
<i>of which: Interest</i>	2.7	1.6	1.4	1.3	1.2	1.2	1.2	1.1
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	4.0	4.0	3.2	2.3	3.5	4.7	4.4	4.5
Net financial assets; non-financial corporations	-200.2	-139.7	-104.3	-117.0	-125.2	-127.2	n.a	n.a
Net financial assets; financial corporations	4.4	0.8	-5.4	-1.0	0.8	1.5	n.a	n.a
Gross capital formation	13.2	13.3	12.3	10.9	11.1	9.8	10.1	10.4
Gross operating surplus	27.5	27.2	23.8	21.4	21.7	21.7	21.7	22.0
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	-1.1	-2.6	-1.7	-1.5	-1.9	-2.1	-1.9	-2.3
Net financial assets	66.1	66.4	54.4	66.2	67.7	70.0	n.a	n.a
Gross wages and salaries	37.3	37.7	40.0	40.4	40.1	40.1	39.9	39.7
Net property income	4.1	4.2	3.8	3.9	3.9	3.7	3.7	3.7
Current transfers received	20.0	19.2	20.8	22.9	23.7	24.1	24.3	24.3
Gross saving	4.9	4.3	5.0	5.2	4.3	4.0	4.4	4.2
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	7.1	4.5	0.7	-1.8	-1.1	0.2	0.3	0.2
Net financial assets	99.2	17.7	1.2	-1.9	2.3	0.5	n.a	n.a
Net exports of goods and services	8.8	5.1	0.9	-0.9	-0.9	0.3	0.4	0.3
Net primary income from the rest of the world	-0.7	0.4	0.8	0.3	1.0	1.1	1.0	1.0
Net capital transactions	0.1	0.1	0.1	0.1	0.1	0.1	0.0	-0.2
Tradable sector	47.8	45.8	41.3	39.0	38.6	38.2	n.a	n.a
Non tradable sector	39.6	41.6	45.9	47.0	47.5	47.9	n.a	n.a
<i>of which: Building and construction sector</i>	5.1	5.5	5.8	5.6	5.4	5.3	n.a	n.a
Real effective exchange rate (index, 2000=100)	92.1	95.4	101.2	104.3	105.8	102.2	102.2	101.2
Terms of trade goods and services (index, 2000=100)	115.0	106.8	99.8	98.1	98.8	101.1	102.0	101.8
Market performance of exports (index, 2000=100)	106.5	106.0	102.3	95.4	91.0	87.6	85.3	83.5
Notes:								
¹ The output gap constitutes the gap between the actual and potential gross domestic product at 2005 market prices.								
² The indicator on domestic demand includes stocks.								
³ Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.								
Source:								
AMECO data, Commission 2016 spring forecast								