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Assessment of the 2015 Stability Programme for

FINLAND

(Note prepared by DG ECFIN staff)

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1. INTRODUCTION

This document assesses Finland's April 2015 Stability Programme (hereafter called Stability Programme), which was submitted to the Commission on 2 April 2015 ahead the 19 April elections. Therefore, the assessment in this document is based on a no-policy-change assumption. The forecast beyond 2015 is based on the existing legislation and no new policy measures are outlined. The incoming government is expected to provide information on the planned measures in the coming weeks to underpin the 2016 budget and the outer years' fiscal plans and to submit an updated Stability Programme in autumn.

Finland is currently subject to the preventive arm of the Stability and Growth Pact and should ensure sufficient progress towards its MTO. As the debt and deficit ratios are projected to be above the Treaty reference value, the Commission has published a report under Article 126(3), which concludes that the deficit and the debt criterions of the Treaty are not considered to be complied with.

This document complements the Country Report published on 26 February 2015 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 2015 spring forecast. The following section presents the recent and projected 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 Commission forecast. Section 4 assesses compliance with the rules of the Stability and Growth Pact, including on the basis of the Commission forecast. Section 5 provides an overview on long term sustainability risks and Section 6 on recent developments and plans regarding the fiscal framework and the quality of public finances. Section 7 summarises the main conclusions.

2. MACROECONOMIC OUTLOOK

Following the recession in 2012 and 2013, Finland’s real GDP contracted by another 0.1% in 2014. While net exports improved, consumption and investment contracted further. The output gap, as recalculated by Commission based on the information in the programme, following the commonly-agreed methodology, was -2.9% of potential GDP.

In 2015, GDP is expected to increase by 0.5% according to the Stability Programme[1]. While gross fixed capital formation is expected to continue to decline, albeit at a slower pace, private consumption is expected to improve and net export is expected to continue to provide a positive contribution to economic growth. The recalculated output gap is expected to remain broadly unchanged at 2.8% of potential GDP.

The Stability Programme projects GDP to grow by 1.4% in 2016 and by roughly the same rate over the years 2017-2018. Growth is expected to be driven by domestic demand, i.e. higher consumption and a recovery in gross fixed capital formation. The contribution from net export is projected to be close to zero. The negative output gap is set to shrink to 1.7% in 2016 and to gradually close over the following years.

[1] The external scenario of the Stability Programme is similar to the Commission’s spring forecast.

The macroeconomic outlook in the Stability Programme is markedly weaker than the one presented in last year's programme, which forecast real GDP growth at 0.5% in 2014 and at 1.4% in 2015. It is also weaker than the outlook in the 2015 Draft Budgetary Plan (DBP), where growth was forecast at 1.2% for 2015. The difference is due to the lower domestic demand in the Stability Programme.

The Commission's 2015 spring forecast forecasts weaker growth for 2015 and 2016 compared to the Stability Programme, mainly as a result of weaker consumption and investment projections. Based on the Commission's forecast, GDP would grow by 0.3% in 2015 and 1.0% in 2016. This would lead to a slower reduction in the output gap compared to the Stability Programme projection.

At the same time, the Commission's forecasts a higher GDP deflator in 2015 due to different assumptions regarding the export and import prices, leading to a higher nominal GDP growth forecast (1.1% versus 0.7% in the Stability Programme). The Commission also projects a steeper increase in unemployment in 2015 and a slower decrease in 2016.

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.

Table 1: Comparison of macroeconomic developments and forecasts

	2014		2015		2016		2017	2018	2019
	COM	SP	COM	SP	COM	SP	SP	SP	SP
Real GDP (% change)	-0.1	-0.1	0.3	0.5	1.0	1.4	1.5	1.3	1.2
Private consumption (% change)	-0.2	-0.2	0.4	0.5	0.6	0.8	1.0	1.0	1.0
Gross fixed capital formation (% change)	-5.1	-5.1	-1.0	-0.4	2.5	3.7	4.1	2.5	2.3
Exports of goods and services (% change)	-0.4	-0.4	1.7	1.5	3.9	3.0	3.5	3.6	3.6
Imports of goods and services (% change)	-1.4	-1.4	1.1	1.0	3.5	2.8	3.4	3.5	3.5
Contributions to real GDP growth:									
- Final domestic demand	-1.1	-1.1	0.1	0.3	0.8	1.3	1.5	1.2	1.2
- Change in inventories	0.3	0.6	0.0	0.1	0.0	0.0	0.0	0.0	0.0
- Net exports	0.4	0.4	0.2	0.2	0.2	0.1	0.1	0.0	0.1
Output gap[1]	-2.9	-2.9	-2.7	-2.8	-1.9	-1.7	-0.8	-0.4	0.0
Employment (% change)	-0.3	-0.4	0.2	0.3	0.4	0.3	0.4	0.5	0.4
Unemployment rate (%)	8.7	8.7	9.1	8.8	9.0	8.6	8.3	7.9	7.6
Labour productivity (% change)	0.2	0.3	0.2	0.3	0.6	1.1	1.1	0.8	0.8
HICP inflation (%)	1.2	1.2	0.2	0.3	1.3	1.3	1.4	1.8	1.8
GDP deflator (% change)	1.1	1.3	1.2	0.7	1.4	1.4	1.6	1.9	1.9
Comp. of employees (per head, % change)	1.4	0.9	1.0	1.2	0.9	1.3	1.5	1.8	2.0
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-1.7	-1.2	-0.6	-0.6	-0.3	-0.5	-0.4	-0.3	-0.2

Note:

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

Source :

Commission 2015 spring forecast (COM); Stability Programme (SP).

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. Deficit developments in 2014

The general government deficit increased in 2014, reaching -3.2% of GDP, a worsening of 0.7 pp. compared to the previous year. General government expenditure increased by 2.6% and the total expenditure-to-GDP ratio reached 58.7% of GDP, which is 0.9 pp. higher than in 2013. General government revenue increased slower, by 1.7%, as was the case in previous years. The increase in expenditure was mainly driven by the increase in social transfers. As a result, the expenditure-to-GDP ratio has reached the highest level in the EU?.

The deficit in the central government sub-sector amounted to 3.7% of GDP in 2014 while it stood at 0.9% of GDP in the local government sub-sector. The social security funds remained in surplus (1.4% of GDP).

The 2014 Stability Programme projected a general government balance of -2.0 % of GDP for 2014, with ratios of expenditure and revenue to GDP both estimated to increase by 0.4 pp. in 2014 relative to 2013. The DBP of October 2014 also projected a substantially lower deficit for 2014, at 2.7% of GDP. Compared with the previous estimations, the deficit turned out higher in the central government sub-sector while the surplus in the social security funds turned out lower than expected. General government revenue amounted to 55.5% of GDP, whereas it was projected to be 55.8% of GDP in the DBP.

A detailed comparison of the 2015 Stability Programme's budgetary projections, especially for expenditure, to its precursor is not straightforward as the latter was published under ESA95 standards while the former reports figures in ESA2010. Linked to this, the end of the special treatment for swaps under the new EDP statistics implies that revenue from swap agreements, which amounted to EUR 0.7 bn or 0.3% of GDP in 2014, is no longer included in the general government balance. Target for 2015 and medium-term strategy.

The target for 2015

The Stability Programme projects under unchanged policy a deficit of 3.4% of GDP for 2015, implying a deterioration of 0.2 pp compared to 2014 both in terms of the headline balance and the structural balance. The expenditure-to-GDP ratio is projected to rise to 59.1 % of GDP (+0.5 pp. compared to the previous year) while the revenue-to-GDP ratio is projected to remain broadly unchanged. The programme implies a 0.2% of GDP deterioration in structural terms.

According to the programme, the deficit of the central government sub-sector would decrease by 0.5% of GDP. However, this is more than offset by the diminishing surplus projected for the social security funds (projected to fall from 1.4% to 0.8%% of GDP), while the deficit in local government sub-sector is set to increase slightly (from 0.9% to 1.0% of GDP).

The DBP for 2015, presented in October 2014, targeted a 2.4% of GDP general government deficit for 2015 and also pointed to a deterioration of the structural balance by 0.2 pp. in 2015. The Stability Programme takes into account the higher deficit for 2014. Total revenue target has been reduced from 55.8% of GDP in the DBP to 55.6% of GDP. Total expenditure forecast has been revised from 58.2% of GDP to 59.1% of GDP.

According to the Commission's spring 2015 forecast, the headline general government deficit would deteriorate by 0.1 pp in 2015 compared to 2014, i.e. to 3.3% of GDP. The Commission's forecast projects a further deterioration in the structural deficit by 0.2 pp, similar to the projections of the Stability Programme.

The medium-term strategy

Under the no-policy-change assumption, the programme projects the general government deficit to stay above the 3%-of-GDP reference value until 2017 included. Thereafter, the deficit would decrease to 2.7% in 2018 and to 2.5% of GDP in 2019, driven by the projected improving economic conditions. The incoming government is expected to provide additional information on the planned measures in the coming weeks and to submit an updated Stability Programme, including new fiscal targets and outlining the policy measures to achieve them, in the autumn of 2015.

The Commission's recalculation (on the basis of the information in the programme) according to the commonly-agreed methodology indicate a deterioration in the structural balance in 2016 by 0.4 pp, to -2.2% of GDP, and in 2017, by 0.4 pp to -2.6% of GDP, as expenditure decreases only modestly and the improving cyclical conditions do not produce an immediate substantial increase in revenue. Increasing social payments and costs of service provision related to ageing reduce the scope for lowering expenditure.

Finland’s MTO of -0.5% of GDP, which reflects the objectives of the Pact, would not be achieved over the programme horizon.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2014	2015		2016		2017	2018	2019	Change: 2014-2019
	COM	COM	SP	COM	SP	SP	SP	SP	SP
Revenue	**55.5**	**55.6**	**55.6**	**55.5**	**55.5**	**55.2**	**55.3**	**55.4**	**-0.1**
of which:									
- Taxes on production and imports	14.5	14.4	14.4	14.3	14.3	14.0	13.9	13.7	-0.8
- Current taxes on income, wealth, etc.	16.6	16.6	16.6	16.8	16.7	16.7	16.8	17.0	0.4
- Social contributions	12.9	13.0	13.1	12.9	13.0	13.0	12.9	12.8	-0.1
- Other (residual)	11.5	11.5	11.5	11.5	11.5	11.5	11.7	11.9	0.4
Expenditure	**58.7**	**58.9**	**59.1**	**58.7**	**58.7**	**58.3**	**58.0**	**57.9**	**-0.8**
of which:									
- Primary expenditure	57.4	57.7	57.9	57.6	57.6	57.2	56.9	56.8	-0.6
of which:									
Compensation of employees	14.3	14.1	14.2	13.8	13.9	13.6	13.4	13.3	-1.0
Intermediate consumption	11.8	11.8	12.0	12.0	12.0	12.0	12.0	12.1	0.3
Social payments	22.5	23.0	23.0	23.2	23.0	23.2	23.2	23.2	0.7
Subsidies	1.4	1.3	1.3	1.2	1.2	1.2	1.2	1.1	-0.3
Gross fixed capital formation	4.1	4.1	4.3	4.1	4.3	4.2	4.2	4.1	0.0
Other (residual)	3.4	3.3	3.2	3.2	3.2	3.0	3.0	3.0	-0.7
- Interest expenditure	1.3	1.2	1.2	1.2	1.1	1.1	1.1	1.1	-0.2
General government balance (GGB)	**-3.2**	**-3.3**	**-3.4**	**-3.2**	**-3.2**	**-3.1**	**-2.7**	**-2.5**	**0.7**
Primary balance	**-1.9**	**-2.1**	**-2.2**	**-2.1**	**-2.0**	**-2.0**	**-1.7**	**-1.4**	**0.5**
One-off and other temporary measures	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1
GGB excl. one-offs	**-3.2**	**-3.3**	**-3.4**	**-3.2**	**-3.2**	**-3.1**	**-2.7**	**-2.5**	**0.7**
Output gap[1]	-2.9	-2.7	-2.8	-1.9	-1.7	-0.8	-0.4	0.0	2.9
Cyclically-adjusted balance[1]	-1.5	-1.8	-1.8	-2.2	-2.2	-2.6	-2.5	-2.5	-1.0
Structural balance (SB)[2]	**-1.6**	**-1.8**	**-1.8**	**-2.2**	**-2.2**	**-2.6**	**-2.5**	**-2.5**	**-0.9**
Structural primary balance[2]	-0.3	-0.5	-0.6	-1.0	-1.1	-1.5	-1.4	-1.4	**-1.1**

Notes:

[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.

Source:

Stability Programme (SP); Commission 2015 spring forecasts (COM); Commission calculations.

Measures underpinning the programme

The Stability Programme incorporates all measures adopted by the government during the 2011-15 parliamentary term, including those that have an impact in 2015 and beyond, and does not contain assumptions on possible new measures to be taken by the new government.

Main budgetary measures

Revenue	**Expenditure**
2014	
• Increase of effective income tax rate (0.2% of GDP) • Taxes on capital income (0.05% of GDP) • Reduction of corporate tax rate (-0.45% of GDP) • Increase of revenue from other direct taxes (0.1% of GDP) • VAT (0.1% of GDP) • Increase of other indirect taxes (0.15% of GDP) • Increase of employers social security contributions (0.15% of GDP) • Increase of employees social security contributions (0.2% of GDP)	• Reduction of consumption expenditure (-0.05% of GDP) • Lowering the transfers to households (-0.1% of GDP) • Other transfers (-0.05%
2015	
• Decrease of effective income tax rate (-0.05% of GDP) • Taxes on capital income (0.05% of GDP) • Decrease of revenue from other direct taxes (-0.05% of GDP) • Increase of other indirect taxes (0.2% of GDP) • Increase of employers social security contributions (0.1% of GDP) • Increase of employees social security contributions (0.1% of GDP)	• Reduction of consumption expenditure (-0.2% of GDP) • Lowering the transfers to business and industry (0.05% of GDP) • Lowering the transfers to households (-0.2% of GDP) • Other transfers (-0.15% of GDP) • Lowering real investment (-0.05% of GDP)
2016	
• Increase of other indirect taxes (0.05% of GDP) • Increase of employers social security contributions (0.05% of GDP) • Increase of employees social security contributions (0.05% of GDP)	• Increasing real investment (0.05% of GDP)

Revenue	Expenditure
2017	
• Increase of employees social security contributions (0.15% of GDP)	• Reduction of consumption expenditure (-0.05% of GDP) • Lowering the transfers to business and industry (-0.05% of GDP) • Lowering the transfers to households (-0.2% of GDP) • Increasing real investment (0.05% of GDP)
Note: 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.	

The measures that have already been put forward have also been accounted for in the Commission's spring forecast. Finland's programme does not rely on one–off measures and the yields of the measures already put forward seem plausible.

3.2. Debt developments

The general government gross debt-to-GDP ratio has increased rapidly over the recent years, growing from 32.7% of GDP in 2008 to 59.3% in 2014, on the back of budgetary deficits and stock-flow adjustments. The deficit and the stock-flow adjustment contributed roughly equally to the growth of nominal debt over these years.

Finland's 2015 Stability Programme plans the debt to increase to 62.5% of GDP in 2015 and to continue increasing throughout the programme horizon to 67.8 % of GDP in 2019.

According to the Commission's spring 2015 forecast, the debt is expected to exceed the 60%-of-GDP reference value, reaching 62.6% of GDP in 2015 and 64.8% of GDP in 2016. The increase in the debt ratio is expected to decelerate over the 2016-2019 period on the back of lower primary deficit, increased economic growth and faster increase in GDP deflator.

In 2015-2016, the debt ratio increases on the back of a relatively stable primary deficit. The increase in interest payments remains contained even if debt increases over time, as the effective interest rates on debt have decreased, outweighing the effects of the increasing debt burden. Nominal growth in 2015-2016 is set to help contain the increase in the debt ratio through the denominator effect.

The stock-flow adjustment persistently drives up the general government debt in Finland. This is because the earnings-related pension system included in the general government sector is partially pre-funded and is in surplus, but the surplus is not used to pay off general government debt as the pension funds have chosen not to invest more than a small fraction of their assets into Finnish bonds. The surplus shows up as a net accumulation of assets in the stock-flow adjustment. The surplus of the pension system stood at 1.9% of GDP in 2013 and at 1.4% of GDP in 2014. In 2015, the surplus is projected to diminish to 0.8% of GDP in the Stability Programme. According to OECD data, Finland's general government net-financial-

assets position amounted to 51.3% of GDP in 2014, down from 54.6% of GDP in 2013.[2] The OECD projects net assets to amount to 45.2% of GDP by the end of 2016. Among the OECD countries, this is one of the highest positive net-financial-asset positions.

In addition, part of Finland's debt has been accumulated due to the country's contributions related to financial stabilisation operations during the financial crisis. According to the Commission's spring 2015 forecast, the cumulative impact of such assistance would amount to 2.9% of GDP in 2015. Thus, Finland's general government gross debt would be 58.3% of GDP in 2015 and 61.9% in 2016 if the debt related to financial stabilisation operations was deducted.

Table 3: Debt developments

(% of GDP)	Average 2009-2013	2014	2015		2016		2017	2018	2019
			COM	SP	COM	SP	SP	SP	SP
Gross debt ratio[1]	**49.2**	**59.3**	**62.6**	**62.5**	**64.8**	**64.4**	**66.0**	**67.0**	**67.8**
Change in the ratio	4.6	3.5	3.3	3.2	2.2	1.9	1.6	1.0	0.8
Contributions[2] :									
1. Primary balance	**0.8**	**1.9**	**2.1**	**2.2**	**2.1**	**2.0**	**2.0**	**1.7**	**1.4**
2. "Snow-ball" effect	**0.8**	**0.7**	**0.3**	**0.4**	**-0.3**	**-0.5**	**-0.8**	**-1.0**	**-1.0**
Of which:									
Interest expenditure	1.4	1.3	1.2	1.2	1.2	1.2	1.1	1.0	1.1
Growth effect	0.4	0.1	-0.2	-0.3	-0.6	-0.9	-0.9	-0.8	-0.8
Inflation effect	-0.9	-0.6	-0.7	-0.5	-0.9	-0.9	-1.0	-1.2	-1.3
3. Stock-flow adjustment	**3.0**	**0.9**	**0.9**	**0.5**	**0.5**	**0.5**	**0.4**	**0.3**	**0.4**
Of which:									
Cash/accruals diff.				0.0		0.0	0.0	0.0	1.0
Acc. financial assets				1.2		1.3	1.1	0.9	0.8
Privatisation									
Val. effect & residual				-1.4		-2.5	-2.5	-2.7	-3.4

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.

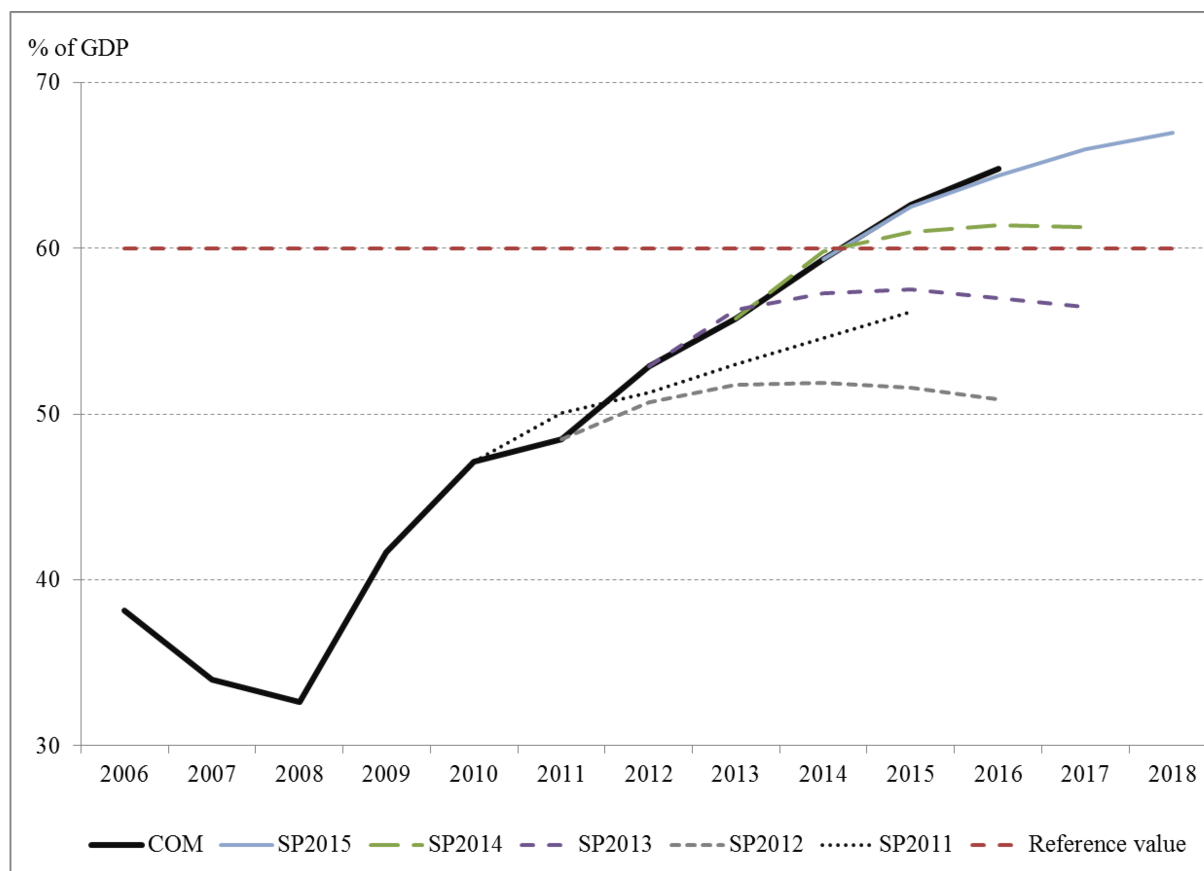
Source :

Commission 2015 spring forecast (COM); Stability Programme (SP), Commission calculations.

Debt projections have proven to have been relatively optimistic in previous Stability Programmes (Figure 1). They projected a stabilization and thereafter a decline in debt-to-GDP ratio, while in reality the debt ratio has increased steadily.

[2] OECD Economic Outlook no 93, Annex Table 33.

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



Source: Commission spring 2015 forecast; Stability Programmes

3.3. Risk assessment

Deficit developments

Taking into account that the programme is based on a no-policy-change assumption, the most significant unknown factor is the magnitude, timing and composition of fiscal measures that will be taken by the new government.

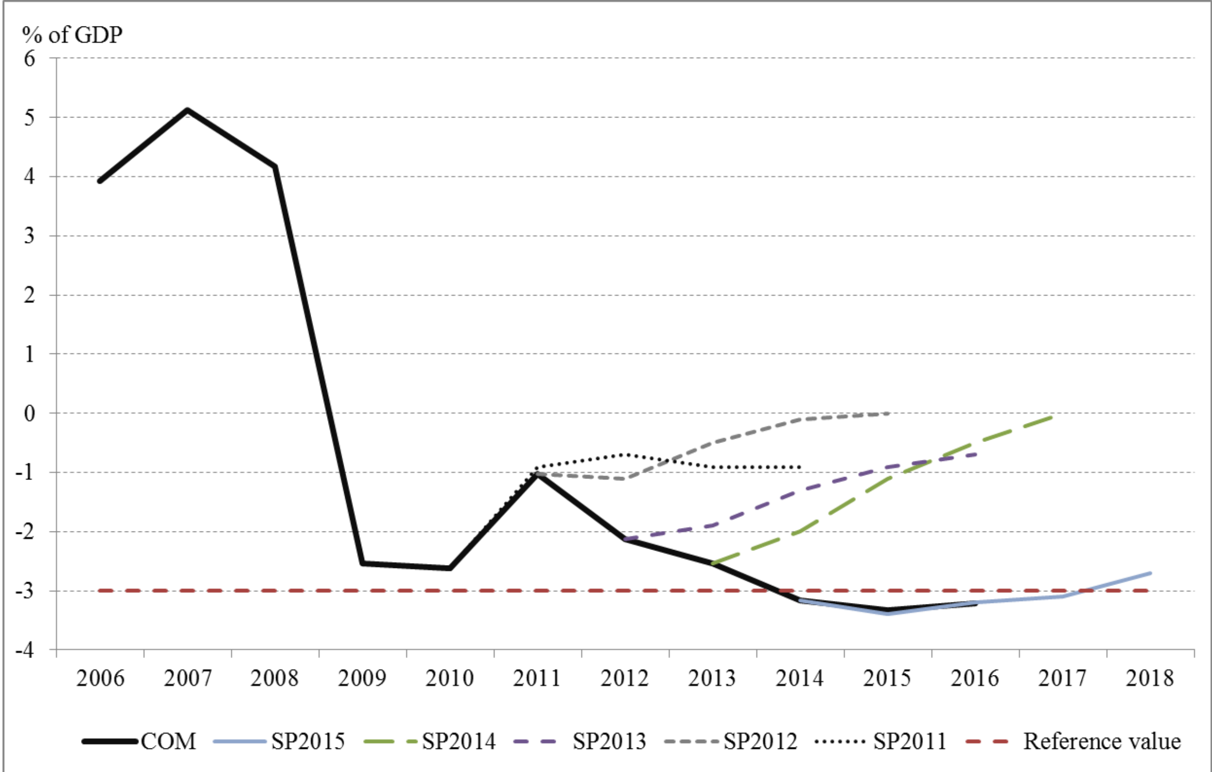
The Commission's spring 2015 forecast considers the risks to the macroeconomic outlook to be balanced. On the negative side, external demand could deteriorate further if demand from Russia surprised negatively, as Russia remains and important trading partner. This could weigh on revenue and further complicate the consolidation of public finances.

An upside risk to the macroeconomic scenario would be higher-than-expected in private consumption, as the largest banks in Finland began offering borrowers a one-year mortgage-repayment holiday early in 2015, effectively easing their credit conditions. A further upside risk, at least in the short term, relates to the development of wages. In 2015, the current wage settlement is up for re-negotiation. The Stability Programme as well as the Commission forecast assume the current general, economy-wide wage agreement, where the wage growth was set at low level, to be extended. While a higher-than-expected wage increase would weigh on competitiveness, its net impact on public finances could be positive in the short-term as higher tax revenues would only be partly compensated by higher general government wage expenditure.

Finally, the Commission's spring forecast expects a higher increase in the price level compared to the Stability Programme. If inflation is indeed higher than projected in the programme, nominal revenue could also be higher.

On the other hand, , the deficit forecasts in previous Stability Programmes have proven to have been optimistic (Figure 2). Previously, the deficit was expected to stabilize and thereafter decrease, as higher growth had been expected resulting in a more development of revenues,

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



Source: Commission 2015 spring forecast; Stability Programmes

Debt developments

Finland had central-government guarantees amounting to 19.0% of GDP in 2014. Guarantees linked to the financial sector amounted to 1.2% of GDP in 2014. Risks related to guarantees in the financial sector are therefore limited. Two thirds of the guarantees are issued to non-financial corporations, mainly through the Finnvera corporation - a specialised state-owned financing company providing guarantees for SME lending as well as export-credit guarantees.

The maturity structure of the debt is not posing any particular risks. Debt redemptions are rather equally divided over the years. Most of the debt is long-term. Debt that is not denominated in euros is coupled with corresponding derivative contracts that cover the exchange-rate risk.

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

Box 1. Council recommendations addressed to Finland

On 8 July 2014, 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 limit the emerging gap relative to the medium-term objective, ensure to return to it in 2015 and respect it thereafter as planned. Ensure that the debt criterion is fulfilled, while pursuing a growth-friendly fiscal policy. Implement rapidly the reforms set out in the structural policy programme and government spending limits and fiscal plan for 2015-2018 in order to reduce the fiscal sustainability gap and strengthen conditions for growth."

4.1. Compliance with the deficit criterion

According to the report published in accordance with Article 126 (3) of the Treaty on 13 May 2015[3], the general government deficit in Finland reached 3.2% of GDP in 2014 and is projected to stay above the 3% of GDP reference value over the forecast horizon, using the no-policy-change assumption. The excess over the reference value is therefore not temporary while it is close to it. The deficit can be considered exceptional within the meaning of the Stability and Growth Pact in 2014, but not in 2015 and 2016. When considering the relevant factors for 2014, it should be noted that there was an important deterioration in structural balance in that year. However, on balance, the relevant factors seem to indicate that there are mitigating factors for the breach of the reference value in 2014. The high general government deficit reflects the impact of the changeover to ESA 2010. Although the increase of the deficit in 2014 cannot be linked to the increase in public investments in this year, Finland's public investment expenditure exceeds the deficit. However, in 2015 and 2016, the debt breaches the 60% reference value of the Treaty while the deficit remains above 3% of GDP. The medium-term budgetary position manifested in the structural balance strongly indicates that Finland is moving away from its MTO as the cyclical conditions improve over 2015-2016. Therefore, overall, the deficit criterion in the Treaty is not considered to be complied with.

4.2. Compliance with the debt criterion

The debt ratio would reach 62.5% of GDP in 2015 according to the 2015 Stability Programme, i.e. above the 60%-of-GDP reference value. Similarly, the Commission's spring 2015 forecast projects gross debt above the reference value at 62.6% of GDP in 2015 and 64.8% in 2016. While the projected breach of the debt criterion is fully explained by Finland's financial support to safeguard financial stability in the euro area in 2015, this would no longer be true in 2016. The debt level has been influenced by large purchases of financial assets by the social security funds, resulting in the accumulation of assets in parallel to the increase of debt. It should be noted that the debt ratio reflects the effects of Finland's current cyclical position, but also this factor cannot, by itself, explain the excess over the 60%-of-GDP reference value in 2016. Overall, the analysis presented in the report published in accordance with Article 126 (3) of the Treaty on 13 May 2015 suggests that that the debt criterion is not considered to be complied with.

[3] COM (2015) 246 final.

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

As Finland started the year 2014 at its MTO and the economy was in recession, no adjustment towards the MTO was required in 2014. However, Finland appears to have moved away from the MTO by 0.8pp. of GDP, which represents a significant deviation under the structural-balance pillar. In contrast, the expenditure benchmark is met with a positive margin of 0.3pp. of GDP. The average deviation over 2013-2014 in the required adjustment is 0.2pp. of GDP and the average deviation based on the expenditure benchmark pillar is positive, 0.6 pp. of GDP.

Half of the difference between the results of the two pillars is explained by the difference in the growth benchmarks used and the remainder is explained by revenue shortfalls in the structural-balance pillar. The difference in growth benchmarks also captures the effects of lower-than-expected inflation. Whereas the expenditure benchmark uses the deflator from the relevant vintages of the forecast, the structural balance reflects actual inflation which turned out much lower than previously forecast.

Based on an overall assessment, there appears to have been some deviation from the requirements.

Table 4: Compliance with the requirements under the preventive arm

(% of GDP)	**2014**
Initial position[1]	
Medium-term objective (MTO)	-0.5
Structural balance[2] (COM)	-1.6
Structural balance based on freezing (COM)	-0.9
Position vis-a -vis the MTO[3]	At or above the MTO
Structural balance pillar	
Required adjustment[4]	0.0
Required adjustment corrected[5]	0.0
Change in structural balance[6]	-0.8
One-year deviation from the required adjustment [7]	-0.8
Two-year average deviation from the required adjustment [7]	0.2
Expenditure benchmark pillar	
Applicable reference rate[8]	0.8
One-year deviation [9]	0.3
Two-year average deviation [9]	0.5
Conclusion	
Conclusion over one year	Overall assessment
Conclusion over two years	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 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 28.).

[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.

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

[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 not at its MTO.

[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.

Source :

Stability Programme (SP); Commission 2015 spring forecasts (COM); Commission calculations.

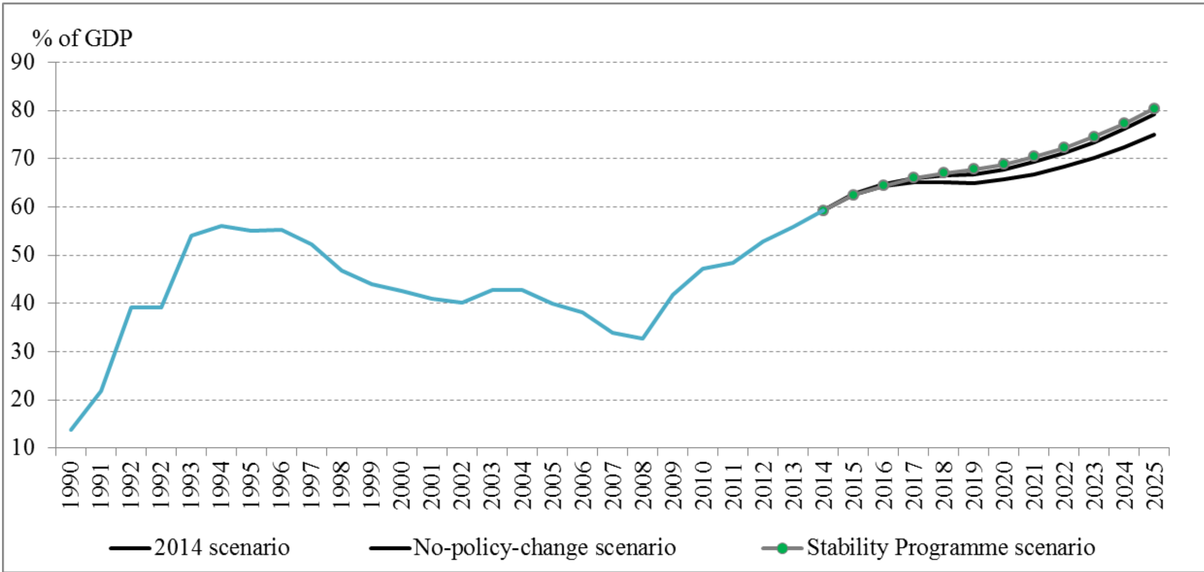
5. LONG-TERM SUSTAINABILITY

The analysis in this section includes the new long-term budgetary projections of age-related expenditure (pension, health care, long-term care, education and unemployment benefits) from the 2015 Ageing Report[4] published on 12 May. It therefore updates the assessment made in the Country Reports[5] published on 26 February.

The government debt-to-GDP ratio stood at 59.3% of GDP in 2014. Based on the Commission's spring 2015 forecast, government debt is expected to rise to close to 80% of GDP by 2025 (based on the no-policy-change scenario, under the assumption that the structural primary balance position evolves according to the Commission's spring 2015 forecast until 2016)(Figure 3). The increase would be driven by the fiscal position in 2016 and ageing-related costs.

Finland is assessed to be at high sustainability risk in the medium term and medium risk at long term due to the structural primary balance in 2016 and the budgetary impact of the cost of ageing (costs associated with pensions and long-term care). The focus, therefore, should be on reducing government debt and containing age-related expenditure growth further so as to contribute to the sustainability of public finances in the medium and long run. Compared with 2014 projections, both the S2 and the S1 indicator have worsened. However, the latest pension reform agreed in autumn 2014 but not yet been legislated by the Finnish parliament, is not included in these assessments.

Figure 3: Gross debt projections (as % of GDP)



Source: Commission 2015 spring forecast, Stability Programme, Commission calculations

[4] See http://ec.europa.eu/economy_finance/publications/european_economy/2015/ee3_en.htm

[5] See http://ec.europa.eu/europe2020/making-it-happen/country-specific-recommendations/index_en.htm

Table 5: Sustainability indicators

	Finland			European Union		
	2014 scenario	No-policy-change scenario	Stability Programme scenario	2014 scenario	No-policy-change scenario	Stability/ Convergence Programme scenario
S2*	4.4	5.0	5.5	1.4	1.7	0.4
of which:						
Initial budgetary position (IBP)	2.2	3.1	4.2	0.4	0.5	-0.7
Long-term cost of ageing (CoA)	2.2	1.9	1.3	1.0	1.1	1.1
of which:						
pensions	0.0	-0.3	-0.8	0.0	0.1	0.1
healthcare	0.6	0.5	0.5	0.8	0.7	0.6
long-term care	1.7	1.6	1.5	0.7	0.7	0.6
others	-0.2	-0.1	0.1	-0.4	-0.3	-0.2
S1**	2.6	3.4	4.7	1.4	1.8	0.5
of which:						
Initial budgetary position (IBP)	0.9	1.4	2.6	-0.4	-0.3	-1.6
Debt requirement (DR)	0.0	0.4	0.7	1.7	1.9	1.8
Long-term cost of ageing (CoA)	1.8	1.6	1.4	0.1	0.3	0.4
S0 (risk for fiscal stress)***	0.23	:		:		
Fiscal subindex	0.10	:		:		
Financial-competitiveness subindex	0.29	:		:		
Debt as % of GDP (2014)	59.3			88.6		
Age-related expenditure as % of GDP (2014)	31.6			25.6		

Source: Commission, 2015 Stability Programme

Note: the '2014' scenario depicts the sustainability gap under the assumption that the structural primary balance position remains at the 2014 position according to the Commission 2015 spring forecast; the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commission 2015 spring forecast until 2016. The 'stability 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.

* 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.

** 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 foercast 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 2016) 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.

*** 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.

Under the agreement, the retirement age brackets would be raised gradually for those born in 1955 or later, until the lowest retirement age is 65. The retirement age would be linked to life expectancy as of 2027 so that the relationship of time in work and on pension remains at the level of 2025.

6. FISCAL FRAMEWORK AND QUALITY OF PUBLIC FINANCES[6]

6.1. Fiscal framework

Finland's fiscal framework is built around the system of central government expenditure ceilings. Also, the framework aims to ensure progress towards the MTO. The functioning of the Finnish Fiscal framework is described in the 2015 Country Report.[7] Since February 2015, there have been no amendments or adjustments to the framework.

Article 4.1 of the Two-Pack Regulation 473/2013 obliges euro-area Member States to make public by 30 April each year their national medium-term fiscal plans (NMTFPs) in accordance with their medium-term budgetary framework. Finland has indicated that the Stability Programme is their NMTFP in the Two-Pack sense.

The macroeconomic forecast underlying the programme has been prepared by the Economics Department of the Ministry of Finance. Legal provisions stating the independence of this department are in place since January 2015. Finland is the only euro area Member State that has decided to dedicate a department within the Ministry of Finance as the independent producer referred to in the Two-pack. Despite the legal provisions in place, this solution leaves some concerns over the operational aspects of this arrangements: e.g. in relation to hierarchical subordination to the Minister of Finance, nomination/dismissal of the management of the Economics Department, authority for approval of forecasts, collection of input data from all relevant stakeholders. These operational aspects could be further clarified by the authorities.

The current framework did not trigger corrections to the deterioration in the deficit in 2014 or to the projections for 2015 foreseeing that the deficit and debt will be above the reference values and the indications that the adjustment path towards the MTO will not be respected. The 2014 deficit outcome was a surprise compared to the previous forecasts and 2015 deficit is largely due to the base effect.

Neither the Stability Programme, as Finland's NMTFP, nor the National Reform Programme includes indications on the expected economic returns on non-defence public investment projects that have a significant budgetary impact.

6.2. Quality of public finances

The expenditure ratio that averaged 50.6% over 2006-2010 period has increased to 58.7% in 2014. This is among the highest expenditure ratios in the EU. Expenditure on social protection accounts for more than 43% of general government expenditure and is projected to increase further by 2019.

The low interest rate environment has had a net negative impact on public finances. Although Finland has benefited from lower interest payments on the public debt, the earnings arising from the assets that the general government holds are also lower.

[6] This section complements the Country Report published on 26 February 2015 and updates it with the information included in the Stability programme.
[7] http://ec.europa.eu/europe2020/pdf/csr2015/cr2015_finland_en.pdf

At over 4% of GDP, public investment has been at a relatively high level. The central government invests mainly in R&D and in transport infrastructure projects. Local government investment is concentrated on housing construction and infrastructure projects.

7. CONCLUSIONS

In 2014, Finland's structural balance worsened by 0.8 pp of GDP, pointing to a significant deviation based on this pillar. On the other hand, the growth rate of government expenditure, net of discretionary revenue measures, was below the applicable expenditure benchmark rate by 0.4% of GDP. Based on an overall assessment, there appears to have been some deviation from the requirements.

Finland's deficit will be above 3% during 2014 to 2017 according to the Stability Programme, which is based on a no-policy change scenario. Debt will exceed the 60%-of-GDP reference value in 2015 and will continue to grow until 2019 according to the programme. According to the report published in accordance with Article 126 (3) of the Treaty on 13 May 2015, overall, the deficit and the debt criterions of the Treaty are not considered to be complied with. Finland will provide additional information on the planned measures in the coming weeks and is expected to submit an updated Stability Programme, including new fiscal targets and outlining the policy measures to achieve them, in the autumn of 2015.

ANNEX

Table I. Macroeconomic indicators

	1997-2001	2002-2006	2007-2011	2012	2013	2014	2015	2016
Core indicators								
GDP growth rate	4.9	2.9	0.6	-1.4	-1.3	-0.1	0.3	1.0
Output gap [1]	1.5	0.1	0.1	-1.7	-2.9	-2.9	-2.7	-1.9
HICP (annual % change)	1.9	1.1	2.4	3.2	2.2	1.2	0.2	1.3
Domestic demand (annual % change) [2]	4.0	2.9	1.3	-1.2	-1.3	-0.8	0.1	0.8
Unemployment rate (% of labour force) [3]	10.6	8.6	7.5	7.7	8.2	8.7	9.1	9.0
Gross fixed capital formation (% of GDP)	22.4	22.3	23.1	22.3	21.1	20.0	19.6	19.9
Gross national saving (% of GDP)	28.8	28.5	25.1	20.6	19.1	18.4	19.2	19.8
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**2.8**	**3.0**	**0.6**	**-2.1**	**-2.5**	**-3.2**	**-3.3**	**-3.2**
Gross debt	**45.3**	**40.8**	**40.8**	**52.9**	**55.8**	**59.3**	**62.6**	**64.8**
Net financial assets	**26.1**	**47.0**	**58.9**	**53.4**	**n.a**	**n.a**	**n.a**	**n.a**
Total revenue	53.7	52.0	52.4	54.0	55.2	55.5	55.6	55.5
Total expenditure	51.0	49.0	51.8	56.1	57.8	58.7	58.9	58.7
of which: Interest	3.1	1.7	1.4	1.4	1.3	1.3	1.2	1.2
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**4.1**	**4.5**	**3.2**	**2.6**	**2.4**	**3.2**	**3.7**	**4.0**
Net financial assets; non-financial corporations	**-194.3**	**-131.9**	**-120.1**	**-96.6**	**n.a**	**n.a**	**n.a**	**n.a**
Net financial assets; financial corporations	**3.2**	**2.0**	**3.0**	**2.8**	**n.a**	**n.a**	**n.a**	**n.a**
Gross capital formation	13.1	12.9	13.0	11.7	10.5	10.1	9.9	10.1
Gross operating surplus	27.2	27.1	25.1	21.6	21.1	21.5	21.6	22.2
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**-0.9**	**-2.1**	**-2.0**	**-2.3**	**-2.0**	**-1.8**	**-1.2**	**-1.3**
Net financial assets	**63.2**	**64.3**	**56.1**	**50.1**	**n.a**	**n.a**	**n.a**	**n.a**
Gross wages and salaries	37.3	37.8	39.2	40.7	40.5	40.3	40.0	39.4
Net property income	4.0	4.2	3.9	3.7	3.8	3.9	3.9	3.9
Current transfers received	20.7	19.5	20.0	22.0	23.0	23.8	24.2	24.4
Gross saving	5.0	4.5	4.8	4.6	4.9	4.4	5.1	5.0
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**6.5**	**5.3**	**1.9**	**-1.8**	**-1.8**	**-1.7**	**-0.6**	**-0.3**
Net financial assets	**102.3**	**19.1**	**3.2**	**-8.0**	**n.a**	**n.a**	**n.a**	**n.a**
Net exports of goods and services	8.5	5.9	2.2	-1.4	-0.9	-0.4	0.5	0.8
Net primary income from the rest of the world	-1.0	0.4	0.7	0.5	0.3	0.0	0.0	0.0
Net capital transactions	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Tradable sector	47.5	46.3	42.6	39.2	38.8	38.5	n.a	n.a
Non tradable sector	39.7	41.1	44.9	47.1	47.2	47.6	n.a	n.a
of which: Building and construction sector	5.1	5.3	5.8	5.7	5.5	5.3	n.a	n.a
Real effective exchange rate (index, 2000=100)	93.2	94.4	100.0	101.2	104.6	106.1	101.4	100.1
Terms of trade goods and services (index, 2000=100)	115.7	109.0	100.8	97.4	97.9	97.9	99.8	99.9
Market performance of exports (index, 2000=100)	104.6	106.3	104.6	96.3	93.9	90.0	87.9	86.8

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 2015 spring forecast