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REPORT FROM THE COMMISSION

Finland

Report prepared in accordance with Article 126(3) of the Treaty

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1. INTRODUCTION

Article 126 of the Treaty on the Functioning of the European Union (TFEU or the Treaty) lays down the excessive deficit procedure (EDP). That procedure is further specified in Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure"[1], which is part of the Stability and Growth Pact (SGP). Specific provisions for euro area Member States under EDP are laid down in Regulation (EU) No 473/2013[2].

According to Article 126(2) TFEU, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3% (unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value); and (b), whether the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

Article 126(3) TFEU provides that if a Member State does not fulfil the requirements under one or both of those criteria the Commission has to prepare a report. This report must also "*take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State*".

This report, which represents the first step in the excessive deficit procedure (EDP), analyses Finland's compliance with the deficit and debt criterion of the Treaty, with due regard to the economic background and other relevant factors.

The report updates the Commission's previous assessment of the excess of the deficit and debt ratio over the Treaty reference values of 18 May 2016[3]. The May 2016 report concluded that overall, the deficit and the debt criteria of the Treaty were considered to be complied with. On 28 April 2017, Finland submitted its 2017 Stability Programme.

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[1] OJ L 209, 2.8.1997, p. 6. The report also takes into account the "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", adopted by the Economic and Financial Committee on 5 July 2016, available at: http://ec.europa.eu/economy_finance/economic_governance/sgp/legal_texts/index_en.htm.

[2] Regulation (EU) No 473/2013 of the European Parliament and of the Council on "common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area" (OJ L 140, 27.5.2013, p. 11)

[3] 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

General government debt amounted to 63.6% of GDP in 2016. This is above the 60% of GDP reference value. The Stability Programme indicates that the gross debt ratio is expected to peak at 64.7 % of GDP in 2017 and turn onto a gradual downward path as from 2018. In 2020 the debt-to-GDP ratio is forecast at 62.7% of GDP. In contrast, the Commission 2017 spring forecast expects the debt ratio to continue to rise in 2017 and 2018 reaching 66.2% of GDP in 2018, at the end of the forecast horizon. The notified debt-to-GDP ratio in 2016 and the projected debt ratios for 2017 and 2018 in the Commission 2017 spring forecast provide evidence of a *prima facie* existence of an excessive deficit in Finland for the purpose of the Treaty and the Stability and Growth Pact, before, however, considering all relevant factors as set out below.

The Commission has therefore prepared this report to comprehensively assess the excess over the Treaty reference values, in order to examine whether the launch of an excessive deficit procedure is warranted after all relevant factors have been considered. Section 2 of the report examines the deficit criterion and section 3 examines the debt criterion. Section 4 deals with the relevant factors, including the assessment of compliance with the required adjustment path towards the medium-term budgetary objective (MTO). The report takes into account the Commission 2017 spring forecast released on 11 May 2017.

Table 1. General government deficit and debt (% of GDP)

		2013	2014	2015	2016	2017		2018	
				COM	COM	COM	National authorities	COM	National authorities
Deficit criterion	General government balance	-2.6	-3.2	-2.7	-1.9	-2.2	-2.3	-1.8	-1.6
Debt criterion	General government gross debt	56.5	60.2	63.7	63.6	65.5	64.7	66.2	64.5
	General government gross debt adjusted for the effect of the cycle				59.7	63.1		65.6	

Sources: Eurostat, European Commission 2017 spring forecast, 2017 stability programme, data communicated by the national authorities

2. DEFICIT CRITERION

According to the spring 2017 notification, Finland's general government deficit was 1.9% of GDP in 2016. The deficit is projected to remain below the Treaty reference value in 2017 and 2018 both based on the Stability Programme as well as based on the Commission 2017 spring forecast. According to the Commission forecast, the deficit is projected to increase to 2.2% of GDP in 2017 and then decline to 1.8% of GDP in 2018, based on the no-policy change assumption. According to the Stability Programme, the deficit is projected to increase to 2.3% before declining to 1.6% of GDP by 2018.

Finland thus complies with the deficit criterion as defined in the Treaty and in Regulation (EC) No 1467/97.

3. DEBT CRITERION

The general government gross debt-to-GDP ratio increased rapidly over the recent years, growing from 32.7% of GDP in 2008 to 63.6% in 2016, on the back of large primary deficits and stock-flow adjustments arising from the financial investments of the earnings-related

pension funds. The deficit and the stock-flow adjustment contributed roughly equally to the growth of nominal debt over those years. In 2016, the debt ratio rose on the back of the primary deficit (0.9% of GDP) but that increase was offset by the "snow-ball" effect (-0.3% of GDP) and the stock-flow adjustment (-0.7% of GDP). The "snow-ball" effect started to curb the increase in the debt ratio in 2016, when nominal GDP growth accelerated. The stock-flow adjustment had been increasing the debt ratio until 2015, mainly driven by the surplus of the statutory earning-related pension funds[4]. In 2016, the stock-flow adjustment reduced the debt ratio because the State treasury used its accumulated cash buffers to pay off the debt at the end of the year and the amount of security deposits in connection with derivative instruments declined[5]. These favourable factors outweighed the surplus of the pension funds, which was also smaller than previously. As a result, the debt ratio declined.

Finland's Stability Programme envisages public debt to increase to 64.7% of GDP in 2017 and to remain broadly unchanged at 64.5% of GDP in 2018. The debt-to-GDP ratio is planned to decline to 62.7% in 2020. According to the Commission 2017 spring forecast, public debt is expected to reach 65.5% of GDP in 2017 and continue to grow to 66.2% of GDP in 2018 (Table 1).

According to the Commission forecast, the primary deficit is projected to increase slightly to 1.1% of GDP in 2017 and decline to 0.8% of GDP in 2018. The projected expansion of nominal GDP is expected to limit the increase in the debt ratio in 2017 and especially in 2018. The stock-flow adjustment component, however, is assumed to turn to positive and increase the debt ratio in 2017-2018.

Both Finland's Stability Programme and the Commission 2017 spring forecast estimate that in 2016, the debt ratio adjusted for the influence of the cycle is less than 60% of GDP, below the Treaty reference value. Based on the 2017 Stability Programme, Finland is projected to fulfil the forward looking debt rule in 2017 and 2018. However, based on the Commission forecast, Finland is forecast not to comply with the debt reduction benchmark in 2017 and 2018, with gaps of 0.8% and 0.5% of GDP respectively.

The analysis thus suggests that *prima facie* the debt criterion for the purpose of the Treaty and Regulation (EC) No 1467/1997 is not fulfilled based on the 2016 outturn data and the Commission 2017 spring forecast as well as the 2017 Stability Programme before, however, consideration is given to all relevant factors set out below.

[4] Due to the statutory status of the earnings-related pension system, the surplus of pension system is included in the financial position of general government. The pension funds, which manage a portfolio with a value of close to 90% of GDP in 2016, earn property income which is not used to cover deficits in the central or the local government subsector.

[5] State Treasury uses derivatives such as interest rate swaps in connection to the central government debt.

Table 2: Debt dynamics

	2014	2015	2016	2017	2018
Government gross debt ratio	60.2	63.7	63.6	65.5	66.2
Change in debt ratio [b] (1 = 2+3+4)	3.7	3.5	-0.1	1.9	0.7
Contributions:					
• Primary balance (2)	1.9	1.6	0.9	1.1	0.8
• "Snowball" effect (3)	0.6	0.0	-0.3	-0.1	-0.9
of which:					
Interest expenditure	1.2	1.2	1.1	1.0	1.0
Real GDP growth	*0.4*	*-0.2*	*-0.9*	*-0.8*	*-1.1*
Inflation (GDP deflator)	-0.9	-1.0	-0.5	-0.3	-0.8
• Stock-flow adjustment (4)	1.2	1.9	-0.7	0.9	0.9

Notes:

[a] In percent of GDP.

[b] The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the "snow-ball" effect, measuring the combined effect of interest expenditure and economic growth on the debt ratio.

Source: Eurostat and Commission 2017 spring forecast

4. RELEVANT FACTORS

Article 126(3) TFEU provides that the Commission's report "*shall also take into account whether the government deficit exceeds government investment expenditure and take into account other relevant factors, including the medium-term economic and budgetary position of the Member State*". These factors are further clarified in Article 2(3) of Regulation (EC) No 1467/97, which also provides that "*any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess compliance with the deficit and debt criteria and which the Member State has put forward to the Council and the Commission*" need to be given due consideration.

In case of an apparent breach of the debt criterion, the analysis of the relevant factors is particularly warranted given that debt dynamics are to a larger extent influenced by factors outside the control of the government than is the case for the deficit. This is recognised in Article 2(4) of Regulation (EC) No 1467/97, which provides that the relevant factors shall be taken into account when assessing compliance on the basis of the debt criterion irrespective of the size of the breach.

In that respect, at least the following three main aspects need to be considered (and have been considered in the past) when assessing compliance with the debt criterion given their impact on the debt dynamics and sustainability:

1. adherence to the MTO or the adjustment path towards it, which, is supposed to ensure sustainability or rapid progress towards sustainability under normal macroeconomic circumstances. As by construction the country-specific MTOs take into account the debt level and implicit liabilities, compliance with the MTO or the adjustment path towards it should ensure convergence of the debt ratios towards prudent levels at least in the medium term;
2. structural reforms, already implemented or detailed in a structural reform plan, which are expected to enhance sustainability in the medium term through their impact on growth, thereby contributing to bring the debt-to-GDP ratio on a satisfactory downward path. Overall, adherence to the MTO (or the adjustment path towards it) alongside with the implementation of structural reforms (in the context of the European Semester) is expected under normal economic conditions to bring debt dynamics on a sustainable path through the combined impact on the debt level itself (through the achievement of a sound budgetary position at the MTO) and on economic growth (through the reforms).
3. unfavourable macroeconomic conditions, and in particular low inflation, which can hamper the reduction of the debt-to-GDP ratio and make compliance with the SGP provisions particularly demanding. The debt reduction benchmark assumes by construction that GDP deflator growth returns to the long-term average value of 2% by 2021, which makes compliance with the forward-looking debt benchmark particularly demanding. Under such conditions, adherence to the MTO or the adjustment path towards it is a key relevant factor in assessing compliance with the debt criterion.

In view of those provisions, the following subsections consider in turn: (1) the medium-term economic position; (2) the medium-term budgetary position including an assessment of compliance with the required adjustment towards the MTO and the development of public investment; (3) the developments in the medium-term government debt position, its dynamics and sustainability; (4) other factors considered relevant by the Commission; and (5) other factors put forward by the Member State.

4.1. Medium-term economic position

Cyclical conditions and potential growth

After Finland's real GDP declined by 8.3% in 2009, the country recovered gradually in 2010 and 2011, but experienced a new recession over 2012-14. In 2015, GDP increased by 0.3% and growth accelerated to 1.4% in 2016. The Finnish GDP is expected to continue growing in 2017 and 2018 (Table 2). The prolonged downturn has negatively affected Finland's potential growth. Estimated in accordance with the commonly-agreed methodology, potential growth averaged 0.1% over 2009 to 2016, being negative (at -0.1%) in 2013. In 2014, potential output growth is estimated to have remained unchanged from 2013. In 2015 and 2016, potential growth is estimated at 0.2% and 0.4% respectively. The contraction of potential output has been caused by declining labour inputs and the estimated negative contribution of

total factor productivity, which reflects the ongoing restructuring of the economy. Moreover, the positive contribution of capital also declined over the crisis period, due to lower investment. Overall, real GDP in 2016 was 4.5% below the level recorded in 2008, whereas potential output grew by just 2.2% in total over 2009-2016 period. It could be explained by the restructuring process, in which the importance of the electronics industry declined and other industries, often with lower productivity levels, expanded their share in total output. The Commission's 2017 Country Report on Finland emphasized Finland's endowment of human capital, stable institutional framework and good conditions for doing business as fundamental strengths that should contribute to total factor productivity growth in the future.

With real GDP below potential over 2012-14, the output gap widened to -2.9% of potential GDP in 2014 and remained broadly stable in 2015. The gap is estimated to have reached -1.8% in 2016 when GDP grew faster than potential. In 2017, GDP growth is forecast to remain above potential growth, reducing the output gap to -1.4% of GDP.

Table 3: Macroeconomic and budgetary developments[a]

	2013	2014	2015	2016	2017		2018	
	COM	COM	COM	COM	COM	National authorities	COM	National authorities
Real GDP (% change)	-0.8	-0.6	0.3	1.4	1.3	1.2	1.7	1.8
Potential GDP (% change)	0.2	0.0	0.2	0.4	0.9	0.0	0.8	0.0
Output gap (% of potential GDP)	-2.3	-2.9	-2.7	-1.8	-1.4	-1.6	-0.5	-0.8
General government balance	-2.6	-3.2	-2.7	-1.9	-2.2	-2.3	-1.8	-1.6
Primary balance	-1.4	-1.9	-1.6	-0.9	-1.1	-1.4	-0.8	-0.7
One-off and other temporary measures	-0.1	0.1	0.0	0.0	0.0	0.0	-0.1	0.0
Government gross fixed capital formation	4.2	4.2	3.9	3.9	3.9	0.0	3.9	0.0
Cyclically-adjusted balance	-1.3	-1.5	-1.2	-0.9	-1.3	-1.4	-1.5	-1.1
Cyclically-adjusted primary balance	0.0	-0.3	0.0	0.2	-0.3	0.0	-0.5	0.0
Structural balance [b]	-1.2	-1.6	-1.1	-0.9	-1.3	-1.4	-1.4	-1.0
Structural primary balance	0.0	-0.4	0.0	0.2	-0.3	-0.5	-0.4	-0.1

Notes:

[a] In percent of GDP unless specified otherwise.

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

Source: Eurostat and European Commission 2017 spring forecast, 2017 stability programme

When corrected for the effects of the cycle over the last three years, the debt ratio in 2016 remained narrowly below the Treaty reference value at 59.7% of GDP, but it is no longer expected to be the case in 2017. Based on the Commission 2017 spring forecast, cyclically-adjusted debt is estimated at 63.1% of GDP in 2017 and 65.6% in 2018 (Table 1).

Structural reforms

In its Communication of 13 January 2015[6], the Commission strengthened the link between effective implementation of structural reforms, investment, and fiscal responsibility in support of jobs and growth, within the existing rules of the SGP.

As described in the Commission's 2017 Country Report, Finland has, overall, made some progress in addressing the 2016 country-specific recommendations (CSRs). The first batch of legislative proposals for the social and healthcare service reforms was presented to the parliament in March 2017. Those laws will establish the legal framework for the 18 new counties that will take over from the municipalities the responsibility for the social and healthcare services as from 2019. In 2016 the social partners signed the Competitiveness Pact (the Pact) aimed at improving Finland's cost competitiveness from 2017 The Pact also extends the possibilities for local bargaining for organised employers. The obligation for the unemployed to accept a job offer as well as the obligation to participate in activation schemes were tightened. In addition, the duration of earnings-related unemployment benefits was reduced. In order to promote entrepreneurship, the government put forward a package which provides additional opportunities for company creation and growth. Some amendments to the establishment conditions for retail outlets have been adopted. De-regulation measures have been passed by the parliament for the transport sector and are underway for gas markets.

Pensions. A major pension reform entered into force in 2017. The reform will link the future retirement age to life expectancy as recommended by the Council. According to the national authorities, the reform is expected to improve long-term fiscal sustainability by approximately 1% of GDP.

Labour market. On an aggregate level, wage increases have been moderate since the centrally agreed wage deal of late 2013 that was extended into 2016. However, in the low inflation and low growth environment, the strategy of restoring cost competitiveness through low wage adjustments has had only a limited effect. The central labour market organisations reached an agreement on the Pact in February 2016. During the spring and early summer, employer and employee organisations carried out industry level collective agreement negotiations to introduce the Pact into about 300 industry- or company-level agreements. To facilitate the conclusion of the industry-level agreements, the government announced in early June that it would cut taxes on labour income in all income categories as of 2017 depending on the coverage of the Pact. In the end, over 90% of employees were covered by the Pact and income taxes were cut by 0.4% of GDP as of 2017.

The Pact includes the following measures to reduce labour costs: i) annual working time will be increased by 24 hours without additional compensation from 2017; ii) wages will be frozen for 12 months; iii) a larger share of social security contributions will be shifted permanently towards the employees. In line with the Pact, public sector employees' annual holiday bonuses, which roughly correspond to 50% of a month's salary, will be temporarily (2017-2019) reduced by 30%, lowering public spending. The savings that are expected to materialise as a result of the Pact will be used to reduce employers' labour costs. Over the long-run, the Pact is expected to have positive impacts on exports, real GDP, employment

[6] COM(2015) 12 final

and public finances. Estimates of the impact of lower wage costs on employment range from 20 000 to 40 000 depending on the method and assumptions used. The social partners also agreed to extend local bargaining possibilities for organized employers.

In parallel, the government launched in April 2016 a reform of unemployment insurance aimed at encouraging quick acceptance of job offers and tightening the obligation to accept work as well as the obligation to participate in employment-promoting activation measures. In addition, in January 2017 the duration of earnings-related unemployment benefits was reduced from 500 to 400 days and further reforms of the earnings-related unemployment insurance in order to activate job seekers more are under preparation. In 2017 and 2018, unemployment benefits may, under certain conditions, be used to finance mobility grants, start-up grants and wage subsidies.

Administrative reform. The government is determined to reform the social and healthcare services. The parliament has started to discuss the legislation that will establish the new layer of government, the counties, in 2019. The legal proposals for the most controversial parts of the reform, in particular a law defining patients' freedom to choose their service provider, were presented in the parliament in early May 2017. The counties have also other duties in addition to social and health tasks such as organising rescue services, public employment services, regional development and business-promotion as well as the management of land-use. The reform will extend the freedom of choice of social welfare and healthcare services, thus also promoting competition in their provision. A temporary administration will start preparing the launch of activities in July 2017, when laws come into force following the completion of the parliament process, which is still ongoing.. Elections for the new county councils will be held in the spring 2018 and the new counties will start to operate from the beginning of 2019. The social and healthcare services reform aims to achieve total savings in the long term through comprehensive integration of social and healthcare services, larger entities in charge of providing the services than at present, and digitalisation.

Services markets. Progress has been made in opening up services sectors such as retail trade and transport to competition, and proposals have been put forward to increase competition in other domestic service sectors. Establishment conditions for retail outlets will be eased. The legislation that came in force in May 2017 increases the minimum surface of the more tightly regulated large retail units from 2 000 to 4 000 square meters. The possibilities to establish those units in areas other than the city centres will be increased and access to outlets will become a more important factor in planning than the outlets' nature and size. The first phase of legislative amendmends to reform transport sector was approved by the parliament in April 2017 while gas market reforms have been announced and the draft legislation prepared.

4.2. Medium-term budgetary position

Structural balance and adjustment towards the MTO

Finland's Medium-Term Objective (MTO) for the structural balance is -0.5% of GDP which the government aims to achieve in 2019. The MTO appears sufficiently stringent under what can be considered as normal economic conditions to ensure debt rule compliance in the medium and long term. According to the Commission 2017 spring forecast, it would require a structural improvement of 0.8% of GDP over 2018-2019. At the same time, the Commission forecast does not expect the structural balance to improve at unchanged policy in 2018, the last year of the Commission projections. As a result, achieving the MTO in 2019 will require substantial additional measures.

In the Draft Budgetary Plan (DBP) for 2017, Finland indicated that the budgetary impact of the exceptional inflow of refugees was significant and provided adequate evidence of the scope and nature of these additional budgetary costs. In particular, the expenditure increase in 2016 was estimated at 0.3% of GDP. In the 2017 Stability Programme, the budgetary impact of the refugees has turned out to be lower than expected with an increase in expenditure by 0.17 pp of GDP in 2016. In 2017 the budgetary impact of refugees is projected to decrease by 0.15 pp of GDP.

In 2016, the structural balance improved by 0.3 pp of GDP to -0.9% of GDP, pointing to a risk of some deviation (deviation of 0.1% of GDP) from the required structural adjustment of 0.3% of GDP after taking into account an allowance of 0.2% of GDP related to the exceptional inflow of refugees[7]. The growth of government expenditure, net of discretionary revenue measures and one-offs, complied with the expenditure benchmark with a positive margin. This calls for an overall assessment. The difference between the two indicators is mainly driven by revenue shortfalls (0.3% of GDP) that could be linked with low inflation and low interest rate environment and seem to distort the structural balance indicator. Taking that factor into consideration, the structural balance pillar would also point to compliance with the recommended structural adjustment, in line with the conclusion based on the expenditure benchmark indicator. Therefore, the overall assessment points to compliance with the recommended adjustment path towards the MTO in 2016.

In its DBP for 2017, Finland requested a temporary deviation of 0.5% of GDP from the required structural adjustment path towards the MTO in 2017, in view of major structural reforms with a positive impact on the long-term sustainability of public finances (the so-called "structural reform clause"), as well as a temporary deviation of 0.1% of GDP to take account of EU co-financed investments[8] (the so-called "investment clause"). The Commission's updated detailed analysis of the output gap estimate for 2017 on the basis of the Commission's spring forecast imply that in 2017 Finland meets the minimum benchmark, which is designed to ensure sufficient safety margin towards the 3% of GDP reference value of the Treaty. In particular, if the output gap was considered to be -2.5% of potential GDP in 2016 as the plausibility tool suggests, the structural balance would be estimated at -0.5% in 2016 (Finland's MTO). The extrapolation of the output gap on the basis of the tool and the common methodology would lead the structural balance to be projected at -1% in 2017 and 2018. Other conditions for structural reform and investment clauses are also met: the structural reforms have been implemented; they are major reforms; and appear to have long-run positive budgetary effects. Regarding the investment clause, the output gap is estimated larger than -1.5% of GDP in 2017 according to the above mentioned detailed analysis and the Commission's spring forecast projects general government gross fixed capital formation to increase by 2.0% in 2017. In addition, based on the spring forecast, Finland is expected to remain sufficiently close to its MTO in 2017-2018 and according to the government plans, Finland would return to MTO in 2019. On this basis, the Commission proposes to grant Finland a temporary deviation of 0.6% of GDP from the required adjustment path towards the MTO in 2017 in line with the "Commonly agreed position on Flexibility within the Stability

[7] In July 2016, the Council gave Finland a recommendation to improve the structural balance by 0.5% of GDP in 2016.

[8] European Structural and Investment Funds support the competitiveness, boost research and innovation, create employment as well as facilitate education and training.

and Growth Pact" endorsed by the ECOFIN Council in February 2016[9]. In November 2016, Finland's DBP for 2017 was assessed to be at risk of non-compliance with the requirements of the SGP.

Taking into account the temporary deviations granted in 2017 for structural reform and investment clauses, and the previously-granted allowance under the unusual event clause, which is carried forward for a period of three years, Finland's structural balance is allowed to deteriorate by 0.5% of GDP in 2017.[10] Based on the spring forecast, both pillars point to compliance with that requirement. An overall assessment would indicate that, on the one hand, the structural balance is negatively affected by revenue shortfalls, which worsen the balance by 0.3% of GDP. On the other hand, the medium-term average potential GDP growth (0.2%) ¬ compared with the potential growth rate which is estimated in the 2017 spring forecast for 2017 to be significantly higher (0.9%) ¬ might result in a rather stringent expenditure growth benchmark for 2017. The expenditure benchmark indicator is also affected by a difference between the current estimate for GDP deflator (0.5%) and the estimated deflator at the time when the requirement was set (0.9%). These differences in the estimated growth rates and the deflators would have an effect on the expenditure benchmark indicator which is estimated at 0.2% of GDP. Taking these factors into consideration, if the expected decrease of the budgetary impact in 2017 stemming from the exceptional inflow of refugees were deducted from the assessment, the overall assessment would not change..

In 2018, taking into account the previously-granted allowances under the unusual event clause and the structural reform and investment clauses, the recommended structural adjustment is 0.1% of GDP.[11] The structural balance is projected to remain unchanged, estimated at -1.4% of GDP, pointing to some deviation from the recommended structural adjustment (deviation 0.1% of GDP) while the expenditure benchmark points to compliance. This calls for an overall assessment. In 2018, the revenue shortfall continues to have an impact on the structural balance (0.4 pp of GDP), while the estimated potential growth rate (0.8%) continues to outpace the medium-term average potential GDP growth rate (0.4%) having an impact on the expenditure benchmark indicator (0.2% of GDP). Taking those factors into account, both indicators would point to compliance with the recommended adjustment path towards the MTO in 2018. Therefore, on the basis of the overall assessment, Finland is expected to comply with the requirements of the preventive arm in 2018. If the expected decrease of the budgetary impact in 2017 stemming from the exceptional inflow of refugees were deducted from the assessment, the overall assessment would not change.

Government expenditure and investment

Government investment as a share of GDP has increased since 2008 when gross fixed capital formation by the government sector amounted to 3.6% of GDP. In 2016 it amounted to 3.9% of GDP. According to the Stability Programme, the investment-to GDP ratio is expected to remain at 3.9% of GDP in 2017, increase to 4.0% of GDP in 2018 and gradually decrease thereafter. Throughout the period, the general government deficit ratio in both headline and

[9] http://data.consilium.europa.eu/doc/document/ST-14345-2015-INIT/en/pdf

[10] The allowed deterioration in 2017 of 0.5% of GDP also takes into account that the observed distance from the MTO at the end of 2016 amounted to 0.4% of GDP.

[11] Based on the matrix, the annual structural adjustment towards the MTO would be 0.6% of GDP in 2018. However, this requirement is adjusted to 0.1% of GDP after taking into account the impact of the previously-granted allowances under the unusual event clause and the structural reform and investment clauses, which are carried forward for a period of three years.

structural terms is projected lower than the government investment-to-GDP ratio. Overall, general government investment, as a share of GDP, is among the highest in the euro area.

The ratio of general government current expenditure, excluding interest, to GDP peaked in 2014 at 52.4% of GDP. The expenditure ratio rose significantly as a consequence of the 2008-2009 economic crisis, when current expenditure increased by 6.7% and nominal GDP contracted by 6.5%. At 51.0% of GDP, the level was one of the highest in the EU in 2016. When considering general government expenditure by function, it appears that expenditure growth is mainly driven by healthcare and pension expenditure, reflecting the ageing of society.

The effective interest rate paid on debt has decreased significantly in recent years. Interest expenditure, as a share of GDP, is forecast by both the Commission as well as by the national authorities to fall over the forecast horizon. Overall, Finland's public finances, however, do not benefit from the decline in interest rates, as the assets which are held by the statutory earnings-related pension funds, which are included in the public sector, are partially interest-bearing assets. The reduction in interest revenue from these assets, as a result of lower interest rates, more than offsets the expenditure savings from the reduced interest payments on government debt.

4.3. Medium-term government debt position

Long-term sustainability of public finances

The general government gross consolidated debt-to-GDP ratio stood at 63.6% of GDP in 2016. Based on medium-term projections building on the Commission's winter 2017 forecast, the debt is expected to rise to close to 80% of GDP by 2027 (based on the no-policy-change scenario, under the assumption that the structural primary balance evolves according to the Commission's winter 2017 forecast until 2018), remaining above the 60%-of-GDP Treaty threshold. The increase would be mostly driven by the costs of ageing.

Finland is assessed to be at low risk of fiscal stress in the short term, but is 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. The focus, therefore, should be on containing age-related expenditure growth further so as to contribute to the sustainability of public finances in the medium and long run. However, it is important to note that the 2017 pension reform is not taken into account in these sustainability risk assessments, as the necessary Economic Policy Committee peer review has not yet been completed.

Stock-flow adjustment

The stock-flow adjustment has a large effect on changes in the general government debt in Finland. In 2010-2015, the stock-flow adjustment accounted for more than half of the increase in the debt-to-GDP ratio. The stock-flow adjustments routinely occur as the earnings-related pension system, included in the general government sector, is partially pre-funded and runs a surplus. The funds' investment decisions are independent from the central government, although the funds are under the regulatory oversight of the government. At the end of 2016, the pension schemes managed assets that amounted to 85% of GDP, of which about 40% was invested in interest-bearing products. The share of interest-bearing assets in the portfolios of pension funds has been on a decreasing trend. In 2016, the pension funds liquidated some of their holdings of domestic central government securities increasing the consolidated general government debt. In 2016, for the first time the share of equity

investment accounted for more than half of the assets. The remaining 10% of the assets are real estate investments. Owing to the accumulated assets in the pension funds, Finland's general government net-financial assets position was estimated at 50.7% of GDP in 2016[12].

Total stock of debt guaranteed by the government

Finland had central government guarantees amounting to 21.5% of GDP in 2016, up from 21.1% of GDP in 2015. That ratio is high in comparison to other Member States. At the end of 2016, about half of the stock of central government guarantees consisted of guarantees to enterprises (excl. housing corporations). They are issued to a wide group of non-financial corporations, mainly through the Finnvera corporation - a specialised state-owned financing company promoting exports and enterprise growth. Guarantees granted to households' mortgages accounted for 28% at the end-2016. Both types of guarantees have nearly doubled since 2010. The rest of the guarantees are linked to European financial stability fund and student loans. The losses linked to the guarantees have been low until now.

Impact of the cycle

As Finland has experienced difficult economic times over 2012-13 and a large negative output gap, estimated at -2.9 % of GDP in 2014, has opened, the debt-to-GDP ratio is also influenced by the cyclical developments. When corrected for the effects of the cycle, the Commission forecast for general government debt is estimated at 59.7% of GDP in 2016, but above the reference value as of 2017 (63.1% of GDP).

4.4. Other factors considered relevant by the Commission

Financial stabilisation operations

Among the other factors considered relevant by the Commission, particular consideration is given to financial contributions to fostering international solidarity and achieving the policy goals of the Union, the debt incurred in the form of bilateral and multilateral support between Member States in the context of safeguarding financial stability and the debt related to financial-stabilisation operations during major financial disturbances (Article 2(3) of Regulation (EC) No 1467/97).

In assessing compliance with the debt criterion, financial assistance to euro-area Member States with a debt-increasing impact has been taken into account. According to the Commission 2017 spring forecast, the cumulative impact of that assistance would amount to 2.7% of GDP in 2016. Thus, Finland's general government gross debt would be 60.9% of GDP in 2016 if the debt related to financial-stabilisation operations was deducted.

4.5. Other factors put forward by the Member State

On 9 May 2017, the Finnish authorities transmitted a letter with relevant factors pursuant to Article 2(3) of Regulation (EC) No 1467/97. The authorities emphasised the impact of the cycle on general government debt, compliance with the obligations under the preventive arm of the SGP, the government's commitment to the fiscal consolidation target set in the government programme, and the growth-enhancing structural reforms that are currently being prepared. In addition, Finland put forward the impact of low inflation environment on public

[12] OECD Economic Outlook no 100, Annex Table 33.

revenue and expenditure and the negative net impact from the low interest rate environment on the general government balance.

The factors put forward by the Finnish authorities have been taken into account in the present report. The impact of the cycle has been analysed in Section 4.1 and compliance with the obligations under the preventive arm is assessed in Section 4.2. In assessing the compliance with the preventive arm, the low-inflation environment, and impact of the low interest rate environment are also taken into account. Structural reforms are considered in Section 4.1.

5. CONCLUSIONS

The general government gross debt decreased slightly from 63.7% in 2015 to 63.6% of GDP in 2016, but remained above the Treaty reference value. The 2017 Stability Programme envisages the debt ratio to reach 64.7% of GDP in 2017 and then slightly decrease to 64.5% of GDP in 2018. The Commission 2017 spring forecast projects gross debt above the reference value, at 65.5% of GDP in 2017 and 66.2% in 2018, based a no-policy-change assumption. This suggests that before consideration is given to all relevant factors, the debt criterion as defined in the Treaty does not appear to have been fulfilled prima facie in 2016. In line with the Treaty, this report also examined the relevant factors.

In 2016, the breach of the debt criterion was no longer fully explained by Finland's financial support to safeguard the financial stability in the euro area. At the same time, Finland is expected to comply with the recommended adjustment path towards the MTO in 2017 and 2018, which should help ensure – in the medium term – that the debt ratio decreases at a sufficient pace. The debt corrected for the effects of the cycle would remain just below 60% of GDP in 2016. Moreover, Finland has made some progress in implementing structural reforms, notably by addressing its 2016 country-specific recommendations in the area of cost competitiveness. These reforms are expected to contribute to enhancing the economy's growth potential and reducing the risks of macroeconomic imbalances, thereby having a positive impact on debt sustainability in the medium to long term. In a letter sent on 9 May 2017, Finland recalled that the cyclically-adjusted debt ratio remained below 60% of GDP in 2016 and that it is projected to comply with the requirements under the preventive arm of the Pact.

In concluding, the current analysis suggests that the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/97 should be considered as currently complied with. However, Finland's debt-to-GDP ratio has been on an increasing trend, and it is forecast to continue rising over the medium term under a no-policy-change assumption. The swift adoption and implementation of structural reforms increasing productivity and the supply of labour are key to enhance Finland's growth prospects in the medium term, which would contribute to improve fiscal sustainability.