MINISTRY OF FINANCE

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Your letter to Ms Mörttinen, 27 October 2023

Dear Mr Verwey,

Thank you for your letter of 27 October, where you ask for clarifications on the compliance of Finland's DBP with the Council Recommendation of 14 July 2023.

We would like to start by underlining Finland's commitment to sound economic and fiscal policy and the EU fiscal rules. The Government of Prime Minister Petteri Orpo has set sustainable growth as its most important economic policy goal and the key to stabilising general government finances is accelerating economic and employment growth. The Government targets a maximum general government deficit of 1% of GDP by 2027. To achieve this, the Government has committed to permanently strengthening general government finances during the parliamentary term through a set of measures amounting to net EUR 6 bn. at the 2027 level (approximately 2% of GDP), which consist of adjusting general government expenditure by EUR 4 bn. and of structural policy measures aimed at strengthening general government finances by EUR 2 bn.

The Government reaffirmed its commitment to sound public finances, when the Council of Ministers on Economic Policy outlined in October that the Government will ensure that the deficit shall remain below the 3% of GDP reference value in the General Government Fiscal Plan for 2025–2028. It also stated that the Government Programme's 6 bn. set of measures will be sufficient to keep the deficit below 3%, in line with the Government Programme scenario.

The measures are being taken in an exceptional situation with a weak economic outlook and a changed security environment, and with population ageing also continuing to weigh on public finances. Besides the worsened economic performance, decreased tax revenues have led to weaker public finances in 2023 compared with 2022. Russia's war of aggression in Ukraine increased expenditure related to the changed security policy situation considerably, as can be seen from the table below. Expenditure related to population ageing will continue to grow in the coming years and decades.

Expenditure related to the changed security policy situation

EUR Bn.	2022	2023	2024	2025
Cyber security	0,04	0,06	0,06	0,05
Border security and national defence	0,70	1,14	0,75	0,58
Immigration	0,34	0,82	0,81	0,73
Security of supply, energy self-sufficiency & green transition	0,46	0,24	0,15	0,12
Measures to be taken in response to rising energy prices	0,17	0,31	0,00	0,00
Assistance to Ukraine	0,11	0,08	0,31	0,32
Other expenditure	0,01	0,00	0,01	0,01
Total	**1,83**	**2,65**	**2,09**	**1,82**

The Government's first General Government Fiscal Plan, for the years 2024–2027, which includes both the Stability Programme 2024-2026 and the 2024 Draft Budgetary Plan, provides detailed information on the measures planned for the Government term and taken in the 2024 budget. Measures for 2024 with a significant impact on net primary expenditure include:

- Defence: An increase in appropriations consistent with the change in the security environment has been allocated to the operating expenditure and defence material procurements of the Defence Forces. Appropriations within the spending limits include total funding in 2025–2027 of EUR 4.4 bn. for the fighter aircraft project and funding totalling about EUR 0.3 bn. for the Squadron 2020 project.[1]
- Health and social services: The formation of the wellbeing services counties is part of the major reform of health, social and rescue services, which addresses a long-standing CSR. This has, however, an initial increasing effect on expenditure. The wellbeing services counties are expected to be in deficit at the end of the first year, but the expenditure required for running of the counties is expected to grow slower in the medium- and long-term through efficiency and centralisation gains.
- Indexation: On the expenditure side, inflation has had the most significant impact on the increase in pensions and other social benefits. Because most social benefits, including pensions, are mainly indexed to the CPI of the previous year, high inflation in 2023 increases social benefits rapidly in 2024. Almost half of this growth in expenditure is caused by increases in pensions, which are indexed to the CPI and earnings growth. To curb the fast increase in social benefits, several social benefits have their indexation frozen in 2024-2027 by the Government as part of consolidation plans. However, to protect the most vulnerable households, basic and employment pensions have normal index corrections 2024-2027. The index freeze will slow the annual increase in benefits by around EUR 100-200 m.
- Discretionary revenue measures: The Employment Fund that collects unemployment insurance contributions to fund i.a. earnings-related unemployment benefits had an obligation to propose a reduction (EUR 1.4 bn.) to unemployment insurance contributions as of 2024, due to improved employment and partly due to proposed cuts

[1] However, as forecast is based on accrual accounting while budgeting is cash-based, the independent forecast slightly departs from the above mentioned assumptions, assuming the expenditure for fighter jets to total around EUR 5 bn. in 2025-2027.

in benefits.[2] Following this reduction and some measures taken by the Government, the tax revenues will increase while public sector employer costs will decrease. Approximately half of the reduction is expected to benefit other parts of general government. The Government is committed to additional EUR 0.5 bn. of savings related to unemployment benefit cuts to be decided in the spring.

As for the CSR to wind down the emergency energy support measures, the effect will be small. Due to the indexation of benefits, the need to increase social benefits or create targeted measures to compensate the households on high inflation and energy costs was small and the measures totalled only EUR 1.37 bn. (0.5% of GDP) in 2023.

There are other drivers behind the development of Finnish public finances that we deem relevant:

- Investment: The consolidation planned by the Government is not at the expense of investment. The Government has planned a fixed-term investment programme of EUR 4 bn. that will be funded by e.g. property income. The programme aims at creating conditions for sustainable growth for decades to come and will consist of significant investments in transport infrastructure projects that are important for the mobility of labour and for export-driven industry and business life. The central government borrowing requirement during the government term should not increase due to the investment programme. Part of this package was allocated in the autumn 2023 budget session. For 2024, this means EUR 0.35 EUR bn.
- Structural reforms: The Government is planning very ambitious labour market reforms, including an unemployment benefit reform package, reforming social security and taxation and other reforms to boost employment. Moreover, the Government will ensure a stable operating environment for entrepreneurship and investment through a predictable and stable regulatory framework as well as through taxation.

Finland's debt level has breached the 60% reference value since 2013 and has increased steadily during the previous Government's term, fuelled by the measures taken in response, first, to the pandemic and then Russia's invasion of Ukraine. This has led to increased interest rate expenditure, further aggravated by rising interest rates. However, as has been highlighted in the past Commission assessments, Finland has a strong net asset position. Finland's net public financial assets are positive and are, at more than 50% of GDP, among the highest in the OECD countries.

Finally, we would like to point out that while Finland may be at risk of non-compliance with the SGP in 2024, this is only temporary. The significant consolidation agreed in the Government Programme ensures that the deficit ratio will return to below the 3% reference value in 2025, as planned in the Stability Programme. In addition, the net expenditure in 2024 will significantly slow down compared with 2022 and 2023. Therefore, and in line with past practice and equal treatment, and also considering that the appropriate deadlines have already been passed, it would not appear to be appropriate to label Finland's situation as a case of particularly serious non-compliance with the SGP. Moreover, we would like to point out that the ad-hoc methodological changes by the Commission in the formulation of this year's CSRs were not discussed with the Member States beforehand. Therefore, we welcome that no further steps are planned based on this set of CSRs.

[2] Part of the unemployment insurance contributions are transferred to a business cycle buffer, the purpose of which is to guarantee that the level of unemployment insurance contributions remains stable. The objective is to build up a buffer that can be tapped into in times of higher unemployment to keep contribution increases lower. Known also as an EMU buffer, this buffer has been used during the past 20 years several times to moderate contribution increases. Now the buffer has reached its upper limit, whereby the Fund has proposed that the contribution percentages would be reduced as of 2024.

Yours sincerely,

Permanent Under-Secretary Leena Mörttinen