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COMMISSION STAFF WORKING DOCUMENT

Analysis of the draft budgetary plans of Finland

Accompanying the document

COMMISSION OPINION

on the draft budgetary plan of Finland

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COMMISSION OPINION

on the draft budgetary plan of Finland

1. INTRODUCTION

Finland has submitted its Draft Budgetary Plan for 2017 on 13 October 2016 in compliance with Regulation (EU) No 473/2013 of the Two-Pack. Finland is subject to the preventive arm of the Pact and should ensure sufficient progress towards its medium term budgetary objective (MTO). As the debt ratio was 63.6% of GDP in 2015 Finland also needs to comply with the debt reduction benchmark.

Section 2 of this document presents the macroeconomic outlook underlying the Draft Budgetary Plan and provides an assessment based on the Commission Forecast. The following section presents the recent and planned fiscal developments, according to the Draft Budgetary Plan, including an analysis of risks to their achievement based on the Commission 2016 autumn forecast. In particular, it also includes an assessment of the measures underpinning the Draft Budgetary Plan. Section 4 assesses the recent and planned fiscal developments in 2016-2017 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. Section 5 provides an analysis of implementation of fiscal-structural reforms in response to the latest country-specific recommendations adopted by the Council on 12 July 2016, including those to reduce the tax wedge. Section 6 summarises the main conclusions of the present document.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

In 2015 Finland exited a 3-year long recession, as output grew by 0.2%. While the Stability Programme submitted in April 2016 had forecast growth to reach 0.9% in 2016 and to accelerate to 1.2% in 2017, the DBP has revised growth expectations upwards to 1.1% in 2016 and downwards to 0.9% in 2017. According to the Commission 2016 autumn forecast, the Finnish economy is expected to grow by 0.8% in 2016 as well as in 2017. The Commission forecast has stronger growth contribution from domestic demand and negative contributions from net exports in both years. Therefore, the DBP forecast uses favourable real growth assumptions.

The Commission 2016 autumn forecast includes a higher increase in the GDP deflator for 2016, leading to rather similar nominal GDP forecast for 2016. In 2017 however, the Commission is projecting a lower increase in the deflator than the national forecast. Overall, taking real and nominal developments together, the macroeconomic scenario underlying the DBP is plausible.

Risks to the macroeconomic scenario are broadly balanced. Based on the autumn forecast, the most recent confidence indicators in manufacturing were very positive which could lead to higher-than-expected activity and exports over the forecast period. At the same time, the overall uncertainty related to the external environment, including the pace of the recovery of the important trading partner Russia's economy remains high and could postpone investment which would also weigh on the growth of Finnish exports.

Table 1. Comparison of macroeconomic developments and forecasts

	2015	2016			2017		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	0,2	0,9	1,1	0,8	1,2	0,9	0,8
Private consumption (% change)	1,5	1,0	1,2	1,4	0,8	0,7	0,8
Gross fixed capital formation (% change)	0,7	5,2	4,3	4,3	3,3	3,3	3,0
Exports of goods and services (% change)	-0,2	1,3	1,0	-0,7	2,9	3,0	1,8
Imports of goods and services (% change)	1,9	2,6	2,0	1,2	3,0	2,9	2,3
Contributions to real GDP growth:							
- Final domestic demand	1,0	1,6	1,5	1,7	1,2	0,8	0,9
- Change in inventories	0,4	-0,2	-0,4	-0,1	0,0	0,0	0,1
- Net exports	-0,8	-0,5	-0,1	-0,7	0,0	0,1	-0,2
Output gap[1]	-2,4	-1,7	-1,6	-1,8	-1,1	-1,4	-1,6
Employment (% change)	-0,4	0,3	0,4	0,2	0,4	0,3	0,3
Unemployment rate (%)	9,4	9,3	9,0	9,0	9,0	8,8	8,8
Labour productivity (% change)	0,6	0,6	0,7	0,6	0,8	0,6	0,4
HICP inflation (%)	-0,2	0,1	0,4	0,3	1,1	1,1	1,1
GDP deflator (% change)	1,6	0,7	0,9	1,1	1,1	1,2	0,8
Comp. of employees (per head, % change)	1,6	1,2	1,6	1,2	1,0	-1,0	-0,8
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-0,8	0,1	-1,1	-0,7	0,2	-1,1	-0,6

Note:

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

Source:
Stability Programme 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations

Box 1: The macro economic forecast underpinning the budget in Finland

The macroeconomic forecast underpinning the budget has been prepared by the Economics department of the Ministry of Finance. Finland is the only euro area Member State that has designated a Ministry of Finance department as the independent forecast producer referred to in the Two-pack. The management of the Economics department is separated from the Budget department and according to the law adopted in spring 2015, the Economics department is independent in its forecasting activities. The forecast is not endorsed by any other third party.

The independent body in charge of monitoring the structural balanced-budget rule is the National Audit Office, but this body has no role in the production or endorsement of the macroeconomic forecasts.

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

The DBP forecasts the headline deficit at 2.4% of GDP in 2016, 0.1 pp worse than in the April 2016 Stability Programme. The Commission 2016 autumn forecast predicts the same deficit for 2016 as the DBP.

For 2017, the DBP forecasts significantly higher general government deficit than the April Stability Programme. In the April Stability Programme the deficit was forecast to decline to 2.1% of GDP in 2017, while the DBP expects the deficit to increase to 2.6%. The reason for the difference is that the April Stability Programme did not include the efects of the Competitiveness Pact (see box 2) which was not yet agreed at the time of its submission. Linked to the Competitiveness Pact, the government lowered social contributions and personal income taxes, which would result in a decline of government revenues.

Box 2: The Competitiveness Pact

Social partners have signed the Competitiveness Pact that covers more than 90% of the employees. The pact includes a reduction of labour costs, a revised approach to local bargaining and wage freezes until the end of 2017. It increases annual working time by 24 hours without compensation, shifts part of social contributions from employers to employees (pension, unemployment benefits and health insurance contributions) and reduces public sector employees' holiday bonus temporarily by 30%. Overall, the measures in the Pact would result in a reduction of labour costs for companies of approximately 4%.

In order to compensate for the increase in social contributions, the government has included a cut in personal income taxation and social contributions in its budget proposal for 2017. These would amount to 0.7% of GDP in 2017. This is partially compensated by lower expenditure on public sector wages, but overall the negative budgetary impact would amount to 0.6% of GDP in 2017.

These measures are expected to enter into force mainly as of 2017 and are expected to have a short-term negative effect on domestic demand and public finances in 2017, but are expected to improve cost competitiveness and therefore are expected to increase exports over the medium term.

The Commission 2016 autumn forecast also takes into account the impact of the Competitiveness Pact and expects the deficit to increase to 2.5% of GDP in 2017. The difference (compared to the DBP forecast) is due to Commission's somewhat more favourable assumption on revenues (linked to the different growth composition) and lower investments on the expenditure side.

Lowering of labour costs is expected to bring along additional employment. It is, however, difficult to forecast the magnitude and timing of this effect.

In structural terms, the DBP implies a worsening of the recalculated structural balance[1] by 0.3% of GDP in 2017. The Commission 2016 autumn forecast similarly points to the worsening of the structural balance by 0.3% in 2017.

1 Cyclically-adjusted balance net of one-off and temporary measures, recalculated by the Commission on the basis of the information provided in the Draft Budgetary Plan, using the commonly agreed methodology.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2015	2016			2017			Change: 2015-2017
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**54,9**	**55,6**	***55,0***	**54,9**	**55,5**	***54,0***	**54,4**	**-0,9**
of which:								
- Taxes on production and imports	14,2	14,4	*14,3*	14,2	14,3	*14,2*	14,2	0,0
- Current taxes on income, wealth, etc.	16,6	16,6	*16,7*	16,5	16,5	*16,3*	16,4	-0,3
- Capital taxes	0,3	0,3	*0,2*	0,3	0,3	*0,2*	0,4	-0,1
- Social contributions	12,9	13,3	*13,1*	13,1	13,2	*12,6*	12,6	-0,3
- Other (residual)	10,9	11,0	*10,7*	10,8	11,2	*10,7*	10,8	-0,2
Expenditure	**57,7**	**58,2**	**57,4**	**57,3**	**57,6**	**56,6**	**56,9**	**-1,1**
of which:								
- Primary expenditure	56,5	57,0	56,3	56,2	56,5	55,6	55,8	-0,9
of which:								
Compensation of employees	13,9	13,8	13,6	13,6	13,6	12,9	13,2	-1,0
Intermediate consumption	11,5	11,7	11,6	11,4	11,7	11,6	11,6	0,1
Social payments	22,7	23,1	22,8	22,8	23,0	22,8	22,9	0,1
Subsidies	1,4	1,3	1,2	1,3	1,2	1,2	1,2	-0,2
Gross fixed capital formation	3,9	4,1	4,0	3,9	4,1	4,1	3,9	0,2
Other (residual)	3,2	3,0	3,1	3,1	2,9	3,0	3,0	-0,2
- Interest expenditure	1,2	1,2	1,1	1,1	1,1	1,0	1,1	-0,2
General government balance (GGB)	**-2,8**	**-2,5**	**-2,4**	**-2,4**	**-2,1**	**-2,6**	**-2,5**	**0,2**
Primary balance	**-1,6**	**-1,4**	**-1,2**	**-1,2**	**-1,0**	**-1,5**	**-1,4**	**0,1**
One-off and other temporary measures	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
GGB excl. one-offs	**-2,8**	**-2,5**	**-2,4**	**-2,3**	**-2,1**	**-2,6**	**-2,5**	**0,2**
Output gap[1]	-2,4	-1,7	-1,6	-1,8	-1,1	-1,4	-1,6	1,1
Cyclically-adjusted balance[1]	-1,4	-1,5	-1,5	-1,4	-1,5	-1,8	-1,6	-0,5
Structural balance (SB)[2]	**-1,4**	**-1,5**	**-1,5**	**-1,3**	**-1,5**	**-1,8**	**-1,6**	**-0,5**
Structural primary balance[2]	-0,2	-0,3	-0,4	-0,2	-0,4	-0,8	-0,5	-0,6

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the DBP/programme as recalculated by Commission on the basis of the DBP/programme scenario using the commonly agreed methodology.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability Programme 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations

Euro area sovereign bond yields remain at historically low levels, with 10-year rates in Finland currently standing at 0.3%[2]. On the one hand, this lowers the interest expenditure on government debt. Based on the information included in the Draft Budgetary Plan, interest expenditure in Finland is expected to fall from 1.2% of GDP in 2015 to 1.1% in 2016 and is projected to decrease further next year, to 1.0% of GDP, well below the 1.4% recorded back

[2] 10-year bond yields as of 31 October 2016. Source: Bloomberg.

in 2012 at the peak of the euro area sovereign debt crisis. The picture stemming from Finland's plans is broadly confirmed by the Commission forecast. Moreover, the low interest rate environment lowers the revenues from government assets which amounted to some 130% of GDP in 2015. Considering that the government debt amounted to 63.6% of GDP in 2015, the loss in revenues from assets more than outweighs the savings on government interest payments. This development has weakened Finland's structural balance over the last years.

The Finnish authorities indicated in the Stability Programme for 2017-2020 that the budgetary impact of exceptional inflow of refugees is significant and should be considered as an unusual event outside the control of the government, as defined in Article 5.1 and Article 6.3 of Regulation (EC) No 1466/97. More specifically, this expenditure increase was estimated to reach 0.2% of GDP in 2016. In relation to this, Finland requested a temporary deviation from the adjustment path towards the MTO of 0.2% of GDP in 2016. In the present Draft Budgetary Plan the government has slightly revised those projections, so that the expenditure increase is currently estimated at 0.3% of GDP.

The Draft Budgetary Plan is also accompanied by a formal request to avail of the flexibility under the preventive arm for 2017 pursuant to the "Commonly agreed position on Flexibility within the Stability and Growth Pact" endorsed by the ECOFIN Council in February 2016 in view of the implementation of major structural reforms with a positive impact on the long-term sustainability of public finances (0.5% of GDP) and national expenditures on projects co-financed by the EU under the European Structural and Investment Funds (0.1% of GDP).

The eligibility conditions for the flexibility include a requirement that the country must respect the Treaty's deficit reference value of 3% of GDP and should preserve a sufficient safety margin towards it. Based on the Commission autumn forecast, the deficit would remain below the 3 % of GDP reference value in 2017. However, *prima facie* an appropriate safety margin with respect to the deficit reference value would not be preserved[3] once the requested deviation is granted. It should be noted, however, that there is significant uncertainty associated with the estimation of the output gap for Finland (see box 4). The results of the plausibility check that have been recently agreed with the Member States indicate that Finland is one of a few countries where the output gap estimated according to the commonly agreed methodology yields counterintuitive results in 2016. The results of the detailed assessment of the output gap estimate for 2016 imply that Finland would meet the minimum benchmark in 2017.

Finland requests the maximum allowed temporary deviation based on the structural reform clause, 0.5% of GDP. Together with the request for investment clause (0.1% of GDP), the deviation would be 0.6% and would not exceed 0.75% which is the total allowed deviation for the two clauses together, according to the "Commonly agreed position on Flexibility within the Stability and Growth Pact" endorsed by the ECOFIN Council in February 2016. In 2017, based on the Commission forecast, Finland is expected to be within the maximum allowed distance of 1.5 % of GDP from its MTO of -0.5% (namely at -1.6 % of GDP), which means that the structural balance is expected to return to the MTO within three years. At the same time the negative output gap is wider than 1.5% of GDP, which allows Finland to benefit

[3] This means that Finland's structural balance, after the temporary deviation has been applied, is projected, at the time of the assessment, to remain below its minimum benchmark of -1.1 % of GDP in 2017 - the year in which the country avails of the structural reform clause.

from the investment clause. The DBP as well as the Commission autumn forecast project increasing gross fixed capital formation for the public sector for 2017 fulfilling the requirement that investment can not decrease in the years where the activation of the investment clause is sought.

The contents, state of implementation and latest impact assessment of these structural reforms have been detailed in Finland’s DBP for 2017. The reform areas with a positive impact on public finance sustainability put forward in the DBP include a pension reform and a labour market reform.

All legislation needed for the pension reform has been adopted in 2015. The reform will link the old-age retirement age to life expectancy as recommended in 2015 CSRs. First, from 2018, the lowest old-age pension age will increase from current 63 years by 3 months for each age cohort, until it reaches 65 years in 2027 and thereafter the link with life expectancy is introduced, so that the time spent working in relation to the time spent at retirement will be fixed at 2025 level. The pension reform is projected to have a positive annual growth impact of 0.1% on GDP from 2020 onwards as the supply of labour increases. Direct fiscal effect upon primary balance is projected to be -0.1% in 2017 (due to the lowering of the pension contributions). Total positive impact upon primary balance would reach 0.6% by 2030. It is estimated that the reform lowers the S2 sustainability indicator by 1pp.

Similarly, the legislation for measures agreed in the context of the Competitiveness Pact (labour market reform) have been prepared and are planned to be adopted together with the budgetary legislation by the end of 2016. Based on the DBP, the measures reduce unit labour cost by ca 4% based on the DBP. The estimated positive longer-term cumulative effect on the level of GDP is 1.5 to 2%, achieved through higher employment. Longer-term total impact on the primary balance is projected to be at least neutral, although the short-term effect is at -0.6% of GDP negative. The reform responds to the 2015 and 2016 CSRs.

Therefore, the reforms presented appear to be major and to have plausible positive direct long term budgetary effects.

3.2. Debt developments

According to the revised estimate as validated by Eurostat, Finland's debt reached 60.2% of GDP in 2014[4] and increased to 63.6% of GDP in 2015. The DBP expects the debt ratio to reach 65.3% in 2016 and 66.7% in 2016, similar to the Commission 2016 autumn forecast.

Finland's debt has been increasing due to the relatively high primary deficits but also due to the stock-flow adjustments. Stock—flow adjustment is driven by the fact that the statutory earnings-related pension system within the general government sector is partially pre-funded and in surplus. The surplus (1.9% of GDP in 2015, for example) is saved and shows up as net accumulation of financial assets under stock-flow adjustment. According to the OECD statistics[5], Finland's general government net financial assets are expected to amount to 52.0%

[4] Regarding 2014, social security funds' EDP debt included received cash collateral related to employment pension schemes' derivative contracts and securities lending for the first time in 2016 autumn notification. Previously, the items in question were included in other accounts payable, which is excluded from the definition of the EDP debt.

[5] Statistical annex of the OECD Economic Outlook (June 2016)

of GDP in 2016, second highest among the OECD countries (most countries have large net liabilities).

Finland's debt-to-GDP ratio is also influenced by the current cyclical position. When corrected for the effects of the cycle, the debt amounted to 59.1% of GDP in 2015 and is forecast by the Commission to reach 61.8% of GDP in 2016.

Risks to the development of the gross debt ratio stem mainly from the macroeconomic developments, low real and nominal growth. Risks related to contingent liabilities, guarantees, financial rescue operations and debt assumptions seem contained.

Table 3. Debt developments

(% of GDP)	2015	2016			2017		
		SP	**DBP**	**COM**	**SP**	**DBP**	**COM**
Gross debt ratio[1]	**63,6**	**65,0**	**65,3**	**65,4**	**66,7**	**66,7**	**67,1**
Change in the ratio	3,4	1,4	1,7	1,7	1,7	1,4	1,7
Contributions[2] :							
1. Primary balance	**1,6**	**1,4**	**1,2**	**1,2**	**1,0**	**1,5**	**1,4**
2. "Snow-ball" effect	**0,1**	**0,1**	**0,0**	**0,0**	**-0,4**	**-0,2**	**0,1**
Of which:							
Interest expenditure	1,2	1,1	1,2	1,1	1,1	1,1	1,1
Growth effect	-0,1	-0,6	-0,7	-0,5	-0,8	-0,6	-0,5
Inflation effect	-1,0	-0,4	-0,5	-0,7	-0,7	-0,8	-0,5
3. Stock-flow adjustment	**1,8**	**-0,1**	**0,4**	**0,6**	**1,1**	**0,1**	**0,2**
Of which:							
Cash/accruals difference		0,0			0,0		
Net accumulation of financial		1,3			1,2		
of which privatisation proceeds		-0,4			-0,2		
Valuation effect & residual		-1,9			-1,6		

Notes:

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual

Source:

Stability Programme 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations

3.3. Measures underpinning the Draft Budgetary Plan

In 2017, Finland continues to implement the consolidation measures foreseen in the government programme and the 2016 stability programme. In addition, some expansion measures linked to the Competitiveness Pact are included in the DBP.

.According to the DBP, the measures on expenditure side result in 0.9% of GDP reduction of expenditure. Consolidation measures in 2017 concern a wide spectrum of expenditure: education, science and culture, social and health services, increase of service charges and fines, lowering of social benefits and enterprise subsidies and continued freeze of index-linked expenditure.

However, linked to the competitiveness pact that extends annual working time and agrees on no wage increases for 2017, the government agreed to lower personal income tax and employers' health insurance contributions. These measures lead to a revenue loss amounting to some 0.7% of GDP. Part (0.1%) of the short-term fiscal loss is mitigated by the lowering of public sector holiday bonuses by 30% over 2017-2019. The holiday bonus accounts for half of a monthly salary, so the measure reduces public salaries by some 1.3%.

Based on the DBP, the consolidation measures do not have a negative effect on investments.

Table 4. Main discretionary measures reported in the DBP

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2016	**2017**	**2018**
Taxes on production and	0.1	0.0	-0.1
Current taxes on income,	-0.1	-0.2	-0.1
Capital taxes			
Social contributions	0.3	-0.4	0.1
Property Income			
Other			
Total	0.3	-0.6	-0.1

Note:

The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that revenue increases as a consequence of this measure.

Source: Draft Budgetary Plan for 2017

Discretionary measures taken by General Government - expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2016	**2017**	**2018**
Compensation of employees			
Intermediate consumption			
Social payments			
Interest Expenditure			
Subsidies			
Gross fixed capital formation			
Capital transfers			
Other	-0.4	-0.9	-0.2
Total	-0.4	-0.9	-0.2

Note:

The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that expenditure increases as a consequence of this measure.

Source: Draft Budgetary Plan for 2017

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

Finland is subject to the preventive arm of the Pact and should ensure sufficient progress towards its MTO of a structural deficit of 0.5% of GDP. Box 3 reports the latest country specific recommendations in the area of public finances.

Box 3: Council recommendations addressed to Finland

On 12 July, the Council addressed recommendations to Finland in the context of the European Semester. In particular, in the area of public finances the Council recommended to Finland to achieve an annual fiscal adjustment of at least 0.5% of GDP towards the medium-term budgetary objective in 2016 and 0.6% in 2017 and to use any windfall gains to accelerate the reduction of the general government debt ratio.

4.1. Compliance with the debt criterion

As the debt ratio was 63.6% of GDP in 2015 Finland needs to comply with the debt reduction benchmark. In 2016, gross debt ratio is expected to reach 65.4% based on the Commission 2016 autumn forecast which *prima facie* indicates that the 60% treaty reference value is not being complied with[6]. For 2017, the debt benchmark can be calculated and Finland is not projected to be compliant with the requirement (gap of 1.6%).

[6] Due to their backward-looking nature, both the backward-looking and the cyclically-adjusted debt benchmarks cannot be calculated in the case of Finland before 2017, as Finland has breached the reference value of 60% of GDP in 2014. Based on the forward-looking debt benchmark, which can be calculated as of 2016, the gap is estimated at of 3.2% of GDP in 2016.

Table 5. Compliance with the debt criterion*

	2015	2016			2017		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio	63,6	65,0	65,3	65,4	66,7	66,7	67,1
Gap to the debt benchmark [1,2]							1,6
Structural adjustment [3]	0,4	-0,1	-0,1	0,0	0,1	-0,3	-0,3
To be compared to:							
Required adjustment [4]							

Notes:

[1] Not relevant for Member Sates that were subject to an EDP procedure in November 2011 and for a period of three years following the correction of the excessive deficit.

[2] Shows the difference between the debt-to-GDP ratio and the debt benchmark. If positive, projected gross debt-to-GDP ratio does not comply with the debt reduction benchmark.

[3] Applicable only during the transition period of three years from the correction of the excessive deficit for EDP that were ongoing in November 2011.

[4] Defines the remaining minimum annual structural adjustment over the transition period which ensures that – if followed – Member State will comply with the debt reduction benchmark at the end of the transition period, assuming that COM (SP) budgetary projections for the previous years are achieved.

Source:

Stability Programme 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations

Finland's compliance with the debt criterion was assessed in the report issued in accordance with Article 126.3 of the Treaty on 18 May 2016[7]. The report found that part of the increase in debt-to-GDP ratio can be linked to the social security funds liquidating some of their holdings of the central government securities and purchasing other securities, thereby lowering the consolidated part of the gross debt. It also found that the social security funds have accumulated assets in parallel to the increase of the central and local government debt and these assets far outweigh the debt, resulting in positive net asset position of the general government. Moreover, the debt ratio reflected the effects of Finland's current cyclical position. The report emphasized that as Finland was expected to broadly comply with the recommended adjustment path towards the MTO in 2016. On this basis, the analysis presented in May 2016 report suggested that the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/97 should be considered as currently complied with.

4.2. Adjustment towards the MTO

The required adjustment for 2016 is at least 0.5% of GDP. Based on the DBP, the structural balance (recalculated based on the DBP data) worsens by 0.1%, pointing to a significant deviation (0.6% of GDP) from the requirement. Over 2015 and 2016 taken together, the average adjustment based on the structural balance pillar falls short by -0.2%, therefore pointing to some deviation. By contrast, the growth rate of government expenditure, net of discretionary revenue measures, in 2016 will not exceed the applicable expenditure benchmark rate. The expenditure benchmark is expected to be met with a positive margin of

[7] COM(2016) 292 final.

0.3% of GDP over one year and with a margin of 0.5% of GDP over 2015 and 2016 taken together. The difference between the two pillars is mainly explained by the revenue shortfalls affecting the structural balance and difference in the potential growth benchmarks used and the effect of lower-than-expected inflation. On balance, the overall assessment points to a risk of some deviation from the required adjustment towards the MTO. If the current estimate of the budgetary impact in 2016 of the exceptional inflow of refugees were deducted, the assessment would point to compliance.

For 2017, Finland's DBP was accompanied by a formal request to avail itself of 0.6% of GDP flexibility under the structural reform and investment clause (see section 3.1). The following assessment of compliance with the required adjustment towards the MTO in 2017 is however carried out on the basis of the preventive arm requirement enshrined in the fiscal CSR (see Box 3).

Box 4: Implementation of the "constrained judgement" approach and its impact in the context of the fiscal surveillance

The April 2016 Amsterdam Informal ECOFIN Council requested that improvements be made to the commonly agreed methodology for the estimation of potential growth and the output gap. In response to this mandate from the Council, two concrete decisions were taken in agreement with the Member States in October 2016. First, it was agreed that a revised methodology for the estimation of the non-accelerating wage rate of unemployment (NAWRU) would be introduced in the commonly agreed methodology. This change has already been implemented in the Commission 2016 autumn forecast. Second, in line with the renewed mandate provided by the ECOFIN Council on 11 October, the Economic Policy Committee – Output Gap Working Group has worked on a "constrained judgement" approach for cases where the common method is shown to produce counterintuitive output gap results for individual Member States.

The objective of the "constrained judgement" approach is to have a transparent and economically grounded tool to statistically test the plausibility of the output gaps for individual Member States estimated on the basis of the common method. To this end, the Commission developed in cooperation with the Member States an objective screening tool to assess if the common methodology produces plausible output gap estimates for all Member States. If this "plausibility" tool identifies counter-intuitive results, the Commission has carried out an "in depth" analysis.

Regarding Finland, the plausibility tool provided indications that the output gap estimated on the basis of the common methodology may be counterintuitive. Based on the commonly agreed methodology (using the new NAWRU methodology), the output gap for 2016 is estimated at -1.8% of potential GDP. The plausibility tool, on the other hand, estimates the output gap at -3.4%, almost twice as wide as the production function estimate. This result indicates that the amount of idle capacities that are available for production (manufacturing capacity and labour force) may be higher than estimated on the basis of the production function method which therefore produces a narrower output gap estimate. It indeed appears plausible that the level of the output gap is higher than what is estimated on the basis of the common methodology, i.a. because of a large and still increasing number of people at working age outside the labour market. On the other hand, current economic indicators (strengthening GDP growth, gradually increasing employment, strongly expanding construction investments) do not necessarily suggest that Finland is experiencing "very bad times" and therefore the alternative output gap estimate of -3.4% may overstate the actual output gap. On balance, the Commission considers it possible that the output gap could be around the lowest limit of "bad times". This is also closely aligned with the output gap estimates of the IMF (2.4%) and the OECD (3.1%).

Both the common methodology (output gap of -1.8% in 2016) and the detailed analysis carried out on the basis of the plausibility tool thus indicate that Finland is experiencing "bad times".

If the output gap was considered to be -2.9% of potential GDP in 2016, the structural balance would be estimated at -0.7% in 2016 and at -1% in 2017. As a result, Finland would meet the minimum benchmark of a 1.1% of GDP structural deficit in 2017.

Based on the Commission 2016 autumn forecast, the structural balance is expected to remain broadly unchanged in 2016 and therefore the structural balance pillar points to some deviation. The expenditure benchmark pillar points to compliance. The overall assessment based on the Commission forecast confirms the results of the analysis based on the DBP.

Table 6: Compliance with the requirements of the preventive arm

(% of GDP)	2015	2016		2017	
Initial position[1]					
Medium-term objective (MTO)	-0.5	-0.5		-0.5	
Structural balance[2] (COM)	-1.4	-1.3		-1.6	
Structural balance based on freezing (COM)	-1.4	-1.4		-	
Position vis-a -vis the MTO[3]	Not at MTO	Not at MTO		Not at MTO	
(% of GDP)	**2015**	**2016**		**2017**	
	COM	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.1	0.5		0.6	
Required adjustment corrected[5]	0.1	0.5		0.6	
Change in structural balance[6]	0.2	-0.1	0.0	-0.3	-0.3
One-year deviation from the required adjustment [7]	0.2	-0.6	-0.5	-0.9	-0.9
Two-year average deviation from the required adjustment [7]	-0.3	-0.2	-0.1	-0.8	-0.7
Expenditure benchmark pillar					
Applicable reference rate[8]	0.7	-0.1		-0.8	
One-year deviation [9]	0.7	0.3	0.2	-0.9	-1.1
Two-year average deviation [9]	0.5	0.5	0.4	-0.3	-0.4
Conclusion					
Conclusion over one year	Compliance	Overall assessment	Overall assessment	Significant deviation	Significant deviation
Conclusion over two years	-	Overall assessment	Overall assessment	Significant deviation	Significant deviation

Notes

[1] The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance = cyclically-adjusted government balance excluding one-off measures.

[3] Based on the relevant structural balance at year t-1.

[4] Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 27.).

[5] Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[6] Change in the structural balance compared to year t-1. Ex post assessment (for 2014) was carried out on the basis of Commission 2015 spring forecast.

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

[8] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.

[9] Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

Source :

Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations.

In 2017, as the output gap becomes narrower and debt ratio remains high, the required adjustment is 0.6% of GDP. The DBP projects 0.3% worsening in the recalculated structural balance, pointing to a risk of significant deviation (gap of -0.9% of GDP) from the required adjustment path in 2017. Similarly, the expenditure benchmark points similarly to significant deviation in 2017 (gap of 0.9% of GDP). Although the indicators point to the same direction, the overall assessment shows that the structural balance is affected by revenue shortfalls whereas the expenditure benchmark indicates differences to the growth benchmarks used. The apparent revenue shortfall in structural balance is due to the discretionary measures, as personal income tax and social contributions are forecast to be lowered. Therefore, the overall assessment leads to the conclusion of risk of significant deviation from the adjustment path towards the MTO. The analysis based on the Commission 2016 autumn forecast broadly confirms these results.

Notwithstanding these findings, the fulfilment of the eligibility criteria for flexibility under the structural reform and investment clause is a factor that could be taken into account in future assessments of a possible deviation from the required adjustment path, to the extent that credible plans are in place to resume as of 2018 the normal pace of structural adjustment and that the safety margin towards the 3% of GDP reference value is preserved, taking into account the uncertainty surrounding the estimation of the output gap.

5. IMPLEMENTATION OF FISCAL STRUCTURAL REFORMS

Finland's reform efforts have centred on the tripartite negotiations regarding a set of measures to increase the economy's cost-competitiveness – a Competitiveness Pact (see Box 2) – to increase the economy's cost-competitiveness. These measures also address the tax wedge (Box 5).

In order to address the long-term sustainability issues, Finland received a CSR to ensure timely adoption and implementation of the administrative reform with a view to better cost-effectiveness of health and social services. Over the summer of 2015, the necessary draft legislation has been prepared and circulated for public consultation. Therefore, the reform can be considered to be on track for the implementation as of 2019.

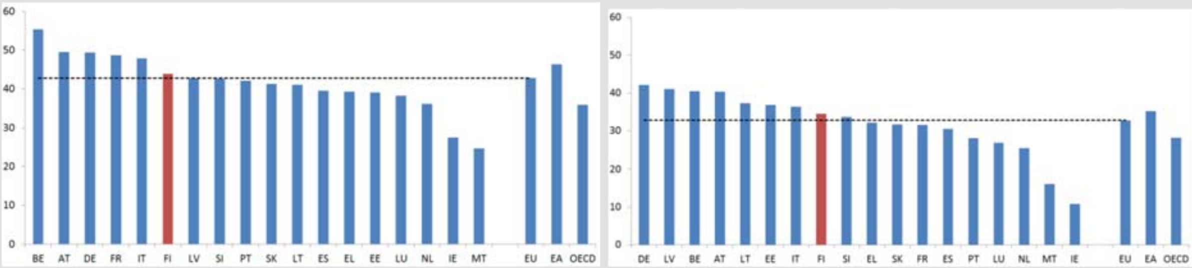
Box 5: Addressing the tax burden on labour in the euro area

The tax burden on labour in the euro area is relatively high, which weighs on economic activity and employment. Against this background, the Eurogroup has expressed a commitment to reduce the tax burden on labour. On 12 September 2015, the Eurogroup agreed to benchmark euro area Member States' tax burden on labour against the GDP-weighted EU average, relying in the first instance on indicators measuring the tax wedge on labour for a single worker at average wage and a single worker at low wage. It also agreed to relate these numbers to the OECD average for purposes of broader comparability.

The tax wedge on labour measures the difference between the total labour costs to employ a worker and the worker’s net earnings. It is made up of personal income taxes and employer and employee social security contributions. The higher the tax wedge, the higher the disincentives to take up work or hire new staff. The graphs below show the tax wedge in

Finland for a single worker earning respectively the average wage and a low wage (50% of the average) compared to the EU average.

The tax burden on labour in Finland at the average wage and a low wage (2015)



Notes: No recent data is available for Cyprus. EU and EA averages are GDP-weighted. The OECD average is not weighted.

Source: European Commission Tax and Benefit Indicator database based on OECD data.

Benchmarking is only the first step in the process towards firm, country-specific policy conclusions. The tax burden on labour interacts with a wide variety of other policy elements such as the benefit system and the wage-setting system. A good employment performance indicates that the need to reduce labour taxation may be less urgent while fiscal constraints can dictate that labour tax cuts should be fully offset by other revenue-enhancing or expenditure-reducing measures. In-depth, country-specific analysis is necessary before drawing policy conclusions.

Finland's Draft Budgetary Plan contains, as part of the reform measures to increase Finland's cost-competitiveness, the reduction of personal income tax and employer as well as employee social contributions. The reform contains an overall reduction of taxes and contributions and all the reform measures are effective as of 2017. Personal income tax cuts are implemented through the cuts of all tax rates (steeper tax rate cuts for lower earnings) and through increased deductibility of earnings from taxable expenditure. As such, the reform somewhat favours lower income earners. The measures are not financed and the reform lowers general government revenues. The government as employer will have to pay lower taxes and as part of the reform, the holiday bonuses of public sector workers are frozen for 2017 to 2019.

6. OVERALL CONCLUSION

Based on the DBP and the Commission 2016 autumn forecast, the public debt-to-GDP ratio will continue to increase in 2017.

Finland has decided to implement a labour market reform that aims at increasing its cost-competiveness as of 2017. As part of the reform, Finland's budget revenues are reduced and thus the previously planned improvements in nominal and structural balance do not materialize.

Based on both the DBP and the Commission 2016 autumn forecast, there is a risk of significant deviation from the adjustment path towards the MTO in 2017 before considering the request for the application of the structural reform and investment clauses. In its Draft Budgetary Plan Finland requests a temporary deviation of 0.5% of GDP from the required adjustment path towards the MTO in 2017 to take account of major structural reforms with a positive impact on the long-term sustainability of public finances and a temporary deviation of 0.1% of GDP to take account of EU co-financed investments. If this flexibility was granted, the Draft Budgetary Plan would point to some deviation from the requirements of the Stability and Growth Pact.

On the basis of the Commission autumn forecast, it appears that Finland fulfils the criteria for the flexibility except for the minimum benchmark which is designed to ensure a sufficient safety margin towards the 3% of GDP reference value of the Treaty. However, the results of the detailed assessment of the output gap estimate for 2016 imply that Finland would meet the minimum benchmark in 2017. Moreover, to safeguard the 3% deficit reference value, Finland's government has given the Commission further assurances[8] to take additional measures in 2017, if necessary, to ensure compliance with the fiscal rules, including the observance of the 3% of GDP reference value of the Treaty in 2017.

[8] Letter by Minister Orpo to Vice President Dombrovskis and Commissioner Moscovici on 27 October 2016 http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/dbp/2017/dbp_2017_reply_finland.pdf