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Mr Marco Buti
Director-General for Economic and Financial Affairs at the European Commission
Office CHAR 15/104
B-1049 Brussels
Marco.Buti@ec.europa.eu

Your letter to Mr Saarenheimo, 14 October 2019

Dear Mr Buti,

Thank you for your letter of 14 October, where you ask for clarifications on the compliance of Finland's planned fiscal expansion in 2020 with the requirements of the preventive arm of the Stability and Growth Pact and for further information on the precise composition of the structural balance changes and expenditure developments envisaged in the DBP in 2020.

I would like to start by underlining Finland's commitment to sound economic policies and to the fiscal rules. The Government's target is to reach balanced general government finances in 2023, which is in line with the achievement of the MTO during the Stability Programme period. The cornerstone of the Government's economic policy strategy is achieving an employment level of 75% by the end of the Government's term. Given the long-term challenges of the Finnish economy, increasing the employment rate is imperative to ensure the sustainability of the economy.

To achieve the 75% employment target, the Government has set up several working groups, involving also the social partners, that will propose concrete actions by next spring to be implemented next year. The Government is committed to act decisively to reach the target.

The Government has also taken measures with more immediate effect in the context of next year's budget, where additional expenditures were targeted at measures supporting future growth, employment and well-being. The additional expenditures consist of permanent spending increases and a future-oriented investment programme. The permanent spending increases will temporarily increase the deficit but will by 2023 be mainly financed by increased indirect taxation and reallocations within the budget. The one-off future-oriented expenditure increases will in turn be financed mainly through the sale of central government assets.

Finland has fared economically quite well in recent years, which has also led to improving public finances. The deficit has fallen from the temporary excess over the 3 percent reference value in 2014[1] to 1 percent in 2019 with growth averaging about 1.5% during this period. Growth in Finland will slow down in the next few years. Due to the buffers built during the period of growth, Finland is now able to increase its investments at a time when uncertainties are increasing. Indeed, public consumption and investment contribute considerably to GDP growth, especially in 2020.

Finland's relatively low debt level makes using the fiscal space we have particularly warranted. In this context, it should be noted that even though the future-oriented investment programme will temporarily increase the deficit, the sale of central government assets ensures that the debt ratio does not increase. Moreover, as has been highlighted in past Commission assessments, Finland has a strong net asset position. The Government will now use this strong net asset position – without endangering it – to promote future growth, and thereby the long-term sustainability of the economy.

The Government recognizes the risk of a significant deviation from the path to the MTO in 2020. It also recognizes and underscores the importance of bringing public finances on a sustainable path and respecting the EU commitments. However, the Government is of the view that the Government's plans to implement employment increasing structural reforms together with the future-oriented expenditure increases is the appropriate approach to achieve these goals.

Indeed, the Government considers that the planned expansion in the short-term is the result of temporary but necessary measures needed to help achieve higher employment and sustainable public finances in the medium and long run. Therefore, even though there may risks to compliance with the fiscal rules for 2020, the Government believes that such risks will be significantly diminished in later years, as the employment measures start taking effect.

The General Government Fiscal Plan provides detailed information on the measures taken in the 2020 budget. Here, the Government would like to underline that boosting employment requires investment. The major measures taken in the 2020 budget and in the General Government Fiscal Plan 2020-2023 to this end include:

- Increasing appropriations for wage subsidies, employment services, labor mobility and integration of immigrants, among others, by nearly EUR 300 m. (just over 0.1% of GDP) during the parliamentary term.
- Launching projects to make early childhood education and care as well as comprehensive school education more equitable and improve their quality, with the aim of improving children and young people's learning outcomes and tackling inequality, for which 300 m. (just over 0.1% of GDP) will be used between 2020 and 2022.
- Universities will get from 2020 onwards, an addition of 200 m. (0.1% of GDP) to both the core financing and compensation for cost increase.

Additional measures include several actions to boost growth-supporting research and development investment, such as temporary incentive for research cooperation and increasing Business Finland's grant-based financing. The Government will also continue to support the level of public investment, especially on infrastructure, in order to improve the growth potential of the Finnish economy. For example, the temporary increase in the maintenance investment on transport infrastructure will be continued in 2020, amounting

[1] The latest data show that the deficit remained below 3% also in 2014 implying that Finland has not had a deficit above the 3% limit during EMU.

EUR 300 million (just over 0.1% of GDP). These investments support the winding up of the maintenance backlog and are essential for the smooth functioning of the economy.

Among the other expenditure increases the Government highlights social protection as one of the main sources of expenditure increase in 2020. Furthermore, the Government is fully committed to fighting climate change and sets as one of its key goals that Finland will achieve climate-neutrality by 2035. On the 2020 Budget, it enacted measures to increase energy subsidies to support investments in energy technologies to replace coal as well as fixed-term circular economy innovation and investment support.

Hence, looking at the precise composition of the structural balance changes and expenditure developments envisaged in 2020 shows that the Government has decided on numerous measures that will support growth and ensure compliance with fiscal rules in the future.

While there is a risk of a significant deviation from the expenditure benchmark next year, the structural balance pillar would appear to bear less of risks. As stated in the DBP, the structural balance would appear to perform better in a situation, where GDP growth has been slow for a long period. Indeed, current potential growth used for the calculation of the structural balance would appear to be a better reference rate for future expenditure growth than the medium-term potential growth rate, as it is not affected by the very low potential growth rates of the past. Furthermore, recent Commission assessments have relied more on the structural balance pillar.

In general, we would like to point out that while Finland is at risk of non-compliance with the preventive arm of the SGP, it is currently not at risk of breaching the Treaty reference values for deficit and debt. Therefore, and in line with past practice and equal treatment, it would not appear to be appropriate to label Finland’s situation as a case of serious non-compliance with the SGP. We would also like to we reiterate our long-standing view that there needs to be a clear procedural differentiation between breaches of the preventive arm and the corrective arm.

Yours sincerely,

Permanent Under-Secretary Tuomas Saarenheimo