MINISTRY OF FINANCE

Mr Valdis Dombrovskis
Mr Pierre Moscovici
European Commission

Helsinki, 27 October 2016

Your letter of 25 October 2016

Dear Commissioners,

Thank you for your letter of 25 October, where you requested further information for your assessment of whether Finland continues to fulfill the requirements of the Stability and Growth Pact.

Let me first emphasize that Finland remains committed to the EU fiscal rules. The strategy chosen by the Finnish Government is to ensure sustainable compliance with the rules through structural reforms that boost potential growth and contain public expenditures. The Finnish economy has faced a succession of negative shocks, and the first priority of the Government is to help the Finnish economy's capacity to adapt to these shocks and return on a sustainable growth path.

The main structural reforms, as outlined in the Draft Budgetary Plan, concentrate on competitiveness, labor markets, and social and health care sector. All of these respond directly to the CSRs given to Finland in recent years. Each of them is crucial for putting the economy back on a path of sustainable growth and sound public finances. Yet, the implementation of these reforms comes with short-term costs that initially mask the beneficial effect on public finances. In particular, the direct effect on 2017 budget balance is negative. The Finnish Government considers Finland a good candidate especially for structural reform clause but also for the investment clause.

On the specific questions you raised in your letter, I would like to point out the following:

- Related to Finland's application for the use of the Structural Reform Clause and the Investment Clause, I would again like to highlight the positive effects of the Competitiveness Pact, which will reduce unit labor costs by some 4% and create 40.000 new jobs in the long term, a significant increase in the Finnish perspective. This demonstrates the Government's and the society's willingness and ability to implement wide-reaching, society-encompassing reforms. The tax concessions linked to the Competitiveness Pact were an integral part of the agreement, indispensable for enabling the necessary consensus.
- Other examples of ongoing major reforms include the comprehensive Social and Health Care Reform and the recently launched Employment Package, which will, among other things, reform the earnings-related unemployment scheme and streamline the provision of active labor market services. The Government is also launching a comprehensive review of company taxation and subsidies. Further, the Government has engaged in

a wide-ranging liberalization of the services sector, including shop opening hours and transportation services.

- Regarding public finances, Finland's general government deficit is estimated at 2.6% of GDP next year and will decline to 2.0% in 2018. This provides a sufficient safety margin to the 3% limit. Moreover, I would like to point to Finland's good track record with observing the 3% deficit reference value, even in highly adverse economic conditions. The Government remains committed to keeping the deficit below 3% also in the future.
- As stated in the DBP, the Government still targets meeting the MTO in 2019. This implies returning to the adjustment path towards the MTO in 2018. This should also help Finland meet the debt benchmark, at least in the forward-looking form. In line with the Government Programme, the Government remains committed to turning general government debt on a declining path.
- As to public debt developments, even though public debt has exceeded the 60% debt reference value, Finland's net public financial assets are positive and are, at more than 40% of GDP, among the highest of the OECD countries. It should also be noted that the debt figures are somewhat artificially inflated by the ECB's bond buying program, which has led the public pension funds to reduce their holdings of Finnish Government bonds. As pointed out in the DBP, Finland's EDP debt could, in theory, be reduced by redirecting public pension funds' investments back into central government bonds. However, the Government respects the autonomy of the pension funds to invest their funds on commercial grounds.

I would also like to call our attention to some additional factors

- Firstly, to remind you that successive governments have taken sizable fiscal consolidation measures, which have been sufficient to keep the deficit sustainably and safely below 3%. Expenditure reductions amounting to 2% of GDP were included in the Government Program and continue to be phased in. Also, the pension reform will gradually raise the retirement age and contain pension expenditures, with a positive effect on sustainability of about 1 %-point of GDP.
- The Government's consolidation efforts have not been at the expense of public investment. On the contrary, public investments in Finland, at 4,1% of GDP in 2017, remain high, and the Government Program included a number of key investment projects aimed at strengthening competitiveness. This demonstrates the high quality of the Government's consolidation efforts.
- Second, as pointed out above, the deviation of the structural balance from the required adjustment in 2017 is linked to the cost of the structural reforms implemented by the Government. If the impact of the Competitiveness Pact were removed from the change in the structural balance, the structural balance would improve in 2017 by nearly 0.2% of GDP, meaning that the deviation would not be significant. Likewise, excluding the short-term effects of the Competitiveness Pact and the pension reform, the deviation from the expenditure benchmark would no more be significant. It should also be noted that the expenditure benchmark for Finland is much tighter for 2017 than it has been in the previous years. The change is caused by lower potential growth rate and higher structural adjustment requirement. Furthermore, lower than expected inflation is making it more difficult to comply with the expenditure benchmark.
- Thirdly, the earning-related pension system has added to the structural deficit in various ways. Obviously, age-related pension expenditures have increased, even in the absence of any active decisions. But beyond that, the low interest environment has had a negative effect on the pension funds' capital income. Unlike nearly all other EU countries, which have benefited from the low interest rates, Finland has actually faced a windfall

loss due to the low interest rates. As a result, the surplus of the earnings-related pension funds fell to 1.3% of GDP in 2015, from 3.0% in 2009.

Finally I would like to emphasize that, when taking stock of the situation in the context of preparing the Spring 2017 General Government Fiscal Plan, the Government commits to take additional measures, if necessary, to ensure compliance with the fiscal rules, including the observance of the 3% deficit limit for 2017.

Sincerely,

Petteri Orpo
Minister of Finance