COMMISSION OF THE EUROPEAN COMMUNITIES

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RESTRICTED

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the updated stability programme of Finland, 2001-2004

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) No. 1466/97, on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], stipulated that countries participating in the single currency were to submit stability programmes to the Council and the Commission by 1 March 1999. In accordance with Article 5 of this Regulation, the Council had to examine each stability programme based on the assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty, the Economic and Financial Committee. The Commission adopted a recommendation on each programme. On the basis of this recommendation and after having consulted the Economic and Financial Committee, the Council delivered an opinion, following its examination of the programme.

Finland's first stability programme covering the period 1998-2002 was submitted on 7 September 1998 and assessed by the Council on 12 October 1998[2].

According to the Regulation, the updated stability programmes, to be presented annually, may also be examined by the Council in accordance with these same procedures. The second annual update, covering the period 2000-2004, was submitted on 11 September 2000 and examined by the Council on 27 November 2000[3].

Finland submitted the third and most recent updated stability programme, covering the period 2001-04, on 22 November. The Commission services have carried out a technical evaluation of this updated programme, which warrants the following assessment:

> The new update of the Finnish stability programme projects growth in Finland to come to a near standstill in 2001, following seven years of buoyant economic activity. This implies a significant downward revision of output growth in comparison with the previous update. This is mainly seen as the consequence of a significantly less favourable external balance, contributing negatively to GDP growth, but domestic demand is also projected to weaken. However, both net exports and domestic demand are projected to pick up in later years of the programme period, leading to a gradual acceleration of output growth to 3% by 2004. Although employment has expanded strongly during past years and unemployment has halved, the number of unemployed persons still remains high and, according to the programme's projections, will rise in 2002. Inflation, however, should ease as both external and internal price-push factors are expected to subside. The programme's short-term projections compare reasonably well with the Commission services' Autumn 2001 forecasts.
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> The programme foresees a decline in the general government surplus from the record level of 6.9% of GDP in 2000 to 4¾ % in 2001, and a further fall to some 2% in 2002-04. This represents a significant downward revision of the projected government surplus for the years between 2002 and 2004 in comparison with the previous update of the programme. The high surpluses attained in 2000-01 clearly provide some room for fiscal action but the downward revision is mainly related to lower GDP growth. The projected reduction of the surplus for 2002 is also

1 OJ L209, 2.8.1997
2 OJ C372, 2.12.1998
3 OJ C374, 28.12.2000

attributable to tax cuts and to higher-than-planned discretionary spending. In any case, the projected path of the government balance remains clearly in line with the requirements of the Stability and Growth Pact (SGP) of a fiscal position close to balance or in surplus.

The main driving force behind the reduction in the projected general government surplus is a worsening of central government finances which are expected to go into deficit in 2003. As a consequence, the government's aim of achieving a structural surplus in central government finances of 1½-2% of GDP in the medium term appears now difficult to reach. But local government finances and the social security sector also contribute to the deterioration. However, while the local government finances are expected to be in deficit between 2001 and 2003, the social security sector should maintain sturdy surpluses over the whole programme period.

The general government debt is estimated to decline only moderately from 44.0% of GDP at end-2000 to 41.8% at end-2004, in stark contrast to the previous programme which projected the gross government debt ratio to decline to 32.2%. The slowdown in the speed of debt reduction is attributable in part to the lower projected general government surpluses over the programme period. In addition, the decline in the gross debt ratio is also slowed by significant financial transactions, in particular the ongoing diversification of social security institutions' assets away from central government bonds and the net acquisition of financial assets .

In order to boost employment creation the current government proposed, when taking office, tax cuts amounting to € 1.7 – 1.9 billion between 1999 and 2003. Including the envisaged tax cuts in the budget proposal for 2002, the actual tax relief between 2000 and 2002 amounts to € 2 billion, thus already exceeding initial plans. The planned tax cuts for 2002 are justified against the background of a still strong budgetary position and high unemployment which is also due to a high tax burden on labour. The tax relief is furthermore well timed in view of the sharp economic slowdown and as price pressures are expected to ease.

However, welcome as they are, against the background of the government's aim of preparing for the forthcoming age-related expenditure pressures tax cuts need to be accompanied by expenditure restraint. But success in the area of expenditure control is less evident in the period 2000-02. Indeed, the new update projects the expenditure ratio in 2002 to lie markedly above the value projected in the previous programme. Clearly, this is partly due to a significantly lower nominal GDP and to changes in accounting practices but the repeated overshooting of the medium-term expenditure guidelines also suggests that the resolve to tightly control expenditure seems to have weakened.

In view of Finland's particular exposure to age-related expenditure pressures the deviation from the expenditure guidelines and the associated slower pace of debt redemption need to be addressed when reviewing the central government spending guidelines in Spring 2002. It should be recalled, in this context, that in the 2001 Broad Economic Policy Guidelines the Council recommended that Finland adhere to the expenditure targets set in the budget for 2001. Budgetary discipline at general government level may be enhanced by a recently adopted legislation requiring local governments to aim for budgetary balance in their finances in the medium term from 2002 onwards. However, in the absence of an enforcement mechanism in the legislation, close surveillance of the regulation seems important to achieve the envisaged results.

The programme shows that government finances in Finland stand a good chance to meet the budgetary consequences of its ageing population. It is worth noting, however, that the results are very sensitive to changes in key economic parameters, notably the achievement of the envisaged surplus in 2004, the interest-growth rate differential and the projected increase in the tax ratio. This underlines that running down public debt in the current decade should be the central element in the budgetary strategy to prepare for the ageing of the population. Moreover, structural reforms seem essential to achieve the envisaged increase in the effective retirement age and participation rate amongst older workers. As a consequence, the planned reform of the unemployment benefit system and of the private sector pension system should be a priority issue for the Finnish government.

Based on this assessment, the Commission has adopted the attached recommendation for a Council opinion on the Stability Programme update of Finland and is forwarding it to the Council.

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the updated stability programme of Finland, 2001-2004

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[4], and in particular Article 5 (3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On [22 January 2002] the Council examined Finland's updated stability programme, which covers the period 2001-04. The Council notes with satisfaction that the general government surplus, which exceeded expectations in 2000, is projected to remain at a fairly high level throughout the programme period. The general government debt to GDP ratio is expected to continue to decline, although more moderately than previously projected. The Council considers that the updated programme is consistent with the Broad Economic Policy Guidelines.

The macroeconomic scenario presented in the 2001 updated stability programme expects a strong deceleration of economic growth in 2001, mainly due to the sharp decline in the external balance. In the following years, GDP is assumed to gradually accelerate attaining a rate close to potential at the end of the period. Although considerable risks regarding the short-term outlook prevail at the moment, most recent data suggest that the economy has bottomed out in the second half of 2001. As consequence, the assumption of a revival from 2002 on appears plausible. However, this crucially hinges on the expected upturn of employment growth which, in order to materialise, needs to be supported by wage moderation.

The Council notes that the programme foresees a decline in the general government surplus from its record height in 2000 to a level of somewhat above 2% of GDP over the period

4 OJ L 209, 2.8.1997.

2002-04. This must be seen in the light of the high surpluses reached in 2000 and 2001. The projected reduction in the surplus partly results from the strong downward revision of GDP growth. But it is also due, in 2002, to tax cuts and to higher than originally foreseen spending, thus deviating from the medium-term central government spending ceilings. Such a deviation had also occurred in 2001. The Council recommends that the spending ceilings are firmly adhered to in coming years and that some of the lost ground is regained in the Spring 2002 review of the spending ceilings. The Council, furthermore, welcomes the recent adoption of legislation requiring local governments to balance their budgets in the medium term. The Council recommends close surveillance of this regulation in order to ensure that its aims are achieved. In the light of Finland's particular exposure to expenditure pressures related to population ageing the Council considers it essential that high government surpluses are maintained in the medium term allowing the government debt ratio to decline at a sufficient pace.

The Council notes that the projected surplus in the government accounts is fully in line with the requirements of the Stability and Growth Pact throughout the programme period. Moreover, the estimated cyclically-adjusted government balance of more than 2% of GDP should provide a sufficient safety margin against a breach of the 3% of GDP reference value for the government deficit in normal cyclical fluctuations.

The Council welcomes the updated stability programme's commitment to continued structural reforms. Planned government action to start the reform of the unemployment benefit system is welcome in the light of rising unemployment. Also, the planned reform is welcome in order to complement the favourable outcome of continued labour tax cuts aimed at reducing the current heavy overall tax burden on labour to boost employment creation. Further structural reforms in the private service sector and in the labour market would also support employment creation. The Council also encourages the government to introduce as soon as possible the measures which are necessary to achieve the aim of shifting taxes away from labour towards capital, property and environmental taxes. Moreover, the reform of the private pension system should be finalised as scheduled.