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COMMISSION STAFF WORKING PAPER

Analysis by the Commission services of the action taken

by Finland

in response to the Council Recommendation of 13 July 2010 with a view to bringing an end to the situation of excessive government deficit

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1. INTRODUCTION

In response to the economic downturn, Finland allowed a full operation of automatic stabilisers and provided a discretionary fiscal stimulus, which turned the general government finances from earlier surpluses into a deficit of 2.5% of GDP in 2009. The deficit was projected to widen further to 4.1% of GDP in 2010 according to the April 2010 EDP notification presented by the Ministry of Finance. The Commission services' spring 2010 forecast projected a slightly smaller deficit of 3.8% of GDP in 2010. Against this background, on 13 July 2010, the Council decided that an excessive deficit existed and addressed recommendations to Finland in accordance with Article 126(7) TFEU with a view to bringing an end to the situation of an excessive government deficit by 2011.[1] In its recommendations, the Council established a deadline of 13 January 2011 for effective action to be taken.

The Council recommended to Finland to bring the general government deficit below 3 % of GDP in a credible and sustainable manner. Specifically, to this end, Finland should (a) implement the fiscal measures in 2010 as envisaged in the latest update of the stability programme, while ensuring that the planned breach of the 3%-of-GDP reference value would remain contained and temporary; (b) ensure a fiscal effort of at least 0.5% of GDP in 2011; and (c) specify measures to ensure that the planned correction of the excessive deficit in 2011 is secured.

The present paper reviews the actions taken by the Finland to meet the above recommendations, in light of the economic and budgetary developments since the Council recommendations were issued on 13 July 2010. In particular, it reviews budgetary implementation in 2010 by comparing the projected budgetary developments in 2010 according to the Commission services' autumn 2010 forecast with the economic and budgetary scenario underpinning the Council recommendations. That scenario was based on the Commission services' spring 2010 forecast and the budgetary projections underlying the central government's 2010 budget[2], which was also incorporated in the stability programme update of 4 February 2010. For 2011, the basis for the assessment of action taken towards the correction of the excessive deficit is the Commission services' autumn 2010 forecast, which incorporates the 2011 budgetary measures, as well as the Ministry of Finance forecast update from 20 December 2010.

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1 All EDP-related documents for Finland can be found at the following website: http://ec.europa.eu/economy_finance/sgp/deficit/countries/finland_en.htm

2 The publication of the central government budgets for 2010 and 2011 can be found at: http://www.vm.fi/vm/en/04_publications_and_documents/01_publications/01_budgets/index.jsp

2. ECONOMIC DEVELOPMENTS

The global crisis strongly affected the Finnish economy in 2009, while solid fundamentals supported a fast recovery in 2010. Economic growth picked up since the second quarter of 2010, following a severe decline of 8% in 2009. The Commission services' autumn 2010 forecast projects real GDP to increase by 2.9% both in 2010 and 2011, mainly driven by domestic demand.

Macro-economic conditions and the outlook for the Finnish economy have significantly improved since the Commission services' spring 2010 forecast (Table 1). In the first quarter of 2010, economic growth was suppressed due to an exceptionally cold winter and several strikes, but picked up in the following quarters. Domestic demand has strengthened considerably, fuelled by historically high levels of consumer confidence on the back of global recovery. Net exports have also progressively gained from strengthening external, following a subdued growth in early 2010. National authorities also revised their economic projections upwards in the second half of 2010. In December 2010, the Ministry of Finance projected real GDP to increase by 3.2% in 2010 and 2.9% in 2011, compared to 0.7% and 2.4%, respectively, in the most recent update of the Finnish stability programme in February 2010.

Table 1: Comparison of macroeconomic developments and forecasts

	2009	2010		2011	
	outturn	**COM SF10**	**COM AF10**	**COM SF10**	**COM AF10**
Real GDP (% change)	-8.0	1.4	2.9	2.1	2.9
Contributions to real GDP growth:					
Final domestic demand	-3.9	0.7	1.5	1.6	2.4
Changes in inventories	-1.8	0.6	0.7	0.2	0.2
Net exports	-1.7	0.1	0.7	0.4	0.2
Employment (% change)	-2.8	-2.1	-0.1	0.4	0.9
GDP deflator (% change)	0.9	1.4	1.3	2.0	2.6

Source : COM SF10 - Commission services' spring 2010 forecast; COM AF10 - Commission services' autumn 2010 forecast.

3. BUDGETARY IMPLEMENTATION IN 2010

Reflecting the operation of automatic stabilisers and a relatively large fiscal stimulus, the general government net lending fell to a deficit of 2.5% of GDP in 2009. Since a substantial fiscal stimulus of about 1% of GDP was also given in 2010, in the February 2010 update of the stability programme the Ministry of Finance projected the deficit to widen to 3.6% of GDP in 2010. In its economic forecast from 30 March 2010, the Ministry of Finance revised the 2010 deficit target further down to 4.1% of GDP. However, reflecting the robust rebound in economic activity recorded since the second quarter of 2010, the fiscal outlook has also improved. Subsequent forecast updates by both the Commission services' and the Ministry of Finance have revised the deficit projection for the better. The Commission services' autumn 2010 forecast projects a deficit of 3.1% of GDP in 2010, which will in turn improve the outlook for the following years. Similarly, the latest Ministry of Finance forecast update from December 2010 expects the deficit to reach only 3.2 % of GDP in 2010. The revisions to the general government deficit forecast were mainly explained by the robust economic recovery boosting tax revenues. Expenditure growth was also somewhat higher in 2010 than projected in the February 2010 stability programme update on account of stimulus measures (Table 2).

Table 2: Composition of the budgetary adjustment

	2009		2010						2011			
	outturn	SP Feb 2010	SP Feb 2010		MoF Sept 2010		COM AF 2010		MoF Sept 2010		COM AF 2010	
	% of GDP	% of GDP	% ch yoy	% of GDP	% ch yoy	% of GDP	% ch yoy	% of GDP	% ch yoy	% of GDP	% ch yoy	% of GDP
Revenue	52.9	53.1	0.8	52.6	2.9	52.5	3.1	52.3	7.1	53.5	6.6	52.9
of which:												
- Taxes on production and imports	13.5	13.4	0.4	13.3	1.4	13.2	1.6	13.2	9.3	13.8	9.8	13.7
- Current taxes on imcome, wealth, etc.	16.2	16.2	-0.7	15.8	3.7	16.2	4.0	16.2	6.5	16.5	5.8	16.3
- Social contributions	13.0	12.8	2.7	12.9	4.4	13.1	4.6	13.0	5.1	13.1	5.3	13.0
- Other (resedual)	10.2	10.6	1.3	10.5	1.7	10.0	1.7	9.9	7.5	10.2	5.4	9.9
Expenditure	56.0	55.3	3.4	56.2	4.2	56.1	4.1	56.0	3.4	55.2	3.7	55.0
of which:												
- Primary expenditure	54.6	53.9	3.5	54.8	4.2	54.7	4.1	54.6	3.3	53.8	3.6	53.6
of which:												
- Compensation of employees	14.8	14.7	1.4	14.7	1.4	14.5	3.5	14.7	2.1	14.1	2.7	14.4
- Intermediate consumption	11.0	10.9	5.1	11.2	5.1	11.2	2.4	10.8	4.0	11.1	4.6	10.7
- Social payments	20.9	20.5	5.7	21.3	5.0	21.1	4.9	21.0	3.9	20.9	3.9	20.7
- Subsidies	1.5	1.5	3.3	1.5	6.3	1.5	6.3	1.5	5.9	1.5	5.8	1.5
- Gross fixed capital formation	3.3	2.8	-1.9	2.7	-1.8	3.1	2.6	3.2	0.9	3.0	1.5	3.1
- Other (residual)	3.1	3.5	-1.2	3.4	8.4	3.2	8.4	3.2	3.9	3.2	4.0	3.2
- Interest expenditure	1.4	1.4	0.9	1.4	5.4	1.4	5.4	1.4	5.4	1.4	5.4	1.4
General government balance (GGB)	-2.5	-2.2		-3.6		-3.3		-3.1		-1.4		-1.6
Primary balance		-0.8		-2.3		-1.9		-1.8		0.0		-0.3
One-off and other temporary measures	-0.1	0.0		-0.2		na		-0.1		na		0.0
Real GDP growth	-8.0	-7.6	0.7		2.1		2.9		2.9		2.9	
GDP deflator	0.9	1.1	1.2		1.6		1.3		2.2		2.6	
Nominal GDP	-7.2	-6.5	1.9		3.7		4.2		5.1		5.5	

Source: SP Feb 2010 - Stability Programme February 2010; MoF Sept 2010 - Ministry of Finance Finland's September 2010 forecast; COM AF10 - Commission services' autumn 2010 forecast.

While fiscal policy was overall expansionary in 2010, reflecting the share of the fiscal stimulus programme implemented in that year (including several tax cuts), some significant tax rises were also implemented as planned. They will also have a positive carry over impact in 2011. The increase of VAT rate by 1 percentage point as of 1 July 2010 was implemented as announced in the 2010 budget and in the February 2010 stability programme update. The full annualised impact of the VAT rise is estimated to amount to 0.4% of GDP, however, due to timing effects its impact in 2010 was limited to just 0.1% of GDP. Additionally, in Finland local governments have almost full autonomy over setting some local tax rates (most notably municipal income tax and real-estate taxes). A large share of local governments increased their tax rates in 2010, estimated by the Ministry of Finance to yield 0.3% of GDP in 2010. It is expected that local governments will continue to increase their tax rates in the coming years as well.

4. PROJECTED BUDGETARY DEVELOPMENTS IN 2011 AND 2012

The Commission services' autumn 2010 forecast projects a deficit of 1.6% of GDP in 2011. The Finnish Ministry of Finance's latest forecast from 20 December 2010 projects a slightly lower deficit at 1.3% of GDP in 2011. Most revenue and expenditure categories are broadly in line between the two forecasts. The discrepancy is mainly explained by the Commission projecting slightly weaker revenues (lower personal income tax and sales receipts) and slightly higher expenditures (personnel costs and intermediate consumption). The deficit outlook has improved considerably since the February 2010 update of the stability programme that projected a deficit of 3.0% of GDP for that year. A major part of this improvement is explained by the better-than-expected economic and fiscal outcome in 2010, which carries over to 2011. However, also some discretionary tax increases have been settled over the course of 2010. The central government budget for 2011, adopted in December 2010, raises energy and some product taxes, amounting to some 0.5% of GDP in 2011 and 0.1% of GDP in 2012. Additionally, the government, in cooperation with social partners, has already decided on changes to pension, health, and unemployment insurance contribution rates, improving the general government balance by 0.1% of GDP in 2011 and 0.4% in 2012. While no exceptional budget cuts have been announced, expenditure growth is also expected to moderate, as some of the investment projects coming from the earlier stimulus package gradually run out and local governments (accounting for a third of general government expenditure) are likely to react to financing constraints by making savings in their budgets. Both the central and local governments are continuing to implement long term programmes to boost public sector productivity, which should also yield some savings in personnel costs. Since nominal GDP is projected to grow robustly and exceed expenditure growth in 2011, the expenditure to GDP ratio is expected to fall by about 1 pp.

The Commission services assesses that the risks to the achievement of the 2011 deficit target are mainly dependent on underlying economic developments. Those risks related to the economic recovery in Finland are considered to be broadly balanced. While a deteriorating external economic environment would have immediate repercussions for the highly open Finnish economy, economic fundamentals remain sound and the domestic market is buoyed by strong consumer and corporate confidence. In a more stable external environment, economic recovery in Finland could also turn out stronger than forecast.

The Commission services' forecast implies an improvement in the structural balance (the cyclically-adjusted balance net of one-off and other temporary measures) relative to GDP by slightly less than 1 pp. in 2011, after a worsening of around 1 pp. anticipated in 2010. These estimates broadly correspond to a bottom-up measurement of the size of the discretionary fiscal measures in 2010 and 2011.

For 2012, the Commission services' autumn 2010 forecast projects the deficit to narrow further to 1.2% of GDP by 2012, thanks to the consolidation measures mentioned above. The authorities project the deficit to improve to 0.6% of GDP. Compared with the authorities, the somewhat higher deficit projected by the Commission services is in line with the lower GDP growth forecast for that year.

Table 3: Comparison of key macroeconomic and budgetary projections

		2008	2009	2010	2011	2012
Real GDP (% change)	COM	0.9	-8.0	2.9	2.9	2.3
	FI	0.9	-8.0	3.2	2.9	2.7
	SP	1.0	-7.6	0.7	2.4	3.5
Output gap (% of potential GDP)	COM	3.7	-6.0	-5.0	-4.0	-3.5
	FI	n.a.	n.a.	n.a.	n.a.	n.a.
	SP	3.6	-5.0	-5.2	-4.3	-2.5
General government balance (% of GDP)	COM	4.2	-2.5	-3.1	-1.6	-1.2
	FI	4.2	-2.7*	-3.2	-1.3	-0.6
	SP	4.4	-2.2	-3.6	-3.0	-2.3
Primary balance (% of GDP)	COM	5.6	-1.3	-1.8	-0.3	0.4
	FI	n.a.	n.a.	n.a.	n.a.	n.a.
	SP	5.9	-0.8	-2.3	-1.2	-0.2
Cyclically-adjusted balance (% of GDP)	COM	2.4	0.6	-0.6	0.4	0.6
	FI	n.a.	n.a.	n.a.	n.a.	n.a.
	SP	2.6	0.3	-1.1	-0.8	-1.0
Structural balance (% of GDP)	COM	2.4	0.6	-0.5	0.4	0.6
	FI	n.a.	n.a.	n.a.	n.a.	n.a.
	SP	n.a.	n.a.	n.a.	n.a.	n.a.
Government gross debt (% of GDP)	COM	34.1	43.8	49.0	51.1	53.0
	FI	34.1	43.8	47.9	50.0	51.3
	SP	34.2	41.8	48.3	52.2	54.4

Source: COM - Commission services' 2010 autumn forecast; FI –Ministry of Finance forecast update of 20 December 2010; SP - Stability Programme February 2010.
Note: The general government deficit according to EDP reporting was 2.5% of GDP in 2009*