COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 7.1.2004
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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, 2003-2007

(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. 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.

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]. Finland submitted the fifth and most recent updated stability programme, covering the period 2003-2007, on 27 November 2003.

The Commission services have carried out a technical evaluation of this updated programme, taking into account the information provided in accordance with the Code of Conduct[3], the Autumn forecasts as well as subsequent evaluations, the commonly agreed methodology for the estimation of cyclically-adjusted balances, the recommendations in the Broad Economic Policy Guidelines and the principles laid down in the Communication of the Commission to the Council of 27 November 2002 on strengthening the coordination of budgetary policies[4]. This evaluation warrants the following assessment:

The new update of the Finnish stability programme presents macro-economic and government finance projections for the period 2003-07. The update is broadly in line with the revised "code of conduct on the content and format of stability and convergence programmes"

The November 2003 update of the Finnish stability programme foresees a marked acceleration of GDP growth to 2.7% in 2004, almost double the growth rate expected for 2003. Between 2005 and 2007, growth is projected at around 2½% p.a. exceeding the potential output by nearly ½ percentage point. Consequently, the negative output gap is seen to close in the last year of the programme period, from a gap of over 1.3 p.p. in 2003 due to the downturn in economic activity. This fifth update of the stability programme assumes, from 2004 onwards, a broadly similar profile of output as the previous programme. Growth contributions from different demand components have been modified somewhat, as the external contribution appears stronger in the current programme whereas support from domestic demand is slightly weaker. In 2003, employment creation has been relatively resilient to the slowdown in activity. Consequently, unemployment is expected to remain unchanged at a rate of 9.1% in 2003 and with growth accelerating, to decline from 2004

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1 OJ L 209, 2.8.1997. The documents referred to in this text can be found at the following web site http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

2 OJ C 372, 2.12.1998.

3 Revised Opinion of the Economic and Financial Committee on the content and format of stability and converge programmes, document EFC/ECFIN/404/01 – REV 1 of 27.6.2001 endorsed by the Ecofin Council on 10.7.2001.

4 COM(2002) 668 final, 27.11.2002.

onwards. Inflation is expected to bottom out at 0.7% by 2004[5] due mainly to tax cuts on alcohol beverages and the absence of external price shocks, and thereafter resumes its earlier trend of around 2% as economy expands and the impact of the tax cuts phases out. Apart from a higher growth estimate for 2004, the programme's short-term projections compare reasonably well with the Commission's own evaluation, notably the Autumn 2003 forecast.

The updated programme foresees a significant decline in the general government surplus from 4.2% of GDP in 2002 to 1.7% in 2004. This is due partly to cyclical factors, which weaken the financial position of the central government, and partly to increased spending introduced in the new government's programme. In addition, according to the programme, increasing external tax competition will make for some erosion in tax bases. In 2005 and beyond, the surplus is expected to edge up only slightly and stabilise somewhat above 2% of GDP, despite growth exceeding potential. Nevertheless, the projected path of the government balance shows that public finances in Finland will provide necessary safety margin against a breach of the 3% of GDP reference value throughout the programme period. The major contribution to the trend fall in the surplus ratio comes from the deterioration of central government finances which are estimated to slip into deficit as from 2003. As a result, the updated programme suggests that the government's aim of having central government finances in balance at the end of its term in 2007 will not be met. Furthermore, local government finances are foreseen to remain in deficit throughout the programme period. Indeed, according to the programme, the general government financial surplus in 2003-07 rests solely on the surplus of the social security funds and, moreover, on that of the earnings-related pension funds preparing for financial pressures stemming from an ageing population. The cyclically-adjusted balance is projected to decline by over ½ percentage points of GDP in 2003-05. Still, according to the programme, the cyclically-adjusted budgetary surplus should remain higher than 2% of GDP throughout the programme period. This should still leave enough leeway against any normal fluctuations in activity. The cyclically-adjusted surplus is forecast to fall by 0.2 percentage points of GDP between 2005 and 2007. These are broadly in line with the Commission cyclically adjusted balance calculations.

The latest programme projects general government debt to fall at a somewhat faster pace (-0.3 p.p.) between 2003 and 2004 than the 2002 programme, although the debt ratio was less favourable than targeted in 2002. However, unlike in the previous programme, a rise in the debt ratio is expected for 2004-06, owing to a slightly lower nominal GDP estimate and deficit in central government finances[6]. In addition, the process of debt reduction is hampered by financial transactions i.e. the ongoing diversification of social security institutions' assets away from central government bonds and to the accumulation of earnings-related pension fund assets of the central government.

The government programme includes a plan to cut income taxes by at least € 1.12 billion or 0.8% of GDP during its term with a view to boosting employment creation. According to the update, the bulk of these tax cuts have been frontloaded into the 2004 budget proposal. This measure can be justified against the background of the cyclical slowdown and the earlier healthy budgetary position and a high overall tax burden on labour. Moreover, the tax cut is

5 Due to the end of the transition period for free import of alcohol and tobacco from other EU countries and the acceding countries joining the EU amounting to a estimated loss of tax revenue amounting to close to 0.4% of GDP.

6 There has been a technical change in the classification of central government debt, the repo portfolio i.e. central government debt held by the State Treasury itself has been removed from the Treasury's balance sheet as it was no longer needed for government debt servicing. As a result, the debt ratio to GDP has increased by 3.2 percentage points in 2003 compared with the previous programme.

accompanied by tight multi-annual spending ceilings in the central government finances in 2004-07.

The update foresees general government expenditure to remain at a virtually constant 48¾% of GDP between 2003 and 2007. While rising social transfers and local government financing will exert upward pressure, the multi-annual spending limits implemented by the new government are to keep expenditure under tight control. According to the update, central government expenditure in the 2004 budget proposal, excluding interest payments, is up by 4% in real terms from 2003. Half of the overrun derives from appropriations increases forced by current legislation and decisions made by the previous government, and the other half from the spending increases and compensations included in the new government's programme. The 2004 budget proposal is keeping with that recommendation since central government expenditure is forecast to be below the spending ceilings agreed in May 2003.

The recently adopted legislation requires municipalities to maintain a balance in their finances over a three-year planning period. Yet, according to the programme, local government finances are expected to show deficits over the whole period from 2003 to 2007. Therefore, the government needs to strengthen implementation of the legislation through careful monitoring[7] of municipal finances.

The 2003 updated programme contains a detailed section on the sustainability of public finances, supplemented by national budgetary projections for public expenditures and revenues up to 2050. They show that age-related expenditures are projected to increase by some 6 percentage points of GDP between 2005 and 2050, while revenues are projected to increase by some 1 percentage point of GDP over the same period. Nevertheless, public finances in Finland seem relatively well set toward meeting the budgetary consequences on ageing population. This is largely reflected by the sustained running of a budget surplus which is leading to a rather swift pace of debt reduction in the long term. Even though the general government surplus is set to decline somewhat over the programme period, gross debt will continue to fall over the coming two decades, as a result of an explicit policy goal. In addition, the sustainability of public finances is supported by a pension system that is to a large extent pre-funded[8]. The recent reforms[9] of pension and unemployment insurance systems should help to contain the long-term expenditure pressures[10]. Some of the budgetary benefits, however, seem to materialise with a considerable lag.

A long-term challenge may result from the fact that the projected sustainability of public finances is based on the assumption of a tax ratio of close to 44% of GDP in coming decades. An overall tax burden of that level would be relatively high when compared with other industrialised countries. Apart from the current concerns about the disincentives of high labour costs for job creation, the desirability of maintaining such high tax ratios over the very long run may also be contested by the increasing mobility of production factors (and consequently tax bases) in the context of globalisation.

The updated programme largely adheres to the recommendations by the Council in the Broad Economic Policy Guidelines (BEPGs) of 2003-05, as the government has introduced the multi-annual spending limits to control budgetary expenditures and put forward measures to

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7 Local governments are administratively fairly independent in Finland.

8 The market value of statutory earnings-related pension funds assets was some 51% of GDP in 2002.

9 E.g. termination of certain early-retirement schemes, incentives to encourage older workers to remain in the labour force and mechanisms to adjust pension entitlements in line with changes in life expectancy.

10 Still, further steps are planned, *inter alia* dealing with pension systems in the public sector.

reduce structural employment and enhance competition. In addition measures have been taken to improve the efficiency of the public sector.

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, 2003-2007

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[11], 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 [20 January 2004] the Council examined Finland's updated stability programme, which covers the period 2003-2007. The updated programme broadly complies with the data requirements of the revised “code of conduct” on the content and format of stability and convergence programmes.

The budgetary strategy underlying the update is based on keeping the expenditure-to-GDP ratio unchanged throughout the programme period, while the revenue ratio, after a temporary decline in 2004 is to resume a gradual upward trend towards the end of the programme period. The government’s budgetary strategy objective is to have central government finances in balance by 2007,however, according the programme this target will not achieved under the current medium-term projections.

The macroeconomic scenario presented in the 2003 updated stability programme projects a strengthening of economic activity from 1.4% in 2003 to 2.7% in 2004, which appears warranted on the light of most recent data. Subsequently, GDP growth is expected to reach its trend rate, averaging 2.5% between 2005 and 2007. Employment falling by 0.2% in 2003, is expected go up by 0.3% on average in 2004-2007. Inflation is forecast to rise gradually from 1.0% in 2003 towards 1.8% by 2007. The near-term projections are closely in line with Commission Autumn 2003 forecast. Given the assumption of a favourable external environment, the projected stabilisation of GDP growth in the later years of the programme represents a rather cautious view.

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[11] OJ L 209, 2.8.1997. The documents referred to in this text can be found at the following web site http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

The programme projects a substantial decline in the general government surplus from 4.2% of GDP in 2002 to 2.3% in 2003 and below 2% in 2004[12]. For the later years of the programme a surplus of 2% or above is to be restored, in line with the newly defined expenditure ceilings. Both the central government and to a smaller degree local governments, account for the trend weakening of the financial position between 2003-07, while the social security funds will be upholding the surplus at the general government level. The projected decline in the cyclically adjusted surplus by 0.6 percentage points of GDP between 2003-05, is partly due to direct (income) and indirect (alcohol) tax cuts and lower receipts from corporate taxes. The cyclically adjusted surplus is seen to fall from 4.3% of GDP in 2002 to 3.0% in 2003 and further in 2004 to 2.4%. In 2005 and beyond the cyclically adjusted surplus will stabilise over 2% of GDP. These are broadly in line with the Commission cyclically adjusted balance calculations. In spite of the higher than expected outcome in 2002, the general government debt to GDP ratio is projected to continue to decline modestly, from 45.1% of GDP in 2003 to 44.6% of GDP in 2007.

In spite of the expected persistent small deficits in central and local government finances, the budgetary stance in the programme of running a comfortable general government surplus should provide sufficient safety margin against a breach of the 3% of GDP reference value for the government deficit in normal cyclical fluctuations.

The decline in the government surplus is mainly due to higher-than-planned income tax cuts in 2000-04 and higher-than-planned discretionary spending at central government level in 2001-03. The previous high surpluses have created some additional fiscal room for manoeuvre, such that under plausible macro-economic and budgetary assumptions, the medium-term objective of a budgetary position of close-to-balance or in surplus should be maintained over the programme period. However, a systematic tendency of exceeding the medium-term spending guidelines, as observed in the past, constitutes a risk to the government's budgetary strategy. Therefore, the multi-annual spending limits introduced by the new government should be considered more binding in order to keep expenditure under control.

The stability programme pays due attention to the sustainability of public finances. On the basis of current policies, public finances appear to be on a sustainable footing to meet the budgetary costs of ageing populations, benefiting from the sustained running of budget surpluses, and a reformed pension system that is to large extent pre-funded. Sustainability should also be underpinned by reforms, both planned and underway, which aim at raising the employment rate, and the Finnish authorities should proceed with their implementation according to the time frame indicated in the stability programme.

The overall tax burden in Finland is high compared with other industrialised countries. The recent tax cuts and some further measures planned are intended not only to boost employment and job creation, but also to stem the erosion of tax bases as a consequence of the increasing international mobility of production factors (labour and capital). In order to safeguard the achievements of the past decade of placing public finances on a sustainable path, strict compliance with the newly defined expenditure ceilings will be all the more crucial.

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12 With the exception of 2002, the general government surpluses have been revised downwards for the whole programme period.

The economic policies as presented in the updated programme are broadly consistent with the Broad Economic Policy Guidelines, which recommended for Finland, inter alia, the introduction of multi-annual spending limits and the reduction of the high level of structural unemployment.