COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 11.1.2006
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Recommendation for a

COUNCIL OPINION

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

On the updated stability programme of Finland, 2005-2009

(presented by the Commission)

EXPLANATORY MEMORANDUM

Background

The Stability and Growth Pact, which entered into force on 1 July 1998, is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. In 2005, the Pact was amended for the first time. The reform acknowledged the Pact's usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Pact, stipulates that Member States have to submit, to the Council and the Commission, stability or convergence programmes and annual updates thereof (Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes). The first stability programme of Finland was submitted in September 1998. In accordance with the Regulation, the Council delivered an opinion on it on 12 October 1998 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. In accordance with the same procedure, updated stability and convergence programmes are assessed by the Commission and examined by the Committee mentioned above, while the Council may examine them.

In these programmes, Member States need to specify their medium-term objective for the budgetary position and set out the policy measures to achieve and maintain it, including the accompanying economic assumptions. Following the reform of the Pact, the medium-term objective should be differentiated for individual Member States in the light of the economic and budgetary heterogeneity in the Union, including as regards the fiscal risk to sustainability. Other elements of the reform are that a more symmetrical approach to fiscal policy over the cycle through enhanced budgetary discipline in economic good times should be achieved, while "major structural reforms" with a verifiable impact on long-term sustainability should be taken into account for a temporary deviation from the medium-term objective or the adjustment path towards it.

Taking into account the Commission services' autumn 2005 forecast, the code of conduct[2], the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances and the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008, the Commission has examined the recently submitted update of the stability programme of Finland and, based on its assessment below, has adopted a recommendation for a Council opinion on it.

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1 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). All the documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

2 Opinion of the Economic and Financial Committee on the "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005.

Assessment

(1) The Finnish stability programme update was submitted on 24 November 2005. The programme covers the period from 2005 to 2009. The programme broadly follows the model structure for stability and convergence programmes specified in the new code of conduct. It has gaps in the compulsory and optional data prescribed by the new code of conduct (especially data on external assumptions for the years 2007-2009 are missing). The update does not explicitly define a medium-term objective (MTO) for the budgetary position as required by the code of conduct.

(2) After recovering from an exceptionally deep recession in the beginning of the 1990s, the Finnish economy expanded strongly over the period 1995–2004, reaching an average growth rate of 3½% p.a., which is about 1½ percentage points above the euro area average. Strong growth has helped to raise the employment rate from its post-recession level of 60 % to 68% in 2004. With an average annual rate of 1½%, the inflation for the period 1995-2004 was ½ percentage point below the euro area level. The macroeconomic scenario underlying the programme envisages real GDP growth to ease from an annual average of 2.7% in 2005-2006 to 2.3% on average over the rest of the programme period. GDP growth rates for 2005 and 2006 are significantly influenced by production stoppages in the paper and pulp industry caused by a labour dispute, explaining the sharp decline in 2005 and a consequent hike in 2006. Both the short-term and medium-term forecasts presented in the programme are more cautious than the Commission services' forecasts. The programme's projections for inflation appear realistic and are in line with those by Commission services.

(3) In its opinion of 17 February 2005 on the previous update of the Stability Programme, covering the period 2004-2008, the Council endorsed the budgetary strategy presented in the programme. The general government surplus for 2005 is estimated, based on the Commission services' forecast, at 1.9% of GDP, which corresponds closely to the targeted surplus in the previous update of the programme.

(4) The government's key objectives in this update are achieving balanced central government finances under normal conditions of economic growth and securing the long-term sustainability of public finances in the light of the adverse effects of population ageing. Measures are also proposed to improve the financial accounts of local governments, which should enable them to record a balanced position by the end of the programme period. The general government surplus will be on a slightly declining trend to reach 1.5 % of GDP by the end of the programme period. Both revenues and expenditures as a ratio to GDP will decline from 2005 to 2007 (both by around 1 percentage point of GDP), after which both ratios, and therefore also net lending, are projected to remain stable. The profile of the primary surplus shows a somewhat steeper fall due to the projected drop in the GDP share of interest expenditure. The decline in the surplus reflects the phased introduction of tax cuts. Expenditure is to be kept in check by the government's budgetary spending ceilings and by a reduction in interest expenditure. Compared with the previous update, the surplus estimates for 2006-2009 have been revised downwards by around 0.5% of GDP, due to the tax cuts and a more cautious outlook on the financial position of social security funds and local governments.

(5) In structural terms, the surplus is projected to decline slightly in the next three years from around 2 % of GDP in 2005 to 1¾% in the period 2006-2008, but to rebound in 2009. However, this rebound is entirely due to the assumed widening of the output gap to about -1% of GDP at the end of the programme period. The programme projects the structural surplus to decline to around 1½ % of GDP by the end of the programme period (2009)[3]. For the purpose of this assessment, this is taken to be the programme's MTO. As the programme's MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. As regards appropriateness, the programme's MTO lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and is significantly more demanding than implied by the debt ratio and average potential output growth in the long term. Having an MTO well above the minimum required level is motivated in the programme by the goal of ensuring the long-term sustainability of public finances.

(6) The risks attached to the budgetary targets in the update appear to be broadly balanced. The targets until 2007 are in line with the Commission services' autumn 2005 economic forecast, with the latter being slightly more optimistic. The multi-annual spending ceilings for central government have worked well so far to contain spending, while tax projections seem to be based on a cautious assessment. As regards economic growth, the stability programme draws attention to the risk that the adverse effects from population ageing and dwindling labour supply might be underestimated; however, taking into account that the growth assumptions seem cautious when compared with the Commission services' forecasts, the risks arising from the growth outlook appear to be balanced.

(7) Taking into account the risk assessment above, the budgetary strategy outlined in the programme seems sufficient to ensure that the programme's inferred MTO is maintained throughout the programme period. In addition, it also provides a sufficient safety margin against breaching the 3% of GDP deficit ceiling with normal macroeconomic fluctuations for the entire period. Overall, the budgetary position is sound and the budgetary strategy provides a good example of fiscal policies run in compliance with the pact.

(8) The general government gross debt level is forecast to remain well below the 60% of GDP reference value throughout the programme period. The update projects the debt ratio to fall from an estimated 42.7% of GDP in 2005 to 40.1% by 2009. The decline in the debt ratio that would result from the significant primary surpluses is tempered by a debt-increasing stock-flow adjustment reflecting the accumulation of assets in the social security funds.

(9) With regard to the sustainability of public finances, Finland appears to be at low risk on grounds of the projected budgetary costs of ageing populations. The gross debt ratio is currently below the 60% of GDP reference value, and is projected to remain below this value throughout most of the projection period which extends until 2050.

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[3] As calculated in the programme. Commission services' recalculations on the basis of the information in the programme according to the commonly agree methodology give a structural surplus of 2% of GDP in 2009.

The significant assets of social security and the currently favourable budgetary position contribute to limit the budgetary impact of ageing populations. However, in the long run, a risk to public finance sustainability could emerge, reflecting rising pension expenditure. Containing age-related expenditure over the long term, including the successful implementation of recent reform measures aimed at rising the effective retirement age, while maintaining sound budgetary positions would be key components in reducing risks to public finance sustainability[4].

(10) The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. In particular, the measures are geared towards ensuring economic and fiscal sustainability and towards promoting growth and job creation, such as a major pension reform that is currently being phased in.

(11) The National Reform Programme of Finland, submitted on 14 October 2005 in the context of the renewed Lisbon strategy for growth and jobs, identifies the following challenges with significant implications for public finances: (i) the sustainability of public finances and (ii) the functioning of the labour market. The budgetary implications of the actions outlined in the National reform Programme are fully reflected in the budgetary projections of the stability programme. The measures in the area of public finances envisaged in the stability programme are in line with the actions foreseen in the National Reform Programme. In particular, the stability programme outlines measures to improve the efficiency of both central and local governments, and confirms the intention to continue with applying central government budgetary spending limits beyond the current legislation period.

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4 Details on long-term sustainability are provided in the technical assessment of the programme by the Commission services, to be published at the website http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

Recommendation for a

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

On the updated stability programme of Finland, 2005-2009

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 coordination of economic policies[5], 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:

(1) On [24 January 2006] the Council examined the updated stability programme of Finland, which covers the period 2005 to 2009. The programme broadly follows the model structure for stability and convergence programmes specified in the new code of conduct. It has gaps in the compulsory and optional data prescribed by the new code of conduct (especially data on external assumptions for the years 2007-2009 are missing). The programme does not explicitly define its medium-term objective (MTO) for the budgetary position as required by the code of conduct.

(2) After recovering from an exceptionally deep recession in the beginning of the 1990s the Finnish economy expanded strongly over the period 1995–2004, reaching an average growth rate of 3.6% p.a.. The strong pace of activity helped to raise the employment rate; nevertheless inflation remained below the euro-area average. The macroeconomic scenario underlying the programme envisages real GDP growth to ease from an annual average of 2.7% in 2005-2006 to 2.3% on average over the rest of the programme period. Assessed against currently available information, this scenario appears to be based on cautious growth assumptions. The programme's projections for inflation appear realistic.

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5 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

(3) In its opinion of 17 February 2005 on the previous update of the Stability Programme, covering the period 2004-2008, the Council endorsed the budgetary strategy presented in the programme. The general government surplus for 2005 is estimated, based on the Commission services' forecast, at 1.9% of GDP, which corresponds closely to the targeted surplus in the previous update of the programme.

(4) The government's key objectives are achieving balanced central government finances under normal conditions of economic growth and securing the long-term sustainability of public finances. The general government surplus is projected to be on a slightly declining trend, to reach 1.5% of GDP by 2008-2009; the decline in the primary surplus is somewhat steeper due to a projected drop in interest expenditure. The decline in the surplus is revenue-driven, reflecting the gradual enactment of tax cuts. Expenditure is projected to be kept in check by the government's budgetary spending ceilings and by a reduction in interest expenditure. Compared with the previous update, the surplus estimates for 2006-2009 have been revised downwards by around 0.5% of GDP, due to the tax cuts and a more cautious outlook on the financial position of social security funds and local governments.

(5) Over the programme period, the structural surplus (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) calculated according to the commonly agreed methodology is planned to weaken slightly in the next three years from around 2 % of GDP in 2005 to 1¾% in the period 2006-2008, but to rebound in 2009 reflecting an estimated widening of the output gap. The programme projects the structural surplus to reach around 1½ % of GDP by the end of the programme period[6], which can be regarded as the programme's MTO as it is in line with the principles for MTOs specified in the Stability and Growth Pact and the code of conduct. As the programme's MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. As regards appropriateness, the programme's MTO lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and is significantly more demanding than implied by the debt ratio and average potential output growth in the long term. Having an MTO well above the minimum required level is motivated in the programme by the goal of ensuring the long-term sustainability of public finances.

(6) The risks to the budgetary projections in the programme appear broadly balanced. Tax projections seem based on cautious assumptions and the expenditure ceiling framework has so far been very effective. The stability programme draws attention to the risk that the adverse effects on economic growth from population ageing and dwindling labour supply might be underestimated in the current calculations; however, as mentioned above, the economic growth projections in the update can be regarded as cautious.

(7) In view of this risk assessment, the budgetary stance in the programme seems sufficient to maintain the programme's MTO throughout the programme period, as

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[6] As calculated in the programme. Commission services' recalculations on the basis of the information in the programme according to the commonly agree methodology give a structural surplus of 2% of GDP in 2009.

envisaged in the programme. In addition, it provides a sufficient safety margin against breaching the 3% of GDP deficit ceiling with normal macroeconomic fluctuations for the entire period. Overall, the budgetary position is sound and the budgetary strategy provides a good example of fiscal policies run in compliance with the pact.

(8) The debt ratio is estimated to have reached 42.7% of GDP in 2005, well below the 60% of GDP Treaty reference value. The programme projects the debt ratio to decline by 2.6 percentage points over the programme period.

(9) Finland appears to be at low risk on grounds of the projected budgetary costs of ageing populations. The gross debt ratio is currently below the 60% of GDP reference value, and is projected to remain below this value throughout most of the projection period which extends until 2050. The significant assets of social security and the currently favourable budgetary position contribute to limit the budgetary impact of ageing populations. However, in the long run, a risk to public finance sustainability could emerge, reflecting rising pension expenditure. Containing age-related expenditure over the long term, including the successful implementation of recent reform measures aimed at rising the effective retirement age, while maintaining sound budgetary positions would be key components in reducing risks to public finance sustainability[7].

(10) The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. In particular, the measures are geared towards ensuring economic and fiscal sustainability and towards promoting growth and job creation, such as a major pension reform that is currently being phased in.

(11) The National Reform Programme of Finland, submitted on 14 October 2005 in the context of the renewed Lisbon strategy for growth and jobs, identifies the following challenges with significant implications for public finances: (i) the sustainability of public finances and (ii) the functioning of the labour market. The budgetary implications of the actions outlined in the National reform Programme are fully reflected in the budgetary projections of the stability programme. The measures in the area of public finances envisaged in the stability programme are in line with the actions foreseen in the National Reform Programme. In particular, the stability programme outlines measures to improve the efficiency of both central and local governments, and confirms the intention to continue with applying central government budgetary spending limits beyond the current legislation period.

[7] Details on long-term sustainability are provided in the technical assessment of the programme by the Commission services, to be published at the website http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008	2009
Real GDP (% change)	**SP Nov 2005**	**3.6**	**2.1**	**3.2**	**2.6**	**2.3**	**2.1**
	COM Nov 2005	3.6	1.9	3.5	3.1	n.a.	n.a.
	SP Dec 2004	*3.2*	*2.8*	*2.4*	*2.2*	*2.0*	*n.a.*
HICP inflation (%)	**SP Nov 2005**	**0.2**	**1.0**	**1.3**	**1.5**	**1.8**	**1.8**
	COM Nov 2005	0.1	1.0	1.4	1.3	n.a.	n.a.
	SP Dec 2004	*0.2*	*1.4*	*1.8*	*1.8*	*1.8*	*n.a.*
Output gap (% of potential GDP)	SP Nov 2005[1]	0.0	-0.7	-0.2	-0.2	-0.5	-0.9
	COM Nov 2005[5]	-0,2	-1.2	-0.7	-0.5	n.a.	n.a.
	SP *Dec* 20041	-0.3	-0.1	-0.2	-0.4	-0.6	n.a.
General government balance (% of GDP)	**SP Nov 2005**	**2.1**	**1.8**	**1.6**	**1.6**	**1.5**	**1.5**
	COM Nov 2005	2.1	1.9	1.9	1.8	n.a.	n.a.
	SP Dec 2004	*2.0*	*1.8*	*2.1*	*2.2*	*2.0*	*n.a.*
Primary balance (% of GDP)	**SP Nov 2005**	**3.7**	**3.4**	**3.1**	**2.9**	**2.8**	**2.8**
	COM Nov 2005	3.8	3.8	3.7	3.6	n.a.	n.a.
	SP Dec 2004	*3.7*	*3.4*	*3.8*	*3.9*	*3.7*	*n.a.*
Cyclically-adjusted balance = structural balance[2,3] (% of GDP)	**SP Nov 2005[1]**	**2.1**	**2.1**	**1.7**	**1.7**	**1.7**	**2.0**
	COM Nov 2005[4]	2.3	2.7	2.3	2.1	n.a.	n.a.
	SP Dec 2004[1]	*2.2*	*1.9*	*2.2*	*2.4*	*2.4*	*n.a.*
Government gross debt (% of GDP)	**SP Nov 2005**	**44.9**	**42.7**	**41.7**	**41.1**	**40.6**	**40.1**
	COM Nov 2005	45.1	42.8	41.5	40.6	n.a.	n.a.
	SP Dec 2004	*44.6*	*43.4*	*42.5*	*41.7*	*41.1*	*n.a.*

Notes:
[1] Commission services calculations on the basis of the information in the programme.
[2] Cyclically-adjusted balance excluding one-off and other temporary measures.
[3] One-off and other temporary measures taken from the programme.
[4] One-off and other temporary measures taken from the Commission services' autumn 2005 forecast.
[5] Based on estimated potential growth of 2.9%, 2.9%, 2.8% and 2.7% respectively in the period 2004-2007.

Source:
Stability programme (SP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations.