COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 7.2.2007
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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, 2006-2010

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. General 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. The 2005 reform of the Pact acknowledged its 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 Stability and Growth 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.

2. Background for the assessment of the updated programme

The Commission has examined the most recent update of the stability programme of Finland, submitted on 30 November 2006, and has adopted a recommendation for a Council opinion on it (see box for the main points covered by the assessment).

In order to set the scene against which the budgetary strategy in the updated stability programme is assessed, the following paragraphs summarise:

(1) the economic and budgetary performance over the last ten years

(2) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the stability programme) and

(3) the Commission's assessment of the October 2006 national reform programme.

2.1. Recent economic and budgetary performance

Over the past decade, the performance of the Finnish economy has been outstanding. The cyclical recovery from the recession of the early 1990s was reinforced by the restructuring of the economy and the emergence of the ICT sector, which largely accounts for the remarkable

[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

advances in productivity. Average economic growth rates have been well above the euro area average while inflation has remained low. The strong expansion of the economy was accompanied by determined fiscal consolidation, restoring a significant surplus to general government finances. In the run-up to EMU, Finland successfully shifted to a low-inflation environment with stability-oriented macroeconomic policies safeguarding competitiveness, which have continued to underpin its good economic performance.

2.2. The assessment in the Council opinion on the previous programme

On 24 January 2006, the Council adopted its opinion on the previous update of the stability programme, covering the period 2005-2009. The Council was of the opinion that "overall, the budgetary position is sound and the budgetary strategy provides a good example of fiscal policies conducted in compliance with the Pact".

2.3. The Commission assessment of the October 2006 national reform programme

The Implementation Report of the National Reform Programme of Finland, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 12 October 2006. Finland's national reform programme identifies as key challenges/priorities: the sustainability of public finances, improving competitiveness and productivity; and improving the functioning of the labour market. The Commission’s assessment of this programme (adopted as part of its December 2006 Annual Progress Report[2]) showed that Finland is making very good progress in the implementation of its National Reform Programme.

Against the background of progress made, Finland was encouraged to focus on the areas of: competition and productivity in services; recruitment procedures for businesses; local wage bargaining systems; and bottlenecks in the labour market.

[2] Communication from the Commission to the Spring European Council, “Implementing the renewed Lisbon strategy for growth and jobs - A year of delivery” - COM(2006) 816, 12.12.2006.

Box: Main points covered by the assessment

As required by Article 5(1) (for stability programmes) and Article 9(1) (for convergence programmes) of Council Regulation (EC) No 1466/97, the assessment covers the following points:

- whether the economic assumptions on which the programme is based are plausible;
- the medium-term budgetary objective (MTO) presented by the Member State and whether the adjustment path towards it is appropriate;
- whether measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the MTO over the cycle;
- when assessing the adjustment path towards the MTO, whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times, and, for euro-area and ERM II Member States, whether the Member State pursues an annual improvement of the cyclically-adjusted balance, net of one-off and other temporary measures, of 0.5% of GDP as a benchmark to meet its MTO;
- when defining the adjustment path to the MTO (for Member States that have not yet reached it) or allowing a temporary deviation from the MTO (for Member States that have), the implementation of major structural reforms which have direct long-term cost-saving effects (including by raising potential growth) and therefore a verifiable impact on the long-term sustainability of public finances (subject to the condition that an appropriate safety margin with respect to the 3% of GDP reference value is preserved and that the budgetary position is expected to return to the MTO within the programme period), with special attention for pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar;
- whether the economic policies of the Member State are consistent with the broad economic policy guidelines.

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2006 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. The assessment of consistency with the broad economic policy guidelines is made against the broad economic policy guidelines in the area of public finances as included in the integrated guidelines for the period 2005-2008.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[3];
- the degree of integration with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[4], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

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[3] Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU" - COM(2006) 574, 12.10.2006 - and European Commission, Directorate-General for Economic and Financial Affairs (2006), "The long-term sustainability of public finances in the European Union", European Economy No 4/2006.

[4] "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.

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On the updated stability programme of Finland, 2006-2010

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 [27 February 2007] the Council examined the updated stability programme of Finland, which covers the period 2006 to 2010.

(2) The macroeconomic scenario underlying the programme envisages that real GDP growth will decelerate from a cyclical peak of 4½% in 2006 to 2½% on average over the rest of the programme period. Assessed against currently available information, this scenario appears to be based on plausible growth assumptions, with those for 2006 and 2010 appearing cautious. The programme’s projections for inflation appear realistic.

(3) For 2006, the general government surplus is estimated at 2.9% of GDP in both the Commission services’ autumn 2006 forecast and in the current programme update, against a target of 1.6% of GDP set in the previous update of the stability programme. This is due to the carry-over from the better-than-expected outcome in 2005 and the positive growth surprise in 2006 boosting government revenue, while expenditure has remained contained.

[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

(4) The main goal of the medium-term budgetary strategy in the programme is securing sustainability in general government finances and balanced central government finances under normal conditions of economic growth. The general government headline and primary surpluses are projected to follow a slight downward trend, both declining by ½% of GDP until 2010. The decline in the revenue ratio, reflecting the gradual phasing in of the tax cuts package up to 2007, is less than fully compensated by the cut in the expenditure ratio owing to the government's budgetary spending ceilings and public sector reform initiatives. While the budgetary strategy has not changed compared with the previous update, the budgetary targets have been revised up by about 1% of GDP in each year, as a result of the carry-over from the better-than-expected outcome in 2005 and higher growth prospects.

(5) The structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) calculated according to the commonly agreed methodology is planned to remain stable at a surplus of close to 3% of GDP throughout the programme period. The medium-term objective (MTO) for the budgetary position presented in the programme is a structural surplus of 2% of GDP, which it plans to maintain throughout the programme period. The previous programme update did not explicitly define an MTO, but the MTO was inferred in the Council opinion from the structural surplus projections in the previous programme to be a surplus of 1½% of GDP. As the MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1¼% of GDP), achieving it should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The 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 and the fact that in Finland the impact of an ageing population kicks in at an early stage.

(6) The risks to the budgetary projections in the programme appear broadly balanced. The programme’s macroeconomic assumptions as well as the tax revenue projections appear plausible. The risks to the latter emanating from the composition of growth are counterbalanced by conservative tax elasticity assumptions. While expenditure restraint is supported by ceilings for central government, there are some risks related to developments in local government expenditure.

(7) In view of this risk assessment, the budgetary stance in the programme seems sufficient to meet the MTO by a considerable margin throughout the programme period, as envisaged in the programme. In addition, it provides a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations over the programme period. The fiscal policy stance implied by the programme is fully in line with the Stability and Growth Pact.

(8) Government gross debt is estimated to have declined to 39% of GDP in 2006, well below the 60% of GDP Treaty reference value. The programme projects the debt ratio to decline by 5½ percentage points over the programme period.

(9) The long-term budgetary impact of ageing in Finland is higher than on average in the EU, although enacted pension reform measures have helped to contain the increase in pension expenditure to close to the EU average as a share of GDP over the coming

decades. The initial budgetary position, with a large structural surplus, contributes significantly to easing the long-term budgetary impact of ageing. Moreover, the large assets accumulated in the public pension fund will finance part of the increase in pension expenditure. However, maintaining high primary surpluses over the medium term would contribute towards containing risks to the sustainability of public finances. Overall, Finland appears to be at low risk with regard to the sustainability of public finances.

(10) The stability programme contains a qualitative assessment of the overall impact of the October 2006 implementation report of the national reform programme within the medium-term fiscal strategy. In addition, it provides systematic information on the direct budgetary costs or savings of the main reforms envisaged in the national reform programme and its budgetary projections explicitly take into account the public finance implications of the actions outlined in the national reform programme. The measures in the area of public finances envisaged in the stability programme seem consistent with those foreseen in the national reform programme. In particular, both programmes envisage the implementation of measures to improve the productivity of both central and local governments and confirm the intention to continue applying central government budgetary spending limits beyond the current legislative period.

(11) The budgetary strategy in the programme is broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008.

(12) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has some gaps in the required and optional data[6].

The overall conclusion is that the medium-term budgetary position is sound and the budgetary strategy provides a good example of fiscal policies conducted in compliance with the Stability and Growth Pact.

6 In particular, the data on external assumptions for the years 2008-2010 are missing.

Comparison of key macroeconomic and budgetary projections

		2005	2006	2007	2008	2009	2010
Real GDP (% change)	**SP Nov 2006**	**2.9**	**4.5**	**3.0**	**2.9**	**2.6**	**2.1**
	COM Nov 2006	2.9	4.9	3.0	2.6	n.a.	n.a.
	SP Nov 2005	*2.1*	*3.2*	*2.6*	*2.3*	*2.1*	*n.a.*
HICP inflation (%)	**SP Nov 2006**	**0.9**	**1.5**	**1.3**	**1.7**	**1.7**	**1.7**
	COM Nov 2006	0.8	1.3	1.5	1.6	n.a.	n.a.
	SP Nov 2005	*1.0*	*1.3*	*1.5*	*1.8*	*1.8*	*n.a.*
Output gap (% of potential GDP)	**SP Nov 2006**[1]	**-1.3**	**0.1**	**0.2**	**0.1**	**-0.2**	**-0.8**
	COM Nov 2006[5]	-1.5	0.1	0.2	-0.2	n.a.	n.a.
	SP Nov 2005[1]	*-0.7*	*-0.2*	*-0.2*	*-0.5*	*-0.9*	*n.a.*
General government balance (% of GDP)	**SP Nov 2006**	**2.7**	**2.9**	**2.8**	**2.7**	**2.7**	**2.4**
	COM Nov 2006	2.7	2.9	2.9	2.9	n.a.	n.a.
	SP Nov 2005	*1.8*	*1.6*	*1.6*	*1.5*	*1.5*	*n.a.*
Primary balance (% of GDP)	**SP Nov 2006**	**3.9**	**4.5**	**4.3**	**4.2**	**4.1**	**3.7**
	COM Nov 2006	4.1	4.3	4.2	4.1	n.a.	n.a.
	SP Nov 2005	*3.4*	*3.1*	*2.9*	*2.8*	*2.8*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**SP Nov 2006**[1]	**3.3**	**2.9**	**2.7**	**2.7**	**2.8**	**2.8**
	COM Nov 2006	3.4	2.9	2.8	2.9	n.a.	n.a.
	SP Nov 2005[1]	*2.1*	*1.7*	*1.7*	*1.7*	*2.0*	*n.a.*
Structural balance[2] (% of GDP)	**SP Nov 2006**[3]	**3.3**	**2.9**	**2.7**	**2.7**	**2.8**	**2.8**
	COM Nov 2006[4]	3.4	2.9	2.8	2.9	n.a.	n.a.
	SP Nov 2005	*2.1*	*1.7*	*1.7*	*1.7*	*2.0*	*n.a.*
Government gross debt (% of GDP)	**SP Nov 2006**	**41.3**	**39.1**	**37.7**	**36.2**	**35.0**	**33.7**
	COM Nov 2006	41.3	38.8	37.3	35.8	n.a.	n.a.
	SP Nov 2005	*42.7*	*41.7*	*41.1*	*40.6*	*40.1*	*n.a.*

Notes:

[1] Commission services calculations on the basis of the information in the programme.

[2] Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.

[3] There are no one-off and other temporary measures in the programme.

[4] There are no one-off and other temporary measures in the Commission services' autumn 2006 forecast.

[5] Based on estimated potential growth of 3.2%, 3.1%, 3.0% and 2.9% respectively in the period 2005-2008.

Source:

Stability programme (SP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations