COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 18.2.2009
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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, 2008-2012

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

The Stability and Growth Pact 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. In particular, it introduced greater flexibility in the application of the rules governing the excessive deficit procedure, notably with regard to definition of "exceptional circumstances" and the setting of deadlines for the correction of an excessive deficit.

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 each Member State has to submit, to the Council and the Commission, a stability or convergence programme 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.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the stability programme of Finland and its addendum, both submitted on 18 December 2008, and has adopted a recommendation for a Council opinion on it.

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

(1) the Commission Communication of 26 November 2008 (“A European Economic Recovery Plan”).

(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)

2.1. The Commission Communication of 26 November 2008 (“A European Economic Recovery Plan”)

In view of the unprecedented scale of the global financial and economic crisis, the European Commission has called for a European Economic Recovery Plan (EERP)[2]. The plan proposes a co-ordinated counter-cyclical macro-economic response to the crisis in the form of an ambitious set of actions to support the economy consisting of (i) an immediate budgetary impulse amounting to € 200 bn. (1.5% of EU GDP), made up of a budgetary expansion by

[1] OJ L 209, 2.8.1997, p. 1. The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

[2] Communication from the Commission to the European Council of 26 November 2008 (COM(2008) 800 final)

Member States of € 170 bn. (around 1.2% of EU GDP) and EU funding in support of immediate actions of the order of € 30 bn. (around 0.3 % of EU GDP); and (ii) a number of priority actions grounded in the Lisbon Strategy and designed to adapt our economies to long-term challenges, continuing to implement structural reforms aimed at raising potential growth. The plan calls for the fiscal stimulus to be differentiated across Member States in accordance with their positions in terms of sustainability of government finances and competitive positions. In particular, for Member States outside the euro area with significant external and internal imbalances, budgetary policy should essentially aim at correcting such imbalances. The plan was agreed by the European Council on 11 December 2008. In this context, Member States were asked to submit an addendum to their updated stability or convergence programme, so as to reflect the measures taken in the context of the Recovery Plan. The examination of how measures (budgetary measures as well as structural measures) contribute to the recovery process in the short term is made in the opinions of stability convergence programmes.

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

In its opinion of 12 February 2008, the Council summarised its assessment of the previous update of the stability programme, covering the period 2007-2011, as follows**:** “The overall conclusion is that the programme envisages continued high surpluses, albeit declining over the programme period. While the risks attached to the budgetary targets are balanced overall, the programme's fiscal projections appear somewhat cautious for 2008. The medium-term budgetary position is sound and should limit the risks to long-term sustainability. Continuing with expenditure restraint will remain crucial to stem the risk of a pro-cyclical fiscal policy stance in 2008 and to adjust to the lower growth path and the implied slower growth of tax revenue over the programme period".

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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, 2008-2012

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[3], 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 [10 March 2009] the Council examined the updated stability programme of Finland, which covers the period 2008 to 2012.

(2) Whereas the fundamentals of the Finnish economy and the domestic financial sector are sound, the global crisis has cut deeply into output of the country's highly export-oriented industries. While households will benefit in 2009 and 2010 from strong wage increases, tax cuts and lower inflation, consumer and business confidence has nevertheless tumbled, holding back private consumption and investment. The Commission services' January 2009 interim forecast projects GDP to contract by over 1% in 2009 and gradually recover over 2010 in step with the expected stabilisation of global markets. In spite of the economy rapidly entering a recession, tax revenues have remained rather firm in 2008 as a whole, reflecting the resilience of the labour market, especially in the first half of the year, and solid personal income growth. The general government surplus is expected to reach 4½ % of GDP in 2008. Given that the economic slump in 2009 is led by a collapse of external demand and confidence, while the fundamentals of the Finnish economy are expected to remain robust overall, the programme plans for a significant fiscal stimulus in 2009, geared towards supporting domestic demand with the aim of upholding employment over the recession.

[3] OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

(3) The macroeconomic scenario underlying the programme envisages that real GDP growth will slow from 2.6% in 2008 to 0.6% in 2009 before recovering to slightly above 2% over the rest of the programme period. In view of the rapid deterioration of the macro-economic outlook in past months,[4] this scenario, which was finalised in November 2008[5] appears now to be based on markedly favourable growth assumptions, most notably for 2009. According to the latest Government estimates, included in the stimulus package and associated supplementary budget proposal from 30 January 2009, GDP is projected to contract by over 2% in 2009. The programme's projections for inflation developments are realistic overall.

(4) For 2008, the general government surplus is estimated at 4.5% of GDP in the Commission services forecast, against a target of 3.7% of GDP set in the previous update of the stability programme. The better-than-planned outcome is largely explained by a carry-over from the previous year when economic growth and tax revenue exceeded expectations. Also, a change in the recording of property income from social security's assets contributed to revise upwards the surplus by almost 0.4% of GDP.

(5) The programme projects the general government surplus in 2009 to drop by 2.3 percentage points to 2.1% of GDP, broadly in line with the projection of the Commission services' interim forecast (2.0% of GDP). Measured by the year-on-year decline in the structural balance, as recalculated by the Commission services on the basis of the information in the programme, the fiscal stance is estimated to be expansionary to the tune of around 1% of GDP. The impact of the automatic stabilisers is estimated to reduce the fiscal surplus by an additional 1½ % of GDP in 2009. The estimate of the fiscal stance broadly matches the size of the government stimulus package announced in the programme, totalling 1.2% of GDP in 2009. Over three quarters of this is spent on tax cuts supporting consumers' purchasing power. These tax cuts also serve the government's long-term objective of reducing the presently relatively high tax burden on labour and increasing employment incentives. The size of the rest of the stimulus measures included in the programme update are relatively limited, amounting to about 0.3% of GDP, spent on various infrastructure investments and securing financing for enterprises. On 30 January 2009, the government announced an additional stimulus package which includes a broad range of measures stimulating infrastructure and housing investment with a particular objective of upholding employment, increasing funding for education and research, and lowering labour costs by decreasing employers' social insurance contribution. The budgetary cost of the additional measures is estimated at 0.5% of GDP in 2009, which is obviously not reflected in the programme target[6].

(6) As in the previous programme, Finland’s medium-term objective (MTO) for the budgetary position is defined as a general government surplus of 2% of GDP in

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4 The assessment notably takes into account the Commission services' January 2009 forecast, but also other information that has been provided by Finland.

5 After the submission of the programme, no addendum has been sent to the Commission services.

6 Together with the measures announced on 30 January 2009, the total level of the stimulus package amounts to 1.7% of GDP. The Government's fiscal projections, included in the stimulus package and the associated supplementary budget proposal from 30 January 2009, predict the general government finances to drop into a deficit of 0.4% of GDP in 2009. This figure incorporates the impact of the stimulus measures.

structural terms, i.e. in cyclically-adjusted terms net of one-off and other temporary measures. The programme expects the headline, primary and structural surpluses to decline steeply in 2009 and 2010, but to stabilise thereafter. The estimate for the structural surplus, calculated according to the commonly agreed methodology, is projected by the programme to remain unchanged at 1½ % of GDP in the outer years of the programme, which is slightly below the MTO. The reduction in the headline balance over 2008-2012 is driven by a combination of a decline in the revenue ratio by about 2% of GDP, largely reflecting the planned tax cuts, and a rise in the expenditure ratio by 1½ % of GDP. The programme update does not include measures for fiscal retrenchment in the years after the downturn.

(7) The budgetary outcomes projected in the programme are subject to downside risks since the macroeconomic scenario is based on markedly favourable growth assumptions. However, the negative risks to the budgetary projections are somewhat mitigated as some of the main tax bases (namely private consumption and household income) are expected to show greater resilience in an economic contraction led by a slump in external demand.

(8) While the long-term budgetary impact of ageing is higher than on average in the EU, enacted pension reforms have helped to contain the projected increase in pension expenditure over the coming decades. The budgetary position in 2008 as estimated in the programme, with a large structural surplus, contributes significantly to offsetting the long-term budgetary impact of ageing and the large assets accumulated by the public pension schemes will help finance part of the increase in pension expenditure. However, from the budgetary developments planned in the programme, a sustainability gap would arise. Maintaining high primary surpluses over the medium term would contribute to limiting risks to the sustainability of public finances, which are currently at a low level.

(9) Over past years, the existing budgetary framework for the central government has proven to be a reliable tool in avoiding expenditure overruns. Finland has over the past years also pursued various structural reforms to improve the quality of public finances and reduce the long-term expenditure pressures.

(10) In response to the financial crisis, the Finnish government has adopted measures to stabilise the financial markets. These measures give commercial banks access to significant credit guarantees (maximum amount of about 25% of GDP) and capital investment by the state (maximum amount of about 3% of GDP). Also, the ceiling of the depositors' guarantee was doubled to 50 000 EUR. However, given that the Finnish financial sector appears to be relatively less affected by the global crisis, the actual utilisation of state funds could turn out to be limited.

(11) In line with the EERP agreed in December by the European Council, Finland has adopted several fiscal stimulus measures for 2009, which are considered to be a broadly adequate response to the economic downturn. In view of the strong budgetary starting position and solid fundamentals of the economy, the stimulus measures included in the programme and the latest measures announced in January 2009 appear appropriate, provided that action will also be taken for fiscal retrenchment in the medium term to ensure long term sustainability. The stimulus package broadly complies with the general principles of the European Economic Recovery Plan. The measures come timely, taking largely effect from the beginning of 2009, and they

appear to be targeted to address the internal economic challenges. Contrasting with the general principles, the bulk of the fiscal stimulus involves permanent tax cuts and is not planned to be reversed. This can be considered partly justified, given the sizeable leeway afforded by public finances and the long-term tax policy goals of the Government. The measures addressing the current economic crisis are focused on sustaining aggregate demand and employment, as well as strengthening competitiveness. The measures are related to the medium-term reform agenda for Finland as reviewed by the Commission on 28 January 2009. In particular, the measures stimulating investment also target improving energy efficiency, and the tax cuts stimulate both labour demand and supply.

(12) The fiscal stance in 2009 and 2010 appears expansionary as measured by the approximately 1 p.p. annual decline in the structural balance in both 2009 and 2010. Thereafter, the programme plans for a neutral fiscal stance. The budgetary stance in the programme appears broadly in line with the Stability and Growth Pact, appropriately allowing for a fiscal stimulus during a recession and a neutral fiscal stance once the economy is forecast to have recovered to growth rates close to the estimated potential. The budgetary stance at the end of the programme period would maintain a large safety margin against breaching the 3% deficit threshold.

(13) 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[7].

The overall conclusion is that public finances remain sound although the programme envisages the present high fiscal surpluses to decline substantially. In view of the sizeable fiscal space, the stimulus measures of the programme update and the latest measures announced in January 2009 appear appropriate and are welcome. The stimulus package broadly complies with the general principles of the European Economic Recovery Plan. The budgetary outcomes projected in the programme are subject to downside risks and action geared to ensure long term sustainability once the crisis abates should be considered.

In view of the above assessment, Finland is invited to:

(i) implement the measures in line with the EERP;

(ii) reverse the adverse budgetary impact of the fiscal stimulus measures once the economy recovers in order to preserve the long-term sustainability of public finances.

[7] In particular, the programme gives a somewhat different breakdown of expenditure components which do not directly match with the data standards of Table 2. Also, compulsory data on "one-off and other temporary measures" is not explicitly given in the tables. The external assumptions for the outer years are not provided. Optional data "liquid financial assets" specified in the Code of conduct Annex 2 Table 4 point 6 is not given for 2007-2011 in the stability programme.

		2007	2008	2009	2010	2011	2012
Real GDP (% change)	**SP Jan 2009**	**4.5**	**2.6**	**0.6**	**1.8**	**2.4**	**2.2**
	COM Jan 2009	4.5	1.5	-1.2	1.2	n.a.	n.a.
	SP Nov 2007	*4.4*	*3.3*	*3.0*	*2.5*	*2.1*	*n.a.*
HICP inflation (%)	**SP Jan 2009**	**1.6**	**4.0**	**2.3**	**1.9**	**2.0**	**2.0**
	COM Jan 2009	1.6	3.9	1.8	1.8	n.a.	n.a.
	SP Nov 2007	*2.4*	*2.4*	*2.2*	*2.0*	*2*	*n.a.*
Output gap[1] (% of potential GDP)	**SP Jan 2009**	**1.7**	**1.3**	**-0.6**	**-1.0**	**-1.2**	**-1.3**
	COM Jan 2009[2]	2.9	1.7	-1.4	-2.1	n.a.	n.a.
	SP Nov 2007	*0.6*	*0.7*	*0.5*	*-0.1*	*-0.7*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**SP Jan 2009**	**5.4**	**4.0**	**3.6**	**3.7**	**3.9**	**3.9**
	COM Jan 2009	6.4	5.2	3.7	3.3	n.a.	n.a.
	SP Nov 2007	*4.9*	*4.6*	*5.0*	*5.0*	*4.8*	*n.a.*
General government revenue (% of GDP)	**SP Jan 2009**	**52.6**	**51.4**	**50.3**	**49.7**	**49.4**	**49.4**
	COM Jan 2009	52.6	52.3	52.0	51.3	n.a.	n.a.
	SP Nov 2007	*51.9*	*51.0*	*50.6*	*49.8*	*49.6*	*n.a.*
General government expenditure (% of GDP)	**SP Jan 2009**	**47.3**	**47.0**	**48.2**	**48.6**	**48.4**	**48.5**
	COM Jan 2009	47.3	47.8	50.1	50.9	n.a.	n.a.
	SP Nov 2007	*47.4*	*47.3*	*47.0*	*47.0*	*47.2*	*n.a.*
General government balance (% of GDP)	**SP Jan 2009**	**5.3**	**4.4**	**2.1**	**1.1**	**1.0**	**0.9**
	COM Jan 2009	5.3	4.5	2.0	0.5	n.a.	n.a.
	SP Nov 2007	*4.5*	*3.7*	*3.6*	*2.8*	*2.4*	*n.a.*
Primary balance (% of GDP)	**SP Jan 2009**	**6.8**	**5.8**	**3.4**	**2.4**	**2.2**	**2.3**
	COM Jan 2009	6.8	6.0	3.3	1.8	n.a.	n.a.
	SP Nov 2007	*6.0*	*5.2*	*5.0*	*4.1*	*3.6*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**SP Jan 2009**	**4.5**	**3.7**	**2.4**	**1.7**	**1.6**	**1.6**
	COM Jan 2009	3.9	3.6	2.7	1.5	n.a.	n.a.
	SP Nov 2007	*4.2*	*3.3*	*3.3*	*2.8*	*2.8*	*n.a.*
Structural balance[3] (% of GDP)	**SP Jan 2009**	**4.5**	**3.7**	**2.4**	**1.7**	**1.6**	**1.6**
	COM Jan 2009	3.9	3.6	2.7	1.7	n.a.	n.a.
	SP Nov 2007	*4.2*	*3.3*	*3.3*	*2.8*	*2.8*	*n.a.*
Government gross debt (% of GDP)	**SP Jan 2009**	**35.1**	**32.4**	**33.0**	**33.7**	**34.1**	**34.6**
	COM Jan 2009	35.1	32.8	34.5	36.1	n.a.	n.a.
	SP Nov 2007	*35.3*	*32.8*	*30.4*	*29.0*	*27.9*	*n.a.*

Notes:

[1] Output gaps and cyclically-adjusted balances from the programmes as recalculated by Commission services on the basis of the information in the programmes.

[2] Based on estimated potential growth of 2.8%, 2.6%, 2.0% and 1.9% respectively in the period 2007-2010.

[3] Cyclically-adjusted balance excluding one-off and other temporary measures. There are no one-off and other temporary measures in any year over the programme period according to the most recent programme. However, according to the Commission services' January interim forecast there is one deficit-increasing one-off measure of 0.2% of GDP in 2010, arising from a temporary loss of VAT revenue due to changes in the tax collection principles.

Source:

Stability programme (SP); Commission services' January 2009 interim forecasts (COM); Commission services' calculations.