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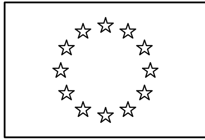

EUROPEAN COMMISSION

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Recommendation for a

COUNCIL OPINION

on the updated stability programme of Finland, 2009-2013

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 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 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.

In accordance with the Regulation, the Council delivered an opinion on the first stability programme of Finland on 12 October 1998 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. As regards updated stability and convergence programmes, the Regulation foresees that these are assessed by the Commission and examined by the Committee mentioned above and, following the same procedure as set out above, the updated programmes may be examined by the Council.

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 4 February 2010, 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 conclusions of the Economic and Financial Affairs Council of 20 October 2009 on the "Exit strategy";

(3) 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).

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[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/sgp/index_en.htm.

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

In view of the unprecedented scale of the global crisis that hit financial markets and the world economy in 2008-2009, the European Commission called for a European Economic Recovery Plan (EERP)[2]. The plan proposed 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 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 called for the fiscal stimulus to be differentiated across Member States in accordance with their positions in terms of sustainability (or room for manoeuvre) of government finances and competitive positions. In particular, for Member States 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.

2.2. The conclusions of the Economic and Financial Affairs Council of 20 October 2009 on the "Exit strategy"

Following the halt of the sharp decline in economic activity and first signs of a recovery from the crisis, the stabilisation of financial markets and the improvement in confidence, the Council concluded on 20 October 2009 that, while in view of the fragility of the recovery it was not yet time to withdraw the support governments provided to the economy and the financial sector, preparing a coordinated strategy for exiting from the broad-based policies of stimulus was needed. Such a strategy should strike a balance between stabilisation and sustainability concerns, take into account the interaction between the different policy instruments, as well as the discussion at global level. Early design and communication of such a strategy would contribute to underpinning confidence in medium-term policies and anchor expectations. Beyond the withdrawal of the stimulus measures of the European Economic Recovery Plan, substantial fiscal consolidation was required in order to halt and eventually reverse the increase in debt and restore sound fiscal positions. Increasing the efficiency and effectiveness of public finances and the intensification of structural reform were desirable even in the short term as they would contribute to fostering potential output growth and debt reductions. The Council agreed on the following principles of the fiscal exit strategy: (i) the strategy should be coordinated across countries in the framework of a consistent implementation of the Stability and Growth Pact; (ii) taking country-specific circumstances into account, timely withdrawal of fiscal stimulus was needed; provided that the Commission forecasts continued to indicate that the recovery was strengthening and becoming self-sustaining, fiscal consolidation in all EU Member States should start in 2011 at the latest; (iii) in view of the challenges, the pace of consolidation should be ambitious, in most countries going well beyond the benchmark of 0.5% of GDP per annum in structural terms; and (iv) important flanking policies to the fiscal exit would include strengthened national budgetary frameworks for underpinning the credibility of consolidation strategies and measures to support long-term fiscal sustainability; in addition, structural reform efforts should be strengthened to enhance productivity and to support long-term investment. The Council

[2] Communication from the Commission to the European Council of 26 November 2008.

agreed that these elements should be reflected in the stability and convergence programmes, to be transmitted by Member States to the Commission by the end of January 2010.

2.3. The assessment in the Council Opinion on the previous update

In its opinion of 10 March 2009, the Council summarised its assessment of the previous update of the stability programme, covering the period 2007-2012, as follows. The Council considers "that public finances remain sound although the programme envisages the present high fiscal surpluses to decline substantially. In view of the fiscal situation, 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 should be considered." In view of this assessment, the Council invited Finland to: "(i) implement the 2009 fiscal policy as planned in line with the EERP and within the framework of the SGP; (ii) subsequently reverse the adverse budgetary impact of the fiscal stimulus measures by returning to its medium-term objective and implementing appropriate structural reforms in order to preserve the long-term sustainability of public finances."

Recommendation for a

COUNCIL OPINION

on the updated stability programme of Finland, 2009-2013

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union,

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 [22 April 2010] the Council examined the updated stability programme of Finland, which covers the period 2009 to 2013.

(2) While Finland entered the global crisis in 2008 from a relatively strong position, having built up a substantial surplus in the current account and in government finances, the global crisis has had a particularly strong impact on its highly export-oriented industry, as well as on the domestic sectors through negative confidence effects. Finland allowed full operation of automatic stabilisers and in addition provided for a relatively large discretionary fiscal stimulus. The general government finances therefore weakened by over 6½% of GDP in 2009. While consumer confidence quickly rebounded in the course of 2009 to levels exceeding the long-term average, and industrial confidence indicators also improved moderately, the improvement in the real economy has been more gradual. The labour market reaction to the crisis has so far been more subdued than could have been expected from the steep fall in output.

(3) Although much of the observed decline in actual GDP in the context of the crisis is cyclical, growth in potential output will resume from a lower starting point. In addition, the crisis may also affect potential growth in the medium term through lower investment, constraints in credit availability and increasing structural unemployment. Moreover, the impact of the economic crisis will coincide with the negative effects of demographic ageing on potential output and the sustainability of public finances. Against this background it will be essential to accelerate the pace of structural reforms with the aim of supporting potential growth. In particular, for Finland it is important to

[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/sgp/index_en.htm.

undertake reforms to increase labour supply in the longer term in order to counter the negative effects on the labour market from the ageing of the population.

(4) The macroeconomic scenario underlying the programme envisages that after a sharp contraction by 7.6 % in 2009, real GDP growth will resume to 0.7% in 2010, accelerating to 2.4% and 3.5% in 2011 and 2012 respectively, before moderating to 3% in 2013. Assessed against currently available information[4], this scenario appears to be based on plausible growth assumptions until 2011 and markedly favourable ones thereafter, given that the projected growth rates are substantially higher than the estimated medium term growth potential. The programme's projections for inflation appear realistic over the programme period.

(5) The programme estimates the general government deficit in 2009 at 2.2% of GDP. The significant deterioration from a surplus of 4.4% of GDP in 2008 reflects to a large extent the impact of the crisis on government finances and stimulus measures amounting to almost 2% of GDP which the government adopted in line with the European Economic Recovery Plan (EERP). The deterioration in public finances was primarily driven by weaker revenues, especially due to a sharp drop in income tax accrual, particularly corporate income tax. According to the programme, fiscal policy is planned to remain supportive in 2010 before turning broadly neutral in the outer years of the programme. Since the fiscal stimulus measures are largely permanent by nature, their completion will not automatically lead to fiscal consolidation. In line with the exit strategy advocated by the Council, and with a view to returning to a sustainable public finance position, the medium term fiscal stance needs to be tightened. The programme states that the government will decide on budgetary consolidation measures later, planned to be specified in the upcoming 2011 budget and in the next stability programme update.

(6) The programme envisages the general government deficit to widen to 3.6% of GDP in 2010, thus temporarily breaching the deficit threshold of 3% of GDP set in the Stability and Growth Pact. The projected increase in the deficit is driven by a further stimulus amounting to somewhat more than 1% of GDP, mainly in the form of tax cuts, but also higher social benefit payments, due chiefly to the expected rise in unemployment. The structural balance, i.e. the cyclically-adjusted balance net of one-off measures recalculated according to the commonly agreed methodology, is set to decline by over 1% in 2010 from the previous year, broadly matching the size of the stimulus measures taking effect in 2010.

(7) The main aim of the programme's medium-term budgetary strategy is to support economic activity and the labour market over the economic crisis, at the same time taking account of the fiscal constraints set by long-term sustainability needs. While the programme emphasises the importance of achieving a sustainable fiscal position, it also states that the current fiscal projections based on existing policies do not fulfil this aim. The programme expects the headline and primary deficits to gradually narrow from 2011 onwards, with the headline deficit reaching about 2% of GDP in 2013. The corresponding path of the structural balance indicates that the fiscal policy stance turns neutral from 2011 onwards. This is in line with the programme scenario built on a no-policy change assumption and given that the government has not yet announced any

[4] The assessment notably takes into account the Commission services' autumn 2009 forecast, but also other information that has become available since then.

major medium term consolidation measures. The programme update sets the medium-term objective (MTO) for the budgetary position at a structural surplus of 0.5% of GDP. In view of the new methodology[5] and given the most recent projections and debt level, the MTO appears to reflect the objectives of the Pact. However, under current policies the updated stability programme does not envisage achieving the medium-term budgetary objective within the programme period.

(8) The budgetary outcomes could turn out worse than projected in the programme. While the risks to the more immediate growth outlook are limited as the latest forward-looking indicators confirm a relatively robust and continuous recovery of consumer confidence and albeit less so, of business confidence, the budgetary outcome in the outer years may be worse than projected given the markedly favourable growth assumptions underlying the budgetary projections. The risks to the targets are somewhat counterbalanced by the commitment of the government to specify exit measures in the 2011 budget and the next stability programme update.

(9) Government gross debt is estimated at 41.8% of GDP in 2009, up from 34.2% in the year before. This is largely driven by the rapid increase in the deficit and the slump in GDP. The debt ratio is projected to increase by a further 14.6 pps. over the programme period, up to 56.4% of GDP by 2013, mainly driven by continued high government deficits. In view of the negative risks to the budgetary targets the debt ratio could rise even more than projected in the programme. As suggested by the sensitivity analysis carried out in the programme, the debt ratio is not projected to exceed the 60% of GDP ceiling stipulated by the Stability and Growth Pact. As in previous years, the social security funds continue to accumulate financial assets, which amounted to about 52.4% of GDP in 2008, and thus currently exceeding government gross debt.

(10) While the long-term budgetary impact of ageing is slightly higher than on average in the EU, enacted pension reforms have helped to contain the projected increase in pension expenditure over the coming decades. Moreover, the large assets accumulated by the public pension funds will help finance a part of the future increase in pension expenditure. The budgetary position in 2009, as estimated in the programme, compounds the budgetary impact of population ageing on the sustainability gap. Ensuring high primary surpluses over the medium term and implementing appropriate structural reforms would contribute to limiting the risks to the sustainability of public finances which were assessed in the Commission 2009 Sustainability Report[6] as low. Medium-term debt projections that assume GDP growth rates to only gradually recover to the values projected before the crisis and tax ratios to return to pre-crisis

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[5] The country-specific MTOs should take into account three components: i) the debt-stabilising balance for a debt ratio equal to the (60% of GDP) reference value (dependent on long-term potential growth), implying room for budgetary manoeuvre for Member States with relatively low debt; ii) a supplementary debt-reduction effort for Member States with a debt ratio in excess of the (60% of GDP) reference value, implying rapid progress towards it; and iii) a fraction of the adjustment needed to cover the present value of the future increase in age-related government expenditure.

[6] In the Council conclusions from 10 November 2009 on sustainability of public finances "the Council calls on Member States to focus attention to sustainability-oriented strategies in their upcoming stability and convergence programmes" and further "invites the Commission, together with the Economic Policy Committee and the Economic and Financial Committee, to further develop methodologies for assessing the long-term sustainability of public finances in time for the next Sustainability report", which is foreseen in 2012.

levels show that the budgetary strategy envisaged in the programme, taken at face-value, would stabilise the debt-to-GDP ratio by 2020.

(11) The main tool in controlling central government expenditure continues to be the multiannual spending limits, which exclude cyclically sensitive expenditure items and have therefore allowed the full operation of automatic stabilisers. While this setup has supported economic activity and social cohesion over the crisis period, it has also led to a relatively sharp downward swing in public finances. Given its good track record, the spending ceilings device can be expected to remain an effective tool in containing non-cyclical central government expenditure. The programme recognises that emphasis should be given to the post-crisis exit strategy and to developing fiscal policy rules that ensure long-term sustainability of public finances. The central government also attempts to achieve productivity increases for municipally provided services, which could in turn contain expenditure pressures. To this end, a framework law was passed by parliament in 2007.

(12) The government has not substantially altered the ongoing reform strategy concerning the reorganisation of service provision both at the central and local government level, with both progressing according to plan. However, the hoped-for productivity gains at the municipal level would likely materialise substantially only in the medium- to long run.

(13) Overall, taking into account the risks to the budgetary targets mentioned above, the strategy to maintain supportive fiscal policies also in 2010 can be considered in line with the EERP. Following the negative effects of the economic crisis, the general government deficit limit of 3% of GDP is projected to be temporarily breached in 2010, gradually abating below the reference value thereafter. However, in view of the risks to the growth projections in the outer years of the programme, even the planned moderate reduction in the deficit may not be achieved. The projected fiscal stance, as measured by the change in structural balances, does not indicate fiscal consolidation to take hold in the medium term and the programme does not envisage progress towards its MTO within the programme period. While the programme states that a consolidation strategy is being planned, it does not specify its precise objectives or main elements. A timely implementation of a comprehensive strategy aiming at a structural fiscal consolidation would be necessary to bring the budgetary strategy in line with the requirements of the Pact.

(14) 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 that the severe economic crisis has substantially weakened public finances, including the long-term sustainability position. The planned expansionary fiscal policies in 2010 are in line with the EERP. However, the programme's projections, based on current policies, indicate that the general government deficit would exceed the 3%-of-GDP reference value in 2010. Moreover, the projected sluggish medium term fiscal consolidation path would not ensure progress towards the programme's MTO. Taking also account of the downside risks attached to these projections, it would be highly desirable that the Government takes timely action to specify a comprehensive and concrete medium term

[7] In particular, external assumptions are not provided for the outer years of the programme period.

fiscal strategy to consolidate from 2011 onwards. In view of the above assessment, Finland is invited to:

(i) implement the 2010 fiscal policy as planned in line with the EERP, while ensuring that the planned breach of the 3%-of-GDP reference value would remain contained and temporary;

(ii) take timely action to define a comprehensive and concrete medium term fiscal strategy to consolidate from 2011 onwards, also with a view to achieve the MTO and to restore the long-term sustainability of public finances.

Comparison of key macro economic and budgetary projections

		2008	2009	2010	2011	2012	2013
Real GDP (% change)	**SP Feb 2010**	**1.0**	**-7.6**	**0.7**	**2.4**	**3.5**	**3.0**
	COM Nov 2009	1.0	-6.9	0.9	1.6	n.a.	n.a.
	SP Dec 2008	*2.6*	*0.6*	*1.8*	*2.4*	*2.2*	*n.a.*
HICP inflation (%)	**SP Feb 2010**	**3.9**	**1.7**	**1.8**	**1.7**	**2.0**	**2.0**
	COM Nov 2009	3.9	1.8	1.6	1.5	n.a.	n.a.
	SP Oct 2008	*4.0*	*2.3*	*1.9*	*2.0*	*2.0*	*n.a.*
Output gap[1] (% of potential GDP)	**SP Feb 2010**	**3.7**	**-5.0**	**-5.0**	**-4.0**	**-2.2**	**-1.2**
	COM Nov 2009[2]	3.5	-4.5	-4.3	-3.8	n.a.	n.a.
	SP Dec 2008	*1.3*	*-0.6*	*-1.0*	*-1.2*	*n.a.*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**SP Feb 2010**	**2.7**	**0.8**	**1.2**	**1.5**	**1.8**	**2.0**
	COM Nov 2009	3.0	1.1	1.2	1.3	n.a.	n.a.
	SP Dec 2008	*4.0*	*3.6*	*3.7*	*3.9*	*3.9*	*n.a.*
General government revenue (% of GDP)	**SP Feb 2010**	**53.4**	**53.1**	**52.6**	**53.4**	**53.2**	**52.8**
	COM Nov 2009	53.4	51.5	50.5	50.6	n.a.	n.a.
	SP Dec 2008	*51.4*	*50.3*	*49.7*	*49.4*	*49.4*	*n.a.*
General government expenditure (% of GDP)	**SP Feb 2010**	**49.0**	**55.3**	**56.2**	**56.4**	**55.5**	**54.7**
	COM Nov 2009	48.9	54.3	55.0	55.0	n.a.	n.a.
	SP Dec 2008	*47.0*	*48.2*	*48.6*	*48.4*	*48.5*	*n.a.*
General government balance (% of GDP)	**SP Feb 2010**	**4.4**	**-2.2**	**-3.6**	**-3.0**	**-2.3**	**-1.9**
	COM Nov 2009	4.5	-2.8	-4.5	-4.3	n.a.	n.a.
	SP Dec 2008	*4.4*	*2.1*	*1.1*	*1.0*	*0.9*	*n.a.*
Primary balance (% of GDP)	**SP Feb 2010**	**5.9**	**-0.8**	**-2.3**	**-1.2**	**-0.2**	**0.4**
	COM Nov 2009	5.9	-1.4	-3.1	-2.9	n.a.	n.a.
	SP Dec 2008	*5.4*	*4.0*	*3.3*	*2.8*	*2.4*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**SP Feb 2010**	**2.6**	**0.3**	**-1.1**	**-1.0**	**-1.2**	**-1.3**
	COM Nov 2009	2.7	-0.5	-2.3	-2.4	n.a.	n.a.
	SP Dec 2008	*3.7*	*2.4*	*1.7*	*1.6*	*n.a.*	*n.a.*
Structural balance[3] (% of GDP)	**SP Feb 2010**	**2.6**	**0.3**	**-0.9**	**-1.0**	**-1.2**	**-1.3**
	COM Nov 2009	2.7	-0.5	-2.2	-2.4	n.a.	n.a.
	SP Dec 2008	*3.7*	*2.4*	*1.7*	*1.6*	*n.a.*	*n.a.*
Government gross debt (% of GDP)	**SP Feb 2010**	**34.2**	**41.8**	**48.3**	**52.2**	**54.4**	**56.4**
	COM Nov 2009	34.1	41.3	47.4	52.7	n.a.	n.a.
	SP Dec 2008	*32.4*	*33.0*	*33.7*	*34.1*	*34.6*	*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 2.1%, 1.0%, 0.7% and 1.1% respectively in the period 2008-2011.

[3] Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures concern only 2010 when they amount to 0.2% of GDP and are deficit-increasing according to both the most recent programme and the Commission services' autumn 2009 forecast.

Source:
Stability programme (SP); Commission services' autumn 2009 forecasts (COM); Commission services' calculations.