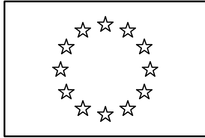

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REPORT FROM THE COMMISSION

Finland

Report prepared in accordance with Article 126(3) of the Treaty

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1. THE APPLICATION OF THE STABILITY AND GROWTH PACT IN THE CURRENT CRISIS SITUATION

Many EU countries are presently facing general government deficits above the 3% of GDP reference value set in the Treaty. The often strong deterioration in the deficit as well as the debt positions must be seen in the context of the unprecedented global financial crisis and economic downturn. Several factors are at play. First, the economic downturn brings about declining tax revenue and rising social benefit expenditure (e.g. unemployment benefits). Second, recognising that budgetary policies have an important role to play in the current extraordinary economic situation, the Commission called for a fiscal stimulus in its November 2008 European Economic Recovery Plan (EERP), endorsed by the European Council in December. The Plan explicated that the stimulus should be differentiated across Member States to reflect their different positions in terms of public finance sustainability and competitiveness and should be reversed when economic conditions improve. Finally, several countries have taken measures to stabilise the financial sector, some of which impact on the debt position or constitute a risk of higher deficits and debt in the future, although some of the costs of the government support could be recouped in the future.

The Stability and Growth Pact requires the Commission to prepare a report such as the present one whenever an actual or planned deficit of a Member State exceeds the 3% of GDP reference value. This report, which represents the first step in the "excessive deficit procedure" (EDP), analyses the reasons for the breach of the reference value with due regard to the economic background and all other relevant factors. The amendments to the Stability and Growth Pact in 2005 aimed specifically at ensuring that in particular the economic and budgetary background was fully taken into account in all steps in the EDP. This means for instance that, if an "excessive deficit" is deemed to exist, adequate attention needs to be paid to the economic background and outlook when making recommendations on the pace of the correction. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation.

2. LEGAL BACKGROUND

This report, which assesses recent and current budgetary developments in Finland and reviews the short- and medium-term prospects in the light of overall economic conditions and policy action taken by the government, is prepared according to Article 126(3) of the Treaty on the Functioning of the European Union (TFEU).

Article 126 TFEU lays down an excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure"[1], which is part of the Stability and Growth Pact. According to Article 126(2) of the Treaty, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3% (unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value); and (b) whether the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

Article 126(3) stipulates that, if a Member State does not fulfil the requirements under one or both of these criteria, the Commission has to prepare a report. This report also has to "take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State".

According to data notified by the authorities in April 2010[2]", the general government deficit in Finland is planned to reach 4.1% of GDP in 2010, thus exceeding the 3% of GDP reference value, while general government gross debt would be 49.9% of GDP, below the 60% of GDP reference but on a rising trend.

Table 1: General government deficit and debt [a]

	2004	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**		**2011**
							COM	FI	COM
General government balance	2.3	2.7	4.0	5.2	4.2	-2.2	-3.8	-4.1	-2.9
General government gross debt	44.4	41.7	39.7	35.2	34.2	44.0	50.5	49.9	54.9

Note:
[a] In percent of GDP.
Source: Eurostat and Commission services' spring 2010 forecast.

1 OJ L 209, 2.8.1997, p. 6. The report also takes into account 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 10 November 2009, available at http://ec.europa.eu/economy_finance/sgp/legal_texts/index_en.htm.

2 According to Council Regulation (EC) No 479/2009, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notification of Finland can be found at: http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/excessive_deficit/edp_notification_tables.

The planned figure for the 2010 deficit provides *prima facie* evidence on the existence of an excessive deficit in Finland in the sense of the Treaty and the Stability and Growth Pact. The Commission has therefore decided to initiate the excessive deficit procedure for Finland with the adoption of this report. Section 3 of the report examines the deficit criterion. Section 4 deals with public investment and other relevant factors. The report takes into account the Commission services' spring 2010 forecast, released on 5 May.

3. DEFICIT CRITERION

In 2010, the general government deficit is planned to reach 4.1% of GDP. Well in excess of 3% of GDP, the planned deficit is not close to the Treaty reference value. The planned excess over the 3% of GDP reference value is exceptional. In particular, it does result from a severe economic downturn in the sense of the Treaty and the Stability and Growth Pact. Even though Finland entered the global crisis in 2008 from a relatively strong position, having built up a substantial surplus in the current account and in the government finances, the global crisis had a strong impact on the export-dominated Finnish industry as well as on the domestic sectors through negative confidence effects. According to preliminary GDP data published by the national statistics office on 1 March 2010, GDP contracted sharply, by 7.8% in 2009. The steep fall has led to an exceptionally large output gap, estimated at 4½ % of GDP in 2010. Although much of the observed decline in actual GDP in the context of the crisis is cyclical, the level of potential output has also been negatively affected. In addition, the crisis may also affect potential growth in the medium term through lower investment, constraints in credit availability and increasing structural unemployment.

Table 2: Macroeconomic and budgetary developments [a]

	2004	2005	2006	2007	2008	2009	2010	2011
Real GDP (% change)	4.1	2.9	4.4	4.9	1.2	-7.8	1.4	2.1
Potential GDP (% change)	2.7	2.5	2.2	2.2	2.1	1.1	1.0	1.3
Output gap (% of potential GDP)	-0.2	0.2	2.4	5.1	4.1	-5.0	-4.6	-3.8
General government balance	2.3	2.7	4.0	5.2	4.2	-2.2	-3.8	-2.9
Primary balance	3.9	4.2	5.5	6.7	5.6	-1.0	-2.6	-1.7
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1	0.0
Government gross fixed capital formation	2.8	2.5	2.3	2.4	2.5	2.8	2.8	2.6
Cyclically-adjusted balance	2.4	2.6	2.8	2.6	2.1	0.3	-1.4	-1.0
Cyclically-adjusted primary balance	3.9	4.1	4.3	4.1	3.5	1.5	-0.3	0.2
Structural balance [b]	2.4	2.6	2.8	2.6	2.1	0.4	-1.3	-1.0
Structural primary balance	3.9	4.1	4.3	4.1	3.5	1.6	-0.2	0.2

Notes:
[a] In percent of GDP unless specified otherwise.
[b] Cyclically-adjusted balance excluding one-off and other temporary measures.

Source: Eurostat and Commission services' spring 2010 forecast.

The planned excess over the 3% of GDP reference value is temporary in the sense of the Treaty and the Stability and Growth Pact. The budgetary forecasts as provided by the Commission indicate that the deficit will fall below the reference value in 2011, supported by the forecast economic recovery taking hold. These budgetary projections are based on current policies, including the rise in VAT and some product taxes worth 0.2% of GDP in 2011. The projection does not rely on any major one-off measures.

In sum, the planned deficit is not close to the 3% of GDP reference value but the planned excess over the reference value is exceptional and temporary in the sense of the Treaty and the Stability and Growth Pact. This analysis suggests that the deficit criterion in the Treaty is not fulfilled.

4. RELEVANT FACTORS

Article 126(3) of the Treaty provides that the Commission report "shall also take into account whether the government deficit exceeds government investment expenditure and take into account other relevant factors including the medium-term economic and budgetary position of the Member State". These factors are further clarified in Article 2(3) of Council Regulation (EC) No 1467/97, which also specifies that "any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess in qualitative terms the excess over the reference value and which the Member State has put forward to the Commission and to the Council" need to be given due consideration.

In view of the above provisions, the following four subsections consider in turn (1) the medium-term economic position; (2) the medium-term budgetary position (including public investment); (3) other factors put forward by the Member State; and (4) other factors considered relevant by the Commission.

4.1. Medium-term economic position

Cyclical conditions and potential growth. Prior to the current global crisis, Finland had benefited from an extended period of rapid export-driven growth, building up a substantial surplus in the current account and in the government finances. This has allowed Finland to provide for a relatively large discretionary fiscal stimulus amounting to about 3% of GDP over 2009-2010 and to allow a full operation of automatic stabilisers, which has cushioned the effect of the crisis on the domestic market to some extent. In spite of the dramatic fall in GDP in 2009, the repercussions of the crisis on the Finnish financial system, labour market and on the household and enterprise sectors has remained relatively contained. Since the main Finnish export markets are also set to recover from the global crisis, GDP growth in Finland is forecast to slightly exceed the EU average in 2010-2011. The medium term GDP growth outlook is nevertheless forecast to be weaker than what was recorded over the previous decade, given the adverse effects of the present crisis and the ageing of the population on the growth potential.

Recent structural reforms. The principal Finnish structural reform efforts in the framework of the Lisbon strategy were concentrated on preparing for the challenges of population ageing, particularly focusing on ensuring long term sustainability of public finances and increasing labour supply in the face of the imminent decline in working age population. These reform initiatives are ongoing and are expected to carry some fiscal benefits in the medium

and long term, while only partly offsetting the ageing related expenditure pressures. Boosting labour supply and employment would have a significant impact on the economic growth potential and tax bases, therefore being an important element of the strategy to improve long term sustainability. On the expenditure side, the government hopes to bring about savings on both the central and local government level. The government has over the past years designed some notable productivity-enhancing reforms for both the central and local level. The central government has set ambitious targets to reduce its personnel by over 10% over 2007-2015 through natural attrition, with the double aim of increasing productivity and adjusting to a shrinking workforce. A framework law promoting the reform of local governments' structure and their service provision was passed by the parliament in the beginning of 2007. It is designed to similarly result in productivity gains and thus reduce expenditure pressures. However, given that the reform of local governments will be implemented only gradually, they would likely bring any substantial net benefits for public finances only in the longer term.

4.2. Medium-term budgetary position

Structural deficit and fiscal consolidation in good times. Finland appropriately ran substantial budgetary surpluses both in nominal and structural (net of cyclical factors and one-off measures) terms over the previously prevailing good economic times when also a sizeable positive output gap emerged. As the current global crisis has had a strong impact on the Finnish economy, the estimated output gap has also turned sharply negative. Finland responded to the global crisis with a relatively large discretionary fiscal stimulus and allowed the full operation of automatic stabilisers. The fiscal stance, measured by the change in the structural balance, indicates a countercyclical impact of public finances over the period of economic contraction. The Finnish Stability Programme update of February 2010 sets its medium-term objective (MTO) for the budgetary position at a structural surplus of 0.5% of GDP. The current level of the estimated structural position stands considerably lower at a deficit of 1.3% of GDP in 2010, estimated to improve slightly to a deficit of 1% of GDP in 2011. The stability programmes' projections foresaw the structural deficit to stay broadly flat in the medium term, based on current policies. Apart from some limited rises in tax rates in 2010-2011, the government has not yet announced a comprehensive medium term consolidation strategy.

Public investment. Government investment (as a share of GDP) amounted to slightly above 2½ % of GDP in 2008, increasing by a few tenths of percentage points over 2009-2010 on account of the fiscal stimulus measures and forecast to return to previous levels thereafter. The general government nominal deficit in 2010 will therefore exceed total public investment in that year, but fall below investment again in the medium term. In structural terms, the deficit estimated at above 1% of GDP in 2010 will be lower than public investment and broadly maintain the difference in the medium term.

Quality of public finances. The main tool in controlling central government expenditure are 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 negative swing in public finances. The budgetary framework will therefore mechanically result in a reduction of central government expenditure pressures, including social expenditure, only once the economic recovery is well underway. While local governments have large constitutionally granted self-governance rights, they are responsible for the majority of education, health care, long-term care and social services and are not

bound by centrally-imposed expenditure limits. Growth in local government expenditure has exceeded central government performance in the past years. To compensate for the relatively high expenditure growth, local governments have typically increased local tax rates, adding to the overall national tax burden. The government pursues reforming local governments' structures and service provision with the aim of curbing expenditure growth, also triggered by additional ageing-related expenditure needs in the medium to long term.

Long-term sustainability of public finances. In its opinion of 26 April 2010 on the most recent stability programme update, the Council assessed the long-term sustainability of Finland's public finances as follows: 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 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 as low. The Council invited the authorities to 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.

4.3. Other factors put forward by the Member State

The authorities of Finland have not presented any relevant factors as they can do according to Article 2(3) of Council Regulation (EC) No 1467/97.

4.4. Other factors considered relevant by the Commission

In its opinion on the most recent update of the stability programme, the Council considered that the budgetary outcomes in the medium term 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 Council invited Finland to 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; and 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.

5. CONCLUSIONS

The general government deficit in Finland is planned to reach 4.1% of GDP in 2010, above and not close to the 3% of GDP reference value. The planned excess over the reference value can be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact. Furthermore, it can be considered temporary. This suggests that the deficit criterion in the Treaty is not fulfilled.

General government gross debt remains below the 60% of GDP reference value. This suggests that the debt criterion in the Treaty is fulfilled.

In line with the Treaty, this report has also examined "relevant factors", which, according to the Stability and Growth Pact, can only be taken into account in the steps leading to the decision on the existence of an excessive deficit if the double condition - that the deficit remains close to the reference value and that its excess over the reference value is temporary - is fully met. Considered on their own merit, the relevant factors in the current case on balance seem to be relatively favourable, based on the good track record of fiscal policy in Finland.