COMMISSION OF THE EUROPEAN COMMUNITIES

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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, 2002-2006

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) No. 1466/97, on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], stipulated that countries participating in the single currency were to submit stability programmes to the Council and the Commission by 1 March 1999. In accordance with Article 5 of this Regulation, the Council had to examine each stability programme based on the assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty, the Economic and Financial Committee. The Commission adopted a recommendation on each programme. On the basis of this recommendation and after having consulted the Economic and Financial Committee, the Council delivered an opinion, following its examination of the programme. According to the Regulation, the updated stability programmes, to be presented annually, may also be examined by the Council in accordance with these same procedures.

Finland's first stability programme covering the period 1998-2002 was submitted on 7 September 1998 and assessed by the Council on 12 October 1998[2].

The first, second and third updates of the stability programme were examined by the Council on 2 March 2000[3], on 28 December 2000[4] and on 6 February 2002[5]. Finland submitted the fourth and most recent updated stability programme, covering the period 2002-2006, on 29 November 2002. The Commission services have carried out a technical evaluation of this updated programme, namely taking into account the Communication from the Commission to the Council of 27 November on strengthening the coordination of budgetary policies[6]. This evaluation warrants the following assessment:

The November 2002 update of the Finnish stability programme foresees a marked acceleration of GDP growth to 2.8% in 2003, nearly a double of the growth rate of 1.6% in 2002. Between 2004 and 2006, growth should remain close to its trend rate of about 2¾ %. Consequently, output gap is seen to fade in later years of the programme period, following a gap of over 2% in 2001 due to exceptional growth of 2000. This fourth update of stability programme assumes, up to 2003, a broadly similar profile of output projections as the previous programme, from whereon growth is seen more strongly constrained by labour supply compared with the earlier programme. Growth contributions from different demand components have been modified somewhat, as the external contribution appears stronger in

[1] OJ L209, 2.8.1997
[2] OJ C372, 2.12.1998
[3] OJ C60/3, 2.3.2000
[4] OJ C374, 28.12.2000
[5] OJ C33, 6.2.2002
[6] COM (2002) 668 final, 27.11.2002.

the current programme whereas support from domestic demand is slightly weaker. In 2002, employment creation has been relatively resilient to the previous slowdown in activity. However, a slight pick-up in unemployment has been noted in the course of the year and although growth is projected to accelerate, a rise in the unemployment rate is projected for both 2002 and 2003. Inflation is expected to decelerate to 2% by 2003 in the absence of external shocks, while a more marked decline is projected for 2004.[1] Subsequently, inflation is expected to resume its earlier trend of about 2%. Apart from a weaker growth estimate for 2004, the programme's short-term projections compare reasonably well with the Commission Autumn 2002 forecast.

The updated programme foresees a significant decline in the general government surplus from 4.9% of GDP in 2001 to just over 2% in 2004, in spite of solid output expansion. This owes partly to income tax cuts which exceed the initial government target for 2000-03 and partly to revenue loss due to erosion in tax base and increased tax competition. In subsequent years, the surplus is expected to resume an upward trend and rise to close to 3% by 2006. Notwithstanding similar growth projections, the current update projects a higher government surplus than its predecessor, notably for 2002, owing to more buoyant revenue intake from corporate taxes. In 2004, however, the surplus is now set to diminish more markedly, owing to revenue shortfalls. Nevertheless, the projected path of the government balance shows that public finances in Finland remain clearly in line with the requirements of the Stability and Growth Pact throughout the programme period. The biggest contribution to the falling surplus ratio comes from the deterioration of central government finances which are estimated to even slip into deficit as from 2004. As a result, the government's aim of achieving a structural surplus in central government finances of 1½-2% of GDP in the medium term appears to be moving further away. Furthermore, the local government financial balance seems to resume its customary deficit in 2003. In fact, according to the programme, general government financial surplus in 2004-06 rests solely on the surplus of the social security funds and, moreover, on that of the earnings-related pension funds preparing for financial pressures stemming from an ageing population. Moreover, the projected decline in the cyclically adjusted balance by 1½ percentage points of GDP between 2002-04 seems to come at the time when the economy should be strongly gathering momentum, implying, thus, a pro-cyclical stance of fiscal policy. Still, according to the programme, the cyclically adjusted budgetary surplus should remain at 2% of GDP, or higher, throughout the programme period. This

[1] Also due to the end of the transition period for free import of alcohol and tobacco from other EU countries.

should still leave enough leeway against any normal fluctuations in activity, although underlying surplus is forecast to fall by 1¾ percentage points of GDP between 2002 and 2004.

The current programme projects general government debt to fall at a somewhat faster pace between 2002 and 2003 than the previous programme, although the initial position was less favourable than targeted in 2001. Indeed, unlike in the previous programme, a rise in the debt ratio is no longer expected, owing also to a slightly higher nominal GDP estimate. On the other hand, the estimated 2.7 pp. of GDP decline in the debt ratio from 43.4% at end-2001 to 40.7% at end-2006 appears modest given the high primary surpluses of general government finances over the programme period and in view of the assumption of stable additional revenues from privatisation. According to the programme, the stickiness of debt reduction is due in particular to financial transactions: to the ongoing diversification of social security institutions' assets away from central government bonds and to the accumulation of earnings-related pension fund assets of the central government. It cannot be excluded, however, given the amount of government debt held by the sector, that the shift in pension fund portfolio might be faster[1] than expected in the programme[2], and the fall of gross debt ratio could slow down even stronger over the period.

The government programme included a plan to cut income taxes by some € 1.7-1.8 billion during its term with a view to boosting employment creation, but also shifting taxation towards capital and environmental taxes. According to the update and including the latest amendment to the 2003 budget proposal, income tax cuts are estimated to amount to some € 2½ billion between 1999 and 2003, exceeding the original target of government programme by about ½ % of GDP. The cuts can be justified against the background of the earlier healthy budgetary position and a high overall tax burden on labour. Moreover, they seem to be accompanied by adhering to tight spending ceilings in the central government finances in 2003. On the other hand, they appear relatively modest with regard to the intended boost in labour demand, even more so, as the rise in local government tax rates will largely offset the tax relief, contributing to a fairly neutral stance of earnings taxation in 2003. Had there been tight spending freezes in 2001-02, the government would have afforded higher income tax

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[1] 55% of all employment fund investments were invested outside Finland in the third quarter of 2002 while the share was 41.2% in the beginning of 2001.

[2] The employment pension funds are assumed to reduce their investments in central government assets by EUR
1.0 billion in 2002, by EUR 0.5 billion in 2003 and by EUR 0.3 billion in 2004 to 2006.

cuts. Altogether, the tax burden is foreseen to fall by a total of € 2.8 billion during the four-year term of the current government.

The update foresees general government expenditure to fall from 47.5% in 2002 to 46.1% in 2006 (although the expenditure ratio is seen 0.7 percentage points higher for 2004 than in the previous programme), due to lower interest payments on debt but, more importantly, on the back of tight budgetary policy. Tight expenditure control has also been the key fiscal policy tool of the current government, but the earlier target of freezing central government spending at the level of 1999 appears out of reach. According to the update, central government expenditure, excluding interest payments, is estimated to have increased at an average annual rate of about 2% in real terms during the term of the current government and be left in 2003 at € 1 billion higher in real terms than the level in 1999. The overrun was particularly evident in 2002, although part of it follows from changes in accounting practices, but there was a slippage already in 2001. Thus, the commitment of carrying out the expenditure control seems to be postponed to the next government to be elected in early 2003. It should be remembered at this point, that in the 2002 Broad Economic Policy Guidelines (BEPG) and in last year's assessment of the stability programme, the Council recommended to firmly adhere to the spending ceilings in coming years and that some of the lost ground is regained in the Spring 2002 review of the spending ceilings. To this end, the 2003 budget appears promising since the central government expenditure is forecast to be limited at the level of spending ceilings agreed in March 2003.

The programme presents various measures to improve the financial balance of local governments[1]. These are clearly a step in the right direction, in particular with respect to strengthening the predictability of local government finances. Still, the recently adopted legislation requires municipalities to maintain a balance in their finances over a three-year planning period. According to the programme, local government finances are expected to show deficit over a period of 2003-06. Therefore, the government needs to further enhance the implementation of the legislation through, as recommended also by the 2002 BEPGs, carefully monitoring[2] municipal finances. In addition, in view of the increasing unemployment, various active labour market policy measures of the programme should help to alleviate the problem of high unemployment in Finland.

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[1] Revenue in local government has been made less sensitive to cyclical fluctuations and better budget monitoring is being developed.

[2] Local governments are administratively fairly independent in Finland.

The 2002 updated programme contains a detailed section on the sustainability of public finances, completed with national budgetary projections for public expenditures and revenues up to 2050. They show that age-related expenditures are projected to increase by some 6 percentage points of GDP between 2005 and 2050: revenues are also projected to increase by some 2 percentage points of GDP over the same period. Consequently, public finances in Finland are in good position to meet the budgetary consequences of ageing populations. This is largely due to the sustained running of a budget surplus which is leading to a fast pace of debt reduction in the long term. Even though the budget surplus is set to decline somewhat over the programme period, over the coming two decades gross debt will continue to fall rapidly, as a result of an explicit policy goal. In addition, the sustainability of public finances is supported by a pension system that is to a large extent pre-funded[1]. The recent reforms[2] of pension and unemployment insurance systems, encouraged also by the 2002 BEPGs, should help to restrain the long-term expenditure pressures[3]. Some of the results, however, seem to emerge with a considerable lag. The most immediate challenge will be to finalise the reforms of the pension systems according to the time frame indicated in the programme. A longer term challenge may stem from the fact that the projected sustainability of public finances is based on an assumption of a tax ratio of some 50% of GDP in coming decades. However, the projected tax ratio is high relative to other industrialised countries and the desirability of maintaining such high tax ratios over the very long-run could be called into question by the increasing mobility of production factors (and consequently tax bases) increases in light of globalisation.

Based on this assessment, the Commission has adopted the attached recommendation for a Council opinion on the Stability Programme update of Finland and is forwarding it to the Council.

[1] The market value of statutory earnings-related pension funds was some 51% of GDP in 2001.

[2] E.g. termination of certain early-retirement schemes, incentives to encourage older workers to remain in the labour force and mechanisms to adjust pension entitlements in line with changes in life expectancy.

[3] Still further steps are planned, *inter alia* dealing with pension systems in the public sector.

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, 2002-2006

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 co-ordination of economic policies[1], 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:

On [21 January 2003] the Council examined Finland's updated stability programme, which covers the period 2002-2006. The Council notes with satisfaction that the general government balance, which exceeded projections in 2001, is expected to remain clearly in surplus throughout the programme period. Furthermore, in spite of the higher than expected outcome in 2001, the general government debt to GDP ratio is projected to continue to decline, unlike in the previous programme, virtually every year during the programme period. The Council considers that the updated programme is consistent with the Broad Economic Policy Guidelines (BEPG).

The macroeconomic scenario presented in the 2002 updated stability programme projects a strengthening of economic activity in 2002 and 2003 which appears warranted on the back of most recent data. Subsequently, GDP growth is expected to decelerate slightly to below its trend rate, in the face of constraints on labour supply. Given the assumption of a favourable external environment, the projected deceleration of GDP growth in the later years of the programme represents a rather cautious view.

The Council notes that the programme projects a substantial decline in the general government surplus from 4.9% of GDP in 2001 to just above 2% in 2004[2] and a return to

[1] OJ L 209, 2.8.1997.

[2] Excluding 2004, this represents an upward revision of the budgetary targets compared with

close to 3% is expected for the later years of the programme owing to assumed expenditure control. The Council notes, that all levels of government appear to be responsible for the weakening of the financial position between 2002-04, with only the social security funds, preparing for the coming age-related expenditure pressures, upholding the surplus at the general government level. Moreover, the projected decline in the cyclically adjusted balance by 1½ percentage points of GDP between 2002-04 seems to come at the time when the economy should be strongly gathering momentum, implying, thus, a pro-cyclical stance of fiscal policy.

The Council notes that, apart from the cyclical adjustment from exceptionally high starting point of 2000, the expected decline in the government surplus is mainly due to higher than originally planned income tax cuts between 2000-03 and higher than planned discretionary spending at central government level in 2001-02. Even though the previous high surpluses have created some additional room (for fiscal manoeuvre), the Council takes note of the apparent customary tendency of deviating from the medium-term spending guidelines which represent the governments´ key fiscal policy instrument. These slippage raise some concern, since, in order to maintain high surpluses in coming years, the programme assumes tight restraints on spending - but also - a decline in the revenue-to-GDP ratio. Therefore, the Council renews its recommendation from last year – along also the lines of 2002 BEPGs - that the Finnish government reinforces its commitment to firmly control central government outlays over the medium-term.

The Council also notes the somewhat slow pace of debt reduction over the programme period, in the light of the comfortably high primary surpluses, but recognises that this follows mainly from net accumulation of financial assets and, furthermore, that the general government financial assets appear to exceed the sectors´ gross debt. Nevertheless, in light of Finland's above-average exposure to expenditure pressures related to the ageing of the population, the Council encourages the Finnish government to maintain the current high surpluses over the medium term to allow a continuous decline in the government gross debt ratio.

The Council notes that the projected surplus in the government accounts throughout the programme period is fully in line with the requirements of the Stability and Growth Pact. This is almost entirely due to a surplus in the accounts of statutory social security institutions preparing for the age-related expenditure pressures. In addition, in spite of expected deficit in central and local government finances, the estimated cyclically adjusted government surplus of at least 2% of GDP should provide a sufficient safety margin against a breach of the 3% of GDP reference value for the government deficit in normal cyclical fluctuations.

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the previous programme, due also to surplus in 2001 having been higher than targeted.

The Council welcomes the measures recently adopted to improve financial stability at the local government level over the medium term. The Council recommends, in line with the 2002 Broad Economic Policy Guidelines and the updated stability programme, to ensure that the envisaged aims are achieved; in this respect, the introduction of a surveillance mechanism underpinning legislation requiring local governments to balance their budgets within a three year period would be welcome.

The Council welcomes the attention given in the stability programme to the sustainability of public finances. The Council considers that on the basis of current policies, public finances appear to be on a sustainable footing to meet the budgetary costs of ageing populations, benefiting from the sustained running of budget surpluses, and a reformed pension system that has a high degree of pre-funding.

The Council also takes note of reforms, both planned and underway, which aim at raising employment rates of older workers, and encourages the Finnish authorities to proceed with their implementation according to the time frame indicated in the stability programme.

The Council notes that the tax ratio in Finland is high compared with other industrialised countries. A major challenge will be to carry out the planned tax reforms, while safeguarding the achievements of the past decade of placing public finances on a sustainable path.