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COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 23.01.2008
SEC (2008)66 final

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Art. 5 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the updated stability programme of Finland, 2007-2011

(presented by the Commission)

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.

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. 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. As regards updated stability and convergence programmes, the regulation foresees that these are assessed by the Commission and examined by the Committee and if necessary 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 29 November 2007, and is recommending 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 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) the orientations for budgetary policies adopted by the April 2007 Eurogroup

(3) the March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies

(4) the Commission's assessment of the October 2007 implementation report of the national reform programme.

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[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). The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

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

In its opinion of 27 February 2007, the Council summarised its assessment of the previous update of the stability programme, covering the period 2006-2010, as follows. "The Council considers 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. Nevertheless, expenditure restraint will remain crucial in the coming years when the forecast cooling of the economy slows growth in the tax bases and the impact of ageing population kicks in."

2.2. Orientations for budgetary policies adopted by the Eurogroup in April 2007

On 20 April 2007, with a view to improving the coordination of fiscal policies in the euro area, Eurogroup ministers discussed national budgetary developments in 2007 and the preliminary policy outlook for 2008 and their implications for the euro area.

Reaffirming their adherence to the sound fiscal policy principles of the revised Stability and Growth Pact and to national fiscal rules, Ministers committed to (i) build on the better-than-expected budgetary outcomes in 2006 to pursue more ambitious budgetary targets than those set in the end-2006 updates of the stability programmes; (ii) implement their 2007 budgets as planned, avoiding expenditure overruns, and using unexpected extra revenues to reduce government deficit and debt; and (iii) carefully design fiscal policy plans for 2008 so as to accelerate the adjustment towards the MTO for Member States which have not reached it and for those which have reached it to avoid feeding macroeconomic imbalances overall[2].

2.3. March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies

On 27 March 2007, the Council adopted a recommendation on the 2007 update of the broad guidelines for the economic policies of the Member States and the Community and on the implementation of Member States' employment policies[3]. Finland was not recommended to take particular action in the area of budgetary policies. However, all euro area Member States were recommended to “make use of the favourable cyclical conditions to aim at or pursue ambitious budgetary consolidation towards their medium-term objectives in line with the Stability and Growth Pact, hence striving to achieve an annual structural adjustment of at least 0.5 % of GDP as a benchmark” and “to improve the quality of public finance by reviewing public expenditures and taxation, with the intention to enhance productivity and innovation, thereby contributing to economic growth and fiscal sustainability”.

2.4. The Commission assessment of the October 2007 implementation report of the national reform programme

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of the October 2007

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[2] The entire statement can be found at: www.gouvernement.lu/salle_presse/actualite/2007/04/20pm_krecke_berlin/MTBR_EG_conclusions-finalCLEAN.rtf

[3] OJ L 92, 3.4.2007, p. 23.

implementation report of Finland's national reform programme[4]. This can be summarised as follows.

Finland's National Reform Programme identifies as key challenges the sustainability of public finances in the face of population ageing, improving competitiveness and productivity, and improving the functioning of the labour market.

The Commission's assessment was that Finland had made very good progress in implementing its National Reform Programme over the 2005-2007 period.

Against the background of strengths and weaknesses identified and the evidence on progress made, the Commission recommended that Finland should focus on the areas of competition and productivity in services, measures to reach its Kyoto target, labour market reforms with a particular view to structural unemployment, unemployment of low skilled workers and young people, and promoting economic migration.

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 2007 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

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"

[4] Communication from the Commission to the European Council, "Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)", 11.12.2007, COM(2007)803.

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[5];

- the degree of consistency with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs, and its October 2007 implementation report. 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[6], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

[5] Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU", 12.10.2006, COM (2006) 574 final 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.

[6] "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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in accordance with the third paragraph of Art. 5 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the updated stability programme of Finland, 2007-2011

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[7], 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 [12 February 2008] the Council examined the updated stability programme of Finland, which covers the period 2007 to 2011.

(2) Finland's macroeconomic performance has been strong and balanced over the last years, with growth in the recent years significantly exceeding earlier expectations. The present cyclical upswing in economic activity has been appropriately used to build up budgetary surpluses and to prepare for the effects of population ageing, reducing considerably the risks to the sustainability of public finances. However, the imminent demographic shift is predicted to dampen economic growth already at the end of the programme period and lead to a smaller fiscal surplus, thereby calling for sustained control over public spending.

(3) The macroeconomic scenario underlying the programme envisages that real GDP growth will moderate over the programme period, while remaining above 3% in 2008-2009 to drop to just above 2% by 2011. Judging from currently available information[8], this scenario appears to be based on plausible growth assumptions**,** leaning towards the

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[7] 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://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

[8] The assessment takes notably into account the Commission services' autumn forecast and the Commission assessment of the October 2007 implementation report of the national reform programme.

cautious side for 2010 and 2011. The programme's projections for inflation appear realistic.

(4) For 2007, the general government surplus is estimated at 4.5% of GDP in the current programme update, broadly in line with the Commission services' autumn 2007 forecast, against a target of 2.8% 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 2006 and the positive growth surprise in 2007, boosting government revenue, while expenditure has been largely contained in line with earlier plans. The implementation of the 2007 budget was broadly in line with the April 2007 Eurogroup orientations for budgetary policies and the Council opinion on the previous programme[9].

(5) The programme's central objective is to ensure sustainability of public finances in the face of population ageing. 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 structural terms, i.e. in cyclically-adjusted terms net of one-off and other temporary measures. The headline and the primary balance are set to decline in each year, albeit from a high level in 2007. The programme plans to maintain structural surpluses above the MTO throughout the programme period. Compared with the previous programme, the new update projects the structural surplus (calculated according to the commonly agreed methodology) to be 1½ percentage points higher in 2007, but by 2010 both updates project the same structural balance. The steeper fall in the surplus in the most recent update is explained by the expenditure ratio declining only marginally while the revenue ratio drops more substantially. The latter reflects the phasing in of announced tax cuts as well as cautiously projected revenues in response to GDP growth. The less marked decline in the expenditure ratio compared with the previous programme reflects a step increase in the multi-annual budgetary ceilings for central government, with expenditure increases being frontloaded to 2008, the first year of the new government term.

(6) The risks to the budgetary projections in the programme appear broadly balanced. In 2008, the budgetary outcome could be better than projected in the programme given the markedly cautious tax revenue assumptions for that year. Some risks could arise from rapid wage growth in the public sector, putting upward pressure on expenditure. On the other hand, the cautious growth projections for the outer years, combined with conservative revenue assumptions, counterbalance the negative risks.

(7) In view of this risk assessment, the budgetary stance in the programme would allow to meet the MTO by a comfortable margin throughout the programme period, as envisaged in the programme. This is in line with the Stability and Growth Pact. However, a fiscal expansion is planned in 2008, indicated by a decline in the structural surplus of ½ percentage point of GDP according to the Commission services' autumn forecast and 1 percentage point according to the programme. While economic conditions are expected to shift from "good times" to neutral during 2008, it is not implausible that the favourable economic conditions of the previous years extend into 2008. Therefore, there is a risk that the fiscal policy stance implied by the programme may turn out to be pro-cyclical in 2008. However, the potential pro-cyclical stimulus to the economy would likely be limited, given that a sizeable budgetary surplus would

[9] OJ C71, 28.3.2007, p. 1.

still be maintained and fiscal policy would assume a broadly neutral stance already in the following year.

(8) Finland appears to be at low risk with regard to the sustainability of public finances. 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 2007 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. Maintaining high primary surpluses over the medium term would contribute to limiting risks to the sustainability of public finances.

(9) The stability programme seems to be consistent with the October 2007 implementation report of the National Reform Programme. In particular, the measures identified in the implementation report of the National Reform Programme to contain the population ageing risks are an integral part of the stability programme strategy. It is foreseen to maintain a strong commitment to measures enhancing productivity in public services in order to contain expenditure pressures. At the same time, the multi-annual expenditure ceilings of the central government, which form the basis of the stability programme projections, will provide a firm limit to the costs of the National Reform Programme measures.

(10) The budgetary strategy in the programme is broadly consistent with the broad economic policy guidelines included in the integrated guidelines for euro area Member States in the area of budgetary policies issued in the context of the Lisbon strategy.

(11) 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[10].

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.

[10] In particular, external assumptions for the outer years are not provided and inflation projections are provided on the CPI rather than HICP basis. Data on "one-off and other temporary measures" are also not explicitly given in the tables (nor are they mentioned anywhere in the text).

Comparison of key macroeconomic and budgetary projections

		2006	2007	2008	2009	2010	2011
Real GDP (% change)	**SP Nov 2007**	**5.0**	**4.4**	**3.3**	**3.0**	**2.5**	**2.1**
	COM Nov 2007	5.0	4.3	3.4	2.8	n.a.	n.a.
	SP Dec 2006	*4.5*	*3.0*	*2.9*	*2.6*	*2.1*	*n.a.*
HICP inflation[4] (%)	**SP Nov 2007**	**1.6**	**2.4**	**2.4**	**2.2**	**2.0**	**2.0**
	COM Nov 2007	1.3	1.5	2.4	2.1	n.a.	n.a.
	SP Dec 2006	*1.5*	*1.3*	*1.7*	*1.7*	*1.7*	*n.a.*
Output gap[1] (% of potential GDP)	**SP Nov 2007**	**-0.3**	**0.6**	**0.7**	**0.5**	**-0.1**	**-0.7**
	COM Nov 2007[2]	-0.4	0.4	0.5	0.1	n.a.	n.a.
	SP Dec 2006	*0.1*	*0.2*	*0.1*	*-0.2*	*-0.8*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**SP Nov 2007**	**4.8**	**4.9**	**4.6**	**5.0**	**5.0**	**4.8**
	COM Nov 2007	5.9	5.3	5.2	5.1	n.a.	n.a.
	SP Dec 2006	*5.4*	*4.8*	*4.6*	*4.4*	*4.1*	*n.a.*
General government balance (% of GDP)	**SP Nov 2007**	**3.8**	**4.5**	**3.7**	**3.6**	**2.8**	**2.4**
	COM Nov 2007	3.8	4.6	4.2	4.0	n.a.	n.a.
	SP Dec 2006	*2.9*	*2.8*	*2.7*	*2.7*	*2.4*	*n.a.*
Primary balance (% of GDP)	**SP Nov 2007**	**5.3**	**6.0**	**5.2**	**5.0**	**4.1**	**3.6**
	COM Nov 2007	5.3	6.0	5.6	5.3	n.a.	n.a.
	SP Dec 2006	*4.5*	*4.3*	*4.2*	*4.1*	*3.7*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**SP Nov 2007**	**4.0**	**4.2**	**3.3**	**3.3**	**2.8**	**2.8**
	COM Nov 2007	4.1	4.4	3.9	4.0	n.a.	n.a.
	SP Dec 2006	*2.9*	*2.7*	*2.7*	*2.8*	*2.8*	*n.a.*
Structural balance[3] (% of GDP)	**SP Nov 2007**	**4.0**	**4.2**	**3.3**	**3.3**	**2.8**	**2.8**
	COM Nov 2007	4.1	4.4	3.9	4.0	n.a.	n.a.
	SP Dec 2006	*2.9*	*2.7*	*2.7*	*2.8*	*2.8*	*n.a.*
Government gross debt (% of GDP)	**SP Nov 2007**	**39.2**	**35.3**	**32.8**	**30.4**	**29.0**	**27.9**
	COM Nov 2007	39.2	35.7	32.4	29.8	n.a.	n.a.
	SP Dec 2006	*39.1*	*37.7*	*36.2*	*35.0*	*33.7*	*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 3.4%, 3.4%, 3.2% and 3.2% respectively in the period 2006-2009.

[3]Cyclically-adjusted balance excluding one-off and other temporary measures. No one-offs have been identified in the most recent programme or in the Commission services' autumn forecast.

[4] The most recent programme provides inflation projections on the basis of the national CPI rather than the HICP. CPI inflation was markedly higher than HICP inflation in 2007. The Finnish authorities have indicated that the corresponding HICP inflation projections are 1.3%, 1.6%, and 2.3% for 2006-2008 respectively and that there would be no difference between both series in the remaining years.

Source:

Stability programme (SP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations