National Audit Office's separate report to Parliament: Effectiveness of the central government spending limits procedure as a fiscal policy instrument

National Audit Office´s reports to Parliament R 21/2010 vp

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ISSN-L 1798-6427
ISSN 1798-6427 (print)
ISSN 1798-6435 (PDF)
Edita Prima Oy
Helsinki 2011

To Parliament

The National Audit Office has conducted an audit concerning the functioning and effectiveness of the central government spending limits procedure as a fiscal policy instrument according to its audit plan. The audit is part of a broader theme area concerning the reliability of the fiscal policy information base and the achievement of fiscal policy objectives. The subject is significant from the viewpoint of Parliament's fiscal power as well as public finances and administration in general. The central government spending limits procedure is the most important steering and decision-making procedure in central government finances and to some extent public finances as a whole. The National Audit Office submits this separate report to Parliament on the basis of section 6 of the Act on the National Audit Office (676/2000).

Helsinki, 11 January 2011

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Main content

This separate report to Parliament presents the main findings and recommendations of an audit conducted by the National Audit Office concerning the functioning and effectiveness of the central government spending limits procedure as a fiscal policy instrument during the electoral term 2007–2010. The report is an external evaluation of fiscal policy during the entire electoral term according to OECD recommendations. The spending limits procedure has succeeded in curbing central government expenditure included in its sphere. Spending limits were not broken during the electoral term – not even in 2009, when Finland's GDP fell more than in any other year since Finland gained independence. The process of preparing spending limits and the division of labour are clear. Preparation is hampered by the tight timetable and the general planning cycle in central government, however. The coordination of the drafting of legislation and the spending limits procedure should be improved. The openness and transparency of the price and structural adjustments that are made in the spending limits as well as the positions that are taken in the spending limits process should be increased.

The bulk of budget appropriations and thus most of the appropriations covered by spending limits are mandated by legislation. As a result, reallocating funds usually requires political decisions even with regard to transfers within an administrative sector. Consequently real room for manoeuvre is quite small. Spending structures and their necessity should be genuinely reevaluated from time to time. The model adopted in years of rapid economic growth has led to a situation in which old spending structures are passed on from one government to another, since priorities are not set. The genuine reallocation of funds would also require the opening of administrative sectors' basic calculations.

Coherence and consistency between the setting of fiscal policy objectives and the setting of spending limits should be strengthened. Spending limits have not been derived consistently and openly from objectives regarding the sustainability of public finances. Objectives regarding sustainability have not been achieved.

The Research Institute of the Finnish Economy (ETLA) is conducting a study concerning the sustainability gap and related uncertainty factors. ETLA's sustainability calculation, which is based on a stochastic population forecast, takes into consideration the uncertainty of population forecasts. In addition the calculation of health and care costs is based on the age structure and mortality. With this method health and care costs increase less than in calculations based solely on the age structure. Although the sustainability gap calculated by ETLA is lower than the figures projected by other organisations, it indicates a significant risk for the maintenance of the welfare state in its present scope. The forecast will be refined in later stages of the project, but on the basis of previous studies it appears that the tax rate in the 2030s could be five percentage points higher, with a probability of 30–40 per cent. If population trends and returns on investment led to a course of development in which the need to increase the tax rate exceeded five percentage points and a major financial crisis occurred, the welfare state would truly be threatened.

On the basis of the audit, the financial foundation of the welfare state in its current form and scope is in serious danger. With current modes of financing, local authorities will not be able to perform the statutory tasks that have been assigned to them without increasing local tax rates.

Central government spending limits cover about one-third of total public expenditure. This causes problems for the sustainability of public finances, since cost pressures resulting from the ageing of the population will particularly affect local services and social security funds. Consequently, spending limits can do only so much to ensure long-term sustainability. In the opinion of the National Audit Office, it is important to take into consideration adjustment needs required for sustainability in evaluating the fiscal policy regulation system and particularly the level of spending limits. In developing fiscal policy rules and in setting objectives during the next electoral term, greater weight should be given to the sustainability of public finances.

According to the results of the audit, rule-based fiscal policy using the spending limits procedure should continue. Spending limits should be expanded to include off-budget funds and central government's share of local government expenditure. It is worth considering whether there are still grounds for the performance of permanent tasks through off-budget funds as prescribed in section 87 of the Constitution, and insofar as these do not exist, off-budget funds should be integrated into the budget economy.

The dimensioning of spending limits should be derived openly and clearly from objectives concerning the sustainability of public finances. The dimensioning of the first spending limits in the electoral term is vitally important for the functioning of fiscal policy objectives and the spending limits system. The setting of objectives concerning the sustainability of public finances and the dimensioning of spending limits should be based on realistic assumptions and expectations regarding economic development and should take into consideration risks involving economic trends and the Finnish economy.

Since spending limits are tied to the electoral term, there is a risk of gaps in fiscal policy. A procedure that would ensure the sustainability of public finances and the continuity of long-term economic planning should be found for spending limits covering public finances as a whole. There is a particular need for rules concerning spending decisions that are left until the following electoral term.

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1 Introduction

To achieve a credible and stable fiscal policy and to curb the rise in central government spending, Finland – along with many other countries – has established fiscal policy rules so that decision-making on annual budgets is tied to objectives or constraints set in advance. Many countries have found that fiscal policy rules are useful in achieving fiscal policy objectives.[1] Finland applies a spending limits procedure that is based on the Government Programme. Spending limits are set for the entire electoral term and are then adjusted annually according to the development of prices and changes in the structure of the budget. Spending limits cover about 75 per cent of total expenditure in the budget. Setting spending limits for the entire electoral term allows the Government to keep spending within the framework agreed in the Government Programme.[2]

Fiscal policy is that part of economic policy that is aimed at influencing the economy through public finances, i.e. revenues and expenditure. Economic policy consists of measures taken in the public sector to achieve macroeconomic objectives. These include stabilising growth in GDP, keeping prices and the rest of the economy stable, boosting employment and economic growth, and ensuring the sustainability of public finances.[3] Key tasks of fiscal policy are to promote the long-term sustainability of the economy, make business cycle adjustments and apply public resources fairly.[4]

The central government spending limits procedure has been in use without interruption since 1991. The aim has been to set ceilings on the amount of expenditure in the budget. The spending limits procedure was reformed in 2003.[5]

The spending limits procedure applied in 2003–2006 and 2007–2010 set ceilings on central government expenditure for the entire electoral term. This provides a framework for expenditure policy during the term.[6] According to the Government Programme of Prime Minister Matti Vanhanen's second Cabinet, the Government's fiscal policy in 2007–2011 is based on the following key principles:

1 Among the member states that have joined the Economic and Monetary Union, there is evidence that public finances are generally in better shape in countries that have applied fiscal rules than in countries that are not committed to a rule-based fiscal policy. See European Commission, DG ECFIN, Public Finances in EMU 2010, European Economy 4/2010.

2 Ministry of Finance regulation on operational and financial planning and the preparation of spending limits and budget proposals, TM 0802, 2.4.2008, section 6.

3 Ministry of Finance: Budget Glossary, Ministry of Finance Studies and Reports, 7/2001.

4 National Audit Office / Puonti: Finanssipolitiikan sääntöjen tarve, National Audit Office Reports and Studies 2009.

5 Justifications and key principles of the reform, see Ministry of Finance: Fiscal Policy Rules and the Reform of Spending Limits in Finland, Ministry of Finance working group report 7.2.2003. The reform was outlined in the Government Programme, see Government statement to Parliament on the Government Programme of Prime Minister Anneli Jäätteenmäki's Cabinet, Government statement 1/2003 vp., section 3.2. p.10. Proposals put forth in the working group's report were used in outlining the reform and were written in a suitable form for this purpose. The working group's report including proposals was sent unofficially by the Ministry of Finance to party representatives negotiating the Government Programme.

6 Government decision on principles for preparing central government spending limits proposals, budget proposals and operational and financial plans, 24.4.2003. This decision was issued at the beginning of the 2003–2007 electoral term, immediately after the newly elected Government had taken office, to provide legal and administrative grounds for the reformed spending limits system agreed in the Government Programme. The decision also includes provisions regarding a new programme management procedure and regulations that allow cross-sectoral spending limits and budget proposals in connection with policy programmes.

1 According to the programme the objective is to achieve a structural surplus corresponding to one per cent of GDP by the end of the electoral term. The Government assumes that central government finances will never show a deficit of more than 2½ per cent of GDP even in a weak economy.

2 The Government is committed to observing spending rules.

3 With regard to tax-policy measures the Government has pledged that they will not endanger long-term sustainability or commitments in Finland's Stability Programme.

4 In timing tax changes, the economic cycle will be taken into consideration so as to keep growth as steady as possible. Wage solutions will also be taken into consideration in dimensioning income tax cuts.[7]

The Government Programme and the expenditure ceilings set on this basis form fiscal policy rules for the electoral term, which other fiscal policy objectives supplement. The Government Programme also sets a ceiling on the budget deficit. If the deficit threatens to exceed this ceiling, the Government must immediately propose the necessary measures to reduce spending and avoid such a contingency.[8] The deficit ceiling was broken in 2007–2010. The Ministry of Finance estimated that the deficit would be nearly 6 per cent of GDP at the end of 2010 and about 4.3 per cent of GDP at the end of 2011. During its policy session on 23–24 February 2009, the Government decided to "relax temporarily", i.e. abolish, the deficit ceiling in order to allow stimulus measures in response to the exceptionally deep recession, providing decisions were made at the same time to strengthen public finances structurally.[9] The deficit ceiling was also part of fiscal policy rules in 2003–2006 but was written into the spending limits decision rather than the Government Programme.[10]

The expenditure ceilings set for the electoral term are revised in annual spending limits decisions, which allocate budget resources by administrative sector. Adjustments are also made according to the development of prices and structural changes in the budget. Spending limits are decided at fixed prices. Annual spending limits decisions are made on a rolling basis and cover the next four years, while the economic policy framework only covers the electoral term.

Legally spending limits decisions are part of the annual preparation of the budget.[11]

Fiscal policy is an essential part of social policy in terms of impacts and significance. Fiscal policy preparation and decision-making determine the resources available to achieve objectives in other sectors of social

7 Government statement 1/2007 vp. Government statement to Parliament on the Government Programme of Prime Minister Matti Vanhanen's Second Cabinet.

8 Government statement 1/2007 vp., p. 15.

9 Budget policy session position 24.2.2009, available on the Government's website at http://www.vn.fi/tiedostot/julkinen/pdf/2009/Politiikkariihi_0209/fi.pdf.

10 Government statement to Parliament on the Government Programme of Prime Minister Anneli Jäätteenmäki's Cabinet, Government statement 1/2003 vp. and Government statement to Parliament on the Government Programme of Prime Minister Matti Vanhanen's Cabinet, Government statement 2/2003 vp., which do not set a direct deficit rule. A deficit rule was set in the first spending limits decision of the electoral term, see Central government spending limits for 2008–2011, pp. 4–5. According to the deficit rule applied during the electoral term 2003–2006, the deficit was not allowed to rise above 2.75% of GDP.

11 State Budget Decree (1243/1992), section 1.

policy and the resources available to arrange public administration and service production as a whole. Fiscal policy and central government spending limits as a fiscal instrument have a bearing on the continuity and effectiveness of public activities over the short and long term. In jurisprudence public finance law has been called a "megafield", since the principles and rules in this field decide how public economic resources will be collected and divided and thus allow and ensure the existence of other fields of law and the entire justice system.[12] In a similar way, fiscal policy stands above and strongly guides other sectors of social policy and allows the existence of social policy as well as public services and administration and related activities. The strong position of fiscal policy in different policy sectors is visible in the Government Programmes for 2003–2006 and 2007–2010, which clearly note the priority of the Government's fiscal objectives and rules in relation to other social policy objectives. According to Government Programme, "The Government is committed to observing the spending rules it has set and the first spending limits decision based on them. Measures entered in the Government Programme will be implemented insofar as it is possible within the parameters of the spending limits decision."[13] Spending rules allow conflicts between a clear fiscal policy and different social policy objectives to be resolved in the Government's practical activities.

Fiscal policy is a key means of stabilising economic policy in the members of the European Economic and Monetary Union, along with legislation and structural policy based on legislation, since monetary policy falls within the decision-making power of the European Central Bank. Fiscal policy rules in general and the central government spending limits procedure in particular thus play a major role in achieving economic policy objectives. Fiscal policy rules are especially important from the viewpoint of Parliament's power to decide on state finances according to section 3 of the Constitution.

A significant risk for the effectiveness of fiscal policy concerns real commitment to fiscal policy rules. Rules cannot stabilise or increase the credibility of an economy if they are not observed. In practice compliance with fiscal policy rules is strengthened by incentives and sanctions. The risk that fiscal policy rules will be ignored and the need to enforce rules concern rules based on political as well as administrative commitments. With regard to the European Economic and Monetary Union and the Stability and Growth Pact, which is a key element of it, the risk has materialised and the resulting problems have become quite timely. The sharp increase in some member states' debt is partly due to non-compliance with the criteria in the Stability and Growth Pact in national decision-making.[14]

As has been noted in the literature an in recommendations issued by international organisations such as the International Monetary Fund (IMF), the Organisation for Economic Cooperation and Development (OECD) and the European Union, in addition to non-compliance there is a risk that

12 Myrsky: Valtiontalousoikeus. Talentum, Helsinki, 2010, p. 2.

13 Government Programme of Prime Minister Matti Vanhanen's Second Cabinet, Government statement 1/2007 vp., section 3.6. p. 14. A similar point was included in the Government Programme of Prime Minister Anneli Jäätteenmäki's Cabinet / Prime Minister Matti Vanhanen's (First) Cabinet, see Government statement 1/2003 vp.

14 This is clearly noted in the legislative package that was proposed by the European Commission in autumn 20to shore up the Economic and Monetary Union and the Stability and Growth Pact, see for example Proposal for a Council Directive on requirements for budgetary frameworks of the Member States, COM (2010) 523, and the Government communication on the legislative package proposed by the Commission, U 34/2010 vp.

spending rules will be circumvented with arrangements that weaken the transparency of central government finances and financial management.

In Finland a risk for the spending limits procedure and commitment to spending limits is presented by the fact that the monitoring and evaluation of compliance with the spending limits procedure and the effectiveness of this procedure have been left almost entirely to the same officials at the Ministry of Finance who are responsible for the preparation of fiscal policy along with central government spending limits and budget proposals. A working group that evaluated the development of the spending limits procedure at the Ministry of Finance noted in a report that was published in 2007 that this arrangement can lead to self-serving misrepresentation. The functioning and credibility of spending limits could be strengthened by the external and independent monitoring of compliance.[15] Official and unofficial sanctions can only work if compliance with rules is assured by an independent body or mechanism.

Public discussion concerning the achievement of fiscal policy objectives requires that correct information on compliance with fiscal policy rules is readily available.[16] The IMF and the OECD have both emphasised the significance of the external evaluation of compliance with fiscal policy rules and the achievement of objectives as well as transparency in general for the achievement of long-term fiscal policy objectives and credibility.[17]

The risk in the term-based evaluation used in the Finnish parliamentary system is that projects that are considered expedient and necessary at the moment will be carried out using means and financing arrangements that require costs to be paid in subsequent electoral terms. From the viewpoint of public finances and good governance, this can weaken the transparency of the state's financial position and particularly budget income and expenditure, revenues, costs, economic position and risks. It can also lead to unsound solutions with regard to economy and cost-effectiveness.

The spending limits procedure, like any steering system and fiscal policy rules in general, always presents a threat of failing in its steering task. The risk is that the spending limits procedure will not be able to achieve the objectives of fiscal policy. It is also possible that the spending limits procedure as a set of fiscal policy rules will not be able to respond to new risks or related priorities regarding the effectiveness of fiscal policy and public finances resulting from changing circumstances.

The functioning of the central government spending limits procedure as a set of fiscal policy rules and planning and steering system for central government finances should therefore be evaluated regularly, for several reasons. Owing to the great financial and social significance of the spending limits procedure, its functioning can be considered an essential question for central government finances.

Rule-based fiscal policy is aimed at ensuring the sustainability of public finances over the long term. In Finland the express objective of the spending limits procedure is

15 Ministry of Finance: Fiscal Policy Rules and the Reform of Spending Limits, Ministry of Finance Publications 5a/2007, pp. 101–102.

16 Ministry of Finance: Finland's Public Finances at a Crossroads - Approach to fiscal policy in the 2010s, Ministry of Finance Publications 8/2010, pp. 117–118.

17 Emphasis on the external and independent evaluation of fiscal policy has steadily increased in IMF and OECD evaluations and recommendations.

to curb growth in public expenditure, but in the background is the broader goal of ensuring sustainability. Calculations and evaluations of the sustainability of public finances describe the ability of public finances and central government finances to take care of obligations and ways of operating and also withstand risks facing the economy. Information regarding the sustainability of finances must be regarded as an essential part of information concerning the current state of central government. Ensuring that information provides a true and fair view and that essential risks in this respect are properly managed are key tasks of external financial audit and other external audit, according to international audit standards and other standards concerning external audit.[18]

Despite its broad social significance, fiscal policy does not differ from other areas of social policy with regard to the constitutional principles of accountability and responsibility. The preparation of fiscal policy must meet the requirements of good governance. The application of fiscal policy rules must be open and a true and fair view of the impacts of fiscal policy must be presented. In the past the preparation of fiscal policy and reporting on its effectiveness and impacts have not been subject to external evaluation and audit in Finland to an adequate degree.

One of the permanent audit areas specified in the National Audit Office's strategy is the Report on the Final Central Government Accounts, which is the Government's annual report to Parliament on its activities as prescribed in section 46 of the Constitution. Another permanent audit area is the fiscal policy information base and the functioning and impacts of fiscal policy instruments, most notably the spending limits procedure.[19]

During the 2007–2010 electoral term a deep recession took place as a result of the international financial crisis that began in 2008. The crisis showed how strongly the Finnish economy is dependent on the international economic and financial system. The drop in GDP in 2009 (8 per cent) was the biggest in our history as an independent nation.[20] Finland's rule-based fiscal policy and spending limits procedure thus had to be applied in completely different circumstances than were anticipated when the Government Programme of Prime Minister Matti Vanhanen's second Cabinet was prepared in 2007. The Government Programme was premised on much stronger economic growth.[21] The crisis also revealed structural weaknesses in the Finnish economy. At the same time it showed concretely how important healthy public finances are in managing economic crises and associated risks. In the wake of the international financial crisis and recession, Finland's fiscal policy framework and spending limits procedure have to be evaluated from new perspectives.[22] As of November 2010 the financial crisis and recession have still not ended in all respects. Many

18 In connection with public sector audit, international standards refer to the International Standards of Supreme Audit Institutions (ISSAI). These are largely based on the International Standards on Auditing (ISA), which are applied particularly in auditing listed companies.

19 National Audit Office's strategy for 2007–2012, National Audit Office 2007, and updated National Audit Office's strategy for 2010-2012, National Audit Office 2010.

20 Statistics Finland, preliminary data on national accounts. See also National Audit Office's separate report to Parliament R 13/2010 vp., p. 26.

21 Government statement on the Government Programme of Prime Minister Matti Vanhanen's Second Cabinet, Government statement 1/2007 vp., section 3, p. 10.

22 This was noted by Governor Erkki Liikanen in his introduction to the Bank of Finland's autumn 20economic forecast, see Bank of Finland: Economic outlook 2/2010, Special issue on the euro and the economy, Helsinki.

countries in the euro area are deeply in debt. According to evaluations made by the IMF and the European Commission, there are strong connections between states' indebtedness and international financial markets that cause instability and financial risks.[23] In the euro area risks have materialised in Greece and Ireland. The euro area's stabilisation arrangements have also increased legal and real liabilities on and off Finland's balance sheet. These facts have a bearing on the significance of the sustainability of public finances and the credibility of fiscal policy and policy objectives.

This report contains the National Audit Office's external audit findings concerning the information base and effectiveness of the spending limits procedure applied in 2007–2010. The report provides an analysis of the functioning of fiscal policy rules as well as related risks and development needs by the external auditor prescribed in the Constitution.

Owing to the exceptionally large significance of fiscal policy and the spending limits procedure as well as Parliament's decision-making power under the Constitution, and considering the provisions in section 90 of the Constitution and their objectives, the results of the audit are submitted directly to Parliament in the form of a separate report. In this way Parliament directly receives information on an important matter for the functioning of its fiscal power and society as a whole, together with observations.

23 International Monetary Fund: Global Financial Stability Report, October 2010, pp. 1–23. European Commission, DG ECFIN: Public Finances in the EMU 2010, European Economy 4/2010.

2 Audit framework

2.1 Subject of the audit: The central government spending limits procedure

The central government spending limits procedure, which was reformed in 2003, has been applied as a fiscal policy instrument in Finland since the 2003–2006 electoral term and the Government Programme of Prime Minister Anneli Jäätteenmäki's/Matti Vanhanen's first Cabinet. Finland has applied a spending limits procedure since 1991 as an instrument for steering the drafting of the budget. The objective has been to constrain expenditure.

The reform of the spending limits procedure in 2003 was based partly on an OECD evaluation of Finland's budgeting and financial administration system as well as work carried out by experts at the Ministry of Finance. In an evaluation that was prepared in 2002 the OECD recommended that the spending limits procedure should be made more binding and extend over a longer period than one year.[24] During the electoral term 2003–2006 the wording in the Government Programme was essentially based on recommendations included in a memorandum on developing fiscal policy rules and the spending limits procedure that was prepared by experts at the Ministry of Finance. An expert group appointed by the Ministry of Finance evaluated the need to develop the spending limits procedure in late 2006 and early 2007.[25] With a few exceptions, the recommendations in the expert group's report were made the basis of rules guiding the central government spending limits procedure and fiscal policy in the Government Programme of Prime Minister Matti Vanhanen's second Cabinet. No essential changes were made in the spending limits procedure at that time. The procedure applied during the preceding electoral term continued mainly without change, although the scope of expenditure falling within the spending limits was partly revised. Numerous details in the spending limits procedure have nevertheless been developed. In particular flexible elements in the spending limits procedure were strengthened in the system that was introduced in the 2007–2010 electoral term.[26]

The basis of the fiscal policy rules and spending limits procedure applied in 2007–2010 is the Government Programme. According to section 62 of the Constitution, the Government must submit its programme to Parliament in the form of a statement without delay. After discussion Parliament votes on whether to accept this statement, in what amounts to a vote of confidence. In this way the Government Programme and essential changes as referred to in section 62 of the Constitution, including fiscal policy, must be

24 OECD: Budgeting in Finland. OECD Journal of Budgeting, Vol. 2, Issue (2003), 119–152.

25 Ministry of Finance: Fiscal Policy Rules and the Reform of Spending Limits. Ministry of Finance Publications 5a/2007.

26 With regard to changes compared with the preceding procedure, see Ministry of Finance: Fiscal Policy Rules and the Reform of Spending Limits. Ministry of Finance Publications 5a/200and Government Programme of Prime Minister Matti Vanhanen's Second Cabinet, Government statement 1/2007 vp.

approved by a majority of Parliament. The Government Programme and its approval by Parliament guarantee the acceptability and bindingness of fiscal policy rules. Spending limits and spending rules are based on commitments made by Parliament and the Government.[27]

The Government Programme of Prime Minister Matti Vanhanen's second Cabinet contains general economic policy objectives as well as a commitment to the agreed spending rules and spending limits procedure. The Government Programmes notes that, *"To safeguard a prudent long-term spending policy, the Government will pursue the system of spending limits and will further hone it. The Government is committed to ensuring that all central government expenditure that falls within the scope of the spending limits is by 2011 at most only EUR 1.3 billion greater than the sum for central government expenditure set in the spending limits on 8 March 2007. A fixed annual provision of EUR 300 million of the total spending limits will be reserved for supplementary budget proposals. An additional provision of EUR 200 million will be set aside from the spending limits for the Government to allocate in connection with its first spending limits decision or at a later date. The Government is committed to observing the spending rules it has set and the first spending limits decision based on them. Measures entered in the Government Programme will be implemented insofar as it is possible within the parameters of the spending limits decision. The Government will review annually the need for the reallocation of expenditure on the basis of initiatives made by the leaders of the governmental party groups with a view to structural reforms or transfers across administrative branches. The overall level of the spending limits will be adjusted annually only for changes in the price level or budget structure. The spending limits decision will enable a more flexible procedure for adapting to changes in the timing of expenditure and for rebudgeting expenditure."*[28]

In addition to spending rules the Government Programme set a general objective for balancing the budget and also set a ceiling on the budget deficit. According to the Government Programme, the Government is committed to policies designed to bolster public finances as set out in Finland's Stability Programme, which was prepared in accordance with the European Union's Stability and Growth Pact. The aim was to implement structural reforms to boost employment so that a structural surplus corresponding to one per cent of GDP could be achieved by the end of the electoral term. This can be considered a general objective of balanced finances. In the Government Programme the Government declared that, *"central government finances must never show a deficit of more than 2.5 per cent of GDP even in a weak economy. If prognoses show that the deficit is at risk of exceeding this limit, the Government will immediately propose action necessary to cut costs and other measures to avoid the deficit exceeding the limit."*[29] The deficit ceiling was meant to supplement the fiscal policy rules agreed for the electoral term.

The spending limits procedure and spending rules cover only part of public finances. Local government finances and social security funds, with the exception of certain trans-

27 Parliament's and the Government's political commitment and its significance for the success of the spending limits system are noted in Finance Committee report 6/2007 vp. Government report on central government spending limits for 2008–2011.

28 Government statement to Parliament on the Government Programme of Prime Minister Matti Vanhanen's Second Cabinet, Government statement 1/2007 vp., section 3.6., p. 13-14.

29 Government statement to Parliament on the Government Programme of Prime Minister Matti Vanhanen's Second Cabinet, Government statement 1/2007, section 3.6., p. 15.

fers that are included in the budget economy and spending limits, are not covered by fiscal policy rules in Finland. In 2010 the spending limits system covered about 37 per cent of total public expenditure.

About 75 per cent of the state budget economy is covered by spending limits. The spending rules set for the electoral term do not limit the development of expenditure not covered by spending limits. What is included in spending limits and what is excluded is laid out in the Government Programme and revised in the first spending decision of the electoral term. Expenditure is excluded from spending limits if setting ceilings is not justified on economic or fiscal policy grounds or is otherwise considered inexpedient. Excluded from the spending limits are (1) automatic fiscal stabilisers, which vary in response to cyclical fluctuations, (2) expenditure corresponding to technically transmitted payments, (3) debt interest payments, (4) financial investment expenditure and (5) expenditure that compensates other tax recipients for the effects of changes in the tax base. Expenditure excluded from spending limits is discussed in section 7.5 of this report.

Spending limits guide the preparation of the budget proposal for the coming year and economic planning for subsequent years. In the revised system that was adopted in 2003, spending limits also include supplementary budgets, which means that supplementary budget proposals must be prepared within this framework. A total of 300 million euros is reserved for supplementary budgets. The Government Programme also provides for an unallocated reserve, which the Government can allocate in subsequent spending limits decisions as it sees fit.

The preparation of central government spending limits is directed by the Ministry of Finance and combines operational and financial planning functions prescribed in the State Budget Act and the State Budget Decree. The process is described in section 5 of this report.

The spending limits decision contains several different parts. At the core are the spending limits set for the entire electoral term, which are updated annually. These are presented in the form of totals for expenditure in areas of the budget economy that are covered by the spending limits. The spending limits decision breaks down expenditure by administrative sector together with an estimate of the development of expenditure excluded from spending limits in each sector. It also presents a supplementary budget reservation and contingency funds at the sectoral level. The spending limits also present a supplementary budget reservation and an unallocated reserve for each sector. The spending limits decision outlines sectoral policies regarding central government finances and the budget. In 2007–2010 these have been used to direct the implementation of the government productivity programme, and productivity measures have been incorporated into key operational policies. The spending limits decision likewise contains the Government's evaluation of economic development and its fiscal policy objectives, a review of the budget and the balance of central government finances as well as a section regarding local government finances and the health and social services programme.

During the electoral terms 2003–2006 and 2007–2010 the Government has followed a procedure in which the spending limits decision was submitted to Parliament in the form of a report. This is considered by the Finance Committee and then returned to the plenary session for approval. Parliament informs the Government of its position in a communication, in which it can require the Government to take specific measures. Parliament evaluates the implementation of measures presented in the spending limits decision when it discusses the budget for the coming year, the Report on the Final Central Government Accounts and reports submitted by the National Audit Office.

The monitoring of compliance with the spending limits for the electoral term as well as spending rules and related reporting have not been prescribed. The Government has reported briefly on compliance with spending limits in the Report on the Final Central Government Accounts, which the Ministry of Finance is responsible for preparing. The general justifications in the Government's budget proposals also mention the relation between the budget proposal or supplementary budget proposal and spending limits.

2.2 Audit questions

The main objective of the National Audit Office's external audit of the fiscal policy information base and the central government spending limits procedure and of this separate report to Parliament is to evaluate the effectiveness and functioning of the spending limits procedure as a fiscal policy instrument. The audit strives to determine whether the objectives that were set for the spending limits procedure during the electoral term 2007–2010 were met and whether the procedure was transparent and open. The main audit question concerned the effectiveness and functioning of the central government spending limits procedure as a fiscal policy instrument. The audit evaluates whether the spending limits procedure and the spending rules in the spending limits system have achieved their fiscal policy objectives and how effectively spending rules have functioned from the viewpoint of achieving fiscal policy objectives. The audit paid special attention to the following perspectives:

How effective and functional was the central government spending limits procedure as an application of rule-based fiscal policy?

How well did the spending limits procedure and the preparation of spending limits meet the requirements of openness and transparency?

Did the Government comply with the spending rules outlined in the Government Programme and the spending limits procedure?

How did the spending limits procedure support the objectives in the Government Programme regarding the sustainability of public finances?

The audit particularly evaluated the preparation and implementation of fiscal policy in the spending limits system to determine what practices were followed in preparing fiscal policy as a result of the application of a fiscal policy rules such as the spending limits procedure. The audit also evaluated risks associated with coordinating the spending limits procedure and the drafting of legislation from the viewpoint of good governance and good management, compliance with expenditure ceilings and the achievement of objectives. On the basis of the audit this report presents recommendations aimed at increasing the clarity and transparency of the setting of fiscal policy objectives, strengthening good governance and improving the quality of the drafting of legislation and the evaluation of its impacts as well as the effectiveness of fiscal policy.

2.3 Audit criteria

General audit criteria in audits on the theme of the central government spending limits procedure as a fiscal policy instrument were the effectiveness and functioning of the spending limits procedure from the viewpoint of achieving fiscal policy objectives and good practices concerning fiscal policy. Other criteria included the implementation of openness and transparency as part of good governance in the preparation of spending limits and related decision-making and reporting as well as the drafting of legislation and the evaluation of the economic impacts of legislation.

2.3.1 Effectiveness and functioning of fiscal policy rules and instruments

The most important criterion in the audit was the effectiveness of the central government spending limits procedure as an instrument to achieve fiscal policy objectives. Effectiveness is one of the performance criteria prescribed in the State Budget Act.[30] The social effectiveness of fiscal policy rules and other fiscal policy instruments can be evaluated from a broad perspective according to whether fiscal policy has been successful socially. In this case clearly defined criteria are needed or else criteria can be derived from general economic expediency. A fiscal policy that strives to achieve the maximum possible economic welfare while meeting a society's expectations regarding fairness can be considered justified in terms of general economic expediency – i.e. economically rational. Economic welfare and objectives regarding fairness, especially when they have to do with income distribution and the fairness of the division of a society's other economic resources, sometimes appear to be at odds with each other.

An economical rational fiscal policy is one that ensures the long-term sustainability of public finances. One clear measure of both economic welfare and economic choice is GDP per capita. This quantity describes economic choice in a society. The sustainability of public finances, on the other hand, is described using various calculations and indicators. These are sensitive to baseline data and underlying assumptions, however.

The effectiveness of fiscal policy rules and instruments can be examined more narrowly to determine whether the objectives set for fiscal policy and the application of fiscal policy rules have been achieved (social effectiveness of fiscal policy). This report and the audits in the theme area concentrated on examining how well the fiscal policy objectives set for the spending limits procedure and spending rules were achieved. The section on economic strategy in the Government Programme of Prime Minister Matti Vanhanen's second Cabinet specifies the aim of securing sustainable public finances. The spending limits system was viewed as a means to ensure responsible fiscal policy and curb growth in public expenditure.

According to regulations issued under the State Budget Act and State Budget Decree

30 Concerning performance criteria in the State Budget Act, see Government proposal 56/2003 vp. Government proposal to Parliament to amend the State Budget Act.

concerning the preparation of spending limits and budget proposals, the spending limits for the entire electoral term are a means for the Government to keep total growth in expenditure within the framework agreed in the Government Programme.[31] According to the Government Programme, the objective of the spending limits procedure was to support the aim of securing sustainable public finances.

The audit evaluated the effectiveness of the spending limits procedure from the viewpoint of supporting the achievement of sustainability objectives and curbing growth in central government expenditure.

A significant question with regard to the effectiveness of rule-based fiscal policy is how to take business cycles into account in setting and applying fiscal policy rules. This involves not only when, on what conditions and with what instruments public authorities should strive to smooth cyclical fluctuations, but also how an active economic policy should be taken into account in fiscal policy rules. As a result of the deep recession in the latter part of 2008 and 2009, it was necessary to rethink the relation between the spending limits procedure and an economic and fiscal policy aimed at stimulating recovery.

The relation between fiscal policy rules and an active economic policy can be described from the perspective of long-term effectiveness. On the basis of observations made in the literature and in the EU member states, it makes sense to take fiscal policy into account in rule systems. One feature of good fiscal policy rules, i.e. those that are effective over the long term, is that they do not sharpen cyclical fluctuations. If public authorities are to take an active role in lessening the impacts of business cycles, fiscal policy rules should be counter-cyclical. The audit evaluated whether the spending limits procedure had the necessary flexibility and smoothing effect from the viewpoint of cyclical policy, without endangering objectives concerning the long-term development or sustainability of public finances.

The audit evaluated the functioning of the spending limits procedure from the perspective of how spending limits as a fiscal rule and procedure have influenced the achievement of objectives concerning sustainability and curbing growth in expenditure. It also evaluated to what extent spending limits have allowed the implementation of stabilisation policies and objectives aimed at promoting economic growth. Observations concerning political economy and the impacts and features of Finland's budget system are decisive in evaluating whether the procedure functions properly in achieving objectives.

The definition of functioning used in the audit is linked to the concept of the quality of public finances developed in coordinating economic policy in the European Union and the monitoring of the Stability and Growth Pact. In quality standards quality is defined in terms of the suitability of a product or process for its purpose.[32]

In the European Commission's criteria concerning the quality of public finances, good fiscal governance refers to the setting of fiscal policy and budget objectives and related procedures and processes that help achieve economic and fiscal policy objectives and

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31 Ministry of Finance regulation on operational and financial planning and the preparation of spending limits and budget proposals, TM 0802, 2.4.2008, section 6.

32 See for example ISO quality standards and glossary. With regard to the concept of quality see Pöysti Tuomas: Communicational Quality of Law – a Legal Informatics Perspective. In Sjöberg & Wahlgren (eds.), Festsrift till Peter Seipel. Norstedts Juridik 2006, pp. 463-493.

sufficiently reduce pressures that could lead to lax fiscal discipline and short-sighted policies. According to the European Commission, good fiscal policy and fiscal governance support the achievement of objectives regarding the quality of public finances. [33]

In order to reduce the administrative burden and costs and to avoid other application problems, a fiscal policy instrument must also meet the requirements of simplicity and cost-effectiveness. Administrative simplicity and applicability were used as criteria in examining the practical implementation of the spending limits procedure and possibilities to develop it.

In addition to effectiveness and functioning, the main criteria in the audit included the openness and transparency of fiscal policy decision-making and preparation. The spending limits system was evaluated from the viewpoint of preconditions for the effective exercise of Parliament's fiscal power and the functioning of democracy as well as the quality of financial management as required by constitutional law. Openness and transparency are part of good governance. Other principles of good governance can also be applied to the spending limits procedure and other fiscal frameworks as quality standards, but the audit focused on openness and transparency because of their key significance for the functioning of democracy and economic rationality.

2.3.2 Openness and transparency as a legal requirement of good governance

Openness and transparency can be considered key principles of good governance with regard to the preparation of fiscal policy and the spending limits procedure. In the European Union openness, efficiency and objectivity have been considered general principles of good governance.[34]

With regard to the forecasts and calculations that are used a basis in preparing fiscal policy, objectivity means striving to present different risks, sensitivities, scenarios and probabilities without trying to lead users of evaluations to a particular conclusion for some ulterior motive. Objectivity also means the obligation to strive for high quality and reliability in preparing and documenting the forecasts and calculations that are used in fiscal policy work.

Objectivity is connected to requirements set by the budget principles prescribed in the Constitution. The principle that the budget should be complete and that revenue should cover appropriations is based on section 84 of the Constitution. According to the principle of completeness the budget must include estimates of all expected revenues and appropriations to cover all expected expenses. The requirement that revenues must cover appropriations or the obligation according to section 84:2 of the Constitution to show how appropriations will be covered is not properly met if revenues are overestimated or binding

33 Communication from the Commission to the Council and the European Parliament: The role of quality of public finances in the EU governance framework, COM (2008) final, p. 6

34 On a European level these are based on Article of the European Union Charter of Fundamental Rights and Article of the Treaty on the Functioning of the European Union with regard to European administration and the Council of Europe's recommendations concerning good governance, particularly Council of Europe Recommendation CM/Rec. (2007)7. Concerning European principles of good governance and particularly openness, efficiency and objectivity see Mäenpää: Avoin, tehokas ja riippumaton eurooppalainen hallinto in Juhlakirja Pentti Arajärvi 19– 2/2008, University of Joensuu Law Publications 20, University of Joensuu 2008, pp. 375-4and 375–380. In Finland principles are based on the Administrative Procedure Act (434/2003), section of the Constitution and the Act on the Openness of Government Activities. The Administrative Procedure Act does not apply to the drafting of the budget, and the preparation of the spending limits decision is likewise subject to the Government's internal guidelines and regulations and thus falls outside its scope. In decisions regarding complaints, the Parliamentary Ombudsman has considered it important to ensure compliance with the principles of good governance and particularly the proper and unbiased performance of official tasks and objectivity in preparatory work outside the scope of the Administrative Procedure Act. See for example decision EOAK 2732/2005, which concerns a complaint regarding an amendment to the Copyright Act. The significance of objectivity can similarly be emphasised in preparing fiscal policy.

expenses are underestimated. The requirement that budget items should be accurate is thus derived from the principle of completeness and the covering of appropriations. This requirement also applies to the economic forecasts on which the budget is based. The budget principles prescribed in the Constitution and the requirement that budget items should be accurate concern the preparation of spending limits, which is one stage in the drafting of the budget, only indirectly. Requiring accuracy is part of good budgeting and management practice, however, and supports the achievement of the purpose of the spending limits procedure.[35]

In addition to openness and transparency, the audit used objectivity in evaluating the fiscal policy information base and the administrative preparation of spending limits as well as fiscal policy reporting to Parliament and the public as supplementary criteria.

The audit likewise evaluated the legal nature of the spending limits procedure and possible legal problems from the viewpoint of the effective exercise of Parliament's fiscal power and principles of good governance applying to the preparation and management of fiscal policy. An essential question was the position of budget principles prescribed in or based on the Constitution and principles of good govin the spending limits procedure and the preparation of fiscal policy. On the basis of budget principles as well as principles regarding openness, transparency and objectivity and also qualitative criteria linked to the effective exercise of Parliament's fiscal power, the audit examined how openly the spending limits procedure has been implemented and whether it has complied with the principles of good governance.

From the viewpoint of the legal evaluation of the spending limits procedure and the examination of its effects on Parliament's fiscal power, an important matter is the distinction between constitutional and political norms. Constitutional norms regulate the exercise of political power and related conditions and obligations. An essential part of constitutional norms is the protection of fundamental rights and freedoms. Political norms, on the other hand, consist of practices that determine by whom and how political power is exercised in reality.[36] The spending limits procedure and spending limits can be viewed as falling somewhere between constitutional and political norms: it is not an institution prescribed in the Constitution, but neither is it an institution completely distinct from constitutional law.[37]

This leads to a division between legal provisions' direct and indirect effects in the spending limits procedure. In order to speak of direct effects, legal provisions must require the preparation of spending limits or prohibit the exceeding of expenditure ceilings unless exceptional circumstances exist. One can speak of indirect effects if provisions do not concern a particular spending limits procedure but the principles in provisions can be applied to such a procedure.

The openness and transparency of the spending limits procedure in Finland are based on the Constitution and the fundamental values and principles incorporated in it. Openness and transparency are also based on international organisations' rec-

35 Concerning accuracy as a budget principle, see Perustuslaki ja valtiontalous. Perustuslakien valtiontaloussäännösten uudistamiskomitean mietintö. Committee report 1990:7, p. 122.

36 Concerning this distinction see particularly Jyränki Antero: Valta ja vapaus. Talentum Media, Helsinki 2003, p. 213.

37 The concept of an institution covers a wide range of structures and mechanisms in social interaction. See for example North, D. (1990), Institutions, Institutional Change and Economic Performance. Cambridge University Press, Cambridge.

ommendations concerning the openness and transparency of fiscal policy. These recommendations in turn sum up standards of good governance worked out by the international expert community and in practical experience as well as research findings concerning the preconditions for successful fiscal policy and financial management in the public sector. A significant source of information on openness and transparency is the IMF Code of Good Practices on Fiscal Transparency and the IMF Manual on Fiscal Transparency).[38] The OECD has also collected best practices with regard to the openness and transparency of budgets and public financial management.[39] The proposal that the European Commission presented to the European Council on 29 September 2010 for a Council Directive on requirements for budgetary frameworks of the Member States contains quite detailed normative requirements with regard to the openness and transparency of the fiscal policy information base, the setting of objectives and the evaluation of the achievement of objectives.[40] The proposal can be also considered a collection of best practices in the member states, particularly those in the European Economic and Monetary Union. The proposal codifies what can be considered a good fiscal policy framework on the basis of experience gained up to now.[41]

Openness and transparency are values underlying the Constitution. Transparency implies clarity, the presentation of justifications and understandability. The principle of publicity prescribed in section 12 of the Constitution contains the objective of Nordic democracy based on broad public discussion. Broad discussion together with access to information and the justification of the exercise of power lie behind the principle of publicity and the principle of democracy prescribed in section 2 of the Constitution. In connection with fiscal policy the values of democracy require that objectives, different means to achieve them and the weighing of options are presented openly and that decisions are properly justified. Only in this way is it possible for citizens to evaluate the exercise of fiscal power. Public discussion and citizens' participation in fiscal policy decision-making also require the openness of the information base used in preparing fiscal policy so that discussion can take place using correct concepts and data.

Openness and transparency are connected to ensuring Parliament's fiscal power. According to the Constitution, democracy and the rule of law together with the protection of individuals' rights and liberties are the fundamental principles of Finland's political system. Section 3 of the Constitution gives Parliament legislative powers, including the power to decide on state finances. According to this section and sections 81–92 of the Constitution, Parliament exercises fiscal power, which includes budgetary power and the right to enact tax and other financial laws, the right to decide on state debt and state securities and guarantees and the right to supervise state finances.[42] Parliament's fiscal

38 International Monetary Fund: Code of Good Practices on Fiscal Transparency, IMF Manual on Fiscal Transparency, IMF, Washington D.C., 2007.

39 OECD Best Practises for Budget Transparency, OECD Journal on Budgeting, 2002.

40 COM (2010) 523 final. Proposal for a Council Directive on requirements for budgetary frameworks of the Member States.

41 U 34/2010 vp. Government communication to Parliament on the Commission's package of measures to improve the application of the Stability and Growth Pact.

42 See Parliamentary Glossary, fiscal power. Also see Myrsky: Valtiontalousoikeus, Talentum Helsinki 2010, pp. 2-and Wacker: The Effects of the Economic and Monetary Union on National Fiscal Power. A Study of the Legal Implications of the Stability Regulations, University of Tampere 2009, p. 37.

power is one of the most important elements of a parliamentary form of government.

Parliament's fiscal power includes a future dimension, which can also be characterised as foresight concerning the management of central government finances and public finances as a whole. Parliament has the power to evaluate long-term objectives for fiscal policy and the management of public finances and ways to achieve these objectives, to decide on the scope of public finances and to establish the fundamental principles, goals and values according to which fiscal policy is prepared.[43] In practice Parliament exercises foresight when it approves the Government Programme and the fiscal policy principles outlined in it, considers the report on central government spending limits, enacts laws concerning state finances and decides on the state budget. Parliament also has the power to supervise and evaluate the management of public finances. An essential procedure in this respect is the submission of the Report on the Final Central Government Accounts. In considering this report Parliament also exercises foresight. In ex post evaluations Parliament can examine longer trends and developments in public finances and fiscal policy.

The precondition for proactive responses to future changes and challenges, both traditional and new, is that Parliament has the possibility to receive true and fair information in a timely manner on economic and fiscal policy options, objectives and the achievement of objectives. Openness and transparency thus concern economic development and the information on which fiscal policy decision-making is based. Openness and transparency allow the evaluation of fiscal policy and alternatives as well as parliamentary and public discussion.

The provision of true and fair information in a timely manner is thus required to ensure openness and transparency and the effective exercise of Parliament's fiscal power. According to regulations concerning the preparation of budget and spending limits proposals, the justifications in a budget proposal must provide a true and fair view of the application of funds and the objectives that funds are intended to achieve and must form a good basis for parliamentary and governmental decision-making.[44] The regulations give concrete form to the principle of ensuring Parliament's fiscal power under the Constitution, which is expressed in provisions regarding Parliament's access to information and emphasised in the Constitution's preparatory documents.[45] The principle can be interpreted as applying to the planning of fiscal policy using foresight and the spending limits procedure.

In exercising supreme fiscal power Parliament has the right to receive true and fair information from the Government on the develop of and outlook for the national and international economy as well as economic and fiscal policy options and justifications for policies and to receive this information in a timely manner.[46] Fiscal policy objectives and rules should be presented in such a way that

43 The Parliamentary Committee for the Future has developed the idea of foresight power as a form of Parliament's strategic social policy steering and exercise of power. The National Audit Office's separate report to Parliament R 12/2009 vp. evaluated what foresight power requires, particularly regarding the spending limits procedure, economic forecasts and the evaluation of economic policy options. Concerning the development of Parliament's role from the viewpoint of futures studies as a forum for setting a futures agenda and values guiding attitudes towards the future and trends and for discussing these values, see Mika Mannermaa: Democracy in the Turmoil of the Future. Societal influence within a new frame of reference. Committee for the Future publication 1/2007, especially pp. 127–129.

44 Ministry of Finance regulation on operational and financial planning and the preparation of spending limits and budget proposals, TM 0802, 2.4.2008, section 7.6

45 See Constitutional Law Committee report 10/19vp. - Government proposal 1/19vp. Government proposal for a new Constitution.

46 See the National Audit Office's separate report to Parliament R 12/2009 vp., p. 33.

they can be critically and thoroughly debated in parliamentary and public discussion. Otherwise fiscal policy would remain based on authoritative arguments and trust in the Government, in which case Nordic democracy based on public discussion would not work properly in practice.[47]

The requirements of openness and transparency are linked to broader principles concerning the responsible management of public finances and accountability. The responsible management of public finances must take into consideration the future impacts of decision-making and also of decisions that are not made. Central government borrowing and legal and political commitments stretching far into the future will have an impact on possibilities to exercise fiscal power in the coming years. Responsibility means that when decisions are made on the budget, provisions must also be made to cover any deficit or to use any surplus wisely. In autumn 2010 the Government submitted a proposal to Parliament to amend section 84 of the Constitution so that a normative message concerning the appropriation of funds as required by the Constitution should be presented more clearly and that flexibility in cash and debt management procedures should be increased according to the state's financial position.[48] The essential content of the constitutional amendment is to emphasise openness and transparency as a prerequisite for the responsible management of public finances.

The provision of true and fair information in an open and transparent way together with justifications and the necessary background require the clear setting of objectives and the ability to evaluate the achievement of objectives and compliance with commitments.

From the viewpoint of openness and transparency and the effective exercise of Parliament's fiscal power, the information base on which fiscal policy rules are set and applied is essential.[49] The requirement of true and fair information can be justified on the basis of the budget principles in the Constitution. From these principles one can derive certain general quality standards, which express constitutional objectives and values of good governance and can be used in the preparation and application of fiscal policy rules such as the spending limits procedure. Openness, transparency and the significance of the exercise of Parliament's fiscal power require the correctness of the information base. In budgeting correctness is also required by the provisions in the Constitution concerning state finances.[50]

True and fair information must also meet the criteria of substantiality and significance. In evaluating the information base, cost-benefit analysis is in order: information should be compiled, edited and documented only as long as the marginal costs do not exceed the benefit obtained from compiling and editing information.[51]

In judging whether information provides a true and fair view, attention must be paid to several factors.[52] First of all the justifications for measures must be presented as clearly as

47 In the literature the openness of justifications and public discussion has been viewed as part of global justice. See Sen Amartya: The Idea of Justice, Allen Lane - Penguin Books, London 2009.

48..Government proposal 158/2010 vp. Government proposal to Parliament to amend section of the Constitution.

49 See for example R 10/2008 vp. Gaps in the information base have also been criticised in other connections, for example with regard to the preparation of productivity measures, R 13/2010 vp.

50 See Perustuslaki ja valtiontalous. Perustuslain valtiontaloussäännösten uudistamiskomitean mietintö. Committee report 1990:7, p. 122.

51 This way of thinking has often been emphasised in economics.

52 See also Audit Committee statement 2/2009 vp. - Government report 3/2009 vp. and Audit Committee report 1/2009 vp. - R 11/2009 vp., R 12/2009 vp.

possible. Secondly, measures and criteria for monitoring effectiveness must be outlined. Thirdly, essential background calculations used in estimates, forecasts and justifications must be described so that conclusions can be drawn regarding the reliability of estimates and related uncertainties. Even rough calculations tell more about the decision-making background than if calculations are not presented at all.[53] Fourthly, sufficient information must be available on fiscal policy options and justifications so that the consequences of different options can be weighed in making decisions. Information from evaluations should be utilised as well.[54] Criteria should also be presented so that measures can be evaluated.

To sum up, Parliament has the constitutional right to receive true and fair information on fiscal policy options and justifications. The information base used in preparing fiscal policy and in fiscal policy decision-making and the effectiveness and social impacts of fiscal policy also fall within Parliament's power to supervise state finances.[55] In the spirit of the principle of clarity, which can be derived from the budget principles in the Constitution, spending limits, forecasts regarding the balance of state finances and revenues, and tax policies are presented in a single official document.[56]

2.3.3 Openness and transparency as requirements of economic rationality and effectiveness

Economic rationality requires the openness and transparency of fiscal policy. Openness and transparency help ensure proper conditions for the success of fiscal policy. Recommendations made by the International Monetary Fund (IMF) and best practices collected by the OECD contain practical findings from studies that have been conducted by the IMF's Research Department, for example. According to these findings, openness and transparency improve confidence in the management of public finances, reduce interest and other financial costs, and improve the ability to adjust public finances to scenarios that support long-term sustainability and economic growth.[57]

The IMF Code of Good Practices on Fiscal Transparency presents several principles that are useful in evaluating the openness and transparency of Finland's spending limits procedure. According to the IMF Code, budget preparation should be guided by well-defined macroeconomic and fiscal policy objectives. The annual budget should be based on a comprehensive medium-term macroeconomic and fiscal policy framework. These recommendations were also included in the Commission's proposal for a Council Directive on requirements for budgetary frameworks of the Member States.[58] The

53 Audit Committee statement 2/2009 vp. - Government report 3/2009 vp.

54 Audit Committee report 1/2008 vp. - R 6/2008 vp., R 10/2008 vp.

55 See National Audit Office's separate report to Parliament R 12/2009 vp. and Audit Committee report 1/2009 vp., in which the Audit Committee concurs with this requirement.

56 R 12/2009 vp. Concerning clarity as a budget principle see Vesanen: Valtiontalouden hoidosta. Finnish Lawyers' Association Publications Series B No. 151, Porvoo, 1970, p. 95.

57 See International Monetary Fund: IMF Code of Good Practices on Fiscal Transparency, IMF Manual on Fiscal Transparency, IMF, Washington D.C., 2007. Concerning recent empirical results see Giuliano et al. 2010: Democracy and reforms: Evidence from a new dataset, IMF WP 173/and Arezki & Brückner: Resource windfalls and emerging market sovereign bond spreads: The role of political institutions, 2010, IMF WP 179/10.

58 See Proposal for a Council Directive on requirements for budgetary frameworks of the Member States, COM (2010) 523 final, point 12 in the introduction and sections IV and V in the proposal.

broader economic impacts of major solutions regarding budget revenues and expenditure in the coming years should also be presented openly. Documents connected to the budget should contain analyses concerning the long-term sustainability of public finances as well as fiscal sensitivities related to economic development and risks. Information concerning the development of public finances, the budget and underlying assumptions and forecasts, projects for the coming years and an evaluation of the biggest risks for public finances should be easily available to the public. Information should also be presented in a way that supports the evaluation of policies, accountability and responsibility.[59] These requirements of openness and transparency are also embodied in the Commission's proposal, which bring together the principles of transparency and accountability based on clear and objective information.

The European Commission considers openness and transparency a guarantee of realism in fiscal policy decision-making and the quality of forecasts. Openness and the public presentation and availability of assumptions and variables underlying forecasts and calculations also provide possibilities to evaluate risk related to uncertainties in public discussion and the work of independent experts. Openness and transparency are thus prerequisites for risk management connected to the preparation of fiscal policy and its effectiveness.[60]

Special challenges for openness and transparency in the spending limits procedure concern the presentation of economic and fiscal policy justifications underlying spending limits and their dimensioning as well as the monitoring of compliance with spending rules. The verifiability of compliance with spending rules is weakened to some extent by the price and structural adjustments that are made during the electoral term. Other challenges for openness and transparency have to do with the forecasts, calculations and assumptions on which economic and fiscal policy is prepared, together with fiscal sensitivities. The ex post evaluation of the success of economic and fiscal policy likewise appears challenging in the light of requirements concerning openness and transparency.

59 IMF Code of Good Practices on Fiscal Transparency 2007. In proactive monitoring of the European Economic and Monetary Union and the Stability and Growth Pact, which is a key element of it, emphasis has been placed on similar principles based on practical experience as well as failures in the EU and the euro area.

60 Proposal for a Council Directive on requirements for budgetary frameworks of the Member States, COM (2010) 523 final, points 8–10 in the introduction.

2.4 Audit boundaries and data

The audit conducted by the National Audit Office was limited to evaluating the effectiveness, functioning, openness and transparency of the central government spending limits procedure applied during the electoral term 2007–2010. The audit also evaluated the coordination of the drafting of legislation and the spending limits procedure and the presentation of the state's hidden liabilities as part of information on central government finances and the current state of public finances. The audit did not strive to form an opinion on the success of the fiscal policy of Prime Minister Matti Vanhanen's second Cabinet, nor did it evaluate how well different sub-objectives of economic policy were coordinated with one another or with fiscal policy objectives or whether the response to the recession was justified economically. The audit did not evaluate the broader question of the expediency of an active economic policy or the success of Finland's stimulus measures. The audit does not take a position on the development of Finland's public finances as a whole but focused mainly on the effectiveness and functioning of the spending limits procedure and the development of the sustainability of public finances. Consequently the audit does not evaluate the effectiveness of individual economic or fiscal policy measures. The dimensioning of spending limits, particularly for the entire electoral term, is a significant question when it comes to evaluating the effectiveness and soundness of fiscal policy. The audit did not evaluate whether the dimensioning of spending limits during the electoral term can be considered successful. An important matter for the economic and social effectiveness of spending limits is the allocation of resources for different purposes. Parliament has repeatedly taken a position on this. It has drawn attention to the need to exclude growth-promoting investments from spending limits. This issue has come up especially in connection with the budgeting of investments in transport infrastructure. The audit did not evaluate the reasoning behind the allocation of resources between administrative sectors or between different types of expenditure.

The audit covered spending limits decisions, budget proposals and budgets together with preparatory materials during the electoral term 2007–2010 as well as final accounts and significant legislation. In addition to the information in the central government final accounts and bookkeeping, the audit analysed information in the national accounts. Several audit projects were conducted for this report as part of the external audit of fiscal policy. These included the ongoing audit of the fiscal policy information base, audit measures taken expressly for the report and separate performance audits on subjects connected to the theme. In addition to its own expert work, the National Audit Office has commissioned research on the theme.

The fiscal policy information base and compliance with spending limits were audited continually during the electoral term. This produced findings that have been reported annually in separate reports on the audit of the final central government accounts as well as in this theme report. Separate reports on the audit of the final central government accounts and the Report on the Final Central Government Accounts presented and will continue to present findings regarding compliance with spending limits, possible risks that need to be taken into consideration and the provision of true and fair information in the Government's fiscal policy reporting to Parliament. In this report findings made in the course of ongoing audit were placed in perspective and expanded with findings in supplementary audits and separate performance audits as well as syntheses of different types of data.

The audit investigated the question of compliance with spending limits decisions in the course of ongoing audit using financial audit methods and independent computer-assisted monitoring of spending limits. On the basis of the Government Programme and the first spending limits decision of the electoral term, the National Audit Office constructed a calculated database that was updated annually and compared with budget proposals and the monitoring of spending limits by the Ministry of Finance. With the help of data obtained in the audit of the spending limits procedure, annual financial audits of government agencies and the audit of the final central government accounts, compliance with spending limits was examined annually and for the electoral term by comparing the budget proposal, supplementary budget proposals, the budget, supplementary budgets and the budget outturn figures in the final central government accounts with the spending limits for the electoral term including price and structural adjustments. Compliance with the spending limits procedure was investigated in the course of financial audit with the help of the following sub-questions regarding calculations:

- How was the spending limits procedure implemented, i.e. how were underlying assumptions and particularly price and structural adjustments translated into calculations in the preparation of the budget?
- How was the budget drafted in relation to the spending limits decision, i.e. how well did the budget proposal and the actual and final budget for the fiscal year correspond to the budgeting principles in the spending limits decision?
- In what respects were there discrepancies between the spending limits decision and the final central government accounts?

With the help of data obtained in the audit of the spending limits procedure, annual financial audits of government agencies and the audit of the final central government accounts, material and structural changes in the operating environment in which spending limits are applied were also examined to determine whether changes have taken place in legislation regarding the budget that have affected or should have affected spending limits or their implementation and whether the information concerning the spending limits procedure in the final central government accounts could be considered to give a true and fair view.

Applying financial audit methods and principles the implementation of the spending limits procedure was examined by studying how calculations were made in preparing annual spending limits decisions on the basis of which budget proposals and budgets were drafted. Comparisons were then made between spending limits decisions, budgets and final central government accounts, and discrepancies and reasons for them were analysed. The objective was to form an opinion on compliance with spending limits and to seek explanations for any discrepancies between spending limits and the budget proposal, spending limits and the budget, and spending limits and the final central government accounts. Central bookkeeping data were used for this purpose. The audit examined the data collected in monitoring compliance with spending limits by the Budget Department at the Ministry of Finance. These data were compared with the data collected independently by the National Audit Office to ensure that the monitoring carried out by the Ministry of Finance has been comprehensive and that the information reported on this basis by the Government and the Ministry of Finance presents a true and fair view.

With regard to 2008 the audit was conducted by comparing the revised spending limits decision that was issued on 25 May 2007 with the spending limits for 2008 in the database calculated by the National Audit Office, the budget proposal for 2008, the final budget for 2008 and the data in the final central government accounts for 2008.

With regard to 2009 the same principle was followed. The budget proposal and budget for 2009 and the final central government accounts for 2009 were compared with the spending limits decision that was issued on 13 March 2008 and the spending limits with price and structural adjustments that was prepared by the Ministry of Finance in connection with the drafting of the budget.

With regard to 2010 the comparison covers the spending limits decision that was issued on 26 March 2009, the budget proposal and the final budget. Since the fiscal year had not ended at the time of writing (October 2010), only one supplementary budget was taken into account, and data for 2010 have not been updated after reporting in spring 2010.

In all comparisons spending was calculated in main titles 21–36. This also included appropriations that are not covered by spending limits. This procedure does not affect conclusions but simplifies comparisons. Calculations were made separately for items covered by the spending limits and items excluded from them, however. Main title 37 Reducing central government debt was included in calculations but was not taken into account in comparison tables.

Price and cost adjustments and structural changes with regard to 2009 and 2010 were taken directly from the Ministry of Finance's calculations.

The following matters were also evaluated by collecting data and following principles concerning the production of evidence according to performance audit guidelines:

- How were evaluations that have been published by the OECD, the IMF, the European Commission and other domestic or foreign research institutions taken into consideration in preparing spending limits decisions and fiscal policy?
- The development of tax subsidies was monitored by following up a performance audit conducted by the National Audit Office concerning tax subsidies and following the development of tax legislation and research work on tax subsidies conducted by the Government Institute for Economic Research. The Government Institute for Economic Research has prepared a new study on tax subsidies.
- Risks associated with central government borrowing
- Fiscal and economic policy decision-making was monitored by repeatedly and systematically examining the justifications in budget and supplementary budget proposals, the conclusions drawn at the Government's strategy and policy sessions, and matters discussed in a preparatory manner by the Cabinet Finance Committee.

The process of preparing spending limits was audited by examining pertinent guidelines and regulations, flow charts and key preparatory materials at the Ministry of Finance and by interviewing participants in the process at the Budget and Economic Departments at the Ministry of Finance as well as officials at other ministries.

To assess the need for fiscal policy rules and prerequisites for effectiveness and functioning, the National Audit Office surveyed literature in the field of economics concerning fiscal policy rules. Observations derived in this way and from recommendations published by international organisations and particularly the IMF, the OECD and the European Commission were compared with the special features of the development of Finland's public finances, and observations regarding budget proposals, spending limits decisions and Parliament's positions with official documents and the Government Programme underlying the preparation of spending limits and justifying the spending limits system. Data obtained in this way were supplemented with interviews concerning the preparation of spending limits.

The provision of true and fair information on central government finances and their current state was evaluated by examining the final central government accounts using financial audit methods. The opinion formed in this way was supplemented by evaluating the information presented by the Government and the Ministry of Finance on the basis of assessments made by other economic research institutions and international organisations and by examining justifications and methods used by the Ministry of Finance in calculations.

As part of the fiscal policy audit theme, a separate performance audit was launched concerning the macroeconomic projections on which fiscal policy was based. The first stage of this audit examined domestic economic literature concerning the success of economic forecasts in Finland. This included a study regarding the quality of tax revenue projections that was conducted by a team at the Pellervo Economic Research Institute for the Parliamentary Audit Committee. The National Audit Office participated in the steering group for this study and in the monitoring of recommendations. During the preliminary study for the performance audit, the Ministry of Finance began developing and implementing a dynamic general equilibrium simulation model to support macroeconomic forecasting. There is no point conducting a separate performance audit on the subject while this work is under way, so observations have been incorporated into this report. The National Audit Office will continue its audit of the quality of economic forecasting at the Ministry of Finance as part of the audit of the fiscal policy information base.

Separate performance audits were also conducted regarding the evaluation of legislation's economic impacts (Evaluation of the economic impacts of legislative projects, 2010) and hidden liabilities (The state's financial liabilities – presentation and consideration in planning and monitoring documents, draft report 434/54/2009).

The audit of the evaluation of legislation's economic impacts was based on descriptions of the evaluation of impacts in the budget proposals that were submitted in 2007 and 2008 as well as information on evaluations during the preparation of a number of legislative projects that were selected as cases. The first stage of the audit looked at descriptions of the evaluation of impacts in the Government's proposals. The form of presentation was examined and the content of descriptions was analysed. Observations in this stage included quantitative data regarding descriptions of applied practices, methods used in describing the information produced in evaluations of impacts and the scope and quality of presented information. Officials in charge of preparatory work at the Ministry of Finance and sectoral ministries were interviewed for the audit and for the preliminary study that preceded it. The audit formed an opinion of the progress of legislative projects on the basis of the chronological stages described by interviewees. In analysing the content of documentation at different stages, data were obtained from background documents and official working papers that were listed by interviewees as well as documents used in negotiations regarding spending limits. Data were also obtained from the HARE project information system. In addition the audit looked at the content of the TTS-ALP[61] information system. The picture thus formed was supplemented during interviews and through the exchange of e-mails. The objective in examining particular legislative projects was to form an idea of connections between the processes used in preparing projects on the one hand and the processes used in the spending limits procedure and the drafting of the budget on the other. Another objective was to see whether the information that is presented on the economic impacts of legislative projects in different stages is consistent and to look for reasons behind any discrepancies. Interviews were conducted at the Ministry of Agriculture and Forestry, the Ministry of Justice, the Ministry of Education and Culture, the Ministry of Social Affairs and Health, the Ministry of Employment and the Economy and the Ministry of Finance.

Parliamentary committee counsels were also interviewed and committee reports and statements regarding the budget proposals that were submitted in 2007 and 2008 were studied. The purpose was to form an idea of the usefulness of the information presented in government proposals from the viewpoint of parliamentary decision-making. Interviewees were from the Administration Committee, the Legal Affairs Committee, the Social Affairs and Health Committee, the Committee for Education and Culture and the Finance Committee. Interviews also included Policy Services at the Prime Minister's Office, which is responsible for monitoring the impacts of policy programmes launched under the Government Programme. Document analysis and qualitative text analysis were used as audit methods.

The main question in the performance audit regarding the state's financial liabilities was whether liabilities are properly and transparently recognised in financial planning, decision-making and monitoring. Key data were the appropriate sections of the Report on the Final Central Government Accounts, budget proposals and spending limits decisions. The audit also looked at sources used in defining the concept and content of liabilities as well as international comparisons and recommendations. The time frame was fiscal years 2007–2010. This separate audit did not attempt to conduct an exhaustive survey of liabilities that are not included in the final accounts, not did it try to ensure that specific liabilities, such as pension liability, had been correctly calculated. The audit did not compare the picture obtained from the documents that were examined with the picture presented in other reporting. It reviewed findings in the report on the audit of the final central government accounts and in financial audits of accounting units regarding the handling of contracts involving liabilities and liabilities in general.

According to the Government Programme,

61 Information system used by the Ministry of Finance in financial planning

ensuring the sustainability of public finances is the Government's most important economic policy objective. The spending limits procedure and fiscal policy rules in general are intended to ensure sustainable public finances. Information regarding sustainability is an essential part of the fiscal policy documentation and framework.[62] Information on the sustainability of public finances is likewise essential information on the state's financial position. Fiscal policy audits have consequently focused special attention on information regarding the sustainability of public finances.

To test evaluations of sustainability and the sustainability gap, the National Audit Office together with the Research Institute of the Finnish Economy conducted a study of the sustainability gap in Finland's public finances and particularly its sensitivity to changes in assumptions underlying calculations. A sustainability calculation based on a stochastic population forecast allows uncertainty regarding age-related costs to be taken into account. A memorandum outlining the study's preliminary findings has been prepared, and these will be presented and analysed later in this report. The study is still under way and publications will be prepared on the basis of findings.

The development of productivity in the public sector will likewise have a considerable influence on the sustainability of public finances, in the light of different analyses. Increasing productivity is accordingly a key economic policy objective in the Government Programme. As a result of the ongoing audit of spending limits, the National Audit Office has drawn attention to the scope of spending limits as fiscal policy rules.[63] The OECD and the IMF have also drawn attention to this matter in their evaluations of Finland. The development of productivity in local government will play a decisive role in this regard, since the bulk of direct public service production takes place at the local government level and local authorities are the most significant public sector employer in terms of personnel. In addition to fiscal policy tasks, the spending limits decision has become an important instrument in group steering. On the basis of the European Commission's communication on the quality of public finances, group steering can also have significant economic and fiscal policy tasks in promoting the efficiency of activities and the application of funds. The spending limits procedure is thus intended to support the improvement of productivity.

The health and social services programme procedure, which coordinates the relation between central government and local government finances and the steering of the production of health and social services, is connected to the spending limits procedure, In cooperation with the University of Tampere the National Audit Office launched a research project to evaluate how well the spending limits procedure and the health and social services programme procedure are used as a means to improve local authorities' productivity. Initial findings from this project as well as other studies concerning the development of local government finances have been used in preparing this theme report.

62 International Monetary Fund: Code of Good Practices on Fiscal Transparency, IMF Manual on Fiscal Transparency, IMF, Washington D.C., 2007.

63 National Audit Office's separate report to Parliament, R 13/2010 vp

2.5 Separate parts of the audit and feedback

This report contains findings from a number of separate audit projects. Annual observations from the ongoing audit of fiscal policy and spending limits have been described in the National Audit Office's separate reports to Parliament on the audit of the final central government accounts. Feedback on the sections of the report dealing with fiscal policy was requested and received from the Ministry of Finance before report were submitted to Parliament.

Auditees were asked for feedback on draft performance audit reports that were prepared for this report according to the performance audit manual. Feedback is taken into account in audit reports.

Feedback on the draft report and audits that were carried out for it was requested from the Prime Minister's Office, the Ministry of Finance, all the sectoral ministries and the Association of Finnish Local and Regional Authorities. Feedback has been taken into account in preparing this report.

The financial audit and performance manuals adopted by the National Audit Office as well as separate guidelines specified in the fiscal policy audit theme and project plan were applied in collecting evidence and in documentation. The form and preparation of the report comply with principles and guidelines concerning reports submitted to Parliament by the National Audit Office. The National Audit Office's audit manuals are based on the International Standards of Supreme Audit Institutions (ISSAI).

The audit was conducted by the National Audit Office's fiscal policy audit group. It was supervised by Auditor General Tuomas Pöysti, Assistant Auditor General Vesa Jatkola, Assistant Auditor General Marjatta Kimmonen, Director for Performance Audit Hannu Rajamäki and Chief of Staff Tytti Yli-Viikari. Principal Performance Auditor Heidi Silvennoinen was in charge of the fiscal policy audit theme area and assembled and presented the report. She was assisted in the audit by Chief of Staff Tytti Yli-Viikari, Project Expert Päivi Puonti, Assistant Auditor General Marjatta Kimmonen, Principal Financial Auditor Anna-Mari Kari, Principal Financial Auditor Risto Palo, Principal Performance Auditor Eija Oksanen, Principal Performance Auditor Juha Niemelä and Principal Performance Auditor Kalle Määttä. Dr Jukka Lassila and Dr Tarmo Valkonen at the Research Institute of the Finnish Economy conducted a study on the sustainability of public finances and sensitivity to changes in assumptions underlying calculations. Researcher Pietu Mänttäri, under the supervision of Professor Jarmo Vakkuri and Professor Emeritus Pentti Meklin, is in charge of a research project at the University of Tampere on the use of the spending limits procedure and the health and social services programme procedure as a means to improve local authorities' productivity.

3 Need for and objective of the spending limits procedure

3.1 Summary of audit findings

The spending limits procedure is a Finnish application of rule-based fiscal policy. An alternative to rule-based fiscal policy is to decide changes in total expenditure and its allocation, the financing of expenditure and the budget surplus or deficit on a discretionary basis, according to the situation (discretionary fiscal policy). International comparisons and research in macroeconomics and political economy have obtained strong evidence that rule-based fiscal policy helps ensure the long-term sustainability of public finances better than discretionary fiscal policy. In the background is the idea that fiscal policy-making has too short a time frame and tends to increase expenditure and budget deficits according to the laws of political economy. In the countries that have joined the European Economic and Monetary Union, fiscal policy is the most important factor in creating economic stability, since monetary policy cannot be used to respond to external disturbances. Practice in the Economic and Monetary Union has shown that the sustainability of public finances is a prerequisite for reaping the benefits of a monetary union and a common currency.

Despite the general effectiveness of rule-based fiscal policy, discretion and flexibility should not be excluded entirely. A certain amount of flexibility is necessary to smooth cyclical fluctuations. Flexibility is necessary to achieve objectives regarding fair income distribution and to reallocate expenditure. Characteristics of good fiscal policy rules are credibility, technical feasibility, transparency, flexibility and comprehensibility. Ensuring the long-term sustainability of public finances and the ability to adapt rules in response to the business cycle are of key importance.

Economic stability requires a fiscal policy that is counter-cyclical or smooths cyclical fluctuations in upswings as well as downswings. In a downswing this calls for an expansive tax and spending policy, i.e. one that boosts consumption and aggregate demand, which means increasing central government expenditure and/or lowering taxes. During an upswing, on the other hand, fiscal policy must be tightened by increasing taxes and/or cutting expenditure. Long-term stability and the achievement of sustainability objectives require that surpluses recorded during an upswing must be saved to finance rising costs during a downswing. A counter-cyclical fiscal policy often includes automatic stabilisers, which are parts of the budget that vary according to the business cycle without the need for separate decisions. A counter-cyclical policy is also implemented through active decisions made by Parliament and the Government regarding expenditure and taxes. The problem here is that it is difficult to implement discretionary fiscal policy at the right time, and measures that are poorly chosen and timed can destabilise an economy.

The reform of the spending limits system in 2003 was aimed at creating fiscal policy rules that provide effective means to prepare for weak economic development. To achieve counter-cyclicity, expenditure items classed as automatic stabilisers are excluded from spending limits. Flexibility is also provided by an unallocated reserve, which the 2007 Government Programme set at 200 million euros on top of the 300 million euros reserved for supplementary budgets. As a fiscal policy instrument, spending limits have a restricted scope, covering only about 37 per cent of public expenditure.

Spending limits and spending rules for the entire electoral term are stated in fixed prices at the prevailing price level. Each year adjustments are made according to the development of prices and structural changes in the budget. The point in using fixed prices is to ensure adaptability to price changes and to avoid unwanted incentives, for example to agree in advance on the budgeting of cost rises resulting from future collective agreements. In practice the Finnish system of adjusting spending limits can be considered counter-cyclical to some extent, since it increases the level of expenditure during the electoral term faster than the overall rise in the consumer price index and GDP. On the other hand, in the case of investments linked to transport projects, price adjustments do not follow the development of the building cost index, so price adjustments in a particular sector may not have counter-cyclical effects and cannot be considered generous in this respect.

3.2 Rule-based fiscal policy

Since fiscal policy that is strictly rule-based has been shown to sharpen cyclical fluctuations and can thus destabilise an economy, many countries have adopted fiscal policy rules that are intended to avoid this tendency.[64] The aim is to keep surpluses accumulated in an upswing available for discretionary measures, while automatic stabilisers continue to smooth cyclical fluctuations.[65]

Fiscal policy rules have been defined in different ways. In a broader sense, Alesina and Perotti speak of budget institutions or the official and unofficial rules and regulations according to which budgets are drafted, approved and implemented.[66] More narrowly the term refers to statutory restrictions placed on targets regarding such things as balancing the budget, taxes, public expenditure and debt. A few countries, notably Switzerland and parts of Canada, have rules that require the arranging of a referendum on major tax initiatives.

Rules can be written into law or based on political agreements such as the Government Programme. They can be numerical or qualitative, national or supranational and can concern central government or general government. Britain, Sweden and Germany are among countries that apply fiscal policy rules that are written into law, while in Finland spending rules are adopted in the Government Programme. The fact that rules are written into law does not guarantee that they will be observed; political commitment is also required, since legislation can always be amended by Parliament. Most often rules are numerical and are monitored using national accounts and other means, which clearly show whether rules have been observed. In addition to numerical rules, Australia and Britain also have qualitative rules. Monitoring their observance requires transparency, clear reporting and external oversight. An example of a qualitative rule is the requirement that debt should be kept at a "prudent level".

The rules in the Stability and Growth Pact, which are also binding on Finland, concern general government, but most national rules in the euro area concern central government. Rules restricting central government may tempt countries to shift expenditure to other parts of the public sector. On the other hand their advantage is applicability in economic and fiscal policy, since they are under the government's direct influence.[67]

Rules have been adopted for many reasons: to stabilise the macroeconomy in postwar Japan, to increase the credibility of fiscal policy and keep public debt in check in Canada's provinces, to ensure the long-term sustainability of fiscal policy, to minimise negative externalities in an international community such as the European Economic and Monetary Union and to reduce the procyclicity of fiscal policy in Chile.[68] Often rules are set because of doubts that the current or future government will be willing or able to

64 Fatás & Mihov: The case for restricting fiscal policy discretion, The Quarterly Journal of Economics, 2003 Vol. 118, issue 4, pp. 1419–1447.

65 Burnside: Fiscal sustainability in theory and practice. A handbook. The World Bank, Washington D.C. 2005, p. 134.

66 Alesina & Perotti: Budget deficits and budget institutions in Poterba & von Hagen (eds.) Fiscal Institutions and Fiscal Performance. The University of Chicago Press, Chicago 1999, pp. 13-36.

67 Ministry of Finance: Fiscal Policy Rules and the Reform of Spending Limits in Finland. Working group report 7.2.2003.

68 Burnside: Fiscal sustainability in theory and practice. A handbook. The World Bank, Washington D.C., 2005. Kennedy & Robbins: The role of fiscal policy rules in determining fiscal performance. Department of Finance Canada Working Paper No. 16, 2001.

pursue an optimal fiscal policy without external constraints. On the other hand there are also examples of countries, such as Canada, that have managed to implement a credible fiscal policy without external constraints.

Fiscal policy rules can be divided into two categories according to whether they apply to public debt or expenditure. Rules concerning deficits, debt and balancing the budget limit the amount of public borrowing, while spending rules set ceilings on budget expenditure. Growth in expenditure can also be curbed by rules that limit growth in revenues.

The problem with fiscal policy rules is that if they are too tight, they can prevent an active economic policy aimed at smoothing cyclical fluctuations: in a downturn spending limits can prevent an increase in public expenditure and debt rules can restrict borrowing.

3.2.1 Budget balance and debt rules

The most common fiscal policy rules concern balancing the budget. The simplest of these is a balanced budget rule, which means estimated revenues must cover appropriations in the budget. A deficit rule sets a ceiling on overspending. All the countries in the European Economic and Monetary Union, for example, aim for a balance in public finances by not allowing budget deficits to exceed three per cent of GDP. Many countries have even stricter rules aimed at keeping the deficit in central government or general government finances under two per cent. Finland and Sweden have rules limiting the deficit in central government and general government respectively. Belgium has aimed for a six per cent budget surplus excluding interest costs. Interest costs have been excluded on the grounds that the government cannot influence short-term interest rates.

Strictly applied budget balance rules are easy to understand and monitor because of their simplicity. One problem, however, is their inflexibility and pro-cyclicity, since in an upswing when revenues increase, expenditure can likewise be increased, but in a downturn expenditure must be cut or revenues must be increased by raising taxes. Finland and Sweden aim for a structural surplus that allows automatic stabilisers to function. Taking the economic situation into account is problematic in that forecasting growth in GDP is always subject to uncertainty, and turning points in the cycle are particularly hard to predict. Rules concerning anti-cyclic measures must be very specific and permanent to avoid manipulation. Such measures make fiscal policy rules more difficult to understand, especially for the general public.

In 2001 Switzerland adopted a "debt brake" rule, which was also written into the constitution. According to this rule, expenditure may not exceed revenues over the cycle. Budget funds are calculated annually on the basis of the deviation between trend growth in revenues and GDP, so the level of expenditure depends on cyclically adjusted revenues. Surpluses resulting from faster economic growth or errors in forecasts concerning revenues and economic growth are booked in a "compensation account", from which corresponding deficits are subtracted. Deficits are allowed in exceptional circumstances, such as a deep recession or natural disaster, if Parliament approves by a majority vote. The rule allows changes in taxation, so additional expenditure can be financed by raising taxes and taxes can also be lowered along with expenditure. The purpose of the debt brake is to keep federal debt at the current level, in which case its share of GDP should decline as the economy grows.

A balanced budget rule is considered suboptimal for two reasons. The first is that it prevents the implementation of a Keynesian counter-cyclical fiscal policy, since it does not allow the budget deficit to be increased if the necessity suddenly arises. The second has to do with Barro's tax smoothing theory, according to which the distortionary effects of taxes (such as impacts on incentives to work) are smaller if taxes are kept constant and if governments can run a deficit or surplus in response to cyclical changes in revenues and expenditure[69] The imposition of a balanced budget rule prevents the use of deficits and surpluses as buffers, which is a prerequisite for tax smoothing.

Observations suggest, however, that optimal taxation is not actually a criterion in selected rules. Instead they are a consequence of the tendency to run budget deficits, which in turn depends on political factors. If the goal of a balanced budget is to achieve fiscal discipline, from this viewpoint the choice is between tax distortions and discretionary fiscal policy.

In addition to budget balance rules, many countries have set objectives regarding public debt. Generally debt is not supposed to rise above a certain percentage of gross domestic product. For countries in the euro area the rule is that general government debt may not exceed 60 per cent of GDP. Some countries have even tighter restrictions. Objectives have also been more ambitious in Finland at times.

Instead of gross debt, the objective can be expressed in terms of net debt (liabilities minus assets). The concept of net debt is not as easy to understand as gross debt, but it gives a better picture of an economy's long-term sustainability. In practice the definition of the term assets and the evaluation of calculation principles may prove problematic and require legislation containing the necessary criteria.[70]

The golden rule

One problem with budget balance, debt and spending rules is that they can overly restrict investments. Britain and Germany, for instance, apply what is known as the "golden rule", which leaves investments outside restrictions. The golden rule is looser than a balanced budget rule, since only current revenues and expenditure must balance. The government can borrow only to invest and not to fund current spending.

The idea behind the golden rule is that fiscal policy rules can lead to excessive cuts in investment, since current spending is harder to cut for practical and political reasons. Britain adopted the golden rule in 1998 because adherence to a balanced budget rule had resulted in a lowering of public investments in order to increase consumption expenditure. With the threat of crumbling infrastructure, it was considered necessary to loosen the balanced budget rule so as to spur investment.

The golden rule is also justified on the grounds that public investment differs in nature from other public spending. Investments require large amounts of money, while outputs are spread out over many years or even generations. Generational equality has been used as an argument for the golden rule, since one generation cannot finance its own consumption at the expense of future generations. On the other hand the present generation does not have to pay the full price of investments whose benefits will mainly be enjoyed by future generations. If money is borrowed only for investments, the budget

69 Barro: On the determination of public debt. Journal of Political Economy 1979: 87, pp. 940–971.

70 Ministry of Finance: Fiscal Policy Rules and the Reform of Spending Limits in Finland. Working group report 7.2.2003

is in balance if borrowing covers net investments. In this case net debt does not rise. The literature also points out that public investments can have a positive effect on private-sector production and thus tax revenues.[71]

One advantage of the golden rule is that it takes into consideration the distinction between capital expenditure and other public spending according to general accounting practice. Correct accounting with regard to capital expenditure is important if fiscal policy rules are to ensure attention to long-term sustainability in budgeting. Correct accounting also increases the transparency of rules by giving a truer picture of the current state of finances. Distinguishing between capital and other expenditure does not mean that investments should be unrestricted; instead separate ceilings should be set for them. In applying rules it is important to define precisely what constitutes an investment. Otherwise loosening numerical rules by excluding a particular factor such as investments can result in "creative accounting" and fiscal laxity. Transparency is thus crucial so that rules cannot be circumvented by classifying consumption expenditure as investments.[72]

Introducing the golden rule is subject to technical problems, one of which involves the difficulty in measuring outputs. Nor is it always simple to specify what counts as a public investment. Furthermore, correct accounting must take into consideration depreciation, which is not always easy to measure.

3.2.2 Expenditure and revenue rules

Expenditure rules

To curb growth in public expenditure and improve fiscal policy predictability, procedures that supplement the budget process are used in many countries. Multiannual expenditure rules that place ceilings on aggregate expenditure for the following years are part of a government's medium-term planning. Their aim is to promote the achievement of fiscal policy objectives. Since these rules are based on government policies, they also indicate the costs of these policies in the coming years.

Expenditure rules are in use in many countries, including Finland, Sweden, the Netherlands, France, Denmark and Austria. International organisations such as the OECD and the IMF consider the system used in the Netherlands exemplary. The systems used in different countries vary in both form and content. There are differences in their scope, adjustments for inflation, temporal length, underlying principles, flexibility and statutory basis.

Expenditure rules are decided before the budget process begins and thus guide the preparation and implementation of the budget. They can cover all or part of central government or general government expenditure, so they are not necessarily equivalent to the budget. The budget also includes items that are not covered by expenditure rules.[73]

Statutory basis

In 2007 the Austrian Parliament approved a comprehensive reform of budget legislation. The first stage of the reform was carried out in 2009 and the second stage will be carried out in 2013. The cornerstone of the first stage is the introduction of medium-term spending rules, which set rolling expenditure ceilings

71 Kennedy & Robbins: The role of fiscal policy rules in determining fiscal performance. Department of Finance Canada Working Paper No. 16, 2001, p. 4.

72 Fatás: Is there a case for sophisticated balanced-budget rules? OECD Economics Department Working Papers No. 466, 2005, pp. 10–14.

73 Ljungman: Expenditure ceilings - A survey. IMF Working Paper No. 282, 2008, p. 4.

for four years at a time, so that each year ceilings are added for the fourth year. The addition each year of ceilings for the fourth year ensures medium-term budget planning regardless of how long the government remains in office.[74] Spending rules have been written into law and deviations are allowed only in exceptional circumstances. Ceilings cover about 80 per cent of the federal government's expenditure.

Sweden's expenditure ceiling procedure, which has been in use since 1997, was given a statutory basis in 2009. This was justified on the grounds that local authorities and provincial governments have statutory budget restrictions. The procedure has functioned well, expenditure ceilings have not been exceeded and if necessary large budget cuts have been made to avoid over-spending. The procedure effectively prevented the squandering of surpluses accumulated in the 2000s and fiscal laxity when the economy weakened.[75]

Fixed or current price

In general spending rules can be set in the form of annual expenditure ceilings at the price level for the year in question (Sweden) or at current/nominal prices or in terms of the volume of expenditure or fixed/real prices, in which the effect of annual price or cost development is not included (Netherlands, Finland). If fixed prices are used, price adjustments do not need to be made during the year, which makes the procedure simple and transparent. The advantage of setting expenditure ceilings at current prices is counter-cyclicity, since a higher rate of inflation leads automatically to budget cuts during an upturn. If prices and costs rise more slowly than projected, the resulting room for manoeuvre allows an expansive fiscal policy to stimulate demand during a period of weaker economic growth. However, the room for manoeuvre created during a period of low inflation can lead permanently to a higher level of expenditure, while the implementation of budget cuts during a period of unexpectedly high inflation is not assured and can present policy-makers with difficult choices.

Spending rules expressed in terms of the volume of expenditure or fixed prices remain the same regardless of price development, since they are adjusted to current prices according to trends. The advantage of using fixed prices is flexibility, since changes in appropriations due to price trends do not change the decided level or allocation of resources. Faster than expected price development does not require budget cuts to avoid over-spending, nor can appropriations be increased if price development is slower than forecast.

The problem with using fixed prices is less transparency compared with current prices, since price adjustments make it more difficult to monitor compliance with spending rules on the outside. Expenditure ceilings are adjusted to the current price level with the help of cost indices.

In the Netherlands prices are adjusted using cost indices reflecting consumer prices and fixed capital formation in tangible assets, covering both private and public consumption and investment costs. The difference compared to a cost index based on the change in GDP is that it excludes changes

74 Meszarits & Seiwald: Budgetary reform in Austria. Federal Ministry of Finance Working Paper No. 3, 2008.

75 Regeringskansliet. Finansdepartementet: Stärkt finanspolitiskt ramverk – Översyn av budgetlagens bestämmelser om utgiftstak, 2009. Available at: http://www.sweden.gov.se/content/1/c6/12/28/56/72646266.pdf.

in inventories and the effect of the prices of imported and exported goods and services, since they cause fluctuations as a result of changes in the terms of trade.[76] Each spring prices are adjusted in the spending limits for the following year according to forecasts made by CPB Netherlands Bureau for Economic Policy Analysis and are not fine-tuned afterwards.

Unallocated reserve

Compared to a budget balance rule, spending rules reduce pro-cyclical fiscal policy because they allow automatic stabilisers to work particularly on the revenue side or through taxes. If spending rules contain a reserve for harder times, i.e. if part of spending is unallocated or items sensitive to the business cycle are excluded from expenditure ceilings, stabilisers will also work on the expenditure side. An unallocated reserve is applied in Finland, Sweden and the Netherlands.

In the Netherlands the unallocated reserve for unexpected expenditure is quite small: in 2002 it was only 0.25 per cent of total expenditure. Expenditure ceilings are based on cautious growth forecasts, so with faster economic growth it has generally been possible to increase expenditure. Furthermore, in the Netherlands appropriations can be carried forward to the following year, which prevents the imprudent application of remaining funds at the end of the year. The amount of funds carried over to the following year is about 1 per cent of total budget expenditure and is specified separately for each administrative sector.

Sweden also applies an unallocated reserve for automatic stabilisers, unexpected expenditure and errors in forecasts. In 2007–2008 this amounted to was 2–2.5 per cent of expenditure covered by ceilings. In previous years the reserve was so small that it was used up early in the year, leaving no room for manoeuvre in the budget. An unallocated reserve is considered important for flexibility, since it avoids the need to make changes in spending limits themselves. When the expenditure ceiling procedure was introduced, the unallocated reserve encountered some resistance because of fear that it would weaken the effectiveness of spending rules. Subsequently this fear has proved groundless and now the division of the unallocated reserve into two separate parts has been proposed. According to one proposal the reserve should include one amount for unexpected expenditure owing to uncertainty factors plus a "planning margin" to finance structural changes. Another proposal would divide the unallocated reserve into a "cyclical margin" and a "reform margin", with the first covering changes in expenditure due to the business cycle and the second the costs of reforms.[77]

Problems with spending rules

The downside of spending rules is that they can be circumvented using creative accounting or by increasing tax subsidies instead of expenditure, for instance. Tax subsidies have been used to avoid breaking spending rules in both Finland and Sweden. In Sweden a calculation of tax subsidies has been presented in connection with the spring budget

76 Ministry of Finance: Fiscal Policy Rules and the Reform of Spending Limits. Ministry of Finance Publications 5a/2007.

77 Regeringskansliet. Finansdepartementet: Stärkt finanspolitiskt ramverk – Översyn av budgetlagens bestämmelser om utgiftstak, 2009, pp. 35-40. Ljungman: Expenditure ceilings - A survey. IMF Working Paper No. 282, 2008, pp. 43–44. Ministry of Finance: Fiscal Policy Rules and the Reform of Spending Limits. Ministry of Finance Publications 5a/2007, p. 112.

since 1996. Temporary tax subsidies have been increased by collecting lower VAT from local authorities, for instance. In Sweden it has been proposed that tax subsidies should be added to spending rules along with other expenditure or that reporting on the application of tax subsidies should be expanded. In the Netherlands significant tax subsidies are discussed in a separate chapter of the budget, but experts have pointed out that many important tax subsidies are not covered by this discussion and are therefore excluded from spending rules.[78] One example is the special treatment of pension savings compared with other types of savings.

Since spending rules do not cover all forms of tax subsidies, these can increase in an uncontrolled manner without receiving due attention. According to critics this distorts the application of funds, since it is necessary to respond to sudden growth in expenditure that is included in spending rules, but this is not the case for items that have been excluded. Furthermore, practice allows spending rules to be circumvented, since expenditure can be increased by raising the amount of tax subsidies.[79]

Although spending rules are intended to curb growth in expenditure, they do not prevent a budget deficit if taxes are cut or total revenues are over-estimated. The risk of a deficit can be reduced by supplementing binding spending rules with a medium-term objective. Although such an objective is not as binding, it can support fiscal discipline. In Sweden expenditure ceilings are set for the medium term by preparing them three years in advance. This means that annual budgets are drafted on the basis of previous frameworks, which are not changed. The aim of multiannual expenditure ceilings is a long-term budget approach: setting ceilings several years in advance serves as a reminder that fiscal discipline must be exercised constantly.

In Sweden a three-year time frame is also considered suitable because it corresponds to the concept of medium-term planning used in the annual convergence programme that is drafted for EU member states that are not in the euro area. In the 2000s the setting of three-year expenditure ceilings has been postponed, however, on the grounds that it has not been possible to forecast economic development and thus tax revenues reliably or that sufficient time is lacking for this purpose. This has been an unwelcome trend, since setting expenditure ceilings for a year at a time shortens the planning time frame and spending rules consequently lose their significance as a fiscal policy instrument. There is also a risk that more weight will be given to short-term needs in budgeting. To preserve a practice that has been regarded as necessary, it has been proposed that budget legislation should require that the government set expenditure ceilings three years in advance.[80]

The tendency to run a deficit can also be mitigated by simultaneously applying a debt rule that places a ceiling on borrowing. If debt is measured in relation to GDP, policy-makers must consider the total amount of debt and not just the balance of the budget during the period in question.[81] The debt brake applied in Switzerland also helps prevent deficits. It allows surpluses and deficits in response to cyclical fluctuations, but the budget must be balanced over the cycle. Surpluses and defi-

78 Bos: The Dutch fiscal framework. History, current practice and the role of the central planning bureau. OECD Journal on Budgeting Vol. 7 Issue 3, 2008, p. 39.

79 Bos: The Dutch fiscal framework. History, current practice and the role of the central planning bureau. OECD Journal on Budgeting Vol. 7 Issue 3, 2008 p. 39, 42. Ljungman: Expenditure ceilings - A survey. IMF Working Paper No. 282, 2008, p. 36.

80 Regeringskansliet. Finansdepartementet: Stärkt finanspolitiskt ramverk - Översyn av budgetlagens bestämmelser om utgiftstak, 2009 p. 31.

81 Dában & Detragiache & di Bella & Milesi-Ferretti & Symansky: Rules-based fiscal policy in France, Germany, Italy and Spain. IMF Occasional Paper No. 225, 2003.

cits are recorded in a compensation account, which is eventually reduced to zero.[82]

Revenue rules

Revenue rules are intended to curb growth in the tax burden. They can also concern the application of revenues. In the Netherlands revenue rules are agreed in government negotiations by setting maximum and minimum levels for total taxes during the electoral term. Compensation must be made for deviations from rules. Previously the application of revenues exceeding the budget estimate was also subject to rules. Depending on the current budget deficit or surplus, a certain percentage of extra revenues had to be used to cut taxes or pay off debt. Subsequently this rule was abandoned because of its pro-cyclical effect.[83] Finland does not apply revenue rules.

According to the "golden hamster" rule applied in Belgium, revenues exceeding the budget estimate must be used to improve the budget balance by paying off debt. In Luxemburg such extra revenues are transferred to a reserve from which funds can be transferred to the budget whenever revenues fall short of the budget estimate.

3.2.3 Comparison of rules

If one compares spending rules and debt rules from the viewpoint of their impact on fiscal behaviour, spending rules have proved more effective. They have the advantages of simplicity and transparency and thus offer fewer possibilities for improprieties, since any breach of the rules is more likely to be detected. The intentional breaching of a debt rule can be concealed by setting a ceiling on the basis of over-optimistic economic forecasts or by promising fiscal discipline in the future without any real intention of honouring this promise.

One long-term criterion is whether rules encourage fiscal responsibility. A deficit rule, which sets a ceiling on overspending, encourages countries to keep deficits close to an agreed amount. This reduces fiscal room for manoeuvre in the case of a sudden downturn, when an expansive fiscal policy is needed. Spending rules, on the other hand, guide policy-makers by providing clear rules in both good and bad times.

If the objective is to smooth cyclical fluctuations, a deficit rule does not encourage strong economies to practice fiscal discipline in an upturn. On the other hand it can restrict the functioning of automatic stabilisers in weak economies. Expenditure ceilings allow stabilisers on the revenue side to function in all circumstances, through taxation, because in an upturn progressive taxation reduces disposable income in the private sector and thus dampens an overheating economy. Furthermore, having an unallocated reserve allows room for manoeuvre for stabilisers on the expenditure side.

Under a debt rule available revenues can vary unpredictably over the cycle, but under spending rules available resources are clearly known in advance. The predictability offered by a budgetary framework also makes it easier to coordinate fiscal and monetary policy and consequently stimulates greater confidence in the private sector.[84]

82 International Monetary Fund: Country Report No. 01/203 Selected Euro-area countries: Rules-based fiscal policy and job-rich growth in France, Germany, Italy and Spain, 2001.

83 Ministry of Finance: Fiscal Policy Rules and the Reform of Spending Limits in Finland. Ministry of Finance Publications 5a/2007.

84 Anderson & Minarik: Design choices for fiscal policy rules, OECD Journal on Budgeting 5:4, 2006 pp. 193–194.

3.3 The need for fiscal policy rules

As was mentioned above, a properly timed counter-cyclical policy can help stabilise an economy. According to the European Commission's report on public finances in EMU 2008, discretionary fiscal policy is at best a-cyclical and often pro-cyclical in the countries in the euro zone. It appears that discretionary fiscal policy seldom has a real counter-cyclical effect, and although this pattern has weakened it has not disappeared, according to the report.[85]

Similar conclusions were drawn by von Hagen[86] when he studied fiscal policy in the EU and Japan in 1980–2003. His findings are in line with previous studies, which showed that discretionary fiscal policy in Europe has been pro-cyclical. Since 1991 the rules laid out in the Treaty establishing the European Union appear to have reduced the effects of the election cycle, i.e. the increase in expenditure and deficits during election years. During an upturn one explanation for pro-cyclicity is that decision-makers falsely interpret increased revenues as a result of changes in the structure of the economy and accordingly cut taxes or increase spending.

Deviations from budgetary discipline in wartime or because of natural disasters or deep recessions have been viewed as justified, but excessive public debt in many industrialised countries such as the United States, France, Germany, Portugal and Italy have shown that discretionary fiscal policy can systematically lead to lax fiscal discipline.[87] Discretionary measures have not had a stabilising effect; instead public consumption has repeatedly exceeded revenues. Discretionary fiscal policy has thus been clearly pro-cyclical and has tended to increase deficits.

Since the 1950s efforts have been made to restore fiscal discipline with the help of permanent rules. In the past few decades rule-based fiscal policy has gained followers in many countries. The basic purpose of each rule has been to promote stable economic growth by holding down deficits and the constant rise in public debt.[88] Another common feature is that fiscal policy rules are intended to increase the credibility of fiscal policy by constraining discretionary measures. The objective is to build confidence by guaranteeing that basic economic factors will remain stable and predictable, even if a new government takes office and introduces new policies.

Economists have tried to explain why discretionary fiscal policy has led to a significant increase in budget deficits in many countries. The large deficits resulting from the 1970s oil crisis are accepted as a special case according to Keynesian economics, but the theory does not explain why they continued after the end of the crisis. Neoclassical economics also calls for deficit spending to cover sud-

85 European Commission: Public Finances in EMU 2008, 2008, p. 20. See Gali & Perotti: Fiscal policy and monetary integration, Economic Policy 18: 37, 2003, pp. 533–572. OECD: Fiscal stance over the cycle: Evidence from panel analysis. Appendix, Economic Outlook No. 74, 2003, OECD, Paris.

86 von Hagen: Fiscal policy rules and fiscal performance in the European Union and Japan, Centre for Economic Policy Research Discussion Paper No. 5330, 2006, London.

87 Kopits: Fiscal policy rules. Useful policy framework or unnecessary ornament? IMF WP 145, 2001.

88 Hallenberg & Strauch & von Hagen: The design of fiscal policy rules and forms of governance in European Union countries. European Journal of Political Economy 23: 2, 2006, pp. 338–359. Kennedy & Robbins: The role of fiscal policy rules in determining fiscal performance. Department of Finance Canada Working Paper No. 16, 2001.

den increases in costs, but the surpluses that the theory requires in normal times have not materialised in the same scope.

In many countries the deficits run up in the 1970s have been attributed to low borrowing costs resulting from low interest rates. There is no evidence that governments base borrowing decisions on interest rates, however. Furthermore, the considerably higher interest rates in the 1980s and 1990s do not lend support to this argument.

Since traditional economics has not been able to explain large deficits in the past, researchers have looked to political factors for an explanation. A key feature of public financial management is decision-making regarding the allocation of resources, which means taking a stance on the principles used in allocating funds. Questions and conflicts regarding this matter have been viewed as a possible reason for deficits and increased borrowing. In this respect special attention has been focused on the political decision-making process and the institutions that influence this process.[89]

Political decision making process

The political decision-making process has features that can lead to sub-optimal decisions for society and thus the failure of discretionary fiscal policy and the accumulation of debt.[90] The literature mentions three reasons that lead to a deficit bias or a tendency to run a deficit resulting from features of the political decision-making process.[91]

The first reason for a deficit bias is the electoral cycle: political decision-makers are more interested in being reelected than in the welfare of society. Before an election they may have an incentive to increase spending, which will boost their own political standing in the short term if voters disregard the future costs of increased spending, namely higher taxes. The second factor is competition among political parties. If a change of government appears likely, the party or parties in office may increase the deficit and leave it to the next government to deal with the consequences. Especially if an opposition party is expected to win an election and introduce radically different policies, the party in office may act this way so as to reduce the next government's room for manoeuvre.

The third reason involves the focusing of budget cuts and can be compared to the "prisoner's dilemma". Society is made up of different groups with conflicting interests. If these groups cannot reach an agreement on how to share the burden of deficit-reducing measures, the consequence can be the postponement or avoidance of decision-making. Agreeing on where to cut costs is assumed to be all the harder, the more parties there are in a coalition government. The risk of a debt bias is thus greater in countries with proportional representation, which tends to result in coalition governments, than in countries with a single-winner system, which are more likely to have a single party in office. This has been explained on the grounds that differ-

89 von Hagen: Budgeting institutions for aggregate fiscal discipline. Center for European Integration Working Paper No. 01, 1998, University of Bonn, Bonn.

90 Kennedy & Robbins: The role of fiscal policy rules in determining fiscal performance. Department of Finance Canada Working Paper No. 16, 2001.

91 von Hagen: Budgeting institutions for aggregate fiscal discipline. Center for European Integration Working Paper No. 01, 1998, University of Bonn, Bonn. von Hagen: Fiscal policy rules, fiscal institutions, and fiscal performance, Economic and Social Review 33:3, 2002, pp. 263–284. Kinnunen: Valtion menokehykset vakauttavat finanssipolitiikka. Euro & Talous No. 3, 2006, pp. 83-88.

ences within a party are smaller and easier to resolve than differences between parties.

Generally speaking the following political factors can be viewed as reasons for deficit bias: voter polarisation, multi-party coalition governments and government instability.

Although the above reasons have received a lot of attention, no one has been able to provide empirical support for them so far. This can be interpreted as good news, since these are basic political factors that are very difficult to change.

In addition to debt bias, discretionary fiscal policy is subject to problems regarding time and information. Decision-making is always based on the information that is readily available concerning the current situation, future prospects and the scope and timing of the impacts of selected policies. Problems arise because there are delays in access to information and in the budget process, and these inevitably result in a delay between economic phenomena and the implementation of fiscal policy. One can divide this into technical delays and political delays.

Technical delays are linked to the collection, processing and preparation of data. Economic data may be misinterpreted for years, so published figures are not necessarily trustworthy.[92] Owing to the slow production of data, determining the current point in the cycle is difficult, which hampers the selection and timing of cyclical policies. Pro-cyclical policies are not necessarily intentional but may be due to a lack of real-time data.[93]

Political delays arise because, after data have been collected, political decision-making and the implementation of decisions take time. For the same reason it is also difficult to reverse selected policies even if this is called for by the situation. In addition to technical and political delays, the impacts of fiscal measures, such as tax cuts' impacts on aggregate demand, are not always immediate. The risk here is that impacts may be poorly timed. For example, if tax cuts are made to stimulate demand but their impact is not felt until an upturn has already started, they sharpen rather than smooth cyclical fluctuations.

Institutions and the budget process

Besides the political reasons mentioned above, growth in expenditure and debt are caused by the "common pool problem". This also has to do with the allocation of public funds. The problem arises because public funds are collected from all taxpayers, but expenditure is focused on particular groups of beneficiaries.

In allocating funds, as a rule beneficiaries are not the same as financiers of expenditure. Those who benefit from expenditure generally pay only a small part of total costs. Consequently politicians representing a particular group have a tendency to overestimate the social benefits of measures financed with public funds, since they focus on their own supporters' share of costs. This is a negative externality resulting from the fact that decision-makers do not consider all the costs to society. For example, ministries strive to maximise their own appropriations without considering that an increase in one ministry's appropriations results in a decrease in the resources that are available for other sectors of society. As every ministry strives to increase

92 Anderson & Minarik: Design choices for fiscal policy rules. OECD Journal on Budgeting 5:4, 2006 p. 185.

93 European Commission: Public Finances in EMU 2008, 2008. See also Golinelli & Momigliano: Real-time determinants of fiscal policies in the euro area. Journal of Policy Modeling, 28:9, 2006, pp. 943–964.

its own appropriations, this swells the budget and the amount of revenues that must be collected. If the number of ministries and thus requests for appropriations increase, this compounds the problem

As in the case of the electoral cycle, the reason behind the common pool problem is that decision-makers do not take budget constraints seriously enough. The budget process is thus hard to coordinate, and resolving this problem requires that decision-makers view the budget as a whole. Taking budget constraints seriously means that decision-makers consider the real benefits and costs of projects financed with tax revenues.[94] If budget decisions are made in a coordinated manner and the budget is viewed as a whole, this is referred to as a centralised budget process. In contrast, a fragmented budget process is one in which a shared budget approach is lacking.

In the literature increasing emphasis is placed on the significance of budget institutions in the management of public finances. For instance, von Hagen[95] has empirically shown the importance of budget institutions in maintaining fiscal discipline. Budget institutions include the official and unofficial rules that guide the drafting of the budget by the government, its approval by the legislature and its implementation. Rules guide the flow of information and different actors' strategic influence in budgeting. Whether a budget process is centralised or fragmented depends on the rules that apply to decision-making.

Two approaches have been taken in an effort to resolve the coordination problem, with both based on institutional incentives and aimed at centralising the budget process. The first is to delegate decision-making and strategic influence to an actor that is less tied to political interests than ministers and can supervise the budget process and ensure co-operation. In Europe this is usually the Ministry of Finance, which prepares the budget proposal and is thus in a better position to view the budget as a whole.

The decision-making authority delegated to the Minister of Finance varies from one country to the next. In France, for example, the Minister of Finance and the Prime Minister together decide on expenditure ceilings for each administrative sector. The Minister of Finance therefore has a great deal of power in setting budget guidelines. In Germany, the Minister of Finance has been delegated authority to veto government decisions that have financial consequences. This veto can be overcome by a majority of the cabinet with the support of the Prime Minister, however. In the German model the Minister of Finance can reject decisions but does not have authority to formulate the budget proposal. In Britain, the Chancellor of the Exchequer conducts budget discussions with different ministries. The authority exercised by the Chancellor of the Exchequer is based on better access to information and the support of the Prime Minister.

Another way to resolve the coordination problem is for an incoming government to reach a political agreement at the beginning of the budget process setting out its medium-term fiscal policy, which may include numerical objectives. In this way the government institutionalises its fiscal policy objectives in a way that resembles fiscal policy rules. The

94 Hallenberg & Strauch & von Hagen: The design of fiscal policy rules and forms of governance in European Union countries. European Journal of Political Economy 23:2, 2006, p. 4.

95 von Hagen: Budgeting institutions for aggregate fiscal discipline. Center for European Integration Working Paper No. 01, 1998, University of Bonn, Bonn.

centralisation of the budget process takes place through internal negotiations that are required to reach an agreement, and this forces decision-makers to consider the budget as a whole. In this model the role of the Minister of Finance is to evaluate the consistency of each ministry's fiscal plans with the expenditure ceilings that have been set.

In Denmark, for example, budgeting begin with discussions among members of the government in which spending limits are decided for each ministry. These are usually decided for the medium term on the basis of fiscal plans. In the Netherlands the authority of the Ministry of Finance in budget negotiations has been based on better access to information, but it has not had strategic power.[96]

This procedure is based on the assumption that the members of the government have equal strategic power, while the delegation of decision-making power involves a hierarchic order between the Ministry of Finance and the other ministries in the background. According to research, delegation is found most often in countries with a two-party system, while political agreements are used in countries that have coalition governments, in which the distance between parties' ideologies can be quite large. This suggests that the choice of an institution is influenced by the number of parties participating in the budget process and gaps between their ideologies.

Data collected from the EU member states in 1985–2004 have been used to study the connection between budget institutions and the constraints imposed by fiscal policy rules as well as their combined influence on the management of public finances.[97] Since 1991 many countries have reformed their budget procedures so that budget processes appear more centralised now than at the beginning of the 1990s. As a result, the budget decision-making process in deeply indebted European countries is assumed to have less of a debt bias than before.

The institutional reforms that have been implemented also strengthen the assumption that tighter fiscal policy rules are more effective at strengthening fiscal discipline in countries where the government is split ideologically than in countries where the government parties are closer in this respect. The tightness of fiscal policy rules has been measured in terms of how much of the budget they cover and over what period as well as the precision of forecasting methods on which rules are based.

Expectations and the credibility of fiscal policy

The benefits of a responsible spending policy depend on its credibility. Fiscal policy rules that constrain decision-makers' possibilities to take discretionary measures have been used to increase credibility. Regardless of the form fiscal policy rules take, if rules are broken this naturally weakens fiscal credibility, but the more rules in themselves promote compliance, the bigger an effect they can have on credibility.[98] Continuously changing fiscal targets according to the economic outlook (for example with a debt rule) can harm credibility, because such changes are asymmetrical. Another reason for asym-

96 von Hagen: Budgeting institutions for aggregate fiscal discipline. Center for European Integration Working Paper No. 01, 1998, pp. 13-16, University of Bonn, Bonn.

97 Hallenberg & Strauch & von Hagen: The design of fiscal policy rules and forms of governance in European Union countries. European Journal of Political Economy 23:2, 2006.

98 Anderson & Minarik: Design choices for fiscal policy rules, OECD Journal on Budgeting 5:4, 2006, p. 180.

metry is that spending cuts and tax increases are generally hard choices for decision-makers, while the political decision-making process more easily results in increased spending and the lowering of taxes.

In macroeconomics researchers have studied what causes political decision-makers to deviate from outlined policies. They have found that political decision-makers actually have an incentive to deviate from stated policies as long as they do incur costs. Once a monetary or fiscal policy has been outlined, private economic actors base their decisions on this policy. If actual measures deviate from this policy, confidence is eroded.

Since economic actors – individual consumers and businesses – form expectations concerning future policy measures and behave accordingly, the erosion of confidence will make it harder to implement economic policy effectively in the future. In an upturn this can mean that the private sector expects tax cuts and consequently a rise in disposable income in the near future, which can influence consumption behaviour. If the intention is for fiscal policy to influence aggregate demand, success also depends on these expectations.

One way to examine the relation between political decision-makers and the private sector is to use the concept of an imperfect contract.[99] In an election voters delegate decision-making to politicians, which can be thought of as a contract binding the winning candidates to promote their supporters' interests and to redeem their campaign promises. This contract is inevitably imperfect, however, since once representatives have been elected, voters do not have a say in decision-making until the next election. Representatives can therefore go back on their election promises either consciously or because of unforeseen changes in circumstances. From this viewpoint the only cost of the erosion of credibility resulting from an inconsistent policy is that a representative many not be reelected.

Alesina[100] has explained deviations from election promises with the median voter theorem, according to which different parties have an incentive before an election to move towards the centre in order to attract support from voters who are closer to the middle ground. Once they are in power, however, they can follow their own policies as long as breaking promises does not impose costs on them. In a democracy a change of government can also lead to the reversal of policies.

Inconsistent behaviour can be avoided if politicians can be held responsible for following through on policies. Fiscal policy rules, which restrict political decision-making, can help achieve a long-term approach. If rules are observed over the long term, the government's reputation and credibility are strengthened, so that in the best case rules will no longer be needed and can be abolished. Rules are not always indispensable for successful fiscal policy. Nor does the existence of rules by itself ensure credibility; compliance with rules must be supervised.[101]

99 von Hagen: Fiscal policy rules, fiscal institutions, and fiscal performance, Economic and Social Review 33:3, 2002, pp. 263–284.

100 Alesina: Credibility and policy convergence in a two-party system with rational voters. The American Economic Review 78:4, 1988, pp. 796–805.

101 Alesina & Tabellini: Credibility and politics. European Economic Review 32:2–3, 1988, pp. 542–550.

AUSTRIA'S BUDGET REFORM [102]

A good example of the significance of budget procedures for the end result is provided by Austria's budget reform. Principles concerning the drafting of the budget are being reformed in two stages: the introduction of a medium-term expenditure framework (MTEF) in 2009 and the shift to performance budgeting beginning in 2013. Previously budgeting took place "bottom-up", which means that ministers prepared their budget proposals and presented requests for appropriations to the Ministry of Finance. Budget proposals generally resulted in a large deficit and the Ministry of Finance had to recommend cuts. Coordinating proposals was difficult and time-consuming. In the framework procedure annual budgeting takes place on the basis of medium-term planning, and framework and budgeting processes must therefore be closely linked. If the framework is regularly altered or adjusted according to budgeting needs, processes change place, which is contrary to the original intention.

The multiannual planning process begins with the Government first deciding on the deficit objective, government programme and strategies for the following year. The Ministry of Finance – without interference from other ministries – then uses these to prepare a budgetary framework. The other ministries receive a report on the criteria for calculating the framework and draft their own detailed budgets fairly independently within this framework. Ministries must also propose spending cuts and reforms to existing legislation if necessary. The fact that cost-cutting benefits ministries should provide an incentive to use resources more effectively. Finally the Minister of Finance and the other ministers hold negotiations to iron out differences.

Shifting to performance budgeting in Austria means new budgeting techniques and a new operating culture on both the administrative and political level. An item-based budget will be replaced with a budget that outlines functions and targeted outputs.

Since the states and municipalities prepare their own budgets in Austria, responsibility for meeting deficit targets will be shared with the help of an internal stability pact.

102 Meszarits & Seiwald: Budgetary Reform in Austria, Federal Ministry of Finance Working Paper 3/2008. Available at http://english.bmf.gv.at/budget/theaustrianfederalb_399/_start.htm?q=budget reform.

3.4 Criteria for good fiscal policy rules

The functioning of fiscal policy rules has been questioned for theoretical and practical reasons. From a theoretical viewpoint economics does not dictate the use of rules, since both traditional macroeconomic analysis and the principles of public finances are based on the assumption of discretionary fiscal policy. From a practical viewpoint several examples have shown that a government can also exercise fiscal discipline without external constraints. Criticism also concerns the increased bureaucracy associated with rules as well as the possibility to circumvent rules using dubious practices, which can be quite costly.

The criteria used in evaluating fiscal policy rules depend on whether rules are meant primarily to support the sustainability of public finances over the long term or to prevent changes in fiscal policy for political reasons. A good fiscal rule must be in line with set objectives so as not to restrict options if political decision-makers' discretionary measures lead to a sub-optimal result, however this may be defined.

To simplify somewhat, the functioning of rules can be evaluated from the viewpoint of effectiveness or implementation. An effective rule is formulated so that it helps achieve set objectives, while a rule guided by technical implementation is designed so that it also ensures political decision-makers' compliance on a practical level.[103] In the best case rules force governments to take a long-term approach to fiscal policy. On the downside rules can hamper counter-cyclical interventions and the proper functioning of automatic stabilisers and can lead to dubious accounting and cover-ups while failing to steer fiscal policy.[104]

Generally speaking rules are evaluated in terms of flexibility, credibility and transparency. These criteria cannot be separated from one another entirely but are interdependent in one way or another. Sometimes they can even be conflicting. For instance, to meet the criterion of transparency a rule should be as simple as possible. But a simple rule is seldom flexible since this would mean adaptability to different situations and changes in the environment, which in turn requires complexity. Evaluation also depends on the country in question, since the functioning of rules is influenced by each country's institutions, such as the political party system.

Credibility

Regardless of the fundamental objective, rules must be credible in economic actors' eyes if they are to be effective. This requires that economic actors understand rules and their importance for fiscal policy, so the content and implementation of rules must be transparent. If economic actors understand that breaking rules cannot result in good fiscal policy, it is not in policy-makers' best interest to break rules. Credible rules must be permanent in nature to ensure that policy-makers will not try to circumvent them by

103 Fatàs & von Hagen et al.: Stability and growth in Europe: towards a better pact, Centre for Economic Policy Research, London, 2003, p. 48.

104 Milesi-Ferretti: Good, bad or ugly? On the effect of fiscal policy rules with creative accounting. IMF Working Paper 00/172, 2000.

changing their content or objectives.[105] The best way to achieve permanence is to give rules a statutory or constitutional basis.[106]

Furthermore, credibility requires that rules are mandatory. The existence of rules does not ensure fiscal discipline; political commitment is needed so that rules will not be circumvented. If a government has too much room for manoeuvre, circumventing rules can result in expensive deception rather than real change. The most common criticism of rules is that they encourage abuses.[107]

The credibility of rules is increased by the existence of a monitoring authority together with sanctions for non-compliance. At the national level this generally means that politicians lose their reputations. In a federal system penalties are often imposed, in a similar manner as the non-interest-bearing deposits required in EMU.

Compliance with rules should be monitored after the fact; the conformity of the budget with rules is not enough by itself. Monitoring must concern the practical implementation of the plans presented in the budget. Since the budget is based on many uncertain assumptions concerning the development of the economy, unexpected development can be used as an excuse for deviating from the budget. Monitoring after the fact can detect a systematic forecasting error or its use as an excuse.

Flexibility

Restricting discretionary measures, which is done for many of the reasons explained above, also reduces the flexibility of fiscal policy and the ability to respond to economic disturbances. If rules are too tight they can prevent a government from taking action to smooth cyclical fluctuations. Particularly if rules are written into law they must be flexible enough to allow them to function in all situations and still binding enough to maintain credibility.

The effectiveness of rules has been the subject of a great deal of empirical research.[108] A government's ability to use fiscal policy counter-cyclically when fiscal policy rules restrict decision-makers' room for manoeuvre has attracted special attention. If rules do not take the business cycle into consideration, they can result in tight fiscal policy in a downturn and thus sharpen cyclical fluctuations. If allowance is not made for the business cycle, a tight spending or deficit rule can restrict an expansive fiscal policy designed to stimulate aggregate demand in a weak economy, for example.

Rules can restrict room for manoeuvre if the political factors mentioned above and the budget process cause a deficit bias. In this case impacts must be weighed from two different perspectives: the economy's long-term sustainability and short-term stability. The results of an active fiscal policy governed by rules have been mixed. How much room for manoeuvre rules allow also depends on whether fiscal policy is used to smooth cyclical fluctuations.[109]

Ideally rules should be flexible if external shocks occur, so that the objective is cyclically adjusted budget balance, which takes into consideration the effect of automatic sta-

105 Kopits: Fiscal policy rules. Useful policy framework or unnecessary ornament? IMF WP 145, 2001, p. 16.

106 In Public Finances in EMU 2009, the first criterion in evaluating fiscal policy rules is their statutory basis.

107 Kennedy & Robbins: The role of fiscal policy rules in determining fiscal performance. Department of Finance, Canada, Working Paper No 16, 2001, p. 3.

108 See for example Poterba: Do budget rules work? In Auerbach (ed.) Fiscal Policy, 1997, MIT Press, Boston. Poterba: Budget institutions and fiscal policy in the United States, American Economic Review 86, 1996, pp. 395–400.

109 Dában & Detragiache & di Bella & Milesi-Ferretti & Symansky: Rules-based fiscal policy in France, Germany, Italy and Spain. IMF Occasional Paper No. 225, 2003, p. 4.

bilisers around the GDP growth trend. This means budget deficits are allowed when growth falls below the trend, while a faster growth rate than the trend demands a surplus. This is how the Swiss debt brake works. Alternatively, flexibility can be achieved by aiming for a balanced budget or a surplus and applying a rule that restricts any deficit, as in the EU's Stability and Growth Pact.

The significance of flexibility increases in a federal system or in an economic area such as EMU, where asymmetrical shocks resulting from different trends in different member states are possible. In EMU if a shock is limited to parts of the economic area, this can be addressed with cyclically adjusted rules or by paying compensation from a fund established for this purpose.[110] An example is the EU's Structural and Cohesion Funds, which are intended to smooth structural differences between member states and to help countries or regions that are sensitive to asymmetrical shocks. EMU's deficit rule also has flexibility to allow for asymmetrical shocks.

Transparency

An effective fiscal policy rule must be simple enough so that it can be implemented easily. A simple rule that is easy to monitor in practice must be transparent. Transparency means supplying information on objectives, measuring methods and the forecasts on which indicators are based. This is to ensure that fiscal policy indicators cannot be manipulated to allow compliance in form only, i.e. deception. Especially when tight fiscal discipline is needed, there may be pressure to take less transparent measures. In order to achieve approaching budget targets, transparency may be reduced to avoid having to take politically unpopular measures. Among the EU member states this happened in France, Greece and Italy (at least) to meet the criteria in the Maastricht Treaty.[111]

The success of rule-based fiscal policy also requires transparency in the different stages of the budget process and reporting. It has been observed that the transparency and size of the budget affect whether rules result in real or deceptive compliance.[112] Combining a tight rule with a budget that is difficult for outsiders to interpret leads more easily to deception rather than real fiscal changes, since rules always involve measuring quantities that in themselves can be imprecise or subject to manipulation.

For example, with regard to budget balance, which is the most commonly available indicator of the current state of finances, transparency depends on how much expenditure is included in the budget and how much is off-budget and also on accounting practices, such as the classification of items and how items are booked. The most significant factor weakening transparency is off-budget funds, for instance social welfare or defence spending, although their exclusion from the budget may be quite justified to begin with. In Finland defence spending is included in central government spending limits. In some countries an indicator has been manipulated by shifting spending to off-budget funds. Figures have also been doctored by making it easier for people to retire on old-age or disability pensions, thereby improving unemployment rates. Reporting on off-budget

110 Kopits: Fiscal policy rules. Useful policy framework or unnecessary ornament? IMF WP 145, 2001, pp. 10–14.

111 Kopits & Craig: Transparency in government operations, IMF occasional paper 158, 1998, p. 2. For examples of creative accounting see Milesi-Ferretti: Good, bad or ugly? On the effect of fiscal policy rules with creative accounting. IMF Working Paper 00/172, 2000.

112 Milesi-Ferretti: Good, bad or ugly? On the effect of fiscal policy rules with creative accounting. IMF Working Paper 00/172, 2000.

funds and functions is often meagre, which further weakens transparency.

Short-term fiscal policy is usually evaluated with cyclically adjusted indicators, for instance using the concept of structural balance and adjusting for cyclical fluctuations. If a rule concerns such a cyclically adjusted indicator, transparency requires clear information on how this has been calculated and what economic indicators and assumptions have been used for this purpose.

3.5 Fiscal policy rules applied in Finland

The spending limits procedure

When spending limits were introduced in Finland during the electoral term 1991–1994, the focus was on curbing growth in expenditure while fighting a slump. During the electoral term 1995–1998 attention shifted to reducing debt. In Finland the use of spending limits as a fiscal policy instrument and their development have been aimed at restoring fiscal health and increasing credibility in an international environment by building confidence in Finland's debt management. In contrast with many other EU and EMU countries, the original reason for introducing spending limits in Finland had nothing to do with meeting the criteria for EU or EMU membership.[113]

The spending limits procedure was reformed in 2003 to extend over the four-year electoral term. The setting of spending limits one year at a time was not considered adequate to serve as a medium-term planning instrument. The sizable cost-cutting measures carried out during the slump were not dependent on spending limits, which remained secondary in importance. Once cost-cutting in response to the slump had ended, fiscal discipline gradually slackened. The reform of the spending limits procedure was aimed at strengthening fiscal stability and preparing for increasing costs as a result of the ageing of the population without placing an unreasonable burden on future generations.[114]

The reform called for fixed-price spending limits covering central government expenditure for the electoral term 2003–2006 regardless of cyclical trends. The Government's express objective was to curb growth in expenditure, which supports the broader objective of lowering central government debt in relation to GDP. The Government Programme outlined the main features of the spending limits system and made a commitment to comply with them. The Government that entered office in 2007 decided to continue the spending limits procedure while making certain changes to make it more flexible.

In Finland the spending limits procedure does not have a statutory basis but is largely up to the Government. The Government did not begin submitting information on spending limits to Parliament until the end of the 1990s. In connection with the handling of the budget, each year Parliament can amend the Government's budget proposal and deviate from spending limits if it wishes.[115] Nor is the Finnish Government required by law to prepare spending limits for the electoral term. This practice has been voluntarily adopted by the Government. The principles according to which spending limits are set for the electoral term are therefore decided by each Government, and an incoming Government is not bound by the spending limits that have been set by its predecessor. The Government has not presented numerical rules or figures on the basis of which spending limits have been set. Without legal force and sanctions, if fiscal discipline slackens, spending limits are no more than an expression of the Government's medium-term objectives. The

113 Ministry of Finance: Fiscal Policy Rules and the Reform of Spending Limits in Finland. Ministry of Finance Publications 5a/2007.

114 Ministry of Finance: Fiscal Policy Rules and the Reform of Spending Limits in Finland, Ministry of Finance working group report 7.2.2003.

115 Brunila & Kinnunen: Menokehykset ja finanssipolitiikan kurinalaisuus euromaissa. Euro & Talous, 2002, No.1, pp. 18–22. Ljungman: Expenditure ceilings - A survey. IMF Working Paper No. 282, 2008, p. 28.

only consequence of failing to meet spending objectives is the weakening of the Government's fiscal policy credibility and possible market reactions that can affect the cost of borrowing.

Excluded expenditure

Since economic development is difficult to forecast over the medium term, setting spending limits several years in advance carries the risk that these will prove either too tight or too loose, depending on the economic situation. To reduce uncertainty, expenditure that varies according to cyclical changes and over which the Government does not have direct control has been excluded from spending limits. In the 2003 and 2007 Government Programme negotiations and the spending limits decisions that were made on the basis of the Government Programme, an agreement was reached to exclude interest costs on central government debt, transfers to the Social Insurance Institution, self-financing suspense account items, financial investment costs and cyclically dependent expenditure.

Excluding interest costs has been justified in Finland on the grounds that short-term fluctuations in interest rates cannot be predicted and do not depend on the Government's current fiscal policy, since the Government cannot influence total debt over the short or medium term. Excluding interest costs from spending limits prevents excess room for manoeuvre when interest rates fall and interest costs are smaller than forecast or in the opposite case the exceeding of a ceiling if interest costs suddenly rise. In the Netherlands the decision was also made to exclude interest costs from spending limits in 2008–2011 because of such fluctuations.

Unemployment security expenditure and housing allowance expenditure have been excluded from spending limits because of their sensitivity to business cycles, so as to avoid pro-cyclical fiscal policy in a downturn and excess room for manoeuvre in an upturn. Leaving such items outside spending limits allows them to act as automatic stabilisers. Discretionary changes in payment principles or in the size of items are subject to spending rules, however. Excluding such items from spending limits is problematic in that they can conceal the need for structural changes in the labour market. If unemployment security expenditure is not covered by spending limits, it can continue to rise without any attention being paid to the underlying reasons. If rising costs are assumed to be the result of cyclical factors, they may be allowed to grow and act as automatic stabilisers. In reality structural weaknesses may be to blame, in which case rising costs signal the need for structural change. According to feedback received from the Ministry of Social Affairs and Health, changes in unemployment security expenditure are in fact monitored in Finland and attention is paid to the underlying reasons, regardless of the spending limits process.

Transfers to the Social Insurance Institution include central government's share of funding based on sickness insurance and pension legislation. This guarantees sufficient funds to pay benefits. The number of beneficiaries depends on economic activity and thus varies over the business cycle. Consequently the total amount that is paid depends on cyclical fluctuations and has been excluded from spending limits. Only the effects of changes in benefit principles, i.e. the level or scope of benefits, are covered by spending limits. Changes in central government's share of funding that are due to changes in the principles according to which charges are collected from employers and the insured, on the other hand, must be paid by the Social Insurance Institution to compensate for tax changes, which are likewise excluded from spending limits.

Self-financing suspense account items have also been excluded from spending limits in Finland because their development depends on the development of corresponding revenues, in which case they do not have an effect on budget balance. This category includes proceeds from the Finnish National Lottery and the Slot Machine Association, which obtain income from betting and gaming activities. The Lotteries Act contains provisions on the use of proceeds, which are intended to promote sports and physical education, the arts and sciences, youth work, and health and social welfare. Since the amount of proceeds depends on the level of gaming activity, restricting income and thus expenditure has not been considered necessary from a fiscal policy viewpoint. As in the case of labour market policy, one could say that including these in spending limits would make them part of the budget negotiations and require open discussion regarding priorities. Items that are not part of the budget negotiations have been assigned a special status, since their funding is independent of the prevailing system of social values and changes in it.

On similar grounds expenditure corresponding to funds received from the European Union has been classified as self-financing suspense account items, as have agencies' VAT costs since 2007. In the first case a supporting argument is that there is often a delay in payments for projects financed from EU funds, and the amount of funds allocated to the year can vary unexpectedly. In the second case VAT costs have been excluded to make the choice between external and in-house production more neutral. Furthermore restricting agencies' VAT costs has not been considered necessary on fiscal policy grounds since VAT payments end up as central government revenues.

Financial investment costs are generally one-off and are related to the procurement or development of assets. The assumption is that invested funds will retain their value and that financial investments can therefore be equated with saving or depositing funds, in which case they should not be covered by spending limits. Other investment costs are included in spending limits, but the exclusion of investments in transport infrastructure, for example, has been discussed. The justification is that investments have a significant effect on future growth potential. Excluding investments requires an evaluation of their significance for future development, however, which in turn requires discussion concerning the relative importance of present and future benefits, how benefits should be weighed and who should pay for investments.

Unallocated reserve

The spending limits decision can leave an unallocated reserve to cover unexpected expenditure. To increase flexibility the 2007 spending limits decision left an unallocated reserve of 200 million euros for the electoral term 2008–2011 on top of the 300 million euros reserved for supplementary budgets each year.

Since the need for an unallocated reserve is due to growing uncertainty concerning mandatory expenditure over time, the reserve is segmented so that the amount available is smallest the first year and gradually increases in each subsequent year. In this way the reserve can be tapped to cover new spending decisions over the course of the electoral term. In some years the available amount has not been fully applied. Any unused portion can be carried forward to the next year, up to a maximum of 100 million euros and only for one-off expenditure. A similar practice has been adopted in Sweden and the Netherlands, for example.

External evaluation and international practices

The country report for Finland[116] that was published by the International Monetary Fund in 2007 points out the benefits of the spending limits system in holding down expenditure. The IMF points out, however, that the limits have not dented the high level of public spending. The significance of spending limits for fiscal discipline and balanced finances in the public sector as a whole depends essentially on how much financial autonomy has been devolved to regional and local government. In some countries in the euro area where regional and local government have a high degree of financial autonomy (Belgium, Finland, Germany, Italy, Spain), central government spending limits have been supplemented by requiring a balanced budget or budget surplus on other levels of government. In Spain, for example, the budget balance requirement concerns each level of government and state-owned companies as well.

Budget balance objectives for regional and local government are aimed at achieving the objectives set for public entities in the Stability and Growth Pact, which by itself does not ensure the coherence of national fiscal policy or the focusing of taxation and expenditure. At the local and regional level budgets can be balanced by cutting expenditure or raising taxes.[117] If taxes are raised, expenditure can be increased without breaking a balanced budget rule. The IMF report recommends that spending rules should be extended to local government, sanctioning their inclusion by a "domestic stability pact".

Austria enacted legislation introducing a domestic stability pact in 1999. This is used to coordinate budgets at different levels of government (federal, regional or state, municipal). In Austria regional government accounts for a third of public expenditure. The federal government nevertheless finances the bulk of expenditure. The federal government collects 95 per cent of taxes. The states draft their own budgets and can borrow money without obtaining permission from the federal government. The domestic stability pact is designed to balance public finances by sharing responsibility among the three levels of government. It requires that the states run a surplus equal to 0.75 per cent of GDP and that the municipalities balance their budgets, while the federal government is allowed to run a deficit amounting to 0.75 per cent of GDP. Legislation provides for penalties if targets are not achieved. A penalty can be imposed on any state or municipality that fails to meet requirements. Up to now penalties have not been necessary, since all the regional governments have fulfilled their obligations.[118]

A few countries have spending limits that cover the entire public sector. Spending limits have most often been set for central government and in some countries for social secu-

116 International Monetary Fund: Finland. Country Report No. 07/279, 2007, pp. 12–13.

117 Brunila & Kinnunen: Menokehykset ja finanssipolitiikan kurinalaisuus euromaissa. Euro & Talous No.1, 2002, pp. 18–22.

118 Blöndal & Bergvall: Budgeting in Austria. OECD Journal on Budgeting 7:3, 2007, p. 41.

rity funds as well. Compared to the systems in Sweden and the Netherlands, Finland's spending limits are quite narrow in scope, owing to the large number of items that are excluded. Sweden's spending limits system covers all central government expenditure except for interest costs and therefore shows directly the level of tax revenues required to finance expenditure. In the Netherlands spending limits comprehensively cover central government finances, which have been divided into three sectors according to the different ways in which they are financed. Spending limits are set for central government expenditure, social security and the labour market, and health care. Comprehensive limits force spending cuts if government policies result in larger than expected expenditure. In addition to the IMF, the OECD also drew attention to the narrow scope of Finland's spending limits in its 2010 country report.

The IMF views the increases in spending limit approved by incoming governments as problematic. Spending limits extend beyond the end of the electoral term, with the goal being to prevent a tendency to increase expenditure when a new government takes office. Since existing spending limits are not binding on an incoming government, it can approve its own spending rules and set spending limits accordingly for the coming term. In this way the level of expenditure was increased in both the 2003 and 2007 spending limits decisions.

The IMF report likewise mentions problems associated with the use of a deflator based on the public consumption index, which tends to grow faster than a GDP deflator or the consumer price index. As a result central government expenditure's share of GDP tends to rise even if the volume of expenditure remains the same. The unintended increase in expenditure's share of GDP can be corrected by adjusting the level at the beginning of a new four-year term, however.

In Finland the choice of the deflator has been justified on the grounds that it is neutral from the viewpoint of the breakdown of expenditure and that price adjustments can therefore be made in a way that corresponds as closely as possible to the increase in costs resulting from rise in the price level. If the GDP deflator or the consumer price index were used, price adjustments would be based on the change in the general price level rather than price development applying expressly to central government expenditure. The IMF report recommends using the GDP deflator or the consumer price index, which would impose more stringent ceilings and therefore provide incentives to increase productivity and reduce costs. In reality price adjustments are more complicated than the IMF report suggests, nor can price adjustments be verified by an outside party.

SWEDEN

Expenditure ceilings were given a statutory basis in Sweden in 2009. Parliament decides expenditure ceilings on the basis of a government proposal, to which both Parliament and the Government are committed. Changes can be made to expenditure ceilings after they have been approved by Parliament, but any major deviations are likely to attract attention from Parliament and the general public. Expenditure ceilings have been applied successfully for over ten years.

In Sweden the possible concealment of structural problems has been taken into consideration by including cyclically sensitive items in expenditure ceilings. Thus any increase in unemployment creates pressure. Instead of excluding expenditure from ceilings, this has forced discussion of the efficiency of labour policy. As a result the Government has strived to reduce unnecessary payments and unemployment.[119] Besides the fact that including labour market payments in expenditure ceilings increases monitoring of trends, it forces the government to set priorities and make political choices. The inclusion of unemployment security and housing support expenditure in expenditure ceilings requires that high priority be given to labour market policy.

There is evidence of the accumulation of transfers in Finland, Sweden and the Netherlands. In other words the same people move from one support system to another, shifting for example from unemployment allowance to disability allowance. Since support systems have an effect on each other in that cutting costs in one system increases costs in another system, they should not be treated separately. For this reason Sweden's budgetary framework covers off-budget public pension expenditure as well as social security and labour market support.

119 Ljungman: Expenditure ceilings - A survey. IMF Working Paper No. 282, 2008, p. 41.

THE NETHERLANDS

In the Netherlands an incoming government decides binding ceilings on general government expenditure for its four-year term and makes a preliminary allocation between different sectors or an estimate of the ceiling in each sector (core functions of government, health care, labour market and social security). Expenditure is further allocated to about 25 budget chapters under these three sectors.

At the beginning of the annual budget process each line ministry submits a policy letter to the Ministry of Finance containing an updated estimate of expenditure based on policy measures, a qualitative and quantitative presentation of priorities for the following year and a request for additional appropriations to finance new policy measures. The Ministry of Finance compares the level of expenditure in policy letters with expenditure ceilings and evaluates what new policy measures can be implemented or whether there is a need to cut or shift spending.[120]

Fixed expenditure ceilings are adjusted annually at the beginning of the budget process using the gross fixed capital formation price index, which includes price development in consumption and investment in the private and public sectors. Although the adjustment is made according to real inflation, the use of this index does not keep inflation from creating room for manoeuvre inside the framework. This is because price development for different items is not the same. For example, items related to wages and salaries (civil servants' salaries, transfers tied to the development of wages and salaries) normally rise faster than other expenditure. Furthermore, in the Netherlands expenditure ceilings do not cover fixed medium-term expenditure such as interest costs or payments to the EU, which are not affected by inflation.

Expenditure ceilings cover all transfers resulting from aid schemes. Despite the cyclical sensitivity of unemployment benefits, the fact that they are covered by expenditure ceilings does not appear to have hampered a counter-cyclical fiscal policy. Because the system covers all transfers, attention is paid to the development of the total costs of the welfare state, regardless of what type of aid people receive. For this reason pension costs are also included in the system, since the ageing of the population is the biggest threat to the sustainability of public finances in the Netherlands. The procedure thus requires the proper examination of sustainability and fiscal policy.

The National Advisory Group on Budgetary Principles has recommended that all cyclically sensitive expenditure with the exception of interest payments should be included in the fixed-price expenditure framework, since unexpected changes in this type of expenditure tend to cancel out the pay and price inflation differential.[121] This is because cyclically sensitive expenditure and the general price level move in opposite directions. For example, in an upturn higher inflation caused by economic growth leads to an increase in civil servants' pay (nominal expenditure rises), but at the same time the cost of unemployment benefits normally falls. Similarly, during a downturn the slower rise in the general price level curbs nominal expenditure and therefore creates room for manoeuvre in the expenditure framework, but this is offset by a rise in social security expenditure, among other things.

The Economic Structure Improvement Fund was established in the Netherlands in 1993. The reason was the gradual fall in government investments in infrastructure over the years. The fund has used natural gas revenues to finance investments in infrastructure, research and innovation. The criteria used in deciding which projects to support have not been entirely transparent, however. Recently the National Advisory Group on Budgetary Principles has criticised the exclusion of investments financed by the fund from the expenditure framework, owing to the fact that natural gas revenues go directly to the fund. Windfall gains resulting from the rapid rise in energy prices have considerably increased the amount of money flowing into the fund, which has stimulated pressure to spend. Although investment decisions are based on cost-benefit analysis at the Central Planning Bureau (CPB), the quality of the investments made by the fund has been questioned.

120 Ljungman: Top-down budgeting - An instrument to strengthen budget management. IMF Working Paper 09/243, 2009, p. 7.

121 Bos: The Dutch fiscal framework: History, current practice and the role of the Central Planning Bureau. OECD Journal on Budgeting 8:1, 2008, p. 41.

AUSTRIA

The expenditure framework procedure that was introduced in Austria in 2009 calls for four-year rolling expenditure ceilings that are enacted by Parliament. The reason for supplementing the Government's policy programme with statutory expenditure ceilings was to provide a more coherent and detailed medium-term planning instrument. To make changes in the framework, the Government must take a clear stand by submitting a proposal to Parliament. In this way the medium-term expenditure framework has a firmer basis than a government plan and is more likely to result in measures that maintain financial stability.

In planning expenditure frameworks, special attention has been paid to keeping the framework procedure and budgeting separate processes. The framework proposal is approved by Parliament, which examines aggregate expenditure from the viewpoint of the economy and fiscal policy but does not examine appropriations at the item level. Expenditure at the item level is not discussed until the following budget negotiations. This has been considered a "best practice" among the members of the OECD, since the examination of expenditure ceilings at the item level would mean the need for Parliament to discuss the same budget twice in one year.

Austria's four-year expenditure framework includes ceilings for each chapter of the budget. Chapters are grouped under five headings or policy fields. The framework for the next year is binding at the chapter and heading levels. However, the frameworks for the three years after that are binding only at the heading level, so changes can be made at the chapter level within the allowed limits. This increases flexibility by taking into account the difficulties involved in medium-term forecasts. Each heading includes a small expenditure reserve for unexpected shocks. If a ministry builds reserves, these can be carried forward to subsequent years.

Frameworks are generally fixed, but more flexible frameworks tied to specific indices are set for items that are highly sensitive to cyclical fluctuations or dependent on aggregate revenues, such as unemployment benefits. In this case frameworks are automatically adjusted to changes in the relevant index. A rise in unemployment thus leads to a higher expenditure ceiling, while a drop in unemployment leads to a lower ceiling. The OECD has noted that entirely fixed ceilings with no flexible parts would improve the effectiveness of frameworks as a medium-term fiscal policy instrument.[122] Flexibility can be provided by an unallocated reserve. The risk in current practice is that frameworks can be circumvented by constantly adding new expenditure to flexible parts, in which case frameworks will become less binding over time.

122 Blöndal & Bergvall: Budgeting in Austria. OECD Journal on Budgeting 7:3, 2007, p. 49.

4 Legal framework of the spending limits procedure

4.1 Summary of audit findings

The central government spending limits procedure is based on a political commitment made in the Government Programme and on the implicit approval of the procedure by a majority of Parliament in a vote of confidence concerning the Government Programme. Parliament considers the Government's spending limits report each year, which increases political commitment to the procedure. Political commitment to spending rules on the part of Parliament and the Government is essential for the proper functioning of the spending limits procedure.

The effective exercise of Parliament's fiscal power under the Constitution, the openness and transparency required by the Constitution and the budget principles based on the Constitution can be used as quality standards that place demands on the preparation of fiscal policy and the information base used in this process.

Parliament is entitled to receive a true and fair view of the fiscal policy information base, policy options and their probable impacts. Achieving credibility and for this purpose supplying a true and fair view also require the openness and accuracy of forecasts and assumptions. From the viewpoint of legal quality standards it is problematic if risks and uncertainties regarding economic development are intentionally overestimated or underestimated or if uncertainty is glossed over. Uncertainties linked to the setting of objectives should also be pointed out clearly and openly where the policies in the Government Programme are concerned.

Off-budget funds total over 25 billion euros. This constitutes a significant deviation from Parliament's budgetary power. One should evaluate whether there are essential grounds, as required in section 87 of the Constitution, to arrange activities and financing through off-budget funds. If such grounds do not exist, funds should be made part of the budget economy.

From a legal perspective off-budget funds should be included in spending limits. Nor should the spending limits procedure provide incentives to use tax subsidies as a policy tool; tax subsidies should only be used when this is justified on the basis of effectiveness.

4.2 Legal basis of the spending limits procedure

The spending limits procedure and particularly the spending rules that are set in this procedure are based on a political commitment that is made in the Government Programme, which is required by section 62 of the Constitution. The legal basis of the spending limits procedure is thus quite narrow. Section 1 of the State Budget Decree mentions the preparation of spending limits as one stage in the drafting of the budget. The spending limits procedure has broader legal dimensions. Other legislation shores it up or touches on it.

A provision in section 12 (1) of the State Budget Act that entered into force at the beginning of 2010 reads as follows: "[123] *Ministries must plan social effectiveness in their field as well as finances and operational performance in their administrative sector on a multiannual basis. Agencies must plan their activities, finances and performance on a multiannual basis. Planning must produce the information needed in drafting the state budget and in other economic planning under the direction of the Government.*"

According to section 12 (2) further provisions regarding planning can be issued by Government decree. The economic planning under the direction of the Government that is mentioned in section 12 (1) refers particularly to the spending limits procedure. It also sets minimum requirements to ensure key information that ministries need in order to plan activities and finances.[124] In the reform of budget legislation emphasis was also placed on the need for the planning system to produce the information required to supervise each administrative sector, set performance objectives as part of this supervision and prepare spending limits and budget proposals.[125] The spending limits procedure was mentioned in preparatory documents, although it is not mentioned in the act itself. In a statement submitted on an interim report concerning the reform of budget legislation the National Audit Office pointed out that reference to the spending limits procedure in the act would give it at least an indirect legal basis.[126]

According to section 1 of the State Budget Decree, the preparation of the budget takes place in the following stages:

- Spending limits proposals are drawn up and the Government issues its spending limits decision.
- Budget proposals are prepared for government agencies.
- Budget proposals are prepared for administrative sectors and other entities.
- The Ministry of Finance's proposal for a draft budget to be submitted to Parliament is prepared.
- The proposal is discussed by the Government in plenary session.

Section 1 a (1) of the State Budget Decree refers to spending limits and the main stages in their preparation as follows: "*Each ministry shall submit its proposal for the framework of its own administrative sector to the*

123 See Government proposal 202/2009 vp. Government proposal to Parliament to amend the State Budget Act.

124 See Government proposal 202/2009 vp., p. 9, Government proposal to Parliament to amend the State Budget Act.

125 Ministry of Finance: Talousarviolainsäädännön kehittämishanke. Nykytilan kartoitus ja kehittämislinjausten alustava arviointi. Ministry of Finance Publications 27/2008, Helsinki, pp. 26–27.

126 National Audit Office statement 252/31/08 in an interim report on the development of budget legislation, 15.9.2008.

Ministry of Finance, which will draw up its own framework proposal for preparation of the budget proposal. Framework proposals on other items may also be submitted to the Ministry of Finance in accordance with the Government stipulations referred to in section 1 b."

On the basis of the State Budget Decree the ministries must prepare their own spending limits proposals and submit them to the Ministry of Finance. The ministry's permanent secretary has a legal obligation to supervise and verify that this is done in practice.

Provisions concerning the spending limits procedure can be issued by decree.[127] On the basis of the State Budget Act and the State Budget Decree, regulations concerning the procedure and the preparation of spending limits are issued by the Government and the Ministry of Finance. In 2003 the Government issued a new decision concerning the principles to be followed in preparing spending limits proposals, budget proposals and operational and financial plans.[128] This is supplemented by the Ministry of Finance's regulations on the preparation of spending limits and budget proposals.[129] According to the Government decision," *The Government will set spending limits for the electoral term and in this connection determine spending rules to implement the fiscal policy in the Government Programme and present other positions concerning central government finances and activities during the electoral term.*

"The Government will issue spending limits and related positions annually according to the spending rules for the electoral term and other positions concerning the electoral term"

According to the decision, spending limits are binding: *"The budget proposal for each administrative sector and policy programme will be prepared according to the spending limits procedure and other regulations.*

"The operational and financial plan for each administrative sector will be prepared on the basis of the spending limits decided by the Government, and the spending limits for the administrative sector included in them and other positions.

"The ministries can make proposals for development projects as necessary."

The binding nature of spending limits does not have legal consequences in the sense that non-compliance would lead to legal consequences. If a ministry fails to prepare its proposal within the framework of the spending limits, no legal action can be taken against the ministry as an organisation.

The spending limits decision is, however, a planning document issued by the Government to guide administrative preparation and financial planning. As such it must be taken into consideration but is not absolutely compulsory from a legal viewpoint. For example, refusing to prepare a spending limits proposal or a budget proposal within the framework of the spending limits decision could in principle be perceived as dereliction of official duties under legislation pertaining to state civil servants. Legally a minister can always be considered to have the right to make spending limits and budget proposals that exceed the agreed framework and to direct the preparation of such proposals by the ministry or its administrative sector and thus ministry personnel. In such a situation personnel must naturally follow the instructions

127 See also Government proposal 129/2007 vp., Government proposal to Parliament to amend the Local Government Act, in which this was emphasised.

128 Government decision on principles for preparing central government spending limits proposals, budget proposals and operational and financial plans. Issued 24.4.2003.

129 See Ministry of Finance regulation on operational and financial planning and the preparation of spending limits and budget proposals, Ministry of Finance TM 0802, 2.4.2008.

given to them by the minister under whom they serve. As a member of the Government a minister must of course apply the guidelines and instructions issued by the Government. In addition to obligations arising from political commitments and the Government's internal political and ethical rules, a minister can be considered to have an obligation to justify deviations from policies that have been decided jointly by the Government and are meant to be binding. This is not a legal obligation that falls within the sphere of the Ministerial Responsibility Act. However, refusing to submit a proposal that complies with the spending limits decision or to provide clear and valid justifications for a proposal that deviates from the agreed framework can be regarded as failing to meet the requirements of good governance.

The regulations issued by the Ministry of Finance on the basis of the State Budget Act and the State Budget Decree contain instructions on the preparation of spending limits proposals and underline their binding nature. The Ministry of Finance is reforming these regulations. In October 2010 a working group appointed by the Ministry of Finance, which includes experts from different ministries and the National Audit Office, prepared a proposal for new instructions concerning the preparation of spending limits proposals. The working group requested statements on the proposal from ministries and the National Audit Office in October–November 2010.[130]

The proposal calls for the clarification of the binding nature of the spending limits decision. The new regulations, like those that have been in force since 2008, would state that a ministry should prepare its budget proposal in accordance with the spending limits adopted by the Government. An additional point would be added concerning the presentation of a budget proposal deviating from the spending limits decision. This would If the minister in charge of an administrative sector has justified reasons to submit a proposal exceeding the appropriations allocated to the administrative sector in the spending limits decision, this must be done in a separate appendix from the budget proposal covering the level of funds allocated in the spending limits decision".[131] The instructions would thus make clear that a minister can still submit a proposal deviating from the spending limits decision if necessary, but this must be justified by the minister. Furthermore, the new wording would spell out the obligation of the ministry as an organisation and ministry personnel as individuals to prepare a budget proposal in line with the spending limits decision. The reformed regulations would also set requirements regarding form and procedure if a proposal deviates from the spending limits decision.

The proposal is aimed at strengthening good governance and ensuring an appropriate division of labour in preparing the state budget proposal. Currently the trimming of budget proposals exceeding the spending limits has all too often been left up to the Ministry of Finance. This allows other ministries to shift some of their responsibility for planning and preparation to the Ministry of Finance in an inappropriate way. The Ministry of Finance does not always have the time or information base needed to bring budget

130 Decision establishing a working group on the development of the budget and the spending limits procedure, Ministry of Finance decision 147:00/2009, 19.11.2009. In addition to the Ministry of Finance and the National Audit Office, the working group includes members from the Ministry of the Interior, the Ministry of Defence and the Ministry of the Environment, and one of the secretaries is from the State Treasury. Auditor General Tuomas Pöysti participated in the working group on behalf of the National Audit Office. Concerning the working group's proposals see Ministry of Finance request for statements 25.10.2010 in project MoF147:00/2009.

131 Ministry of Finance request for statements 25.10.2010 and the appended working group proposal, request for statements 25.10.2010 in project MoF147:00/2009.

proposals in line with spending limits, however. Revising the regulations would clarify that a ministry must always prepare an alternative budget proposal that complies with the spending limits. The aim is to strengthen ministries' responsibility and possibilities to allocate funds in their main divisions and to dispel the idea of focusing and enforcing the spending limits decision at the item level.[132]

The binding nature of the spending limits decision as a planning document would therefore be more administrative and political and linked to the Government's internal rules in an ethical sense rather than binding in a strictly legal sense and enforced with sanctions.

The provision in the State Budget Decree is based on section 10 a of the State Budget Act: "Provisions concerning the stages of and procedures to be followed in the preparation of the budget proposal may be issued by Government decree." The relevant government proposal (188/199) briefly pointed out that the submission of the budget proposal is prescribed in section 83:2 of the Constitution. It also emphasised that provisions at the practical level concerning the preparation of the budget proposal will continue to be issued by decree. The provisions in section 6:1 (4) of the Act on the Openness of Government Activities (621/1999) regarding the publication of budget proposals and related proposals have been taken into consideration in the decree.[133] Unless otherwise provided with regard to the publicity or secrecy of a document or some other restriction of access to information, with regard to budget proposals a document prepared by an authority enters the public domain as follows:

"The budget proposals of ministries and the agencies in their administrative sector enter the public domain when the Ministry of Finance has signed its first position on the budget proposal; thereafter, the proposals submitted to the Ministry of Finance by the other ministries and other proposals prepared for and included in the budget proposal enter the public domain when the budget proposal has been submitted to Parliament".

Spending limits are also mentioned in section 14:2 of the Government Decree on Regional Authorities (906/2009) and in section 21:2 of the Government Decree on Centres for Economic Development, Transport and the Environment (910/2009).[134] The provisions underline the significance and role of the spending limits decision in operational and financial planning.

The fact that provisions regarding spending limits are primarily at the decree level does not mean that the spending limits procedure is not important from the viewpoint of legal assessment in many respects. Section 12:1 of the State Budget Act, which was amended at the beginning of 2010 by act 1096/2009, also refers indirectly to the spending limits procedure. It says that ministries must plan the effectiveness of operations as well as finances and operational performance in their administrative sector several years ahead. Planning must produce the information necessary in preparing the budget and otherwise planning finances under the direction of the Government. According to the commentary to the government proposal, planning finances under the direction of the Government refers specifically to the current spending limits procedure but also

132 Interview with Tuomas Pöysti.

133 Government proposal 188/1999 vp. Government proposal to Parliament to amend the State Budget Act.

134 This mainly regards the preparation of strategy documents.

includes any other financial planning processes taking place under the Government's direction.[135] When the Act on Client Fees in Social Welfare and Health Care and sections 29 b and 29 d of the Social Welfare Act were reformed, preparatory documents referred expressly to the spending limits decision for 2008–2011.[136] Numerous other legislative proposals are likewise tied to spending limits. They influence what legislative reforms can move forward in the Government and Parliament. The operational policies in the spending limits decision have often outlined key legislative projects for central government finances and activities. The Better Regulation project, conducted under the direction of the Ministry of Justice, has prepared process descriptions concerning the drafting of legislation. In these process descriptions one stage is the description of connections between a legislative project and spending limits. The spending limits decision can also lead to the cancellation or postponement of a legislative project. The thorniest problem arises if a legislative project proceeds even though the required funds are not available on the basis of spending limits and the ministry cannot or will not reallocate resources in its administrative sector.[137]

Legally binding provisions and particularly the budget principles prescribed in the Constitution can indirectly have a key significance for spending limits. Attention must also be paid to the principles of good governance, including the provision of a true and fair view to support decision-making. This is linked essentially to the exercise of Parliament's budgetary power.

135 Government proposal 202/2009 vp. Government proposal to Parliament to amend the State Budget Act, detailed justification regarding section 12.

136 See Government proposal 37/2008 vp. Government proposal to Parliament to amend sections 29b and 29d of the Act on Client Fees in Social Welfare and Health Care.

137 With regard to Sweden see Regeringskansliet, Finansdepartementet: Stärkt finanspolitiskt ramverk - översyn av budgetlagens bestämmelser om utgiftstak. Ds. 2009:10, Stockholm, p. 5.

4.3 The spending limits procedure and Parliament's budgetary power

In the literature some authors have argued that the spending limits procedure has restricted Parliament's budgetary power, on the grounds that power has in practice been shifted to the Government and particularly the Ministry of Finance.[138] The issue will not be analysed on such a general level in this report, which will instead look at factors that could weaken Parliament's budgetary power from a legal perspective. The point of departure is the real effectiveness of Parliament's fiscal power and budgetary power as part of it.

According to section 3:1 of the Constitution, *"Legislative power is exercised by Parliament, which also decides on state finances."* Budgetary power is not mentioned in this section, which speaks of finances instead. It is true that other sections of the Constitution dealing with finances focus on the budget and budget proposal. Looking only at the letter of the law, one could draw the conclusion that the spending limits decision is not part of this whole. In the worst case an improper spending limits decision could erode Parliament's real budgetary power. This is unacceptable. First of all, if a spending limits decision has been prepared improperly, Parliament can disregard it in deciding on the budget. Secondly, even if a spending limits decision offers true and fair information, in exercising its budgetary power Parliament can disregard it, citing section 3 of the Constitution for support. Although Parliament has in practice gone along with the spending limits decision up to now, it does not have any legal obligation to do so and can therefore deviate from spending rules.[139] Therefore the spending limits procedure does not restrict Parliament's budgetary power formally with regard to content or procedural rules. In this respect the Finnish system differs considerably from the systems in other countries where procedures based on the constitution or legislation restrict the ability of the Government or Parliament to decide on the budget in a way that disregards fiscal policy rules.

From the viewpoint of the real effectiveness of Parliament's fiscal power, it is significant that the spending limits procedure and the spending rules applied in it are outlined in the Government Programme. Section 62 of the Constitution requires that the Government submit its programme to Parliament in the form of a statement. After discussing this statement Parliament generally holds a vote of confidence. In practice the Government Programme must therefore enjoy the active support of a majority of MPs, or at least a majority of MPs must refrain from opposing it. Parliamentary consideration and approval of the Government Programme also give democratic legitimacy to it and to any spending rules it may contain. From the viewpoint of the parliamentary system of government, this essentially reduces tension between the spending limits procedure and Parliament's

138 See for example Harrinvirta & Puoskari: Kehysbudjetointi poliittisena päätöksentekoprosessina. Kansantaloudellinen aikakauskirja 3/2001, p. 455–457.

139 See also National Audit Office: Finanssipolitiikan sääntöjen tarve, National Audit Office Studies and Reports, 2000, Helsinki, p. 53 together with references.

budgetary power. Parliament's budgetary power specifically means deciding on the broad outlines of economic and fiscal policy rather than formally scrutinising and amending individual items in the Government's budget proposal.

According to the procedure applied in 2003–2006 and 2007–2010, the Government submits spending limits to Parliament in the form of a statement. A vote of confidence cannot be held with regard to a statement as such.

In practice, besides preliminary debate in plenary session, the statement is broadly discussed in Parliament's special committees as well as the Finance Committee and its various subcommittees. The Finance Committee subsequently prepares its report, which contains a proposal for Parliament's position on the statement. The report and position are debated in plenary session in a single reading, and Parliament then approves a position on the statement. In this position a majority of MPs either support or have no objections to the views and policies expressed in the statement. In its position Parliament also presents other matters that it considers important.[140] In handling the first spending limits statement in the electoral term 2007–2010, Parliament voted to approve the position in the Finance Committee's report and to forward it to the Government for information and the necessary measures.[141] The Finance Committee's report proposes that Parliament should accept the statement without objections.[142]

The Finance Committee's report on the spending limits statement often discusses appropriations that are of special interest to MPs in considerable detail and also evaluates general economic development and economic and fiscal policy issues. In dealing with individual appropriations the Finance Committee often expresses wishes concerning additional funds for certain purposes and projects. In its report on the spending limits statement, unlike its report on the budget proposal, the Finance Committee does not have an obligation to indicate how additional expenditure can be financed, by cutting other expenditure, raising taxes, borrowing money or selling assets. Failure to consider wishes for additional appropriations in the report on the spending limits statement and interpreting these as one-off appropriations in connection with the handling of the budget proposal are in practice a major cause of political friction between the Government and Parliament. This can also be viewed as resentment and criticism regarding the restriction of Parliament's budgetary power by the spending limits procedure.

In Finance Committee report 9/2008 on Government statement 2/2008 the Finance Committee questioned whether the spending limits decision needs to be discussed each year in the form of a statement or whether the procedure could be streamlined. The committee considered it necessary to handle the first spending limits decision in an electoral term in this way, but not subsequent spending limits decisions if they mainly contained technical adjustments. On the other hand, if

140 See for example parliamentary consideration of Government report 2/2010 on spending limits for 2011-2014 and the position in Parliamentary communication 12/2010 vp., which states that Parliament has approved a position according to the proposal in the committee report. (1) Parliament concurs with the positions and policies in the report and (2) Parliament calls for the Government to take measures to ensure the sustainability of public finances and particularly to promote employment and economic growth. The year before, after considering Government report 3/2009 on spending limits for 2010-2013, Parliament noted that it had no objections to the report but called for the Government to monitor the economic and employment situation closely and to reevaluate the adequacy of measures if necessary, see Parliamentary communication 10/2009 vp. - Government report 3/2009 vp. and Finance Committee report 9/2009.

141 See Government report 1/2007 vp. and Parliamentary communication 15/2007 vp.

142 See Ministry of Finance report 6/2007 vp.

subsequent spending limits decisions contained significant changes in policies and views, this would call for the submission of a statement as in the past. The National Audit Office considers that measures should be taken to streamline the statement procedure as suggested by the Finance Committee, provided it does not result in a narrowing of Parliament's budgetary power.

Finance Committee report 6/2007 on Government statement 1/2007 criticised the first spending limits decision approved by the incoming Government for the electoral term 2007–2010 on the grounds that the spending limits procedure does not provide possibilities to react to sudden spending needs. It made reference to Finance Committee report 4/2006 on Government statement 2/2006, which called for increased flexibility and possibilities to reevaluate appropriations during the spending limits period if the level of appropriations turns out to be clearly inadequate. Determining whether the level of appropriations is adequate should also play an important role in the exercise of Parliament's budgetary power. Such cases vividly display the tension between legal and political institutions. Finance Committee report 6/2007 nevertheless pointed out reforms in the spending limits system for the electoral term 2007–2010 aimed at increasing flexibility and expressed satisfaction with these. The committee considered that the most significant structural issue in the spending limits system was the possible division into investment and operational expenditure. In reforming the spending limits system attention should be paid to clarifying the treatment of investment and operational expenditure. The committee noted that investments strengthen the entire economy's growth potential and that separate spending limits could have been prepared for them.[143]

The Finance Committee has emphasised that the Government should take Parliament's budget decisions into consideration better because budgetary power is vested in Parliament. This also refers to the small increases in budget proposals that Parliament approves each year that can be regarded as having a longer scope than the current fiscal year.[144] The Finance Committee has drawn attention to this matter several times.[145] for example in the following position: "Parliament calls for the Government to take into consideration increases in appropriations that are intended to be permanent and to establish them on such a level that Parliament does not have to correct the situation annually in connection with the handling of the budget.[146] It should be pointed out that the Government does not have a legal obligation to comply with the Finance Committee's views. As part of the preparation of fiscal policy it is the task of the Government and the Ministry of Finance to evaluate fiscal policy as a whole and the financing of functions as a whole. The Finance Committee's reports display tension between microeconomic, fiscal policy viewpoints and the focus on details in spending limits and the budget. This is largely a matter of political evaluation in which the presentation of a proposal is up to the Government, which must enjoy Parliament's confidence, but in handling the budget Parliament can make changes if it sees fit.

In approving the budget Parliament has required that the spending limits for the com-

143 Ministry of Finance report 6/2007 vp.

144 Ministry of Finance report 6/2007 vp. - Government report 1/2007 vp.

145 Ministry of Finance report 4/2005 vp. - Government report 1/2005 vp.

146 Ministry of Finance report 33/2008 vp. Government proposal 116/2008 vp, Government proposal 199/2008 vp.

ing electoral term should from the beginning contain sufficient funds for the long-term development and maintenance of transport infrastructure and the improvement of public transport, for instance. From the viewpoint of Parliament's budgetary power it can be considered problematic if the spending limits decision does not contain clear implemental increases for basic infrastructure management or decisions on new development projects. On the other hand the idea is that the Government has pledged to prepare the spending limits statement – which has been considered a good and justified solution – because this allows Parliament to play a more central role in deciding on transport policy over the long term.[147] Parliament's clear role particularly in the long-term planning of transport structure investments is justified from the perspective of the effective exercise of Parliament's fiscal power.

147 Ministry of Finance report 6/2007 vp. - Government report 1/2007 vp.

4.4 Budget principles as criteria of the openness of the spending limits procedure

4.4.1 Direct application of budget principles

On the basis of the literature and working group reports, budget principles form a heterogeneous group.[148] In a legal sense the only budget principles that have relevance are those that are legally binding and are thus prescribed in the Constitution or the State Budget Act or can justifiably be derived from them. It should also be pointed out that not all budget principles, even if they are legally binding, have relevance with regard to the spending limits procedure. Budget principles are not strictly defined norms but inevitably leave room for interpretation concerning whether or not a principle has been applied.

Section 1 of the State Budget Decree lists the spending limits procedure as one stage in the drafting of the budget. Section 83:1 of the Constitution concerns the state budget but does not mention stages in the drafting of the budget: "Parliament decides on the state budget for one fiscal year at a time. It is published in the Statutes of Finland." This clearly calls for the approval of the budget for a single fiscal year[149], which is at odds with the spending limits procedure, in which the aim is longer-term fiscal planning.[150] It also requires the publication of the budget in the Statutes of Finland, but this does not extend to spending limits.

The Constitution also contains provisions on the submission of the budget proposal, for instance in section 83:2. As a rule the Constitution concerns either the budget as a whole or the budget proposal and not decisions on spending limits. On this basis one can tentatively conclude that the provisions in the Constitution do not apply directly to the spending limits procedure or spending rules.

The many details in those parts of the Constitution that concern the budget reveal that the budget principles prescribed in the Constitution do not have direct legal weight with regard to the spending limits procedure. For example, section 84:1 of the Constitution reads as follows: "Estimates of annual revenues and appropriations for annual expenditure as well as reasons for appropriations and other justifications shall be included in the state budget." The spending limits procedure deviates from this firstly in that it only considers expenditure and not estimated revenues. According to international recommendations and the literature, however, spending rules and thus the spending limits procedure should be based on a complete picture of the current state, development and balance of public finances as a whole, which means that revenues should also be taken into consideration.[151] With regard to the justifications for appropriations, one should note that the key idea in the spending limits procedure is to stay within spending limits and not to

148 See Lahtinen & Mäki-Fränti & Määttä & Volk: Valtion talousarvioiden verotuloennusteiden osuvuus, Audit Committee publication 1/2009, Parliament, pp. 76–98 together with sources.

149 Concerning this point see Tuori: Budjetti, laki ja suunnitelma, Ministry of Finance/Public Management Department, 1985, Government Printing Centre. Helsinki, pp. 105–108.

150 See Harrinvirta & Puoskari: Kehysbudjetointi poliittisena päätöksentekoprosessina, Kansantaloudellinen aikakauskirja 3/2001, p. 446.

151 See International Monetary Fund: Code of Good Practices on Fiscal Transparency, IMF Manual on Fiscal Transparency, IMF, Washington D.C., 2007.

specify in great detail how each appropriation will be allocated. The first sentence in section 84:2 of the Constitution is likewise at odds with the spending limits procedure: "The revenue estimates in the budget shall cover the appropriations included in it." This is for the simple reason that revenue estimates do not have direct significance from the viewpoint of the adjustment of spending limits each year. Of course the goal is to keep expenditure from reaching such a high level that revenues are inadequate to cover it. In this respect the reform of the spending limits procedure in 2003 brought the system more closely in line with the current recommendations of the International Monetary Fund and the content of budget principles in that spending limits decision include an examination of the balance of central government finances.[152]

On the whole it is fair to say that the wording of the Constitution does not support the direct application of provisions concerning state finances to the spending rules procedure but only to the budget and the budget proposal. The above discussion of provisions in the Constitution likewise reflects this viewpoint. One should also note that the budget and spending limits have different functions: spending limits are a planning instrument prepared to curb expenditure over the medium term, while the budget is a decision-making instrument designed for the annual allocation of appropriations and revenues.

The budget principles in the Constitution require Parliament to decide on the budget annually. The concept of multiannual budgeting is contained in a provision that allows certain revenues and expenditure immediately linked to one to another to be included in the budget. This provision has not been given concrete content in preparatory documents or practice. The essential thing is that the Constitution even in its present form has nothing to say about a system in which Parliament decides in a legally binding way on spending limits covering more than one year. Since the Constitution speaks of approving the budget for one fiscal year at a time, tying the approval of the budget to a multiannual decision that Parliament has approved in the past cannot be done by enacting legislation in the normal order. It is possible, however, that Parliament can enact legislation setting multiannual ceilings that govern the preparation of the budget proposal and financial planning or enact legislation setting fiscal policy rules that concern other aspects of planning and preparation. This issue is also addressed in section 8.3.2 in considering the possible need to enact provisions regarding fiscal policy rules and spending limits.

4.4.2 Indirect applicability of budget principles

Budget principles can be thought of as determining the constitutionally derived quality criteria that apply to budgeting. In this way they also influence the content of openness, transparency and other general principles of good governance.[153] Budget principles thus have indirect legal weight as far as the preparation of spending limits is concerned. Budget principles also crystallise what can be regarded as economically justified procedures on the basis of economic rationalism

152 This was a significant change in the 2003 reform of the spending limits system compared to previous practice, in which expenditure ceilings were presented only by administrative sector. Owing partly to this change the concept of budgetary frameworks was introduced. See Ministry of Finance: Fiscal Policy Rules and the Reform of Spending Limits in Finland, Working group report 7.2.2003.

For the theory behind this approach see Pöysti: Communicational Quality of Law – a Legal Informatics Perspective. In Cecilia Magnusson Sjöberg & Peter Wahlgren (eds.), Festsrift till Peter Seipel. Norstedts Juridik, 2006, pp. 463-493.

as well as the economic literature and the recommendations of international economic cooperation organisations into normative messages concerning the Constitution and budget legislation. For example, the IMF Code of Good Practices on Transparency in Fiscal Policy contains key budget principles that are also considered legally binding in Finland. Attention can be drawn particularly to the principles of completeness and accuracy/reliability.

According to the principle of completeness, budget revenues and expenditure must be estimated as accurately as possible.[154] The budget must therefore include estimates of all expected revenues and appropriations to cover all expected expenditure.[155] Revenues and appropriations should correspond to the anticipated amounts.[156] Applied to spending limits this principle would mean that expenditure should be included as comprehensively as possible. This can be justified on the grounds that otherwise the spending limits would give a misleading picture of the amount of public expenditure. This would lead to incorrect conclusions regarding the achievement of the objectives set in the spending limits procedure and would provide an incentive for different parties to demand that expenditure should be excluded from the spending limits in their particular case.[157] According to the principle of reliability, revenue and expenditure items should be included in the budget with the greatest possible accuracy.[158] During the drafting of the budget provisions in the Constitution, the principle of reliability was sometimes referred to as the principle of accuracy. Revenues and expenses must be estimated according to anticipated outcomes.[159] With regard to the spending limits procedure the principle can be interpreted as requiring that the estimates of expenditure included in the spending limits are as accurate as possible. In keeping with the principle of completeness and the requirement that appropriations must cover all expenses, the evaluation of total revenues and the balance of central government finances should also be as accurate and reliable as possible.

From the viewpoint of the principle of reliability and accuracy, essential questions in preparing fiscal policy and providing information to Parliament and the public are the reasoning and basic assumptions behind sustainability calculations and forecasts as well as the measures used to achieve objectives. Another sensitive and significant question involves risks associated with economic development. Reliability and accuracy combined with the openness and transparency of the fiscal policy information base require that basic assumptions and risks are presented openly and as reliably as possible in budgeting. Basic assumptions are also related to effectiveness chains and major risks regard-

154 See particularly the first sentence in section 84:1 of the Constitution as well as Government proposal 133/2002 vp., Government proposal to Parliament to amend the State Budget Act. See also Ministry of Justice reports and statements 53/2010, Valtion talousarvion tasapainottaminen. Perustuslakisääntelyn muutostarve. Helsinki. This report proposes a revision of the principle of completeness.

155 Government proposal 262/1990 vp. Government proposal to Parliament to amend provisions in the Constitution Act and the Parliament Act.

156 This should not be confused with the requirement that revenues must cover all appropriations in the budget. Concerning this requirement see National Audit Office performance audit report 168/2008, The state's cash management. Helsinki 2008. See also Ministry of Justice reports and statements 53/2010, Valtion talousarvion tasapainottaminen. Perustuslakisääntelyn muutostarve. Helsinki 2010.

157 See also Tullock: The Welfare Costs of Tariffs, Monopolies, and Theft. Western Economic Journal 5:3, 1967, p. 224–232, which uses the term rent-seeking for this phenomenon.

158 See for example Vesanen: Valtiontalouden hoidosta. Suomalaisen Lakimiesyhdistyksen Publications series B No. 151. 1970, Porvoo, p. 91 and Lahtinen & Mäki-Fränti & Määttä & Volk: Valtion talousarvioiden verotuloennusteiden osuvuus, Parliamentary Audit Committee publication 1/2009, Helsinki, pp. 87–88.

159 See Perustuslaki ja valtiontalous. Perustuslakien valtiontaloussäännösten uudistamiskomitean mietintö, Committee report 1990:7, p. 122.

ing the effectiveness of measures. In its audit findings the National Audit Office has often drawn attention to the failure to identify connecting mechanisms between objectives and results and regarded this as an essential shortcoming in the setting of objectives.[160] In a system based on openness and transparency the desired results cannot be based merely on hopes or unspecified measures.

With regard to completeness, it is noteworthy that only about 73 per cent of budget appropriations have been included in the spending limits for the electoral term. The amount of expenditure excluded from the spending limits for 2011–2014 has been estimated at 12.3 billion euros for 2011[161], while the adjusted spending limits at the 2011 price level is about 38 billion euros. The excluded expenditure, which mostly varies according to the business cycle and automatic stabilisers, is closely linked to certain revenue items or transfers in which the state technically acts as an intermediary. Although this type of expenditure is not included in the spending limits, in keeping with the principles of completeness and reliability these items should also be estimated as comprehensively and reliably as possible in the spending limits decision. In this respect the Government's spending limits decision for 2011–2014 and the procedure applied in 2007–2010 can generally be considered appropriate.

As a quality standard the principle of completeness can be viewed as requiring at least a general estimate of all revenues and expenditure in connection with the spending limits decision. As an indirect quality standard one cannot derive from this principle the requirement that spending rules should cover all expenditure: spending rules can be designed to focus only on expenditure that needs to be curbed on fiscal policy grounds. Objectives regarding the long-term sustainability and balance of public finances must, of course, take into account the development of expenditure that has been excluded from the spending limits, since this must be financed as well.

The incomplete scope of spending limits is undoubtedly a key problem in Finland's current fiscal policy rules.[162] The OECD drew special attention to this problem in its economic survey for Finland because the cost pressures caused by the ageing of the population will particularly affect municipal services and social security funds.

In the light of the budget principles prescribed in the Constitution, off-budget funds are highly problematic. In the Constitution such funds are viewed as an exception to the principle of completeness, and they restrict Parliament's budgetary power. Section 87 of the Constitution sets conditions for off-budget funds and requires a two-thirds majority vote to establish a new fund or substantially expand an existing fund or its purpose. Off-budget funds have been created in the course of historical development and each one can be viewed as a special case. In some respects the development and growth of funds may have been influenced by the fiscal policy planning systems and rules adopted by the Government. For instance, if reducing total expenditure in the budget is an economic

160 See National Audit Office's separate report to Parliament R 12/2009 vp., particularly findings regarding effectiveness information in the Report on the Final Central Government Accounts, and Audit Committee report 1/2009 vp.

161 In the following years expenditure outside the spending limits is expected to grow slightly in absolute terms but not as a percentage.

162 Harrinvirta & Puoskari: Kehysbudjetointi poliittisena päätöksentekoprosessina, Kansantaloudellinen aikakauskirja 3/2001. Although this paper is about 10 years old, it is relevant even though spending limits have been reformed.

policy objective, there is an incentive to arrange certain kinds of social benefits through off-budget funds. The historical development of the Housing Fund of Finland can serve as an example of this.

Off-budget funds are important financially. According to the information summarised in the Report on the Final Central Government Accounts for 2009, based on funds' final accounts for 2009, off-budget funds' equity totalled 23.9 billion euros. Investments made by the State Pension Fund to prepare for the payment of future pensions accounted for 10.6 billion euros. Off-budget funds had total assets of 25.8 billion euros in 2009. Large amounts of money are transferred in this sector. In 2009 off-budget funds paid about 744.6 million euros in support, which is booked as transfers in central government accounting. Some of this would have been covered by the spending limits for 2007–2010 had it been included in the budget economy. In 2009 different forms of support through off-budget funds such as the Housing Fund of Finland were increased to stimulate the economy, and measures had a considerable fiscal policy impact. This must be kept in mind in evaluating the need to develop the spending limits system and how well and on what conditions the system has allowed stimulus measures.

The statutory tasks of some off-budget funds could be performed just as well within the state budget. By amending legislation pertaining to these tasks and related financing, it would also be possible to accomplish funds' purpose and social objective if they were included in the state budget. To comply with the objectives and principles in section 87 of the Constitution, regular evaluations should be conducted regarding the need for off-budget funds as a whole and individually in the current situation and also whether the performance of "permanent tasks" requires this "in an essential manner", as stipulated in section 87 of the Constitution.

In 2009 the National Audit Office conducted a performance audit regarding the steering and administration of off-budget funds.[163] On the basis of the audit, the information that is received by Parliament concerning funds' activities is meagre and the off-budget position of funds reduces Parliament's budgetary power. The Report on the Final Central Government Accounts does not provide a true and fair view of off-budget funds in response to Parliament's requirements as outlined in connection with reforms aimed at developing financial reporting and accountability. Critical findings can also be extended to the spending limits procedure. In connection with the preparation of spending limits the Ministry of Finance compiles provisional statements of source and application of funds according to the ministry's instructions and the form appended to them for off-budget funds as well.[164] These statements or summaries are not included in the spending limits decision or appended to it in any way and are therefore not covered by the spending limits report that is submitted to Parliament.[165]

Furthermore, separate information on off-budget funds is not provided in the spring economic review. This is compiled and pub-

163 National Audit Office: The steering and administration of off-budget funds. National Audit Office performance audit report 184/2009. Off-budget funds are also examined from the viewpoint of fiscal policy and budgeting in the National Audit Office's separate report to Parliament on the audit of the final central government accounts for 2008 and the Report on the Final Central Government Accounts, R 12/2009 vp.

164 See Ministry of Finance regulation on operational and financial planning and the preparation of spending limits and budget proposals, Ministry of Finance TM 0802, 2.4.2008.

165 See for example Ministry of Finance: Central government spending limits for 2011–2014, MoF/2202/02.02.00.00/2009.

lished by the Economic Department at the Ministry of Finance in connection with the spending limits decision and has been expressly referred to as background material in the decision since 2010.[166] The economic review also examines central government finances and the balance of finances (net lending/borrowing) according to the concepts used in the national accounts, in which case the examination includes off-budget funds with the exception of the State Pension Fund. Statistics Finland made changes in the classification system used in the national accounts in 2010 and as a result the State Pension Fund is considered part of the employment pension institutions sector rather than the central government sector. The economic review separately mentions net lending/borrowing and the total surplus in off-budget funds, including the State Pension Fund. A complete picture of off-budget funds cannot be obtained from the economic review.

Parliament can of course obtain information on off-budget funds on the basis of the data collected by the Ministry of Finance. Criteria regarding transparency and openness and the provision of a complete picture of central government finances in an easily accessible form are not met, however. From a legal perspective, there are good reasons to reevaluate the relation between the spending limits system and the funding of permanent tasks arranged through off-budget funds. This issue will be addressed from the viewpoint of the effectiveness of fiscal policy in a later section of this report.

With regard to comprehensiveness, state-owned companies that perform special tasks can also be problematic in principle. The Limited Liability Companies Act allows the use of this form of company for other purposes besides profit-seeking business operations, with procedural provisions that are quite broad and flexible. Companies that have only a small number of shareholders and particularly companies in which the state is the sole shareholder can easily be given non-profit tasks in the articles of association, which can include public administration tasks. Consequently state-owned companies can signify a deviation from Parliament's budgetary power and weaken the overall picture of central government finances and the steering of central government activities as a whole. Activities can also be arranged in this form to circumvent the constraints of the spending limits system. This issue has been brought up in connection with investments in transport infrastructure, for example. The tight constraints that the spending limits impose on investments have stimulated discussion concerning new financing models in which expenditure would be excluded from the spending limits. Arranging public administration and service tasks in limited company form signifies a deviation from Parliament's budgetary power and should therefore by justified in terms of activities and effectiveness. In evaluating the spending limits procedure and fiscal policy rules in general from a legal perspective, it is important to ensure that fiscal policy instruments do not create unjustified incentives to rearrange activities in company form or otherwise shift them outside the budget.

Tax subsidies present another challenge with regard to comprehensiveness.[167] The aim has been to keep the spending limits

166 See Ministry of Finance: Central government spending limits for 2011–2014, MoF/2202/02.02.00.00/2009 and Ministry of Finance: Economic Survey, spring 2010, Ministry of Finance Publications 17a/2010.

167 See for example OECD: Tax Expenditures in OECD Countries, 2010, Paris. See also National Audit Office audit report 141/2007, Tax Subsidies - Achievement of Accountability. Helsinki 2007.

procedure as simple as possible, and as a result tax subsidies have not been included in the spending limits system. The expert group that was appointed by the Ministry of Finance to evaluate and develop the spending limits system concluded in its report that presenting the value of tax subsidies can be difficult and that including tax subsidies in the system is complicated administratively. The Parliamentary Audit Committee has emphasised the need to develop methods so that tax subsidies can be evaluated along with direct subsidies.[168] Parliament's position is justified by the fact that tax subsidies can often be viewed as alternatives to direct subsidies or income transfers.[169] Parliament's position has in fact led to a thorough study of tax subsidies and the presentation of information concerning tax subsidies in the commentary to the relevant revenue items in the budget proposal.[170] According to the principle of completeness and comprehensiveness, lost revenues resulting from policies that are meant to achieve the same purpose as expenditure should in principle be examined in connection with the spending limits. Technical difficulties related to evaluating and presenting tax subsidies must naturally be taken into consideration and can be taken into consideration. From the viewpoint of Parliament's fiscal power, in the spending limits procedure it is important to evaluate the current state of public finances as a whole and to present true and fair information on which to base this evaluation.

The spending limits decision should be subjected to ex-ante and ex-post control. In ex-ante control it is important for the spending limits decision to describe the information base and basic assumptions that underlie it. In ex-post control it is necessary to evaluate how accurate expenditure estimates have proved to be and how well the spending limits have curbed growth in expenditure. According to the principle of reliability, it is necessary in any case to determine whether actual figures have deviated substantially from expenditure estimates in an earlier spending limits decision. An integral part of this is investigating the reasons behind deviations.

On the whole, in preparing the spending limits particular attention should be paid to the principles of completeness and reliability as discussed above. This also provides a means to ensure a coherent and logical process in drafting spending limits and the budget. Budget principles have been written into law to protect Parliament's budgetary power[171], and the principles of completeness and reliability should be kept in mind against this background as well.

168 Audit Committee statement 2/2009 vp. - Government report 3/2009 vp. and Audit Committee report 5/2010 vp. - R 11/2010 vp., R 13/2010 vp.

169 The National Audit Office has already drawn attention to this matter for example in report 13/2010 vp., National Audit Office's separate report to Parliament on the audit of the final central government accounts for 2009 and the Report on the Final Central Government Accounts.

170 Government Institute for Economic Research: Verotuet Suomessa 2009, Policy reports 5, October 2010. Beginning with the budget proposal for 2011, the commentary to the budget proposal has included an examination of tax subsidies, and these are also examined in the commentary to relevant revenue items. In a statement on the 2011 budget proposal the Audit Committee considered this an improvement compared with past practice. The Audit Committee emphasised the importance of examining central government finances as a whole, particularly in the face of a serious sustainability gap. In this case it is important to study the development of debt, borrowing, the amount of tax subsidies and their impact on accumulated tax subsidies. See Audit Committee statement 6/2010 vp.

171 This was stressed for example in Tuori: Budjetti, laki ja suunnitelma, Ministry of Finance Public Management Department, 1985, State Printing Centre. Helsinki, p. 23.

4.5 EU aspects of fiscal policy rules

Legal discussion and evaluation regarding fiscal policy rules and instruments have traditionally taken place on the basis of national institutions. The greater role that is nowadays played by European institutions means, however, that the content of fiscal policy, fiscal policy procedures and national budgeting legislation are increasingly influenced by European Union law and broader European law.

The content of the openness, transparency and objectivity of fiscal policy procedures and instruments as legal principles is determined by international sources such as the Council of Europe's recommendations on good governance and the principles of good governance contained in the EU Charter of Fundamental Rights and European Union law in general. Thus the concept of open, efficient and objective administration and good governance steadily receives more influences from the common European legal tradition. This can considerably reshape principles' content over the long term.

European Union law has a direct influence on the content of the member states' fiscal policies. The Economic and Monetary Union and the Stability and Growth Pact, which is a key part of it, also contain legally binding provisions, legal norms. These include the obligation to avoid excessive deficits, procedural provisions applying to the preparation of a stability programme and the avoidance of excessive deficits, and binding norms regarding preventive control. Union law having to do with reporting to the Commission and preparing statistics is also legally binding. It is fair to say that Union law restricts national fiscal power in the sense that national fiscal policy decisions that deviate from the legally binding criteria in the Stability and Growth Pact can be considered a breach of members' obligations.[172]

Article 4 of the Treaty on European Union contains the requirement of loyalty to the Union, which was written into the Treaties a long time ago. It calls for the member states to take any appropriate measure, general or particular, to ensure fulfilment of the obligations arising out of the Treaties or resulting from the acts of the institutions of the Union. The member states must also refrain from any measure that could jeopardise the attainment of the Union's objectives. Article 126 of the Treaty on the Functioning of the European Union sets out the legal requirements used in examining whether government debt and budget deficits comply with budgetary discipline criteria in economic and monetary union. The Treaty on the Functioning of the European Union contains a protocol (No 12) on the excessive deficit procedure. Article 3 of this protocol expressly requires that the member states ensure that national procedures in the budgetary area enable them to meet their obligations deriving from the treaty and the protocol. Union loyalty and the provisions in the Treaty on the Functioning of the European Union and its protocol contain the obligation to take the necessary measures

172 The impacts of the Economic and Monetary Union and especially the Stability and Growth Pact on the national fiscal policy power exercised by Parliament and local authorities is evaluated in a study that was conducted by Jani Wacker for a doctoral dissertation at the University of Tampere in 2009. See Wacker: The Effects of the Economic and Monetary Union on National Fiscal Power. Tampere University Press 2009.

at the national level in order to comply with the legally binding limits and procedures in the Stability and Growth Pact, for instance. The coordination of economic policies according to Article 121 of the Treaty on the Functioning of the European Union likewise imposes obligations based on Union loyalty. On the basis of loyalty obligations pertaining to treaties under general international law, the introduction of national procedures that promote the fulfilment of an international obligation and the achievement of agreed objectives can also be regarded as complying with Union loyalty.

Monitoring of the member states' economic policies by the European Commission has found that the use of well-formulated fiscal policy rules promotes the implementation of the Stability and Growth Pact. In light of this one can derive from existing Union law a weak obligation to arrange national fiscal policy procedures that help achieve the obligations and objectives in the Treaties and Union law. These considerations support the use of the spending limits procedure and other such procedures. From the viewpoint of Union law, procedures must be sufficiently comprehensive or in practice extend to public finances as a whole. The requirements in Union law and the priority of Union law over national law, including constitutional law, must also be taken into account in interpreting any restrictions on the use of fiscal policy rules and frameworks resulting from constitutional law and other national legislation. Among other things, in practice this means that the requirements in Union law allow Finland to set conditions and restrictions on the exercise of municipal self-government, which includes extensive economic autonomy, if this is necessary.

In connection with the financial crisis and recession as well as the public debt crisis, particularly in the euro area but also in the European Union as a whole, the European Commission has proposed legislation to improve the preventive and corrective arms of the Economic and Monetary Union. The Commission has called for the reform of existing regulations concerning the Economic and Monetary Union, a new regulation on the prevention and correction of macroeconomic imbalances and a directive concerning requirements for budgetary frameworks of member states.[173] The directive would strengthen openness and objectivity in national accounting and in preparing and presenting forecasts and assumptions on which national fiscal policy is based. The proposed directive points out the benefits of applying a rule-based fiscal policy and would require that the member states set multiannual and numerical rules covering general government finances together with the open and objective monitoring and evaluation of compliance with these rules.

The provisions in the proposed directive are quite detailed and far-reaching. Article 2 defines a budgetary framework as the set of arrangements, procedures and institutions that underlie the conduct of budgetary policies of general government. Numerical policy rules would be part of such a framework.

The Finnish Government supports the Commission's proposals. The Commission's proposal to codify fiscal policy rules

173 Proposal for a Council Directive on requirements for budgetary frameworks of the Member States, COM (2010) 523 final. Concerning the content of the proposal and Finland's position see the Government communication on the Commission's proposals to improve the coordination of economic policy in the European Union and the euro area, U 34/2010 vp., the Government report on Finland's positions regarding the work of the van Rompuy working group and the Commission's communication on enhancing economic policy coordination for stability, growth and jobs E 31/2010 vp., and Grand Committee statement 9/2010 vp. on the Government report regarding the Commission's Europe 2020 strategy.

and budgetary frameworks at the national level is based on best practices.[174] With regard to general principles it is in line with the codes of good practice compiled by the International Monetary Fund as well as principles regarding good budgeting and good governance that are also applied in Finland. According to the Government's assessment, implementing the directive does not face any insurmountable obstacles. In practice the proposed directive does not impose significant new obligations since the Treaty on the Functioning of the European Union already obliges the member states to create the necessary mechanisms to monitor government finances. The Constitutional Law Committee has evaluated the Commission's package of measures to improve the application of the Stability and Growth Pact, including the proposed directive on budgetary frameworks. In the committee's opinion the proposals do not include significant new procedures in relation to the obligations set out for member states in the Treaties or other elements that have not already been approved in connection with the Treaties. As a whole the new legislation may have significant effects for Parliament's fiscal power, depending on how they are applied.[175]

174 Government communication to Parliament on the Commission's package of legislative measures to strengthen the Stability and Growth Pact U 34/2010 vp.

175 Constitutional Law Committee statement 49/2010 vp.

5 The spending limits process

5.1 Summary of audit findings

Officials at the Ministry of Finance and sectoral ministries regard the spending limits procedure as a highly successful planning tool for central government finances. The procedure has improved the planning of the use of appropriations, helped eliminate pressures in handling the budget and created an atmosphere of efficient cooperation. The spending limits procedure helps stabilise the level of central government expenditure. In Finland's system of coalition governments the spending limits procedure creates a strong foundation for the Government's activities based on the Government Programme. There is a firm commitment to the spending limits procedure among political actors and officials.

On the basis of the audit, those participating in the process regard the administrative preparation of central government spending limits as good, but there is room for improvement in transparency and guidelines. The biggest problem is tight schedules. The procedures and roles involved in the official preparation of spending limits function well. Some draftsmen at sectoral ministries had hopes and expectations regarding the provision of more detailed guidelines for the 2007–2010 electoral term at the Government level, so that guidelines would also focus on political objectives and emphases to assist officials in preparatory work.

On the basis of the audit, there is variation in the quality of spending limit proposals produced by sectoral ministries as well as in the data on which their preparation is based. Quality could be improved through a more systematic feedback procedure.

The planning and monitoring of central government finances and activities is on the whole characterised by scheduling pressure that was described as the "treadmill of eternal planning". It becomes more difficult to form an overall picture of the current state and future needs of central government finances and each administrative sector or the relationship between the Government Programme and spending limits when ministries' preparatory resources, particularly those of their financial units, are tied up in the continuous drafting of planning documents. The preparation of important reallocations and genuine strategic planning would require more time and possibilities to focus on essentials.

The link between the Government Programme and the preparation of spending limits is difficult to verify. As a fiscal policy procedure, the preparation of spending limits is directly connected to the Government Programme, while other measures are implemented according to the Government Programme within the framework set by the spending limits. The link is not as clear or strong between policies and the preparation of spending limits for administrative sectors and the Government Programme. In practice the preparation and examination of the budget at the item level separate financial and policy planning. The formulation of policy and the allocation of resources should be integrated.

Cross-sectoral entities should be examined during each stage in the spending limits process, starting with preparation at the ministry in each administrative sector. This would help bring issues concerning strategic policies and the examination of resources closer.

Sectoral ministries were uncertain as to whether administrative sectors were treated equally and consistently by the Ministry of Finance when it considered reallocations within spending limits or cuts in proposals submitted by sectoral ministries. Uncertainty may lead to ministries not making some proposals that are necessary to ensure good preparation. Ministries may fail to propose a reallocation for fear that a proposed cut in a budget item may be accepted while a proposed increase in another item may be rejected.

The general principles that the Ministry of Finance applies in submitting proposals that differ from ministries' proposals and in accepting or rejecting ministries' reallocation proposals should be presented more clearly and openly. According to the view formed by the National Audit Office, there were no significant shortcomings or problems regarding the equal treatment of administrative sectors, however.

5.2 Practical actors in the administrative preparation of spending limits and steering

5.2.1 Process owner and actors

Under the State Budget Decree and the Government Decree on the Ministry of Finance, the Ministry of Finance is in charge of preparing spending limits and steering the preparatory process. At the Ministry of Finance the spending limits process is the responsibility of the Budget Department, operating under the supervision of the Minister of Finance, but other departments at the ministry also take part in the process. Compared with several other horizontal processes, such as the preparation of government proposals or decisions on the Government's horizontal strategies, the stages in the preparation of spending limits and related responsibilities have been defined quite clearly.

The Economics Department at the Ministry of Finance produces the macroeconomic forecasts and sustainability calculations required in the process of formulating fiscal policy. The Economics Department monitors, analyses and forecasts economic developments and regularly publishes reviews. The department's duties also include assessing the impacts of economic policy measures and drawing attention to the economic perspective for decision-making. A key purpose of forecasting is to produce data for economic policy formulation, particularly for annual budgeting and medium-term budgeting within the framework of the spending limits.

The Budget Department at the Ministry of Finance is responsible for compiling spending limits. Annual spending limits proposals are based on the previous year's spending limits decision. The Budget Department is also in charge of the management of central government finances, steers national financial administration and is responsible for general principles regarding central government accounting. Tax revenue forecasts for the spending limits procedure are produced by a separate working group at the Ministry of Finance.

Officials' roles and responsibilities in preparing spending limits have been regarded as functioning well. The Budget Department at the Ministry of Finance acts as the spending limits process owner and according to the audit the sectoral ministries have confidence in the competence of the department's preparatory staff.

Each sectoral ministry prepares the spending limits proposal for its own administrative sector on the basis of guidelines provided by the Ministry of Finance and the preceding spending limits proposal submitted by the Government, utilising agencies' operational and financial plans. This intra-sectoral preparation results in the production of the administrative sector's spending limits proposal and any preliminary financial estimates for off-budget funds.

5.2.2 Timetable for the preparation of central government spending limits and budget proposals

At the beginning of its term, the incoming Government has decided on spending limits for the entire term and on the spending limits or revised spending limits that give them concrete form based on the Government Programme. During the 2003–2006 and 2007–2010 terms, the incoming Government's first spending limits decision in May was based on the spending limits decision approved by the preceding Government, with the revisions required by the Government Programme. The spending limits for the electoral term cover the Government's entire four-year term in office and set an expenditure ceiling for the electoral term that covers the bulk of budget expenditure. The overall spending limits are further divided into spending limits for each administrative sector.

The Government approves a spending limits decision each year in March (Table 1), with technical revisions for changes in prices and costs (since spending limits for the electoral term are based on the first year's price level) and any structural changes, i.e. transfers between administrative sectors and items according to the structure of the budget.[176]

The preparation of central government spending limits actually begins at the end of the preceding year at sectoral ministries, which submit their spending limits proposals to the Ministry of Finance. The proposals are considered by the Ministry of Finance in January and February, after which the Ministry of Finance and sectoral ministries conduct bilateral negotiations on any issues that remain open. Following these negotiations, the Ministry of Finance prepares a spending limits proposal and in March the Government holds negotiations to agree on overall and sectoral spending limits. The result is the final spending limits decision that is formally approved by the Government, consisting of spending limits for the following four years, i.e. expenditure ceilings (within the scope of the spending limits) for each fiscal year.[177]

The spending limits decision is approved annually for a four-year period, so one year is added each time. This means that when a new Government takes office, spending limits already exist for its entire term. These are, however, "technical spending limits" that specify expenditure originating from decisions that have already been made. It is up to the incoming Government to decide whether or not it will make a commitment to these limits. In 2007 parliamentary elections took place after the spending limits decision had already been approved, so the post-election Government first adopted spending rules and then revised the 2008–2011 spending limits in May. The outgoing Government's last spending limits decision is not necessarily just a basic calculation, however. It may also have discretionary components that are described in the text section of the spending limits decision.[178]

The spending limits decision sets a ceiling on the bulk of budget appropriations. Once the spending limits decision has been approved in March, the preparation of the budget proposal can begin within this framework. In practice, however, the drafting of the budget begins at the Ministry of Finance and sectoral ministries in January alongside the preparation of the spending limits decision.

The Ministry of Finance issues guidelines on preparing the budget to the other ministries, which in turn issue guidelines to subordinate agencies. In May the ministries submit the draft budget for their administrative sectors to the Ministry of Finance. These are processed by the Ministry of Finance dur-

176 Ministry of Finance's internal process charts, 4.3.2008. The timetable is described on the Government's website http://www.Government.fi/toiminta/talousarvio/fi.jsp;http://www.vm.fi/vm/fi/09_valtiontalous/01_talousarvio/index.jsp.

177 Ministry of Finance: Budget Glossary, Ministry of Finance Studies and Reports, 7/2001.

178 Interviews, National Audit Office, 2010.

ing the spring and summer. Based on these drafts, in June–July the Minister of Finance prepares its budget proposal and returns proposals to the respective ministries. After this, the Minister of Finance conducts a round of negotiations with each sectoral ministry in order to reach agreement on the size of appropriations.

In August the Government holds a budget session that lasts two or three days to discuss the draft budget proposal produced by the Ministry of Finance and to decide on its final content. The final budget proposal is presented at a Government plenary session attended by the President of the Republic. The Ministry of Finance usually submits a supplementary proposal in November, in which the Government revises the budget according to updated economic forecasts and projections concerning revenues and the development of statutory expenditure. Discretionary changes based on revised policies can also be presented in a supplementary proposal. Supplementary proposals can be submitted up to the delivery of the Finance Committee's report on the budget proposal. The proposal is considered by Parliament in the autumn session, and the budget is usually approved by the plenary session in mid-December. If necessary, supplementary budget proposals can be presented to Parliament during the year, following a similar process but on a shorter timetable.

The preparation of the Report on the Final Central Government Accounts begins in November, when the government financial controller's function at the Ministry of Finance prepares guidelines for ministries regarding the preparation of final accounts. Between December and April the Ministry of Finance, sectoral ministries and the Treasury take part in preparing the final central government accounts and the Report on the Final Central Government Accounts, which the financial controller's function compiles by the end of April. This means the final central government accounts for the previous year are completed each April.[179]

According to law, the Government must submit a report to Parliament on the final central government accounts for each budget year by the end of June the following year. The reporting process has, however, been brought forward and since 2008 the report has been submitted in mid-May. Because Parliament has drawn attention to the fact that the processing of final accounts information in the spring would allow the information to be utilised in preparing the budget, the Ministry of Finance has asked the Treasury whether it would be possible to receive preliminary financial accounts even earlier than this.[180]

5.2.3 Stages in the process for preparing the spending limits

The following description of the process for preparing the spending limits is largely based on the Ministry of Finance's internal process description and guidelines issued to ministries, such as request letters. The description is supplemented by interviews with Ministry of Finance officials participating in the spending limits procedure, sectoral experts at the Ministry of Finance and the heads of financial administration at sectoral ministries.

179 Ministry of Finance's internal process charts.
180 Ministry of Finance memorandum, 2.7.2010.

TABLE 1: TARGET TIMETABLE FOR THE 2007–2010 ELECTORAL TERM

	Spending limits process	Budget proposal process	Final accounts process	
October	Request letter from MoF to ministries			October
November	Sectoral preparation in ministries and subordinate agencies		Preparations of guidelines for drafting the Report on the Final Central Government Accounts	November
December			Drafting of the Action Report on the Budget and budget statement responses; sectoral preparation; final accounts process at the State Treasury	December
January	MoF's internal handling of administrative sectors' spending limits			January
February	Bilateral negotiations between MoF and sectoral ministries			February
March	Government's spending limits negotiations	Preparation of MoF's request letter		March
April	Spending limits for year t+1 ready	Sectoral preparation in ministries and subordinate agencies First draft budget proposal and supplements	Compilation and evaluation of the Report on the Final Central Government Accounts Final accounts for year t ready	April
May				May
June		MoF's internal handling		June
July				July
August	Spending limits process for year t-2 begins	Bilateral negotiations between MoF and sectoral ministries	Second draft budget proposal and supplements	August
September		Government's budget session (2-3 days); consideration by Parliament		September
October	Request letter from MoF to ministries			October
November	Sectoral preparation in ministries and subordinate agencies	Supplements to budget proposal		November
December		Parliament approves the budget in plenary session	Budget for t+1 ready	December

The Ministry of Finance's request letter to ministries

The spending limits process begins in October. This is when the Ministry of Finance draws up a request letter for spending limits proposals in which it issues guidelines to ministries concerning the content, structure and scheduling of spending limits proposals. The first stage in the process also includes updating the Spending Limits and Budget Data System used in preparing spending limits at the Ministry of Finance.

The current system is due to be replaced by a new system called Buketti. In this system spending limits, budgets, final central government accounts and EU financial processes will be in the same database, which will facilitate searches for and the utilisation of historical data. In the new system it will be possible to edit a document simultaneously in several locations as the system features automated version management. Until now the Ministry of Finance has used the TTS-ALP data system in its internal preparation. The new system will be used in preparing budgets and spending limits by all ministries, Parliament, the Office of the President of the Republic, the Office of the Chancellor of Justice and the Parliamentary Finance Committee.[181] The launch of the system has been postponed to 2011. A precise launch date has not been set.

In the Budget Department at the Ministry of Finance the preparation of request letters is the responsibility of the Fiscal Policy Unit, while technical implementation is up to the Calculation Group. The guidelines provided in request letters are based on a regulation issued by the Ministry of Finance. The request letter is approved by the management of the Budget Department and sent to the ministries in mid-October. Ministries are asked to submit their spending limits proposals by the end of December.

Sectoral ministries regard the guidelines issued by the Ministry of Finance as appropriate, despite their focus on timetables for submitting proposals rather than instructions regarding content or quality.

The ministries enter their spending limits proposals in the Spending Limits and Budget Data System, which contains templates for figures and notes. The preceding spending limits decision as well as macroeconomic forecasts and assumptions made by the Economics Department at the Ministry of Finance are used as a template for new spending limits proposals. The template also contains data from the latest final central government accounts and the budgets (including supplementary budgets) for the preceding two years for comparison purposes. The Spending Limits and Budget Data System is updated as soon as new data become available: updated forecasts, amendments resulting from the parliamentary consideration of the budget proposal, supplementary budget data, etc. Sectoral ministries are notified automatically when the system becomes accessible and whenever updates are made.[182] Spending limits proposals are drawn up following the same process applying to budget proposals. Spending limits are prepared on the basis of the preceding spending limits, while budget proposals are based on the preceding budget proposal.

The request letter begins with a summary of the Government's fiscal policy, which guides the preparation of spending lim-

181 Ministry of Finance: Valtiotason arkkitehtuurit -hanke – Valtioneuvoston kokonaisarkkitehtuuri, 29.6.2010 www.vm.fi.

182 Ministry of Finance's internal process charts.

its proposals. Otherwise the request letter is rather technical in content. Therefore it does not guide policy-making or the implementation of fiscal policy in the formulation of sectoral policy. The description of fiscal policy is followed by guidelines concerning the preparation of the basic calculation and ministries' spending limits proposals as well as macroeconomic forecasts and assumptions provided by the Economics Department for use in calculations. The content of the request letter varies according to the content of the Government Programme, reforms or procedural changes insofar as these affect the preparation of spending limits. Examples include the Basic Public Services Programme, policy programmes, the reform of central government transfers to local government, the reform of regional state administration and the productivity programme. Regarding the implementation of the productivity programme and other instruments such as the Government strategy for premises, the request letter has repeated and spelled out the Government's operational policies, usually with regard to issues that fall within the scope of the Ministry of Finance.

The basic calculation is a calculation at the item level according to the Ministry of Finance regulation that ministries complete to serve as the basis for the spending limits proposal for their administrative sector. The basic calculation is computed at the price and cost level of the year preceding the first year of the four-year period covered by the spending limits, with the impacts of decisions as well as changes in automatic factors being entered in the previous spending limits decision. Both calculation assumptions and trends on which these assumptions are based (such as demographic change) are clearly indicated in the calculation.

The basic calculation is also referred to as a technical framework as it specifies the level of appropriations for the next four-year period resulting from decisions already made and from automatic factors. In this context decisions mean permanent changes resulting from existing legislation and permanent changes decided by Parliament during the consideration of the budget proposal, changes in the structure of the budget and other technical adjustments as well as agreements and binding positions adopted by the Government. Automatic factors affecting the level of expenditure include the population, the structure of the population, the age structure, the number of school pupils, the number of unemployed, the number receiving pensions, interest rates and social security contributions, among other things. When a new Government takes office, the basic calculation shows the level of expenditure before the impacts of decisions made by the new Government are taken into consideration.

According to a Government resolution, ministries may propose development projects where necessary. Adding ministries' proposals for reforms to the basic calculation produces their spending limits proposals. If ministries propose increases or reallocations in appropriations, they must specify the part of the Government Programme on which the change is based. Proposed changes must also be itemised and justified in an appendix, by describing the operating environment, policies and focuses in the administrative sector together with the most important social objectives. If a ministry proposes changes in appropriations, it must also specify what reallocations within the spending limits will enable these changes. Development projects can also be funded from the unallocated reserve, which allows flexibility.

In addition to their spending limits proposal, ministries are asked to present an estimate of the development of items excluded from the spending limits and estimates of their administrative sector's revenues, check preliminary financial estimates for off-budget funds and submit their proposal for the text of their administrative sector's spending limits decision.[183] This means ministries have to plan their activities and finances more extensively during the drafting of the spending limits proposal than required by the spending limits decision.

Procedures and consequently the content of the request letter remain more or less unchanged from year to year. In addition to the basic procedure, the letter contains guidelines regarding the handling of reforms and changes. With regard to changes in personnel, the ministries have no other official guidelines besides the request letter.

In practice, however, ministries begin to prepare their spending limits proposals before the letter arrives.[184] The schedule in the request letter ultimately depends on the internal schedule of the Economics Department at the Ministry of Finance; the letter goes out once the Economics Department has submitted its mid-term forecast and data regarding indices and changes in the level of expenditure, which are appended to the letter. Whether the request letter can be sent out earlier therefore depends on any flexibility in the Economics Department's schedule. In August the Economics Department works on the shorter-term forecast, but the Ministry of Finance has expressed its intention to send the request letter earlier in the year.[185] If they wish, ministries can begin their preparations and provision of guidelines to agencies in August, since in certain respects the content of the letter remains unchanged from year to year.

The request letter states that the heads of ministries and policy programmes must cooperate with one another in preparing the spending limits and that spending limits must be formulated in accordance with the Government's frameworks and other regulations.

Preparation at the ministerial level

Sectoral ministries begin preparing their spending limits proposals and internal guidelines before they receive the request letter from the Ministry of Finance. They produce their basic calculation at the item level and spending limits proposal for the Ministry of Finance according to the guidelines provided in the request letter, the preceding spending limits decision approved by the Government and the operational and financial planning documents for the agencies in their administrative sector. Preparation for the administrative sector is the responsibility of the ministry's financial planning staff, usually the director of finance.

Preparation at the ministerial level takes place from October to January. In practice it begins before the arrival of the request letter, as soon as the budget proposal has been formulated, with the preparation of the ministry's internal schedule and guidelines. If necessary, ministries supplement their guidelines for subordinate agencies and off-budget funds in accordance with the letter. Departments are responsible for compiling the spending limits proposal for the func-

183 Ministry of Finance memorandum, 2.7.2010.

184 Interviews, National Audit Office, 2010.

185 Interviews, National Audit Office, 2010.

tions under their responsibility. Draft spending limits proposals are based on agencies' multi-year operational and financial planning documents.

Arrangements and guidelines regarding the preparation of spending limits take place independently within each sectoral ministry. This means quality criteria applying to preparation vary from one sector to another. At the ministries preparation is the responsibility of the financial unit[186], which works in cooperation with other ministerial departments' financial planning staff as well as the financial units of subordinate agencies. The role played by the financial unit in the preparation process varies. In some ministries the financial unit coordinates preparation in great detail and makes sure intra-sectoral examination and any focus assessments are completed before the proposal is submitted to the Ministry of Finance. The audit found that in one administrative sector proposals made by agencies are included as they are in the ministry's proposal, with no opinion being expressed by the ministry. This approach emphasises the role of the sectoral expert at the Budget Department from the viewpoint of sectoral steering.

When the basic calculation, the spending limits proposal for the administrative sector, justifications, estimates of revenues and expenditure excluded from the spending limits as well as preliminary financial estimates for off-budget funds have been entered in the Spending Limits and Budget Data System, the draft is considered by the ministry's senior management (usually the Management Team) and approved by the minister(s) as the sector's spending limits proposal. The spending limits proposal contains the spending limits proposal for the administrative sector, including justifications, entered in the Spending Limits and Budget Data System, estimates of expenditure and revenues excluded from the spending limits as well as preliminary financial estimates for off-budget funds.

The Ministry of Finance is notified as soon as financial planning staff have finalised the drafting of the spending limits proposal for the administrative sector and entered it in the Budget Data System. Spending limits proposals and calculations at the item level only become public once the Ministry of Finance has signed its first opinion concerning the draft budget.[187] Consequently, the documents are not public when the Government approves the spending limits decision.

On the basis of the audit, there is variation in the quality of data on which sectoral ministries' spending limits proposals are based. The Ministry of Finance does not provide ministries with qualitative assessments or feedback regarding the data produced by them. Sectoral ministries expressed different needs in this respect. It is apparent that access to feedback on the data used in preparing spending limits depends on the sectoral experts at the Budget Department. The Ministry of Finance should consider introducing a uniform feedback system for sectoral ministries. The aim should be to improve the quality of preparatory data throughout central government. The need to improve the guidelines issued to ministries by the Budget Department so as to steer quality should also be studied.

186 In some ministries the Financial Administration Unit.

187 Ministry of Finance's internal process charts.

Internal process at the Ministry of Finance

As soon as the ministries' spending limits proposals are received by the Ministry of Finance, a summary is submitted to the Minister of Finance and presented to the Government following a plenary session. Policy can also be discussed at this stage. Depending on the situation, important issues such as the progress of the productivity programme have also been addressed by the Cabinet Committee on Economic Policy.

In January and February the Ministry of Finance revises basic calculations and formulates its own proposal regarding the spending limits for administrative sectors on the basis of ministries' proposals. The spending limits proposal that is prepared by the Ministry of Finance for each administrative sector serves as the basis for negotiations between the Ministry of Finance and sectoral ministries.

The Economics Department at the Ministry of Finance is in charge of updates to macroeconomic forecasts and texts describing the overall economic situation. The technical maintenance of the system – structural, price and cost adjustments to spending limits for the electoral term – is carried out by the Fiscal Policy Unit, which is also responsible for compiling the spending limits decision under the senior management of the Budget Department. Structural changes may include transfers between appropriations included in and excluded from the spending limits, changes in budgeting methods (gross or net), changes in the schedule of a project or other measure, rebudgeting or technical flow-through elements in items included in spending limits. Adjustments affecting the level of the spending limits are made at all stages of the spending limits process. If necessary, the Budget Department analyses proposals in relation to documents such as the previous spending limits decision and budget proposal.

Other departments at the Ministry of Finance comment on the ministries' proposals by entering their opinions in the system under the relevant main title, class or item. The Personnel Department comments on personnel expenditure, Administrative Governance and Development on ICT expenditure and administrative development projects and the Department for Municipal Affairs on the basic public services budget. Each ministry's spending limits proposal, including appendices and justifications, together with comments and opinions provided by other departments at the Ministry of Finance are processed and compiled by the sectoral expert at the Budget Department, who also checks the basic calculation and the calculation in the spending limits proposal and drafts an opinion. To obtain further information needed to formulate the opinion, the official communicates with the ministry in question by email and phone, utilises the views of different departments at the Ministry of Finance and studies opinion, proposals, reports and other documents produced by the Government, Parliament, the National Audit Office and different working groups.[188]

To facilitate the handling of proposals, the management of the Budget Department issues guidelines and updates by email and at departmental meetings. Guidelines may cover such things as how cuts in operational expenditure in the budget should be taken

188 This includes the Government report on transport policy 3/2008 vp., the Government report on security and defence policy (Prime Minister's Office Publications 11/2009), the forest package approved by the Government in spring 2008 and binding decisions made by the Cabinet Committee on Economic Policy such as Finland's participation in the Shanghai World Expo.

into consideration during the period covered by spending limits and implemented in practice in the basic calculation or whom sectoral experts should contact in cross-sectoral issues mentioned in the spending limits.[189]

A summary of these views is provided using a template in the system. Based on this view, the sectoral expert supports or opposes the sums proposed at the item level by the ministry and edits the table and text accordingly. The sectoral expert also saves justifications and comments in the system. Some comments are not accessible outside the Ministry of Finance. Not all communication between sectoral experts at the Ministry of Finance and officials at sectoral ministries is officially documented, as the majority of discussions take place by email or phone.

The next stage involves the director general of the Budget Department and results in a general line based on ministries' proposals and sectoral experts' summaries. In practice the director general monitors and directs the application of the spending rules. The director general's contribution also includes formulating an overall view of the spending limits. In addition a review of the main titles takes place during this stage of the process. The ministries' basic calculations and spending limits proposals are examined item by item. The sectoral experts at the Ministry of Finance present their views on ministries' proposals to the director general, who in turn enters their opinions in the system. The director general makes notes on decisions, but these are not filed or published. Documentation is meagre considering how significant these issues are, but on the other hand this is a process that covers central government finances as a whole on a very tight schedule. If necessary, sectoral experts make changes to figures and/or text on the director general's recommendation. New solutions differing from those presented in proposals may also be sought at this point. The spending limits proposal is formulated on the basis of the basic calculation, to which carefully itemised and justified revisions have been made. At this stage the director general obtains an overall view that becomes sharper once every administrative sector's spending limits proposal has been processed.

The next stage in the process is an opinion by senior officials, which means that the permanent secretary either approves a main title as is or asks for changes to be made. The opinion is then submitted to the political leadership at the Ministry of Finance, i.e. the Minister of Finance, who may also request that changes be made by the sectoral expert. In this the Minister of Finance may be assisted by a political state secretary appointed for the minister's term. During the current electoral term the minister's adviser on economic policy has also played an important coordinating role. Following approval by the political leadership, the proposal of the Ministry of Finance regarding the spending limits for the administrative sectors is ready and those concerned are automatically notified of this in the Spending Limits and Budget Data System. After this, the Ministry of Finance compiles the spending limits decision texts for each administrative sector.

The sectoral experts at the Budget Department play a vital role in the spending limits and budget process. According to interviews conducted during the audit, sectoral ministries regard good cooperation with sectoral experts at the Ministry of Finance as a key criterion for success. At its best cooperation

189 For example with regard to the productivity programme or premises.

was described as continuous informal communication that results in a smooth flow of real-time information and prevents misunderstandings on both sides. Officials' good knowledge of the activities in their respective sectors was regarded as valuable, while at the same time the importance of an overall view was emphasised, particularly in preparing spending cuts.[190]

Interviewees also expressed concerns about the equal treatment of administrative sectors in the spending limits process with regard to interpretations of the spending limits and the rules for reallocating appropriation at the item level or making cuts. Sectoral ministries voiced uncertainty about the criteria applied by the Ministry of Finance in exercising its power to decide on cuts.

Uncertainty and different interpretations may lead to sectoral ministries not making proposals that are comprehensive enough to ensure good preparation. An example that was mentioned earlier involved the preparation of reallocations at the item level. A sectoral ministry decided not to submit a proposal to cut an appropriation under one item, with the goal of shifting the saving to another item, because it feared that the Ministry of Finance would not accept the addition but would accept the cut. In this case the ministry would lose funds included in the spending limits. This openness to interpretation is not conducive to the efficient planning of central government finances, since in the view of the Ministry of Finance, increases in expenditure, reallocations and cuts in appropriations should take place according to consistent justifications and logic.

Negotiations between the Ministry of Finance and sectoral ministries

The ministries have a little over a week to prepare their replies to the spending limits proposal produced by the Ministry of Finance. The Ministry of Finance conducts bilateral negotiations with the sectoral ministries on any undecided issues on the basis of its proposal and the ministries' replies. These negotiations lead to the preparation of the draft spending limits decision.

The Ministry of Finance is represented in the negotiations by the Minister of Finance, who leads the negotiations, the permanent secretary, the senior management of the Budget Department and the sectoral expert at the Budget Department. The negotiators have access to the ministry's comments and justifications at the item level. The ministries are represented by the minister(s), the permanent secretary, the director of finance and, where necessary, other staff. The negotiations take from thirty minutes to two hours and the entire round of negotiations lasts two or three days.

The purpose of the bilateral negotiations is to discuss issues upon which the sectoral ministries and the Ministry of Finance disagree. Therefore it is possible to cover issues requiring political discussion and decisions in these negotiations and, according to the process, this is actually the purpose of this stage. In practice, however, the nature of the bilateral negotiations depends on the current Minister of Finance. The bilateral negotiations enable the parties to share new information, discuss justifications for proposals and correct technical errors and misunderstandings. The bilateral negotiations have proven to be an important stage in the process and may result

190 Interviews, National Audit Office, 2010.

in changes in the opinion of the Ministry of Finance and revisions of the proposal.

The audit revealed that bilateral negotiations between the Ministry of Finance and sectoral ministries are regarded as necessary for the most part. Their objectives vary depending on the practice adopted by the current Minister of Finance. The negotiations were regarded as providing a good opportunity to discuss the situation in the administrative sector, including any changes in focus, and the main reasons for conflicting views between the sectoral ministry and the Ministry of Finance. The negotiations were considered particularly helpful in correcting misunderstandings.

The composition of negotiators was regarded as good because, unlike Government spending limits negotiations that are attended by the entire Cabinet, these negotiations include a representative of the sectoral ministry's financial unit. This helps ensure a smooth flow of information and more detailed knowledge of the data used in the preparation process. One thing that was criticised from the perspective official preparation was that the negotiations did not result in actual decisions. This meant that in certain administrative sectors the content of discussions and outcomes of negotiations failed to generate added value beyond the written reply procedure, although this was desired by preparing officials.[191]

There is no specifically determined procedure in the administrative preparation of the spending limits for the reassessment of expenditure included in the basic calculation during the budget planning period. The opinion emerged during the audit that bilateral negotiations focus too strongly on expenditure in the sectoral ministry's proposal that exceeds the spending limits, since this expenditure is marginal in relation to expenditure included in the basic calculation. The fact that the basic calculation is not opened in the negotiations considerably speeds up the negotiation schedule, but sectoral ministries also voiced concerns regarding the achievement of a broader picture and the difficulty of setting genuine priorities.

The spending limits process proceeds step by step from preparation by officials to the political level, towards higher-level decision-making. The purpose of the bilateral negotiations is to discuss issues upon which the sectoral ministries and the Ministry of Finance do not fully agree and which require political discussion and decision-making.

The Government's spending limits negotiations

The final spending limits decision and spending limits for the administrative sectors are worked out in March during the Government's spending limits negotiations, which are directed by the Prime Minister. The Prime Minister's Office is responsible for making the necessary arrangements. The Government receives the draft spending limits decision, the draft spring economic survey produced by the Ministry of Finance and a proposal regarding the Basic Public Services Programme three to five days before the negotiations begin. The Basic Public Services Programme is negotiated between central and local government as laid down in the Local Government Act and is then considered by the programme's ministerial group.

In the negotiations agreement is reached

191 Interviews, National Audit Office, 2010.

on changes in the text of the spending limits decision but discussion regarding appropriations only covers items for which ministries still propose changes. Issues requiring political decisions have already been discussed between the leaders of the Government parties (referred to as 'the Quartet' during the 2007–2010 electoral term). The basis for the Quartet is the draft spending limits decision compiled following the bilateral negotiations and formulated on the basis of the opinion of the Ministry of Finance. The spending limits negotiations are preceded by contacts between the Prime Minister and the Minister of Finance and their closest political advisers. This contact is political in nature and therefore not part of the administrative preparation process.

Information about the outcomes of the negotiations is distributed by the senior management of the Budget Department at the Ministry of Finance, which participates in the negotiations. Changes are prepared by the department's sectoral experts, while technical maintenance is the responsibility of the Fiscal Policy Unit and the Calculation Group. The spending limits decision is formally adopted by the Government in plenary session following consideration by the Cabinet Finance Committee, after which the Government submits its report on central government spending limits to Parliament.

5.3 Prerequisites of information-based policy formulation

The audit revealed that the planning and monitoring of central government finances is on the whole characterised by scheduling pressure that was at its worst described as the "treadmill of eternal planning".[192] The scheduling pressure also makes it difficult to monitor the implementation of the Government Programme and the spending limits in relation to each other. The functioning of the planning system is put to the test when cuts are required in central government expenditure. It becomes more difficult to form an overall picture of the current state of central government finances, administrative sectors' finances or future needs when the resources of ministries' financial units are tied up in the preparation of planning documents.

Sectoral ministries expect such an overall picture from the leadership of the Budget Department at the Ministry of Finance, which exercises decision-making power regarding the spending limits proposal. An overall picture of the current state of central government finances and the public sector is regarded as necessary for the optimal allocation of expenditure and as a basis for setting priorities in public activities. Those interviewed for the audit stressed the need for officials' views to support the views of political actors, particularly during the preparation of the first spending limits decision of a new Government.

In practice the preparation of an incoming Government's first spending limits decision is largely left up to officials, and for scheduling reasons political actors's possibilities to provide an overall view in decision-making regarding public activities were regarded as weak.[193]

The audit found that it is the view of officials at the Ministry of Finance who participate in the administrative preparation of the spending limits that sectoral ministries should have a comprehensive overall view of relevant sectoral and cross-sectoral issues.

Within the Budget Department at the Ministry of Finance, sectoral experts' knowledge concerning the current state of affairs in their own sector varies according to experience and other factors. Consequently, the contribution of the leadership of the Budget Department in the various stages of the preparation process depends on the quality of preparation conducted by sectoral experts and the amount of timely issues.[194] An overall administrative view is formed in the process of preparing the spending limits during the stage when proposals are considered by the director general of the Budget Department. Cross-sectoral issues are covered in preparatory discussions between sectoral experts. There are, however, no guidelines or references regarding these stages in the preparation process.

In practice consideration by the director general of the Budget Department makes it possible to control the quality of the spending limits proposal of the Ministry of Finance

192 Interviews, National Audit Office, 2010.

193 Interviews, National Audit Office, 2010.

194 The productivity programme and organisational changes in administration received a great deal of attention in 2007–2010, for example.

and the coherence and consistency of the work performed by sectoral experts. This is an important stage in the preparation of the spending limits. Key material produced in this stage and especially justifications for changes made by sectoral experts and ministries should be documented as part of the documentation of the administrative preparation of the spending limits. This is also the premise in the Act on the Openness of Government Activities (621/1999), although notes kept by draftsmen that are unofficial and do not influence presentation are not included in the scope of official documents under the act.

Besides official material recorded in the process of preparing the spending limits, the flow of information between the Ministry of Finance and the sectoral ministries is based on a vast quantity of unofficial communication that takes place between individuals and in various professional networks. The sectoral ministries found that they receive sufficient information from the Ministry of Finance regarding the preparation of the spending limits, but, as regards proposals for changes, they hoped for more detailed justifications concerning things such as cuts in appropriations or rejected reallocations. The current data system does not allow sectoral ministries to utilise the notes that have been entered in the system by sectoral experts when the proposal is edited. The audit revealed that most of these notes are unofficial entries that are difficult for an outsider to comprehend. Because of the schedule pressures in planning work and the high level of confidence based on smooth long-term cooperation, certain sectoral ministries did not find they needed any more extensive or formal justifications for changes to the ministry's spending limits proposal made by sectoral experts at the Ministry of Finance.

The preparation of spending limits is based on the preceding year's spending limits decision, which means the process moves on from one plan to the next. In practice the final central government accounts are completed too late in the spring for them to be taken fully into consideration in formulating the spending limits decision. Data on budget outturns available in the central bookkeeping system can be employed in preparing the spending limits throughout the year via the central government online reporting tool (Netra) maintained by the Treasury. This helps those preparing the new spending limits decision to see how the previous decision has been implemented.

The process of preparing the spending limits does not as such oblige participants to monitor outturns, so the degree of knowledge depends on the person. According to interviewees, information in the final central government accounts is utilised with regard to variable annual appropriation items. This is because the way in which the grounds for determining statutory expenditure have developed must be taken into consideration in budgeting. Interviews also revealed that officials participating in the preparation of spending limits are under a considerable workload, so the process takes place in a hurried atmosphere. The National Audit Office observed that this situation may lead into outturn information not being taken sufficiently into consideration, in which case the planning of spending limits can become detached from actual expenditure.

The link between the Government Programme and the preparation of central government spending limits is difficult to verify. The preparation of the spending limits is directly connected to the Government Programme, but financial and policy planning are separate from each other due to examination and formulation at the item level. The Prime Minister's Office is responsible for monitoring the Government Programme, but cooperation between the Ministry of Finance and the Prime Minister's Office is essential for the monitoring of appropriations. Cross-sectorality is a challenge in monitoring the implementation of the Government Programme and the spending limits. Spending limits are prepared specifically for each sector, which is also reflected in the division of duties between the personnel involved. Experts at the Budget Department focus on a particular sector. Differences in linkages between the preparation and monitoring of the Government Programme and the planning of spending limits were also observed in ministries. In some ministries planning with regard to the Government Programme takes place separately from the planning of spending limits, which presents a risk that the ministry's internal view of coherence between measures and appropriations will remain insufficient.[195] Cross-sectoral issues should therefore be examined at every stage in the spending limits preparation process, starting with internal preparation at ministries.

It is difficult to verify whether the administrative sectors are treated equally during the administrative preparation process because of the scarcity of relevant guidelines for participating officials and official documentation of material produced during the process. The National Audit Office notes that the audit did not reveal any essential shortcomings related to the equal treatment of the administrative sectors. However, the National Audit Office recommends that internal work guidelines at the Ministry of Finance should be revised in this respect and that a possible summary of the main changes made to proposals should be reported to the administrative sectors as part of the feedback process.

195 Interviews, National Audit Office, spring 2010.

6 The fiscal policy information base and compliance with spending limits

6.1 Summary of audit findings

The Ministry of Finance's forecasts and assumptions play a key role in preparing fiscal policy. They also give an idea of room for manoeuvre over the longer term. From the viewpoint of transparency it is important that reporting on the preparation of fiscal policy forms a clear picture of the impact of macroeconomic development and fiscal policy measures on central government revenues and expenditure.

The accuracy of the Ministry of Finance's economic forecasts stands comparison with those made by other Finnish forecasters. Inaccuracy is due particularly to the difficulty of predicting turning points in the cycle. This difficulty in anticipating reversals in general economic development has also been observed in international research and applies to all economic forecasters. The forecasting performed by the Ministry of Finance has been independent of political decision-making and is marked by a striving for objectivity and reliability. The Economic Department at the Ministry of Finance is developing a general balance model to help prepare cyclical forecasts. The introduction of this model will facilitate the evaluation of sensitivities and scenarios, which can improve the quality of preparation and forecasting. The National Audit Office believes that model calculations and their documentation can be a significant addition to the preparation of fiscal policy and related public discussion.

The economic survey on which spending limits are based and the Government's budget proposal together with background materials form an extensive whole. The increasing amount of material involved in the preparation of the budget is becoming a problem. For this reason the production of additional material is not considered useful. Primary aims in developing forecasting and reporting are consistent justifications and careful risk analysis. Explaining the methods and assumptions behind forecasts is important to improve the openness of the fiscal policy information base.

Spending limits were not exceeded during the electoral term 2007–2010. Parliament has also made a commitment to keep expenditure with the agreed framework. Spending limits were not exceeded even during the sharp downswing in 2009. The room for manoeuvre allowed by the spending limits system was utilised to the full that year.

Reporting on compliance with spending limits may seem opaque if one is unfamiliar with the budget process. The presentation of price and structural adjustments was considerably improved in 2007–2010. Partly because of the complicated presentation of price and structural adjustments, the external evaluation of compliance with the spending limits is extremely difficult. The spending limits thus have clear shortcomings from the viewpoint of transparency. This weakens possibilities for critical public discussion and external evaluation. In addition to compliance with expenditure ceilings, reporting should provide information on spending policy and its development with the help of a time series showing actual outturns.

6.2 Fiscal policy forecasts and assumptions

6.2.1 The Ministry of Finance as a producer of forecasts

The Economic Department at the Ministry of Finance produces macroeconomic forecasts and sustainability calculations to aids in the preparation of fiscal policy.[196] It monitors, analyses and forecasts economic development and publishes economic surveys and bulletins. The Economic Department is also responsible for evaluating the impacts of economic policy measures and drawing attention to economic perspectives in policy-making. A key task of forecasting is to produce data for the preparation of economic policy, particularly annual budgets and medium-term spending limits. The Tax Department produces forecasts of tax revenues. The economic survey that is published twice a year is an extensive and detailed analysis of the economic situation and outlook. The September survey is appended to the budget proposal, and the spring survey is appended to the spending limits decision. The economic bulletins that are published in June and December contain forecast updates and discuss the current state of the economy and the short-term outlook.

Forecasting at the Ministry of Finance is based on sectoral experts' knowledge and expertise. Experts' views concerning their special sectors are compiled and coordinated into a coherent whole using the concepts in the national accounts. To ensure a consistent and logical approach, a calculation model that projects accounts two years ahead is utilised in forecasting. Forecasts are produced using several quantitative and qualitative methods within the framework of the sectoral expert system. The lengthening of the economic policy time frame and the need to prepare different scenarios and policy simulations have made modelling an important addition to work based on sectoral expertise in the preparation of fiscal policy. The Economic Department at the Ministry of Finance is developing a general balance model. A special challenge here is to include channels for influencing the structure of public finances and fiscal policy in the model.[197]

In Finland the Ministry of Finance has often been criticised for presenting economic forecasts that are overly pessimistic compared with actual development. One reason suggested that has been for this is the tightness of the spending limits and the little room that is available for discretionary fiscal policy. Below is a brief survey of discussion in Finland concerning the accuracy of economic forecasts.

Pehkonen (2002) examines the accuracy of the forecasts made by nine Finnish economic forecasters in 1997–2001. The Ministry of Finance is included in this group. According to Pehkonen's findings, all the forecasters underestimated the strength of economic growth and did not foresee the high rate of growth in 1997 and 1998. Inversely, all the forecasts made in 2000 and spring 2001 overestimated growth. A similar phenomenon was observed in connection with the slump that took place in the early 1990s, when forecasting errors were significant. Pehkonen draws the conclusion that it

196 Sustainability calculations are discussed in section 8.2.

197 Jokinen: Miksi emme vielä viime kesän lopussa nähneet taantumaa/lamaa?, Kansantaloudellinen aikakausikirja, 105, 3/2009, pp. 335–340

is difficult to forecast not only turning points in the cycle but also faster than normal economic growth. Comparing forecasters in 1997–2001 on the basis of the accuracy of forecasts shows that the Ministry of Finance and the OP Bank Group Central Cooperative provided a picture of economic development over the four-year period that was slightly better than average.[198] It should be pointed out that the period examined by Pehkonen is too short to allow conclusions to be drawn about the Ministry of Finance as a preparer of economic forecasts compared with other forecasters. Kiander & Virén (1999) likewise note that the cyclical forecasts used by the Ministry of Finance in preparing fiscal policy have been inaccurate but that the ministry has been no better or worse in this respect than other Finnish economic forecasters.[199]

In Finland the spending limits decision only covers expenditure, but revenue estimates are in the background when the spending limits and the budget are prepared. Forecasts concerning future economic development in turn underlie tax revenue projections. Projected and actual revenues were compared in the National Audit Office's performance audit report 6/99.[200] According to Virén (1999), the most essential finding in the audit is the large discrepancy between projections and actual development. Virén analysed the accuracy of budget revenue and expenditure estimates in 1960–1998. The analysis shows that revenue estimates in budget proposals were clearly lower than actual revenues except during the slump in 1990–1993.[201] On the basis of Virén's findings it is not possible to say whether the forecasts that were made by the Ministry of Finance and used in drafting the budget were out of line with those made by other forecasters, since the analysis only concerns the figures in the budget and the final accounts.

The Report on the Final Central Government Accounts for 2006 includes an analysis that mentions the large gap between revenue estimates and actual tax revenues in 2003–2006. On average estimates are 1.6 billion euros lower than actual tax revenues. The main reason is that economic growth has been forecast too cautiously. It is not possible to say whether the Ministry of Finance was more pessimistic than other forecasters, however, since the report does not make such a comparison.

The Parliamentary Audit Committee commissioned the Pellervo Economic Research Institute to conduct a study on the accuracy of tax projections in the state budget in 1998–2007.[202] The study commissioned by the Audit Committee takes a comprehensive look at the organisation of forecasting at the Ministry of Finance and the quality of the information that is produced. The study indicated that the forecasts made by the Ministry of Finance stand comparison with those made by other Finnish economic forecasters. No systematic errors were found in tax revenue projections statistically or in comparison with other economic forecasters. Inaccuracies in tax revenue projections were due mainly to the difficulty of predicting turning points in the cycle. On average growth in GDP has been underestimated during an upswing and overestimated during a downswing. The difficulty of predicting turning points in general economic development has also been observed in international studies and

198 Pehkonen: Talousennusteiden osuvuus 1997–2001: valistuneita arvauksia, Kansantaloudellinen aikakausikirja, 2/2002.

199 Kiander & Virén: Tarvitaanko vielä finanssipolitiikkaa?, Kansantaloudellinen aikakausikirja, 3/1999.

200 National Audit Office: Valtion talousarvion tulot ja niiden arviointi, 1999, Performance audit report 6/99, Helsinki.

201 Virén: Valtion talousarvion tulot ja niiden arviointi, Kansantaloudellinen aikakausikirja, 4/1999.

202 Lahtinen & Mäki-Fränti & Määttä & Volk: Valtion talousarvioiden verotuloennusteiden osuvuus, Parliamentary Audit Committee publication 1/2009, Helsinki.

concerns all economic forecasters. Revenue estimates are particularly subject to uncertainly, since revenues depend on macroeconomic development and fluctuate more than expenditure.

The period covered by the study is unfortunately short. The study commissioned by the Audit Committee nevertheless confirms findings obtained in earlier domestic evaluations of forecasting by the Ministry of Finance. As was noted above, the cyclical forecasts used in preparing fiscal policy have been inaccurate, but the ministry has been no better or worse than other Finnish economic forecasters.[203] It is fair to say that the picture that the study presents regarding the quality of the ministry's forecasts would probably not have changed much if a longer time frame had been examined.

The conclusions drawn in the study and the statement issued by the Parliamentary Audit Committee[204] recommend that a separate analysis of risks and sensitivities be appended to tax revenue projections. According to observations made by the National Audit Office, reporting on tax revenue projections has clearly improved. This applies particularly to reporting on final accounts. The Report on the Final Central Government Accounts for 2009 contains a separate section that presents deviations from projections for key tax revenue items together with follow-up projections prepared by a Ministry of Finance working group. Tax revenue projections are based on an evaluation of the development of the tax base. Projections take into consideration existing tax principles and expected changes in them. Follow-up projections describe what revenues would have been if the tax base and tax principles had been known when the original projection was made. In the opinion of the National Audit Office, the working group's follow-up projections and reporting on deviations in tax revenue items should continue and should be made a permanent practice in the Report on the Final Central Government Accounts.

Risks involving tax revenue projections have also been reported more extensively than before in the autumn economic survey. The economic surveys published in September 2009 and September 2010 include a separate section on this matter. The 2011 budget proposal also contains a separate section on risks pertaining to tax revenue projections. In both cases risk factors associated with the development of the tax base are examined for key tax categories, along with their possible impacts on tax revenues in money terms. No sensitivity analysis is presented, however. The general balance model currently being developed by the Ministry of Finance to aid in cyclical forecasting will facilitate the evaluation of sensitivities and scenarios. The National Audit Office believes that model calculations and their adequate documentation could be a significant addition to the preparation and implementation of fiscal policy and related public discussion.

In the opinion of the National Audit Office, consistent justifications and careful risk analysis remain primary aims in developing forecasting and reporting, even though clear improvement has taken place. It should also be emphasised that the budget proposal and the economic survey that serves as background material for it form such an extensive whole that the production of additional material is not considered necessary. The increasing amount of material produced in connection

203 Pehkonen: Talousennusteiden osuvuus 1997–2001: valistuneita arvauksia, Kansantaloudellinen aikakausikirja, 2/2002. Kiander & Virén: Tarvitaanko vielä finanssipolitiikkaa?, Kansantaloudellinen aikakausikirja, 3/1999. Virén: Valtion talousarvion tulot ja niiden arviointi, Kansantaloudellinen aikakausikirja, 4/1999. Lanne: Ennustajien tappiofunktiot ja BKT-ennusteen rationaalisuus, Kansantaloudellinen aikakausikirja, 4/2009.

204 Audit Committee statement 1/2010 vp.

with the preparation of spending limits and the budget was also pointed out in interviews that were conducted by the National Audit Office for the present audit. Instead of producing additional materials, the emphasis in development work should be on explaining the methods and assumptions behind forecasts. The description of the procedure for preparing revenue projections that was published on the Ministry of Finance's website in March 2010 is a key part of this work.[205] It provides a good and thorough picture of the methods used in projecting tax revenues as well as key problems regarding projections for different tax categories. The National Audit Office believes that this document should be updated and maintained. Materials connected to the preparation of the budget could also refer to the document, and a similar description could be considered for the Ministry of Finance's macroeconomic forecasting.

6.2.2 Factors responsible for forecasting errors

Evaluating the quality of forecasts after the fact is problematic, since the information that was available when a forecast was made differs considerable from the information that is available in an ex-post evaluation. The latest published GDP figures are used for this purpose, instead of the real-time observations that were available when the forecast was made. Revisions of macro-data can be considerable. Consequently it is important to distinguish between genuine forecasting errors and statistical changes. The accuracy of single-point projections should be viewed with reservations. Evaluating the accuracy of a single-point projection for a specific variable does not taken into account the relation between different variables and the fact that a forecast is the sum of different macroeconomic and fiscal policy variables.

The objectives of applied macroeconomic research conducted in the public sector and by research institutions are linked to forecasting and policy analysis supporting economic decision-making. In this work the availability and quality of macroeconomic data and particularly data based on the national accounts are important. The reliability of forecasts depends on data that are as accurate as possible. The annual national accounts allow the monitoring of economic development. The preparation of economic forecasts requires timely data obtained from shorter-term statistics, however. This includes quarterly accounts and the monthly trend indicator of output and volume index of industrial output. Short-term statistics provide a picture of the situation faster but less accurately than annual statistics.

The first figures in the annual national accounts are often quite inaccurate, and it takes time to revise figures. Statistics may need to be revised extensively particularly in connection with a turning point in the cycle. This involves correcting measuring errors as well as structural changes. For example, at the end of 1991 preliminary data indicated that GDP had fallen by 5.20 per cent compared with the year before. Five years later this figure was revised to a drop of 7.10 per cent, and a subsequent revision in 2003 placed the figure at 6.40 per cent.[206] Revisions can thus cause figures to vary by more than a percentage point. According to Tyrväinen (2007), arguments about forecasts are useless since statistical revisions can invalidate them at any time.[207]

205 Budjettitalouden tuloarvioiden laadintamenettelyt valtiovarainministeriössä, http://www.vm.fi/vm/fi/04_julkaisut_ja_asiakirjat/03_muut_asiakirjat/tuloarvioiden_laadintamenettelyt.pdf, 2.3.2010

206 Lanne: Taloustilastojen merkitys empiiriselle makrotaloudelliselle tutkimukselle, Kansantaloudellinen aikakauskirja, 103, 4/2007.

207 Tyrväinen: Suomen kasvuluvut arvontakoneesta? Kansantaloudellinen aikakauskirja, 103, 4/2007.

The problem in evaluating the quality of forecasts after the fact is that time series contain figures that have been repeatedly updated. Particularly at the end of a time series figures should be viewed with reservations, since the picture of the accuracy of forecasts will change as statistics are revised. On the other hand, it should be noted that forecasters have only real-time data at their disposal, so the accuracy of forecasts should be compared to the first observations when a forecast is made. This is difficult to do after the fact, however, owing to the inaccessibility of information.

In addition to changes in basic data and adjustments, the revision of cyclical data is influenced by statistical methods and practices. As a result of changes in Eurostat's guidelines, for example, Statistics Finland reformed the methods used in calculating quarterly accounts. Quarterly accounts based on these new methods were published for the first time in September 2006. Since then the revision of statistics has been slower than before. Macroeconomic data for preceding years also had to be revised as a result of the changes.[208]

The seasonal adjustment method that is applied also affects the revision of cyclical data. Seasonal fluctuations have been eliminated from figures in order to get a more general picture of the economy. Statistical methods particularly at turning points in the cycle may react to change slower than they should. The timing of the turning point in 2008 came as a surprise because of the revision of quarterly accounts. The change compared to the previous quarter is monitored with the help of a seasonally adjusted series. The seasonal adjustment method applied by Statistics Finland calculates forecasts for future points to allow seasonal adjustments. The last observation in the time series is very significant, since it largely determines the direction of change predicted by the method. According to data in December 2008, the third quarter was still slightly positive. The start of the downturn in summer 2008 was not revised to the third quarter of 2008 until the end of February 2009 on the basis of figures in the published quarterly accounts. The problem of identifying turning points in the seasonal adjustment method that is applied has been widely recognised, but this time it was felt more concretely than before.[209]

In addition to problems involving the revision of statistical data, judging the quality of forecasts after the fact is complicated by uncertainty regarding the forecaster's loss function. In the ex-post evaluation of forecasts the assumption is that the forecaster's loss function is symmetric. A symmetric loss function is one in which the cost of a positive error and the cost of a negative error of similar magnitude are the same. If the forecaster's loss function is symmetric, optimal forecast behaviour should not display any systematic bias. The absence of bias means that over a long enough period, the mean forecast error should not deviate significantly from zero.[210] The forecaster's loss function is not necessarily symmetric, however, and the existence of systematic bias is not always proof of irrationality on the forecaster's part. Caution may be warranted in forecasts used in preparing fiscal policy if, for example, overestimating tax revenues results in higher costs than underestimating them. In the United Kingdom a statutory task of the National Audit Office has been to evaluate whether the Treasury

208 Tyrväinen: Suomen kasvuluvut arvontakoneesta? Kansantaloudellinen aikakauskirja, 103, 4/2007.

209 Orjala & Tyrkkö: Suhdannetilastoihin kuuluvat revisiot, Tieto & trendit 3/2009, p. 5. Hakala: Miksi taantuma havaittiin jälkijunassa? Tieto&trendit, 3/2009, pp. 10–12. Sorjonen: Mikä yllätti suhdanne-ennustajat tällä kertaa?, Kansantaloudellinen aikakausikirja, 105, 3/2009, pp. 347–353.

210 Auerbach: On the performance and use of government revenue forecasts, National Tax Journal, 1999 Vol. 52, No. 4, December, pp. 765–782.

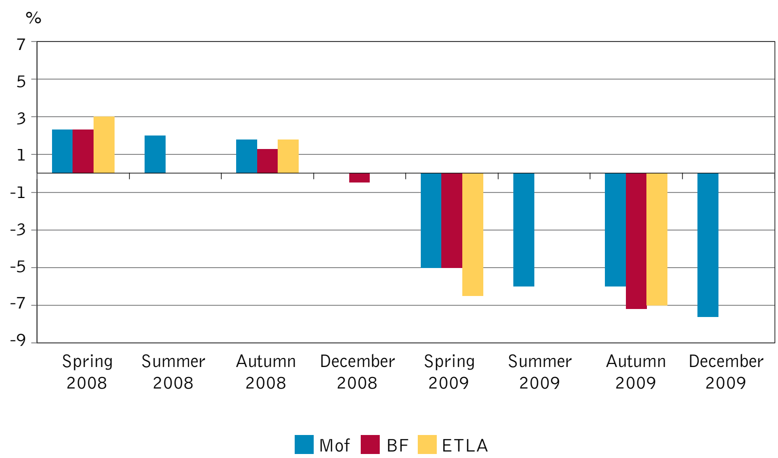
has prepared forecasts used in drafting the budget with due caution.

Lanne (2009) used data covering the period 1982–2008 to examine the loss functions and rationality of four Finnish economic forecasters: the Research Institute of the Finnish Economy, the Labour Institute for Economic Research, the Pellervo Economic Research Institute and the Ministry of Finance. The results support a symmetric loss function most clearly for the Ministry of Finance. Furthermore, the conclusions drawn in a study that was conducted by the Pellervo Economic Research Institute for the Parliamentary Audit Committee note that forecasting by the Ministry of Finance has been independent of political decision-making. These findings can be interpreted as indicating that the ministry strives for objectivity in its forecasting.

Although evaluating the quality of forecasts after the fact is far from simple, ex-post evaluations produce important information regarding problems in forecasting methods and processes. Evaluations are especially valuable if they identify reasons for deviations so that forecasting can be developed. Instead of improving the accuracy of single-point forecasts, the goal in developing forecasting should be consistent justifications and careful risk analysis. From the viewpoint of transparency it is important that reporting on the preparation of fiscal policy forms a clear picture of the impact of macroeconomic development and fiscal policy measures on central government revenues and expenditure.

The financial crisis and the revision of GDP forecasts

Figure 1 presents the revision of forecasts of GDP in 2009 in forecasts made by the Ministry of Finance, the Bank of Finland and the Research Institute of the Finnish Economy from spring 2008 to December 2009. The figure shows that in spring 2008 all three forecast that Finland's GDP would rise by more than 2 per cent in 2009. The Research Institute of the Finnish Economy was most optimistic, forecasting in March 2008 that GDP would rise by three per cent in 2009. In the forecasts that were published in September 2008 all three forecasters still expected

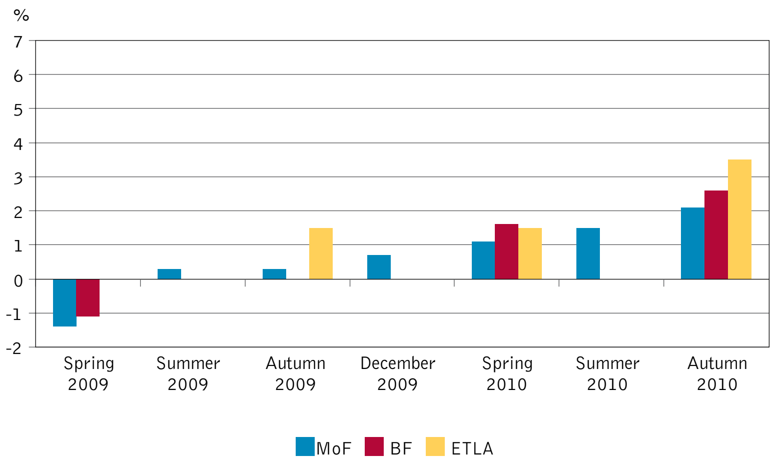


Source: Ministry of Finance, Bank of Finland and the Research Institute of the Finnish Economy (ETLA)

FIGURE 1: GDP forecasts for 2009

growth to exceed one per cent in 2009. At this stage the Bank of Finland had trimmed its forecast most sharply. In September it predicted 1.3 per cent growth in GDP, while the forecast in spring 2008 had been 2.3 per cent. After the financial crisis hit Finland in autumn 2008, forecasts rapidly turned more pessimistic. The Bank of Finland was the first to predict that GDP would contract in 2009. In December 2008 it forecast a contraction of 0.5 per cent in 2009. In connection with its December economic bulletin the Ministry of Finance had also updated its forecast for 2009. As was mentioned above, Statistics Finland's quarterly accounts showed that the third quarter of 2008 was still slightly positive. The downturn that started in summer 2008 was consequently not visible in the statistics on which forecasts were based until February 2009, when Statistics Finland published preliminary data concerning the previous year. By March 2009 all three forecasters had revised their forecasts for 2009 sharply downwards. At this stage the most pessimistic forecast was presented by the Research Institute of the Finnish Economy, which predicted that GDP would shrink by 6.5 per cent in 2009. Figures subsequently worsened. In February 2010 preliminary data published by Statistics Finland indicated a 7.8 per cent drop in GDP in 2009, and this was revised to a drop of 8 per cent in July 2010.

Figure 2 presents revisions of forecasts for 2010 for the same three forecasters. In March 2009 the Bank of Finland and the Ministry of Finance both forecast that GDP would contract by over one per cent in 2010, while the Research Institute of the Finnish Economy predicted 1.5 per cent growth. The Bank of Finland and the Ministry of Finance were considerably slower in revising their forecasts for 2010 upwards. According to the most recent forecasts for the year, which were published in September 2010, all three forecasters expect growth in Finland's GDP to exceed 2 per cent in 2010. The most optimistic of the three is the Research Institute of the Finnish Economy, which in September 2010 predicted growth of 3.5 percent for the year.



Source: Ministry of Finance, Bank of Finland and the Research Institute of the Finnish Economy (ETLA)

FIGURE 2: GDP forecasts for 2010

6.3 Compliance with spending limits

6.3.1 Reporting on the final accounts

Each year the Government reports on the achievement of fiscal policy objectives and compliance with the spending rules set in the first spending limits decision of the electoral term in the Report on the Final Central Government Accounts. The Ministry of Finance monitors compliance by comparing spending limits adjusted for price and structural changes with the budget. Compliance means that the appropriations in the budget do not exceed the expenditure ceilings in the spending limits for the electoral term. The Report on the Final Central Government Accounts is transparent if outsiders can monitor the implementation of spending rules easily enough on the basis of the information provided in the report. The National Audit Office has evaluated reporting on compliance with spending limits during the terms of Prime Minister Matti Vanhanen's first and second Cabinets.

Reporting on compliance with spending limits in the Report on the Final Central Government Accounts follows the same structure each year. The report begins with a statement of compliance with the spending limits during the previous year. An exception to this is the report for 2007, which was an election year. The Report on the Final Central Government Accounts for 2007 notes that the spending limits for the electoral term 2003–2006 were not exceeded. There is no mention of compliance with the spending limits in 2007. The report continues by noting the level of expenditure set in the first spending limits decision and the revised spending limits adjusted for price and structural changes for the year in question. The revised spending limits indicate the total amount of funds available for expenditure during the year. Next the report goes over appropriations covered by the spending limits in the government proposal, the unallocated reserve in the draft budget, appropriations added by Parliament that are covered by the spending limits and appropriations in supplementary budgets. In general appropriations in supplementary budgets are not broken down according to whether or not they are covered by spending limits. Consequently it is difficult for outsiders to tell whether appropriations covered by the spending limits do not exceed expenditure ceilings. During the period that was examined appropriations in supplementary budgets were broken down according to whether or not they were covered by the spending limits only in the reports for 2004 and 2005. The report for 2005 notes, for example: "Expenditure included in the spending limits was increased by a total of 290 million euros in supplementary budgets." This could be made a permanent practice in reporting on supplementary budget appropriations in the Report on the Final Central Government Accounts. In 2007–2010 supplementary budgets are also likely to be in compliance with spending limits where these are applicable. This is no excuse for failing to indicate what part of supplementary budget appropriations are included in the spending limits, however.

Reporting on compliance with spending limits in the Report on the Final Central Government Accounts is sketchy and difficult to understand if one is unfamiliar with the budget process. The report states that the level of appropriations did not exceed the spending limits but as a rule it does not say anything about shortfalls in spending. On the basis of the information that is provided, it is hard to get a clear picture of the level of expenditure covered by the spending limits during the year. Consequently there is no way to determine to what extent expenditure has fallen short of ceilings. The Report on the Final Central Government Accounts does not describe the level of expenditure excluded from the spending limits, which is left up to the reader to calculate. This is awkward, since it is difficult enough to determine the level of expenditure covered by the spending limits, as was mentioned above.

In the opinion of the National Audit Office, to increase transparency the Report on the Final Central Government Accounts should clearly indicate what appropriations in the government proposal are covered by spending limits. Furthermore, with regard to supplementary budgets as well as appropriations added by Parliament, appropriations should be broken down according to whether or not they were covered by spending limits. In this way an outsider could easily check whether the appropriations in the final budget comply with the revised spending limits for the year.

6.3.2 Financial audit findings and the transparency of the spending limits

The National Audit Office has evaluated compliance with the spending limits numerically on the basis of calculations made by the Financial Audit unit. Data used for the purpose were spending limits decisions in 2007–2011, budget proposals, budgets and supplementary budgets together with preparatory materials, and final accounts. The aim is to promote compliance with spending limits decisions in financial solutions and open reporting if spending limits have been exceeded or principles have been changed. Audit findings regarding compliance with spending limits concern the final budgets for fiscal years 2008 and 2009, including supplementary budgets, and the budget for 2010 together with the first supplementary budget proposal. The National Audit Office presents major findings in the ongoing audit of the spending limits procedure and the fiscal policy information base and effectiveness in its separate report to Parliament on the audit of the final central government accounts and the Report on the Final Central Government Accounts each year. The separate report to Parliament examines compliance with the spending limits decision and the relation between the spending limits decision and the final accounts on the basis financial and performance audit findings. Findings were also included in the National Audit Office's separate reports for 2008 (R 12/2009 vp.) and 2009 (R 13/2010 vp.).

With regard to 2010 the National Audit Office has also examined the application of spending limits in the second, third and fourth supplementary budgets for the year.

Compliance with spending limits in fiscal year 2008

According to the Report on the Final Central Government Accounts for 2008, spending limits were not exceeded in 2008 despite the stimulus measures that were added in the third and fourth supplementary budgets for the year. The audit conducted by the National Audit Office indicated that evaluations of compliance with spending limits in fiscal year 2008 can be considered correct. With regard to 2008 the audit was conducted by comparing the spending limits decision that was revised on 25 May 2007 with the calculated spending limits prepared by the National Audit Office for 2008, the budget proposal for 2008 and the final budget for 2008, which includes the actual budget together with all the supplementary budgets for 2008. Key problems in verifying compliance with spending limits are connected to the documentation of price and structural adjustments. In spending limits decisions structural changes have been presented in aggregate by item and price and cost level revisions according to the economic nature of spending by item group. Particularly from the viewpoint of managing structural changes, this increases the transparency of the spending limits procedure and makes it easier to prepare comparison tables. In the table appended to the decision, some changes have been presented in a general way, so the focusing of adjustments cannot be verified definitely from the decision. With regard to price indices one problem is that, although the applied indices together with their content and changes have been presented in the spending limits decision, the grounds for the adjustments that have been made have not been presented for each index or in aggregate in the spending limits decision.

The Ministry of Finance monitors compliance with spending limits by comparing price and structurally adjusted expenditure development with the budget. This supports the curbing of growth in expenditure, which is the objective of the spending limits procedure. In connection with the audit of compliance with spending limits, the National Audit Office compared the adjusted spending limits with expenditure according to the final central government accounts for 2008. In the light of the information in the final central government accounts, it appears that the spending limits procedure has tended to curb expenditure in normal conditions.

Compliance with spending limits in fiscal year 2009

The National Audit Office compared the 2009 budget proposal, the budget and the final central government accounts for 2009 with the revised spending limits decision that was issued on 13 March 2008 and the spending limits with price and structural adjustments prepared by the Ministry of Finance in connection with the preparation of the budget. For this calculation the National Audit Office had access to the spending limits decision issued on 13 March 2008, which presents the revision of the spending limits decision of 25 May 2007 to the 2009 price and cost level. In addition it had access to tables prepared by the Ministry of Finance that present the indices and price and cost level adjustments used in preparing the budget compared with the level on 13 March 2008. Some of the changes are statutory or agreement-based. Some adjustments take place according to changes in pay, and price adjustments vary annually particularly depending on the timing of pay increases. Since all increases are not made automatically according to specific accounting rules, these were not reconstructed by the National Audit Office for 2009, but instead the index and price change percentages used in the 2009 price and cost level adjustment were taken directly from the Ministry of Finance's calculations.

The division in the calculation between expenditure included in the spending limits and expenditure excluded from the spending limits was made partly by the National Audit Office. The first division into expenditure included in the spending limits and expenditure excluded from the spending limits is obtained annually from the Ministry of Finance in connection with the spending limits decision. The division for subsequent changes and additions is made by the National Audit Office. These changes concern, for example, items that have not been included in the spending limits or that have been grouped together or broken down after the spending limits decision. With regard to the spending limits, budgets and final accounts, comparisons have been made in a similar way.

On the basis of the audit conducted by the National Audit Office, the evaluation of compliance with spending limits presented in the Report on the Final Central Government Accounts for 2009 can be considered correct in essential respects. According to calculations made by the Financial Audit unit, it appears that the spending limits for fiscal year 2009 were not exceeded. It should be pointed out, however, that the National Audit Office's calculations contain inaccuracies related to price and structural adjustments as well as the division of appropriations between expenditure included in the spending limits and expenditure excluded from the spending limits. This can be considered problematic from the viewpoint of the transparency of the spending limits procedure. It is still difficult for an outsider to monitor compliance with spending limits, although information regarding price and structural adjustments in connection with spending limits decisions has been improved. On the basis of the National Audit Office's findings, there is no reason to assume that the calculation made by the Ministry of Finance contains errors or gaps, however. The National Audit Office recommends that special attention should be paid to improving the transparency of the spending limits procedure in documentation related to the preparation of spending limits and the budget.

Compliance with spending limits in fiscal year 2010

The budget proposal for 2010, which the Government submitted in September 2009, was designed to stimulate aggregate demand and growth. It contained proposals to move up investments and take other action aimed at rapidly spurring employment. The first supplementary budget in 2010 likewise included stimulus measures.

The National Audit Office has also evaluated compliance with spending limits for fiscal year 2010. The 2010 budget proposal and the budget were compared with the spending limits decision issued on 26 March 2009 and the spending limits with price and structural adjustments prepared by the Ministry of Finance in connection with the preparation of the budget. The fact that the budget had been supplemented with one supplementary budget proposal at the time of the calculation on 13 April 2010 was taken into account. On the basis of the calculation, after the first supplementary budget for 2010 the level of expenditure was within the spending limits. However, the same remarks concerning inaccuracies that were noted in connection with calculations for fiscal years 2008 and 2009 apply to this finding as well.

The audit also evaluated the information presented in the second, third and fourth supplementary budgets for 2010 concerning the application of the spending limits for the electoral term. For this separate report the National Audit Office did not verify information with a detailed calculation but checked to see if the information presented in connection with supplementary budgets was correct in essential respects. After the fourth and last supplementary budget, the 2010 budget did not exceed the spending limits for the electoral term. According to the supplementary budget proposal, 262 million euros of the unallocated reserve remained unspent.

On the basis of the audit, spending limits were not exceeded during the electoral term 2007–2010.

To sum up, the audit conducted by the National Audit Office revealed problems in the presentation of price and structural adjustments in spending limits decisions, although considerable improvement has been made compared with the spending limits decision for 2008–2011. On the basis of the National Audit Office's findings there is no reason to assume that calculations contain gaps or errors, but a lack of documentation and in some respects continuity between spending limits decisions and also between spending limits decisions and the preparation of the budget is a serious shortcoming from the viewpoint of the transparency of the spending limits procedure. In 2008 the Ministry of Finance prepared a description of the calculation process, and this has improved transparency and documentation to some extent.

The Ministry of Finance's calculation appears to be based on information in budgets, spending limits and forecasts. At this point in the audit it is still not clear how information in the final accounts has been utilised in the calculation. Since indices are based on actual expenditure, which deviates somewhat from the assumptions for item categories, utilising business accounting information would provide a more accurate picture of the expenditure on which the calculation is based. For instance, wages and salaries' share of operational expenditure can only be determined on the basis of business accounting. The success of the spending limits procedure can nevertheless be evaluated only on the basis of historical information.

7 The implementation of fiscal policy within the spending limits

7.1 Summary of audit findings

The active reallocation of expenditure within the central government spending limits has been inconsequential. Structural changes in society and the economy together with the policies outlined in the Government Programme nevertheless require a reallocation of budget resources in certain situations. The policies in the Government Programme and the allocation of resources to different sectors in the spending limits for the electoral term can become disjointed as a result.

The spending limits system does not prevent the reallocation of resources, but in practice this requires political decisions. The preparation of the spending limits, which in reality begins with calculations at the item level, in practice tends to raise obstacles both of a political nature and associated with administrative culture to the reallocation of resources within the spending limits for the electoral term.

The bulk of budget expenditure is tied to statutory tasks. In years of rapid economic growth the pattern has been to increase appropriations on top of the old expenditure structure in order to meet requirements related to the Government Programme and new needs. The old expenditure structure is thus dragged along from one electoral term to the next. Some of the legislation on which expenditure is based is quite old. From the viewpoint of the sustainability of public finances this way of operating is not appropriate. It would make more sense to explore possibilities to carry out reforms without increasing the level of expenditure. This requires the setting of real priorities. Expenditure structures and the need for them should be reevaluated from time to time. In preparing the spending limits it should be possible to open the basic calculation describing the level of expenditure according to current legislation and decisions so that resources can be reallocated.

Owing to the mandatory nature of expenditure, legislation has a substantial impact on how fiscal policies can be achieved. Integrating fiscal policy rules and the spending limits procedure with the drafting of legislation is indispensable. It is also necessary to achieve openness and transparency. According to audit findings, the integration of the setting of fiscal policy objectives and the spending limits procedure with the drafting of legislation should be improved.

The Government Programme often outlines the principles of legislative reforms. Conformity with the Government Programme has become a precondition for the preparation of a reform to proceed. Commitment to the Government Programme can be considered positive from the viewpoint of the implementation of democracy and the clear setting of objectives.

According to the principles of good governance, in preparing legislation different options and alternative means to achieve social objectives should be investigated before means are selected. The audit found that the Government has often made a commitment to detailed aspects of legislative projects in the Government Programme. This does not encourage or in some cases even allow the choice of the best possible means to achieve objectives or the evaluation of impacts. The detailed nature of the Government Programme and the constraints it places on the drafting of legislation can present a risk for sound financial management over the long term if the Government Programme does not promote the search for the most economical and functional alternative to achieve the desired effects. The detailed nature of the presentation and application of the Government Programme should be reconsidered and there should be sufficient room for manoeuvre so that the best possible means can be selected.

From the viewpoint of ensuring the achievement of fiscal policy objectives, evaluations of the impacts of legislative projects are inconsistent and often have gaps in content. Comprehending the combined impacts of different proposals is especially difficult. The impacts of legislation over a longer term than one year or the planning period covered by the spending limits should also be presented better. The examination of behavioural impacts on business should particularly be strengthened. With regard to setting fiscal policy there are obvious shortcomings regarding the impacts of central government measures on local authorities' finances and cost pressures. Implementing financial relations between central and local government according to the constitutionally derived principle of adequate financing requires better and more consistent evaluations of the impacts of legislation.

A sufficiently systematic and concise presentation of long-term commitments and risks as well as their development is not presented in the justifications in the budget proposal or in the Report on the Final Central Government Accounts. To meet the requirements of fiscal policy planning, preparation and decision-making, an overall picture of central government liabilities and their development should be compiled in the form of numerical data together with a qualitative evaluation. The development of net assets in central government and general government is essential information from the viewpoint of the sustainability of public finances.

The measures taken in response to the recession focused on revenues and expenditure excluded from the spending limits. A large part of stimulus measures involved financial investments, which are not covered by the spending limits. On the basis of the audit, the question is to what extent strong commitment to spending limits resulted in stimulus measures being shifted outside the spending limits.

The audit indicated that the recession temporarily increased expenditure excluded from the spending limits. Otherwise the amount of excluded expenditure remained fairly stable in 2004–2010. Expenditure covered by the spending limits was not shifted outside the spending limits to any significant degree.

7.2 Changes in focuses and reallocations

The active reallocation of expenditure inside the spending limits system was inconsequential between and within administrative sectors. Although spending limits are prepared for each administrative sector, the reallocation of expenditure between main titles is possible and desirable. Little use has been made of this possibility, however, during both electoral terms following the reform of the spending limits procedure. A report that was published by the Ministry of Finance in spring 2010, entitled Finland's Public Finances at a Crossroads, regards this as the biggest disappointment in the reformed spending limits procedure. The flexibility that was one aim of the reform has not been achieved in this respect.

There has been no change in main titles in the budget. Although there is some change in main titles' share of the budget each year, the systematic arrangement of main titles has remained practically unchanged throughout the 2000s, with the exception of 2010, when the share of appropriations going to the Ministry of Finance increased at the expense of the Ministry of Social Affairs and Health and the Ministry of Education and Culture. The reason for this was a reform of government grant legislation that entered into force in 2010. In the new government grant system so-called sectoral grants and general government grants for social and health services and in the field of education and culture were combined into a "single pipe" under the Ministry of Finance. The financial audit calculation conducted by the National Audit Office likewise did not observe changes in focuses between or within main titles in the budget.

As was mentioned above, one criterion of a good fiscal policy rule is flexibility. To allow flexibility, in Finland cyclically sensitive expenditure has been excluded from spending limits and the procedure includes an unallocated reserve as well as a reserve for supplementary budgets to cover unanticipated expenditure.[211] Structural changes in society and the economy together with the policies outlined in the Government Programme require changes in focuses according to new needs in certain situations or the reallocation of resources compared with previous spending limits decisions and budgets.

The use of the spending limits procedure to steer budgeting does not prevent changes in focuses. (See the accompanying box.) Compliance with spending rules means that agreed expenditure ceilings will not be exceeded in budgeting, in which case appropriations can be reallocated within the agreed framework. Cross-sectoral changes in focuses, which involves the horizontal shifting of appropriations between administrative sectors and the earmarking of appropriations to implement specific policies, in practice requires a political decision on the spending limits for different sectors.

The budget allocates appropriations for each administrative sector according to the strategic objectives outlined in the Government Programme and the Government strategy document. If changes are necessary

211 Expenditure items that change in response to the business cycle, i.e. automatic stabilisers, allow a counter-cyclical fiscal policy, and an unallocated reserve leaves room for discretionary fiscal policy.

SPENDING LIMITS AS A BUDGETARY FRAMEWORK[212]

Spending limits' strengthening effect on fiscal discipline is based on top-down budgeting. The size and allocation of appropriations is decided top-down in the sense that the order proceeds from general to detailed. The essential thing is that the level of aggregate expenditure is decided before proceeding to sectoral[213] allocations and detailed budgeting.

In a bottom-up budgeting process, on the other hand, total expenditure is obtained by adding together the negotiated spending proposals for different administrative sectors and comparing the result with revenue forecasts. The process thus proceeds from a detailed examination of budget items to aggregate expenditure. A bottom-up budgeting process without an expenditure ceiling that is set in advance tends to result in increased spending and does not promote cross-sectoral transfers, since each sector presents its own spending proposal. This does not encourage actors to propose cost-cutting measures. Instead actors strive to maintain or increase their own funding base, and the Ministry of Finance has to decide where to make cuts in proposals. Another risk involves the blurring of the overall picture of the budget and policies since attention is focused on negotiating details.

In bottom-up budgeting the level of aggregate expenditure consists of many individual decisions regarding individual items between sectors and the Ministry of Finance, whereas in top-down budgeting the strengthening effect of the process on fiscal discipline is based on the fact that a single actor decides on the level of aggregate expenditure. The practice also lightens the burden and work load placed on actors, since political and technical decisions can be kept separate to a larger degree.

The first step in budgeting with spending limits is to decide on aggregate expenditure. Next a political decision is made concerning the allocation of expenditure among administrative sectors. This means setting spending limits for each sector according to its own political agenda and focuses. Sectoral ceilings force each sector to set priorities or choose between conflicting goals. Only after this has been done do the sectors begin budgeting within the agreed framework. The procedure requires the clear definition of priorities and the preparation of the budget on this basis.

To function properly the procedure requires the sharing of decision-making power. With its technical expertise the Ministry of Finance is responsible for evaluating the credibility of sectoral expenditure plans and monitoring compliance with spending limits. As an expert in its own special field each sector is responsible for deciding how to allocate appropriations within parameters so as to comply with spending limits. The Ministry of Finance nevertheless has the right to veto reallocations within a sector if the intention is to take advantage in the temporary cutting of costs to finance new political initiatives of a permanent nature or if expenditure is underestimated so that projects included in the budget can no longer be cancelled. Financing permanent expenditure items with temporary savings leads to a greater burden on public finances in the future. Transfers between consumption and investment expenditure may also need to be constrained.

Since each sector has to comply with spending limits in budgeting, the procedure provides an incentive to seek ways to cut costs, eliminate inefficiencies and shortcomings and cull projects. The resources that are saved can then be used for other purposes in the sector. Improving efficiency within the sectoral spending limits thus pays off.

The budget reform that was implemented by Austria in 2009 is based on top-down budgeting using expenditure ceilings. The procedure is aimed at encouraging economy on the part of ministries and it allowed budgetary discipline to be maintained even during the financial crisis in 2009.[214]

212 The following is a general examination of budgeting within the framework of spending limits and is not a direct description of the spending limits procedure in Finland. For theory see for example Ljungman: Top-down budgeting - An instrument to strengthen budget management. IMF Working Paper 09/243, 2009 together with sources and European Commission: DG ECFIN, Public Finances in EMU 2010, European Economy 4/2010.

213 A sector can mean an administrative sector under a ministry or a task, programme or other area for which expenditure ceilings are set in the spending limits procedure.

214 Steger: Austria's budget reform: How to create consensus for a decisive change of fiscal policy rules, OECD Journal on Budgeting Vol. 2010/1, pp. 12-17, OECD 2010, pp. 7–20.

during the electoral term, expenditure can be reallocated within administrative sectors during the four-year period covered by the spending limits. In other words, if an increase in an appropriation is offset by a decrease elsewhere in the budget, the spending limits for the administrative sector are not exceeded and so appropriations at the item level can be changed. It should be noted that the administrative sectors differ in the extent to which their budgets consist of expenditure tied to statutory tasks and operational expenditure. The nature of expenditure has an effect on what changes in focuses or reallocations can be made during the electoral term, since changes in expenditure tied to statutory tasks require a political decision, while operational expenditure can be changed in a less complicated process.

The OECD criticised Finland's spending limits procedure for its administrative inflexibility in its public governance review of Finland, which was published in spring 2010.[215] The OECD particularly cited the lack of cross-sectoral cooperation. According to the review, since the spending limits decision is made on the basis of the previous spending limits decision and the budget is prepared according to the spending limits decision, it is difficult for the sectoral ministries to allocate resources according to the Government's priorities. The allocation of limited resources is hampered by the inclusion of ongoing projects and programmes in previous spending limits, and the continuation of funding for these is not questioned. Instead they are part of the basic calculation. The Ministry of Finance also notes in Finland's Public Finances at a Crossroads that the insignificant reallocation of expenditure is partly due to the item-based expenditure calculation that underlies the spending limits. When expenditure is examined at the item level during the spending limits process, the preparation of the budget for the following year is already well under way, even though the original idea was to keep the spending limits process and the budgeting process separate. The sectoral ministries consider the current procedure good for the most part, however, since examination at the item level during the spending limits process facilitates ministries' budgeting.[216]

Officials at the Ministry of Finance who were interviewed by the National Audit Office emphasised that the spending limits procedure in itself does not prevent changes in focuses or reallocations. The essential thing is to ensure that expenditure does not exceed the ceiling that has been set. The political leadership can decide to make cross-sectoral transfers. Nor does examination at the item level prevent changes in focuses or reallocations within an administrative sector as long as an increase in an appropriation is offset by a decrease elsewhere in the budget. Of course a reallocation cannot be approved if it is in conflict with the productivity programme or if what is supposedly a one-off transfer is meant to remain a permanent increase in an item. The sectoral ministries seldom propose transferring resources from one item to another, however, since it is difficult to find items in which the necessary cuts can be made.[217]

The bulk of expenditure in the budget and consequently the spending limits procedure is tied to statutory tasks. Consequently reallocating appropriations often requires political decisions even with regard to transfers

215 OECD: OECD Public Governance Reviews Finland - working together to sustain success, 2010, p. 17.

216 Interviews, National Audit Office, 2010.

217 Interviews, National Audit Office, 2010.

inside an administrative sector. Real room for manoeuvre is therefore quite small. In this connection it should be pointed out that some legislation is quite old. Expenditure structures and the need for them should be reevaluated from time to time. The current way of operating in which an increase in appropriations resulting from new needs comes on top of the old expenditure structure according to the focuses in the Government Programme is not appropriate from the viewpoint of the sustainability of public finances. It would make more sense to explore possibilities to carry out reforms without increasing the level of expenditure. As a result of the pattern that developed in years of rapid economic growth, the old expenditure structure is dragged along from one electoral term to the next, because priorities are not set. Genuine reallocations would also require opening administrative sectors' basic calculations. If the sectoral ministries were free to act within the framework of the spending limits for their own administrative sector, without the Ministry of Finance's examination at the item level, ideally priorities would be revised as necessary throughout the electoral term. Interviews with officials from sectoral ministries indicated that examination at the item level is inflexible and that a more general evaluation would be welcome in the case of ministries that mainly have operational expenditure, while changing statutory expenditure necessarily requires political approval.[218]

An OECD report[219] suggests that the plans that are described in detail in the Government Programme and the Government's strategy documents are not conveyed to the operational level. Owing to a lack of cross-sectoral cooperation, it is challenging for officials in specific departments to achieve concrete objectives that would support the Government's broader objectives. Since the present way of operating has a long history and since officials are not encouraged to cooperate or sanctioned for failing to cooperate, the benefits of cross-sectoral cooperation are hard to see. According to the OECD current practices impede inter-ministerial cooperation, which is necessary to achieve objectives that have been set by the Government. Differences between operational plans and the spending limits procedure reduce possibilities to set priorities and reallocate resources in central government and general government. Because the preparation of the Government Programme takes place separately from the preparation of the spending limits, which are set at the item level on the basis of the Government Programme, resources in the budget remain allocated according to previous decisions and reallocating resources is difficult regardless of changes in political priorities. Government Programmes and strategy documents follow one another without the evaluation and culling of ongoing projects. This means that the projects in the Government Programme are simply piled one on top of another. The OECD concluded that the current way of operating does not force the Government to rank objectives in order of priority.

Nowadays the sectoral ministries present their spending limits proposals at the item level on the basis of the previous spending limits. This means that appropriations decided during the spending limits process go straight into the budget. Priorities are not set

218 Interviews, National Audit Office, 2010.

219 Steger: Austria's budget reform: How to create consensus for a decisive change of fiscal policy rules, OECD Journal on Budgeting Vol. 2010/1, pp. 12–17, OECD 2010.

between existing and new projects. Changes in focuses within each administrative sector are small, since ministries see little room for manoeuvre within the spending limits. Resources are not available for all the proposed projects, so ministries make more requests for additional appropriations. As a result the Ministry of Finance has to decide where to make cuts in sectoral ministries' proposals, which includes reallocating resources when requests for additional appropriations exceed ceilings. Making genuine changes in focuses requires that ministries are willing to look for ways to cut expenditure in order to offset requests for increased appropriations. It should also be possible to evaluate expenditure tied to statutory tasks, which means questioning spending included in basic calculations within administrative sectors and at the central government level. Since the first spending limits decision of the electoral term is made on the basis of basic calculations, there is a risk that the objectives in the Government Programme will be implemented by raising spending limits.

Since transfers within an administrative sector do not affect the overall level of expenditure, binding decisions could be deferred to the budget. In this case the sectoral ministries would be free to allocate their own appropriations provided they comply with the expenditure ceiling for their administrative sector. The Ministry of Finance should prevent transfers if these are not genuine transfers in which an increase in expenditure is offset by a conscious decision to cut spending elsewhere in the budget, if expenditure is underestimated or if consumption is financed by reducing investments. Allowing more freedom in budgeting could encourage ministries to seek ways to cut costs in their own sector, since they could then use resources for other purposes.[220]

220 This is the basis for Austria's budget reform, see for example Steger: Austria's budget reform: How to create consensus for a decisive change of fiscal policy rules, OECD Journal on Budgeting Vol. 2010/1. For theory see Ljungman: Top down budgeting – An instrument to strengthen budget management. IMF Working Paper 09/243, 2009.

7.3 The economic impacts of legislation

A large part of central government expenditure and revenues is tied either directly or indirectly to legislation. More broadly legislation has an essential influence on how the fiscal policy objectives that are presented in or underlie the spending limits can be achieved. Integrating fiscal policy rules and the drafting of legislation is thus indispensable to achieve fiscal policy objectives and is a necessary precondition for the implementation of openness and transparency and the presentation of true and fair information.

A performance audit that was conducted by the National Audit Office on the evaluation of the economic impacts of legislative projects noted that the openness of the relation between the spending limits procedure and the drafting of legislation is weakened first of all by the fact that it is possible for legislation to circumvent spending limits. Tax subsidies and the assigning of obligations to local authorities based on underestimated cost projections are especially problematic. Openness is also weakened by shortcomings in the evaluation of the impacts of reform projects on central government finances and the fact that the information on which evaluations are based is not transparent and consistent in all stages of decision-making. The audit noted that the lack of openness presents a risk that the spending limits procedure and the legislative process will not encourage ministries to conduct thorough advance studies regarding the economic impacts of legislative projects when the economic impacts of reforms are tied to statutory tasks. These matters weaken Parliament's role as the exerciser of budgetary power and also present a risk for the functioning of the spending limits procedure in a way that ensures the sustainability of central government finances.

The drafting of legislation according to the principles of good governance requires that a thorough study is made of different options and steering instruments that could be used to address problems before a commitment is made to a concrete legislative solutions. On the basis of the audit, a commitment to budget-related legislative projects' basic solutions is often made on the political level before the parliamentary consideration of legislation, in the content of the Government Programme or a ministry decision. The link between the drafting of legislation and the content of the Government Programme is given concrete form in the spending limits negotiations between different ministries and the Ministry of Finance. Conformity with the Government Programme has become a precondition for the preparation of a reform to proceed. Commitment to the Government Programme can be considered positive in itself.

Apart from the Government's strategy document, in practice the Government Programme is the only document considered in a political forum that contains broad reform projects extending over several years. Since the Government Programme is firmly linked to the Government's spending limits decision, it can also serve as a strategic steering instrument. The spending limits decision does not cover policies concerning revenues or exceptions such as tax subsidies in much detail, however, although the spending limits include an examination of the balance of central government finances and a review of tax policies. Links between legislative reforms based on the Government Programme and the development of revenues remain somewhat unclear in the spending limits and preparatory materials. Consequently making a commitment in the Government Programme to the implementation of specific reform projects can present a risk from the viewpoint of the sustainability of central government finances if assumptions concerning the development of revenues prove to be wrong.

The detailed nature of the Government Programme and strict commitment to it can also pose a risk for sound financial management if the content of the programme does not promote the search for the most economical way to achieve the desired impacts.

Since the spending limits procedure is based on the structure of budget items and on principles related to the allocation of appropriations according to the time frame and tasks specified in items, it steers the implementation of reform projects, responsibility for implementing projects and the nature of expenditure.

On the basis of the audit, the spending limits procedure provides predictability for ministries, giving them an idea of the appropriations that will be available for reforms over the next few years in their administrative sectors. The problem is that in their present form, the spending limits procedure and the real political and administrative practices that have been adopted and established in connection with it do not allow the allocation of appropriations for reforms if these deviate from the structure of the budget. The procedure does not encourage genuine cross-sectoral cooperation aimed at solving social problems or the reallocation of resources based on cross-sectoral cooperation. Coordinating timetables in the annual spending limits process, the preparation of the budget and the drafting of finance acts limits opportunities to prepare and evaluate reform projects more broadly.

The relation between the Government Programme, the spending limits procedure and the drafting of legislation should be reevaluated. The coordination of the content of the Government Programme, the annual spending limits process and the drafting of legislation could be improved if the listing of detailed reforms together with timetables were reduced in the Government Programme.

Legislative reforms differ in how clear and direct an impact their implementation will have on central government expenditure or revenues. The National Audit Office considers that the specification of reforms in the Government Programme should be in relation to the predictability of impacts. In specifying reforms attention should also be paid to the irreversibility of impacts. If legislation can be applied in a clear-cut way and the desired impacts are clear, predictable and economically controllable, the specification of projects in the Government Programme can be considered justified. Conversely, if legislation applies to a complex network of actors and changes in the operating environment are unpredictable, a commitment to detailed projects in the Government Programme should be avoided.

The Government's spending limits decision forms the financial parameters for new legislative projects. New projects that will have impacts on central government finances and concern expenditure that is included in the spending limits must fit within this framework. The interdependence of the spending limits procedure, the preparation of the budget and the drafting of legislation in terms of timetables and content thus depends on the financial impacts of legislative projects. From the viewpoint of complying with spending limits, legislative projects that will increase central government expenditure directly or indirectly are of key importance. Finance acts, which have accounted for about one-fifth of government proposals in recent years, have the clearest direct impact on expenditure. The audit found that officials' interpretations of the justification for presenting legislative projects in finance acts were inconsistent. Justifications for presenting legislation in the form of a finance act should be clarified, and the justification for presenting a finance act should be noted in the government proposal. Finance acts must be considered within a short timetable. The economic impacts of finance acts should be pointed out in a visible way. The National Audit Office considers that measures should be taken so that the impacts of finance acts on central government finances are pointed out more clearly in proposals' structure.

According to guidelines concerning the preparation of government proposals, one general principle is to explain all the essential impacts of the content of a proposal in a clear and coherent manner.[221] Positive and negative impacts and costs should be clarified not only for the proposed legislation but also for alternative steering or regulatory instruments. According to guidelines concerning the evaluation of the impacts of legislation, with regard to financial impacts it is necessary to specify how funding is to be provided within the framework of the spending limits and the budget or in off-budget funds.[222]

Legislative projects often involve reforms that will have impacts on central government finances by raising or cutting expenditure through different elements. On the basis of audit data, government proposals have not adequately stated what factors have been taken into consideration in determining total costs. In this case the information that is presented is not very useful. Furthermore, if financial impacts are presented as part of the description of objectives and justifications, this makes it even harder to form a clear picture of financial impacts as a whole.

On the basis of the performance audit on the evaluation of the economic impacts of legislative projects, there are gaps in information in government proposals regarding the evaluation of impacts, and the information that is presented generally remains on the budget level and does not look at impacts over the longer term. According to the committees, proposals would be more useful if the overall impact on central government finances were clearly indicated and broken down. The committees noted that the use of tables showing the extent and timing of economic impacts and changes in different actors' financial liabilities would make proposal more readable.

The audit found that during the preparation of the spending limits proposal in the spring, it is often unclear what legislative projects will be included in the spending limits decision after negotiations have been completed. Consequently the ministries do not view the detailed presentation of impacts meaningful in this stage. The concrete drafting of legislation begins only after ministries' spending limits have been approved in the spring and individual legislative reforms have been given the go-ahead. The audit indicated that the presentation of different options in government proposals is often meagre. One suggested reason is that if projects have been decided in the Government Programme, describing options would be pointless since a commitment to a particular solution has already been made on the political level.[223]

221 Ministry of Justice: Hallituksen esitysten laatimisohjeet, Ministry of Justice publication 2004:4.

222 Ministry of Justice: Guidelines for evaluating legislative proposals. Ministry of Justice publication 2007:6.

223 Audit data collected by the National Audit Office in 2010.

Administrative preparation in legislative reforms that result in increased central government expenditure concentrates mainly on other ministries besides the Ministry of Finance, which prepares legislation that determines the formation of revenues. On the basis of the audit, the usefulness of proposals in drawing conclusions regarding the financial impacts of legislation was weakened by complex causal relations and the fact that the structure and presentation of proposals varied in different administrative sectors with regard to the description of impacts. The evaluation data formed in different stages of preparation is fragmented. The main documentation concerning information on impacts is contained in the government proposal and draftspersons' working papers. In documents produced before the actual drafting of legislation (reports submitted by working groups or rapporteurs) the economic impacts of different options generally receive scant attention. More light could be shed on these by expanding justifications in government proposals, developing clear reference practices and using online links to other documents, for example.

With regard to structural reforms the audit noted that if a commitment is made to a reform in the Government Programme or the spending limits decision, the estimated economic impacts are lower than the eventual costs revealed in later stages. One reason that was often mentioned for this discrepancy is the underestimation of transitional costs. Actual costs only become clear after reforms have been implemented. The National Audit Office found that in some projects a commitment was made and then during the practical implementation of a reform certain cost items exceeded estimates or had not been anticipated at all. These cost items had to be financed in supplementary budgets. In the university reform, for instance, actual impacts on central government finances differed considerably from estimates during the spending limits stage.[224] The evaluation of impacts naturally becomes more accurate in subsequent stages of preparation. Nevertheless, when reforms are decided it is important to give as realistic a picture as possible of their financial impacts.

The audit found that benefit systems' economic impacts are expressed over the short term. The financial impacts of benefits granted in the form of subjective rights depend on the number of beneficiaries at any given time, however. In describing economic impacts attention should therefore be paid to the anticipated development of potential beneficiaries and related factors. This kind of information is important from the viewpoint of the sustainability of central government finances in justifying reforms.

The practices used in evaluating the impacts of legislative projects on business are undeveloped. The do not provide a good basis for identifying the combined impacts of legislation in different administrative sectors in a timely manner before a commitment is made to legislative projects. The audit also indicated that insufficient foresight has been exercised regarding the development of EU norms on which the drafting of national legislation is based. Examining behavioural impacts over the longer term from a financial perspective has also received scant attention.

The economic impacts of legislative proposals also need to be evaluated in applying the principle of adequate financing, i.e. if the state imposes obligations on local authorities it must also provide the necessary funds, and

224 Government proposal 7/2009 vp. concerning the total reform of the University Act.

in presenting obligations on local authorities as a result of legislation. The audit observed that changes in financial obligations are not always presented clearly in proposals. Some government proposals mentioned factors on the basis of which central government financial impacts are falling, such as the percentage of central government transfers to local government and cost development. Making actual calculations on the basis of the presented information may be left up to the reader, however.

There are many links between central government finances and local government finances.[225] The inadequate evaluation of impacts makes it difficult to obtain a picture of the impact of central government measures on local government finances and particularly the balance of finances and cost pressures. The National Audit Office has conducted several performance audits concerning the quality of legislation pertaining to welfare services, and in its 2009 activity report to Parliament compiled an evaluation of the implementation of the principles of better regulation in the field of welfare services.[226] The report noted that the constitutionally derived principle of adequate financing that is meant to govern the relation between central government and local government and the balance between the assignment of tasks and the provision of funds should be implemented better. This requires adequate evaluation. To ensure that reforms have the intended effect on the implementation of the principle of adequate financing, the impacts of legislation in the relation between central government and local government should be described in a sufficiently uniform way. The evaluation of impacts should also support the open setting of priorities within the framework of financial restrictions and objectives concerning the development of public services. Openness in the setting of priorities would also support compliance with the spending limits and the broader achievement of fiscal policy objectives.

The National Audit Office emphasises that the information base for the spending limits decision and the preparation of the budget should evaluate the impacts of reform projects on central government finances. It is also necessary to create an adequate information base for the parliamentary consideration of legislative proposals. The usefulness of the information that is produced is weakened by the fact that the evaluation of impacts on central government finances is characterised by the examination of short-term impacts, a sector-centred approach and the exclusive focus on expenditure. Moreover, too little attention has been paid to ensuring the sustainability of central government finances in evaluating the impacts of reforms and in the content of evaluations.

According to audit findings, information formation during administrative preparation is narrow in scope and concentrates on examining impacts at the item level that are the responsibility of officials at the sectoral ministries and the Ministry of Finance. The evaluations produced by sectoral ministries when the spending limits are being negotiated are aimed at obtaining the appropriations required to implement projects. The approach taken by the Ministry of Finance, on the other hand, emphasises the need to minimise central government expenditure and ensure conformance with the spending limits in different stages of preparing the

225 The relation between central government finances and local government finances is discussed in section 8.1.3 of this separate report

226 National Audit Office's report to Parliament on its activities for fiscal year 2009, R 15/2009 vp., section 4, pp. 23–41.

budget and finance acts following the spending limits decision. The broad evaluation of the impacts of reform projects on central government finances has not received much attention. The actual drafting of legislation begins in ministries after the issuing of the spending limits decision. When legislation is drafted evaluation data can be supplemented through hearings, generally in the form of requests for statements. Since the spending limits decision sets the economic parameters for reform projects, there is a risk that supplementary information on economic impacts that becomes available during the drafting stage will not be given proper significance as a result of the constraints in the spending limits procedure.

Rapid changes in the operating environment can threaten the sustainability of central government finances. Sustainability can require speedy solutions, and the multi-stage process of drafting legislation can be too slow to respond to problems that arise suddenly. This should be taken into consideration in developing legislative models and related principles. In developing more flexible legislative models it is necessary to ensure that Parliament retains legislative and budgetary power, however.

Improving efficiency in the public sector requires the evaluation of the need to reform existing legislation, the evaluation of the impacts of reform projects and the monitoring of the impacts of implemented legislation. This should be based on an identification of key processes for the sustainability of central government finances that determine the revenue and expenditure base, public and private actors connected to these processes and relations between actors. The timeliness of reforms and the content and impacts of reform projects should be examined so that legislation supports processes that are beneficial for society and promote the accumulation of revenues while preventing negative impacts for society that result in increased expenditure. In order to identify essential causal relations involving the revenue and expenditure base in individual reform projects, evaluation and monitoring procedures should be established. In a reform project the aim should be to present essential cause-and-effect relations and to draw attention to the management of impacts rather than to produce evaluation data for a set period.

7.4 Long-term liabilities

The National Audit Office's draft audit report on central government financial liabilities notes that information concerning long-term liabilities that is essential for planning fiscal policy is not presented clearly enough in financial planning and monitoring documents. Central government financial liabilities mainly consist of different obligations to which a commitment has been made.[227] Significant liabilities include the national debt and central government pension liability. The International Monetary Fund emphasises the significance of liabilities in terms of financial risks and recommends that the information system describing central government finances should provide a reliable basis for monitoring liabilities.[228] The State Budget Act (423/1988) and the State Budget Decree (1243/1992) contain provisions on the handling and presentation of liabilities in the Report on the Final Central Government Accounts. In his statement on the Report on the Final Central Government Accounts for 2009 the Government Controller-General drew attention to the complicated nature of the information in the report concerning the current state of public finances and the application of resources. A project that is being conducted under the direction of the Ministry of Finance will also address the question of how liabilities in the balance sheet should be presented in future.

To support financial decision-making, what is needed is an examination of essential central government financial liabilities together with amounts and schedules over several years, in easily understandable form. Categorising and specifying central government liabilities is challenging, however, since some liabilities are hidden and future risks associated with a sustainability gap must be taken into consideration in describing financial risks. The audit found that the handling of authorisations in the budget is fragmented and that evaluations of the development of authorisations are not presented in a systematic way. Consequently the budget does not provide a clear picture of commitments resulting from authorisations as a whole or over the medium term. A Ministry of Finance working group suggested that presenting authorisations by administrative sector in table form in the budget proposal would improve the information base.[229] The audit noted that the Report on the Final Central Government Accounts contains sparse information on central government liabilities and financial risks. The Report on the Final Central Government Accounts has drawn attention to the costs of an ageing population as a risk factor in recent years, and in the past two years it has drawn attention to the costs of adjusting to climate change. Note 12 (Government guarantees, pledges and other commitments) breaks down liabilities into three categories: government guarantees and pledges, other commitments and major multi-year financial contract liabilities.

227 See draft performance audit report on central government financial liabilities, Journal No. 434/54/2009. National Audit Office 2010.

228 International Monetary Fund: Code of Good Practices on Fiscal Transparency, IMF Manual on Fiscal Transparency, IMF, Washington D.C., 2007.

229 Working group on the development of the budget and spending limits procedure (MoF147:00/2009).

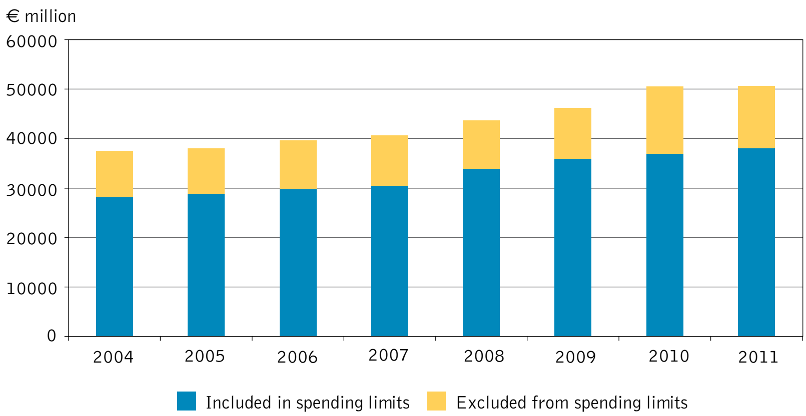
A clearer description of central government financial liabilities would be a significant addition to the information used in preparing fiscal policy. According to the National Audit Office's draft audit report, central government financial liabilities and the development of net wealth are not taken into consideration in a sufficiently transparent and appropriate manner as part of financial planning and decision-making in connection with the state budget and the handling of the final accounts. In future years the bulk of spending in the state budget will be tied by legislation. It is essential for information describing aggregate financial liabilities and the development of liabilities to support decision-making regarding central government spending limits. The National Audit Office points out that current projects directed by the Ministry of Finance to develop financial planning and monitoring documents can promote the clearer and more comprehensive presentation of information on liabilities. The National Audit Office considers that information on the development of central government liabilities and net wealth as a result of spending limits decisions should be added to the spending limits decision and spending limits report.

7.5 Development of expenditure excluded from the spending limits

One-fourth of central government expenditure is excluded from the spending limits. This section examines how expenditure excluded from the spending limits has developed during the terms of Prime Minister Matti Vanhanen's first and second Cabinets. The examination is based on information presented in the Government's budget proposals, since supplementary budget proposals do not distinguish between expenditure included in the spending limits and expenditure excluded from them. Budget expenditure has been divided in this way since 2004.

Table 2 and Figure 3 show the development of expenditure included in the spending limits and expenditure excluded from the spending limits in the budget proposals for 2004–2011.

Unemployment allowance, housing allowance and transfers to the Social Insurance Institution form the largest category of expenditure excluded from the spending limits. These vary over the economic cycle and act as automatic stabilisers. The impact of the recession is reflected in growth in these items in 2010 and 2011. Other significant items that



Source: Government budget proposals for 2004-2011

FIGURE 3: Expenditure included in the spending limits and expenditure excluded from the spending limits in the budget proposals for 2004–2011.

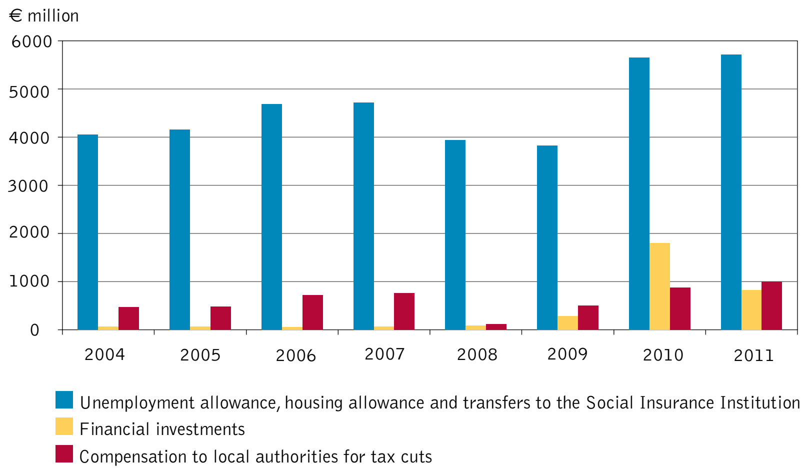
TABLE 2: DEVELOPMENT OF EXPENDITURE INCLUDED IN THE SPENDING LIMITS AND EXPENDITURE EXCLUDED FROM THE SPENDING LIMITS IN THE BUDGET PROPOSALS FOR 2004–2011, MILLION EUROS.

	2004	2005	2006	2007	2008	2009	2010	2011
Included in spending limits	28 106	28 846	29 829	30 510	33 905	35 967	36 975	38 072
Excluded from spending limits	9 390	9 187	9 855	10 106	9 769	10 209	13 558	12 596

are excluded from the spending limits are financial investments and compensation to local authorities for tax cuts, which can change on the basis of a decision. Table 2 shows the development of these items during the period that was examined. The increases in 2010 and 2011 resulted particularly from stimulus measures.

According to the September 2009 economic survey published by the Ministry of Finance, half of the decision-based stimulus measures in 2009 and 2010 concerned expenditure (tax cuts, dispensation from social welfare charges, change in the apportioning of corporate tax). The other half consisted of construction and financial investments. Consequently the increase in the budget in 2010 was due to growth in expenditure excluded from the spending limits. The fact that stimulus measures focused on expenditure excluded from the spending limits and factors on the revenue side raises questions about the strength of commitment to the spending limits procedure and expenditure ceilings.

Table 3 and Figure 4 clearly show an increase in financial investments, which are ex-



Source: Government budget proposals for 2004–2011

FIGURE 4: Development of key expenditure excluded from the spending limits in 2004–2011

TABLE 3: EXPENDITURE EXCLUDED FROM THE SPENDING LIMITS IN THE BUDGET PROPOSALS FOR 2004–2011, MILLION EUROS.

	2004	2005	2006	2007	2008	2009	2010	2011
Unemployment allowance, housing allowance and transfers to the Social Insurance Institution	4 054	4 154	4 683	4 719	3 938	3 826	5 652	5 707
Financial investments	73	70	65	66	90	292	1 800	825
Compensation to local authorities for tax cuts	472	483	716	759	119	498	873	1 002
Other	4 791	4 480	4 391	4 562	5 622	5 593	5 233	5 062
Total	9 390	9 187	9 855	10 106	9 769	10 209	13 558	12 596

cluded from the spending limits, in 2010 and 2011. A Ministry of Finance working group on the spending limits procedure wrote in its 2007 report[230] that financial investments result in the procurement of central government assets or a change in assets and therefore do not constitute final expenditure but can be compared to saving. In its evaluation of stimulus measures in the September 2009 economic survey[231] the Ministry of Finance speaks of financial investments ″above all in loans granted by the state, which weaken the financial position of the budget economy″. Since financial investments are excluded from the spending limits, the fact that expenditure ceilings were not exceeded did not prevent a weakening of the budget balance. The recession temporarily increased expenditure excluded from the spending limits, but otherwise it remained fairly steady during the period that was examined. On this basis one can say that expenditure included in the spending limits is not shifted outside the spending limits to any significant degree.

230 Ministry of Finance: Fiscal Policy Rules and the Reform of Spending Limits in Finland. Ministry of Finance Publications 5a/2007, p. 75.

231 Ministry of Finance: Economic Survey September 2009, Ministry of Finance Publications 32a/2009, p. 63.

8 The spending limits procedure and the sustainability of public finances

8.1 Summary of audit findings

The sustainability of public finances means the ability to manage the financing of current debt and future expenditure. The sustainability gap is the difference between the current state and a sustainable pattern. The difference can be expressed as the need to raise the level of taxation or the need to cut spending in relation to GDP. Indicators describing the sustainability gap are dependent on the baseline situation and assumptions regarding future development. Significant factors affecting the evaluation of the sustainability gap are the balance of public finances at the starting point, the level of public debt in relation to GDP and cost pressures resulting from the ageing of the population.

The audit revealed the sensitivity of sustainability calculations to the balance of public finances at the starting point. Consequently the recession has significantly affected evaluations of the sustainability of public finances. According to the current outlook, the effects of the recession on the sustainability gap will, however, be insubstantial in comparison with other factors. The National Audit Office therefore emphasises the importance of reporting and communication regarding sustainability calculations. In addition to an evaluation describing the need to adjust public finances, attention must be drawn more clearly to the factors behind sustainability calculations. The sensibility of indicators describing the sustainability gap to changes in the balance of public finances at the starting point means that when the recession bottoms out and medium-term economic prospects improve, the estimate of the sustainability gap in public finances will fall. This will present a serious risk that attention will not be paid to structural factors behind sustainability calculations in political decision-making.

To meet the needs of the National Audit Office in the external audit of fiscal policy, the Research Institute of the Finnish Economy (ETLA) is conducting a study concerning the sustainability of public finances. The evaluation of sustainability is based on a stochastic population forecast. In addition the calculation of health and care costs is based on the age structure and mortality. With this method health and care costs increase less than in calculations based solely on the age structure. According to the estimate presented by ETLA in the study that was conducted for the National Audit Office, the sustainability gap is 2.5 per cent of GDP. A confidence interval of 50 per cent related to population forecasts and returns on investment is about two percentage points wide and a confidence interval of 80 per cent about four percentage points wide. In spite of uncertainty, the possibility of a change in the estimate of the sustainability gap for the worse must be taken seriously. The forecast will be refined in later stages of the project, but on the basis of previous studies it appears that the tax rate in the 2030s could be five percentage points higher or else welfare services will have to be cut back significantly, with a probability of 30–40 per cent. If population trends and returns on investment led to a course of development in which the need to increase the tax rate exceeded five percentage points and a major financial crisis occurred, the welfare state would truly be threatened. Although ETLA's estimate of the sustainability gap is smaller that other institutions' estimates, it points to significant risks in maintaining the welfare state in its current scope.

Changes in the starting point resulting from short-term rapid economic growth will not substantially alter the conclusions drawn on the basis of calculations. Improving productivity in the public sector could significantly improve the situation provided the rise in productivity is used to improve the financial position.

The Government Programme was prepared assuming clearly faster economic growth than was suggested by economic forecasts in 2007. According to the Ministry of Finance's forecasts, central government finances would have ended up in surplus following the spending policy outlined in the Government Programme. The setting of objectives thus involved risks, which materialised to some extent. The financial crisis and its depth could not have been foreseen when the Government Programme was prepared in 2007. This emphasises the need for fiscal policy rules to be flexible in case of shocks in a small, open economy such as Finland's. As a result of the financial crisis it was necessary to deviate from the balance objectives set in the Government Programme. Spending cuts in the midst of the recession would have unnecessarily deepened the downturn.

The dimensioning of the spending limits and the balance objective in the Government Programme have not been clearly and consistently derived from objectives regarding sustainability and the objective of balanced public finances based on them. Spending rules should be derived in a clear and open way from objectives aimed at closing the sustainability gap according to a reasonable timetable.

About 37 per cent of total expenditure in the public sector is included in the central government spending limits in 2010. The spending limits are thus quite narrow in scope from the viewpoint of the achievement of fiscal policy objectives, particularly with regard to the sustainability of public finances. Growth in expenditure and costs has been rapid in local government and social security funds. Growth in expenditure and costs in local government and social security funds has also been more rapid than in central government.

Among off-budget funds the State Pension Fund is considered part of the employment pension institutions sector in the national accounts. In practice, however, it falls within the scope of the spending limits. Transparency regarding the relation between the budget economy and the State Pension Fund and associated liabilities should be improved. Other off-budget funds have 13,788 million euros on their balance sheets and constitute a significant deviation from Parliament's budgetary power. One simple way to expand the scope of the spending limits, which is in line with the principles in section 87 of the Constitution, is to evaluate in which off-budget funds there are no longer essential grounds to arrange activities in this way and to make such funds part of the budget economy. Insofar as off-budget funds are still justified, their revenues and expenditure should be included in the spending limits.

Financial investments are excluded from the spending limits. By making financial investments in state-owned companies that perform special tasks and do not operate entirely on normal business principles, it is possible to circumvent the spending limits. Using the form of a limited company to arrange tasks and financing should always be based on operational and economic benefits for central government finances as a whole. This principle should also be spelled out more clearly in the Government's ownership steering policy and fiscal policy rules. A summary of the finances and performance of state-owned companies handling special tasks, along with associated risks and their development, should be compiled in connection with decision-making on the budget and the Report on the Final Central Government Accounts.

Local government accounts for over half of the sustainability gap in Finland's public finances. Recent evaluations indicate that the need to raise local taxes is considerable. Local authorities' current financing does not allow investments that are necessary to make up for depreciation and perform statutory tasks. This is visible in an increase in the difference between depreciation according to plan and booked depreciation. Local authorities cannot perform current tasks on the basis of current financing.

The audit indicated that the spending limits procedure should be extended to local government finances as a whole as part of the financing relation between central and local government and the reapportioning of costs between central and local government. It does not make sense for central government to approve spending limits for individual local authorities, however, since local authorities' needs and situations are quite different. Spending limits extending to local government finances could be implemented as part of the Basic Public Services Programme and the revision of the basic public services budget. The essential thing is to set adequate objectives concerning costs to local authorities resulting from legislation and central government measures. This requires a substantial improvement in the evaluation of the impacts of legislation.

A significant part of net wealth in Finland's public finances is in social security funds. Owing to the ageing of the population, expenditure from social security funds is set for a long-term rise. Social security funds' financing and expenditure are prescribed in legislation. Social security funds should be examined separately as part of general government spending limits and fiscal policy rules and objectives.

The fact that spending limits are tied to the electoral term is a problem when it comes to resolving the sustainability gap over the longer term and ensuring long-term financial planning. In Finland it is necessary to establish rules regarding what kind of expenditure and liabilities each Government can leave to the following electoral term.

8.2 Institutional coverage of the spending limits

The success of the spending limits in achieving fiscal policy objectives also depends on how comprehensively spending limits can influence public finances as a whole. From this perspective it is necessary to evaluate whether the coverage of the central government spending limits is appropriate.

8.2.1 Expenditure included in the spending limits as a share of total public expenditure

According to information in 2010, the spending limits cover about 37 per cent of total public expenditure in Finland and about 75 per cent of the state budget economy. In Finland's system a practical approach has been taken in determining what is covered by the spending limits. In developing the system, expenditure which the Government can easily influence on the basis of existing powers and systems and which is therefore directly connected to the state budget has been included in the spending limits. To ensure the transparency of the system, when the spending limits procedure was reformed in 2003, the Government's leeway in practical decision-making was restricted to the state budget economy, not central government finances as a whole, as defined in the national accounts. The Ministry of Finance working group that studied the reform of the spending limits procedure in 2003 noted in its report that the examination of the spending limits can be expanded later to central government finances as a whole, once the preconditions for steering and monitoring off-budget funds have been adequately assured.[232] The working group also considered including off-budget funds in the spending limits as early as spring 2003.[233] When the spending limits procedure was revised for the new electoral period in 2007, the question of the position of off-budget funds or the possible inclusion of social security funds in the spending limits was not addressed.

Legal requirements related to Economic and Monetary Union, recommendations concerning Finland's economy and economic policy presented by international organisations and particularly the OECD, and the development of Finland's public finances raise questions about the comprehensiveness of Finland's current fiscal policy framework. In its separate report to Parliament on the audit of the final central government accounts for 2009 and the Report on the Final Central Government Accounts, the National Audit Office also pointed to the need to consider whether the scope of rules-based fiscal policy in Finland should be expanded. The National Audit Office noted that the rise in costs in the public sector is fastest in local government.[234] In 2009 local authorities' operational costs totalled 33.7 billion euros, up 3.8 per cent from the year before. The rise in operational costs nevertheless slowed during the year, since the rate of growth in 2008 was 7.7 per cent.[235] Social security funds' expendi-

232 Ministry of Finance: Fiscal Policy Rules and the Reform of Spending Limits in Finland, Ministry of Finance 2003, pp. 6 and 22–23.

233 Ministry of Finance: Fiscal Policy Rules and the Reform of Spending Limits in Finland, Ministry of Finance 2003, pp. 22–23.

234 National Audit Office's report to Parliament on its activities for fiscal year 2009, R 12/2010 vp., p. 21.

235 Statistics Finland, Finances and activities of municipalities and joint municipal boards.

ture also showed fast growth, rising by 9.7 per cent from 2007 to 2008 according to the information in the national accounts.[236]

Assumptions and principles in evaluating comprehensiveness

The comprehensiveness of fiscal policy rules can be evaluated from a legal perspective or from the viewpoint of fiscal policy objectives and their effectiveness. This report evaluates the comprehensiveness of the spending limits procedure and development needs in terms of the effectiveness of fiscal policy and associated risks, particularly with regard to what separate institutional sectors and financial units should according to the national accounts or on the basis of domestic legislation be included within the scope of fiscal policy rules. The examination pays special attention to how the fact that only part of the state budget economy is included in rules-based fiscal policy has affected the achievement of the fiscal policy objectives that have been set.

Finland's stability programme and its most recent update, which are part of the coordination of Economic and Monetary Union and the preventive arm of the Stability and Growth Pact, concern general government according to the concepts in the national accounts, i.e. central government, local government and social security funds. On this level Finland has a systematic framework for examining general government finances and related fiscal policy. The link between the stability programme and national fiscal policy decision-making has been relatively thin from Parliament's viewpoint, although Government Programmes have committed Finland to the policies and objectives expressed in the stability programme update. The stability programme does not receive as much attention as the spending limits procedure in discussions between the Government and Parliament concerning the budget, legislation and social policy in different sectors. The effective implementation of the obligations, objectives and spirit of the Stability and Growth Pact in itself would support the expansion of the spending limits procedure.

The Commission's proposal for a Council Directive on requirements for budgetary frameworks of the Member States would change the situation so that Finland would have a clear legal obligation to prepare spending limits covering general government finances. General government spending limits and fiscal policy rules would also have to cover local government and social security funds. The question of the comprehensiveness of the spending limits is in practice changing from whether spending limits need to cover local government and social security funds to what form such expanded spending limits should take and how they should be linked to the central government spending limits procedure.

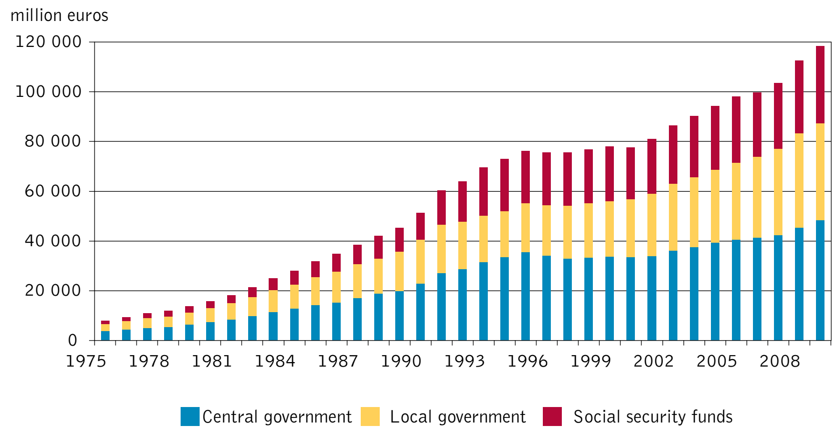
According to an OECD evaluation, the central government spending limits procedure has succeeded in curbing central government expenditure particularly in an upturn. The spending limits have a narrow scope and rapid growth in expenditure has taken place outside the spending limits system. In its evaluation of Finland's economic policy the OECD recommended that fiscal policy rules be extended at least to local government. Spending rules should also be linked more closely to objectives regarding the sustainability of public finances.[237]

236 Statistics Finland, General government expenditure by function.

237 OECD Economic Surveys: Finland. Vol. 2010/4, April 2010.

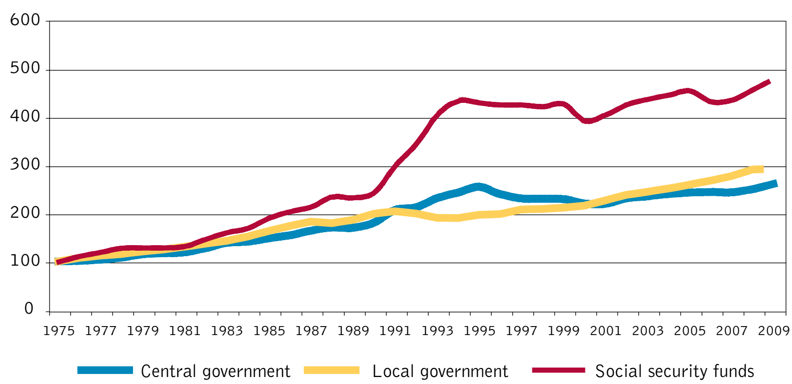
International recommendations and the good practices codified in the draft directive are justified from the viewpoint of the current state of Finland's public finances and related fiscal policy challenges. Central government finances and especially the state budget economy is only one part of the public sector, despite its role as guarantor of last resort and ultimate bearer of responsibility. Central government's role in smoothing cyclical fluctuations is nevertheless significant.

Examining the development of public expenditure at real prices one is struck by the rise in expenditure in the local government sector. Particularly during the past ten years real growth in local authorities' expenditure has exceeded growth in central government expenditure (Figures 5 and 6).



Source: Statistics Finland

FIGURE 5: Public entities' total expenditure by sector in 1975–2009



Source: Statistics Finland

FIGURE 6: Total expenditure in the public sector in 1975–2009 indexed at 2005 prices, 1975=100

8.2.2 Central government finances excluded from the spending limits and state-owned companies

Off-budget funds

Off-budget funds perform permanent tasks according to the principles prescribed in section 87 of the Constitution. Off-budget funds' expenditure is thus central government expenditure. With the exception of the State Pension Fund, off-budget funds are considered part of the central government sector in the national accounts. Since 2010 the State Pension Fund has been considered part of the employment pension institutions sector in the national accounts. With the exception of the State Pension Fund, off-budget funds' revenues, expenditure and liabilities thus affect the deficit or surplus of general government finances as well as Finland's EMU debt according to the rules of Economic and Monetary Union. As was mentioned in section 4 (Legal framework of the spending limits procedure), off-budget funds constitute a deviation from Parliament's budgetary power. This deviation should be kept as small as possible.

Matters regarding the setting of fiscal policy objectives and the effectiveness of fiscal policy as well as openness and transparency all call for keeping central government finances coherently within the scope of the budget. In this case all revenues and expenditure can be allocated coherently on the basis of a clear picture of central government finances as a whole. This is justified from the viewpoint of the dimensioning of fiscal policy, fiscal discipline and the efficient allocation of resources. Different needs can then compete genuinely and on equal grounds and efficiency losses resulting from sub-optimal decisions can be avoided. Matters related to good governance and effectiveness in the sphere of fiscal policy in turn call for the evaluation of each off-budget fund to determine whether there are essential grounds to arrange tasks in this way, as required in section 87 of the Constitution.

Including off-budget funds' tasks and resources and thus revenues and expenditure in the state budget would provide a simple way to close the gap in the spending limits as a fiscal policy rule. As part of the budget economy, funds' tasks as well as revenues and expenditure would fall within the scope of the fiscal policy rules applied to the budget economy.

The question of off-budget funds is not insignificant for fiscal policy as a whole. Off-budget funds have considerable economic importance. Off-budget funds had 25,837 million euros on their balance sheets at 31 December 2009. The State Pension Fund's share of this was 12,049 million euros. The total balance sheet value of off-budget funds classified as part of the central government sector in the national account is thus about 13,788 million euros. Off-budget funds' total result in 2009 came to 2,057 million euros, which includes the State Pension Fund. Off-budget funds have grown recently.

The State Pension Fund is significant in terms of fiscal policy on account of its volume and tasks. The State Pension Fund provides a means to prepare for state civil servants' future pension payments and is part of the employment pension institutions sector in the national accounts. According to the provisions in the Act on the State Pension Fund (1297/2006), the State Pension Fund operates on different principles from other pension funds. In many way it operates as an investment fund. Furthermore, state pensions are not paid directly from the State Pension Fund but from the state budget. On the basis of section 134 of the State Pension Act (1295/2006), 40 per cent of annual expenditure resulting from pensions based on employment by the state according to the State Pension Act is transferred from the State Pension Fund to the state budget. Once the State Pension Fund has accumulated this amount, a decision can be made in the budget concerning the amount that is transferred from the fund to the state budget. In 2009 the State Pension Fund received 1,639.9 million euros in operational revenues from pension premiums paid by employers and employees in the state pension system. In 2009 1,427 million euros was transferred from the State Pension Fund to the state budget as prescribed in the State Pension Act. The State Pension Fund's investments totalled about 10,668 million euros at 31 December 2009. Relations between the State Pension Fund and central government finances and the way in which central government pension liability is presented are quite complicated in the current system. Central government pension liability is not included in the final central government accounts but is presented as separate information in the Report on the Final Central Government Accounts, in addition to which it is presented in a note to the State Pension Fund's financial statements. Thought should be given to clarifying the presentation of these financial relationships and related information.

With regard to the spending limits procedure it should be noted that employers' charges that are paid by state agencies in the budget economy to the State Pension Fund are financed in operational expenditure or other consumption expenditure items in the state budget. These are subject to the central government spending limits. In the state budget appropriations for the payment of state pensions are considered part of the spending limits. Thus the State Pension Fund in fact falls within the scope of the spending limits and fiscal policy rules.

From the viewpoint of the comprehensiveness of fiscal policy rules, the other off-budget funds with about 13,788 million euros on their balance sheets are thus problematic. On the basis of their volume and the nature of their activities, the Housing Finance and Development Centre of Finland (ARA) is significant. Its loan receivables total 8,962 million euros and thus account for the bulk of the balance sheet value of off-budget funds in the central government sector. ARA can borrow money for its activities. In fact it accounts for 400 million euros of the long-term liabilities in off-budget funds. ARA also had current liabilities totalling 1,380 million euros according to its balance sheet at 31 December 2009. In addition to loans ARA grants interest support and direct subsidies. According to the final accounts ARA granted 178 million euros in subsidies in 2009. In 2010 the amount of subsidies was even higher.

ARA was an important tool in financing and implementing stimulus measures in response to the recession. The 2009 budget significantly expanded authorisations to grant subsidies and interest support from ARA and also introduced cyclical subsidies. Stimulus measures continued and were expanded in the 2010 budget. Since they were paid out of ARA, they fell outside the central government spending limits. By using this possibility, the Government was able to implement stimulus measures without the need for a special spending rule to allow for such a sharp downturn. Subsidies helped maintain housing and repair construction during the financial crisis and thus supported employment in the construction field.

The possibility that measures in a certain sector that fall outside the scope of the spending limits may have resulted in the financing of stimulus measures from ARA and investments in its field is problematic. From the viewpoint of the effectiveness of fiscal policy there is no logical reason why transfers paid through ARA should not fall within the scope of the spending limits. It would make sense and be in the interest of effective fiscal policy if all expenditure were covered equally by fiscal policy rules. The flexibility required to respond to exceptional cyclical development should be included in the fiscal policy rules system itself.

The 462 million euros in television licence fees received by the State Television and Radio Fund and the 451 million euros transferred from the fund to the Finnish Broadcasting Company can be considered significant from the viewpoint of fiscal policy. In fact, however, this is a technical transfer item that has been excluded from the central government spending limits. The activities of the State Television and Radio Fund are also connected to the implementation of constitutional media rights and the independence of the Finnish Broadcasting Company. Consequently the current model does not provide a special fiscal policy justification for allocating funds through the spending limits procedure. The fund should be reevaluated if financing arrangements change, however. The more charges collected to finance the Finnish Broadcasting Company can be regarded as taxes under the Constitution, the more there are fiscal policy justifications to include the level and use of charges within the scope of fiscal policy rules.

As a channel for transfers, i.e. support and subsidies, the Fund for Agricultural Development is also of interest from a fiscal policy viewpoint. It had about 729 million euros on its balance sheet at 31 December 2009. Transfers from the fund totalled about 106 million euros. The fund receives some revenues from the European Union (about 4.6 million euros in 2009), with the remainder of capital having come from the state budget. Transfers from the budget to the fund are included in the spending limits. The Intervention Fund of Agriculture mainly handles flow-through items connected to the European Union's Common Agricultural Policy and it has a volume of nearly eight million euros.

Taxes earmarked for a specific purpose are collected and managed in the Fire Protection Fund, the Security of Supply Fund and the Oil Pollution Fund. The purpose of the Security of Supply Fund is to finance government stockpiles and to ensure certain vital social functions. The Security of Supply Fund had about 1,192 million euros on its balance sheet at 31 December 2009, including about 900 million euros worth of stockpiled materials. The fund received about 45 million euros in security of supply charges. The tax-like charges collected by the Fire Protection Fund and the Oil Pollution Fund are used for grants and compensation. The Fire Protection Fund grants about 10 million euros a year. The compensation paid by the Oil Pollution Fund, which varies from year to year, totalled about 12 million euros in 2009. The Nuclear Waste Management Fund is also a contingency fund and receives nuclear waste management charges as well as statutory charges that are collected in the Nuclear Safety Research Fund. The Nuclear Safety Research Fund has considerable financial revenues, including about 44 million euros in 2009. The level of tax-like charges and corresponding grants is about 4.5 million euros. The Nuclear Waste Management Fund's equity was provided by the owners of nuclear power plants, which were assigned shares according to their capital base. The legal nature of the fund differs in this respect from other off-budget funds.

One purpose of fiscal policy rules is to curb growth in public expenditure so as to keep the level of taxes reasonable for taxpayers. This is linked to the objective of sustainability. The sustainability of public finances provides economic preconditions for activities and the continuity of activities in the public sector. An essential objectivity with regard to the sustainability of public finances is to keep the tax burden on a reasonable level. This means that in dimensioning fiscal policy with the help of fiscal policy rules it is necessary to examine the broader and longer-term objectives of fiscal policy. One must also look at balance and taxation and approach the question of an appropriate level of expenditure in this way. To ensure the achievement of these objectives, the activities of funds that manage earmarked taxes should also be included in spending rules, particularly if a fund can by varying expenditure determine the amount of money that it collects.

The Government Guarantee Fund was established following the banking crisis of the early 1990s. By law the fund is a permanent tool for managing any crisis in the financial market. The fund had about 13.2 million euros on its balance sheet at 31 December 2009 and received revenues from profits on bank subsidy investments and repayments. In case of a crisis on the financial market the fund's operational volume increases rapidly to an entirely new level. Since the fund is responsible for an emergency task – acting as lender of last resort – there is no point guiding its activities with fiscal policy rules.

The State Guarantee Fund serves as a buffer for any losses resulting from Finnvera's guarantees or other commitments. Finnvera and then the fund are responsible for liabilities materialising on the basis of commitments. If the capital in the fund is not sufficient to cover liabilities, the fund is topped up with a transfer from the state budget. Such a transfer is covered by the spending limits unless it is by nature a financial investment and meets the criteria for this purpose. Guarantees, export credits and other commitments provided by such a fund present a significant accumulation of hidden risks and obligations. There is no information on total risks in fiscal policy decision-making documents. Risks associated with the State Guarantee Fund and state credit activities arranged in company form should be monitored and evaluated as clearly and transparently as possible.

Off-budget funds each have their own history and tasks. This must be taken into consideration in evaluating the grounds and possibilities for including funds' activities in the budget economy. The State Pension Fund's activities are already covered by the spending limits in practice. With regard to several other funds there is good reason to consider bringing them within the scope of fiscal policy rules.

State-owned companies and unincorporated state enterprises

The state has large assets in the form of state-owned companies. The value of the state's direct holdings in Finnair Plc, Fortum Corporation and Neste Oil Corporation, which are listed on the stock exchange, was 11,215 million euros according to the market value at 24 November 2010, and holdings in other listed companies through Solidium, a limited company fully owned by the state, were worth about 20,102 million euros. This item improves the state's net worth position and also has fiscal policy significance as a factor influencing this position.

According to the information in the final accounts for 2009, the state controls shares and participations in unlisted companies with a book value of 7,187 million euros. The book value of unlisted companies that the state owns indirectly through Solidium was 5,375 million euros, leaving a book value of 1,812 million euros for the remaining companies. Some of these companies are market-based but others operate as in-house service providers from the viewpoint of competition law and do not have profit-seeking as their primary aim (e.g. Hansel Ltd, HAUS Finnish Institute of Public Management Ltd and State Security Networks Ltd). Some of the companies are thus responsible for performing special tasks. In addition the state owns two financially significant unincorporated state enterprises, Senate Properties and Metsähallitus. The former manages the state's real-estate holdings on an in-house basis. The latter manages state-owned forests and operates according to commercial principles and objectives while at the same time handling tasks that can be considered part of public administration on the basis of the Constitution.

State-owned companies can thus be divided into listed companies, market-based companies and companies that are responsible for special tasks. The state has a strategic interest in some market-based companies. Comprehensive information on the activities, finances and performance of companies that are responsible for special tasks, which generally do not come under the ownership steering of the Prime Minister's Office but are steered by different ministries or agencies, is not easily available.[238] This information is not included in the annual report of the Ownership Steering Department at the Prime Minister's Office, for instance, nor are these companies examined as a whole in the Report on the Final Central Government Accounts or systematically in the sections of the report dealing with different administrative sectors.

State-owned companies that are responsible for special tasks and unincorporated state enterprises are not covered by the spending limits. Government agencies' purchases from in-house actors that operate in the form of a company or unincorporated state enterprise, including rent paid to Senate Properties, come within the scope of the spending limits. Capital investments in companies and unincorporated state enterprises are financial investments and are excluded from the spending limits.

State-owned companies and unincorporated state enterprises do not have direct significance for the spending limits procedure. The present Limited Liability Companies Act allows the use of this form of company for other purposes besides profit-seeking business operations. If a company has no other shareholders, the state as the sole shareholder can freely make decisions that diverge from the normal division of power in a company. State-owned companies have been used to finance justified investment projects in Finland when the necessary funds could not be allocated within the spending limits. This procedure was followed in financing the renewal of the Seinäjoki–Oulu line section, for instance: in its own interest VR (the rail operator) took responsibility for 80 million euros of the project's total costs, although the state is the rail infrastructure manager. VR's participation in financing the renewal of the Seinäjoki–Oulu line section was decided in connection with the first supplementary budget in 2009. At that time VR agreed to pay 40 million euros of the project's costs. The 2010 budget included a commitment by VR to pay an

238 The Ownership Steering Department at the Prime Minister's Office is responsible for steering Solidium Oy ja Governia Oy, which perform special tasks that fall within the administrative sector of the Prime Minister's Office.

additional 40 million euros. VR had a substantial interest in the project, since renewing this important line section on too slow a timetable would permanently endanger rail transport's competitiveness on this route. According to the picture that was formed in the audit, the scarcity of investment funds influenced the procedure that was adopted and to some extent this procedure weakened financial relations between the state budget economy and state-owned companies as well as the transparency of the state budget. The Parliamentary Finance Committee and Audit Committee have repeatedly drawn attention to problems in financing transport infrastructure projects, particularly in the rail sector. Finavia, which is an unincorporated state enterprise, has provided financing for the construction of the Airport station on the Ring Rail Line.[239] Neste Oil Corporation has also provided interest-free financing to speed up the construction of transport infrastructure in Kilpilahti, which is important for the company.[240] Financing aimed at speeding up a project should not be a problem for the spending limits system in itself. Furthermore, the financing provided by these companies is considered a flow-through item under current rules and is therefore excluded from the spending limits. In its feedback the Ministry of Transport and Communications has pointed out that handling financing aimed at speeding up a project in connection with the preparation of the spending limits and the budget presents problems. It is necessary to evaluate whether relations between external financing and financing included in the scope of the spending limits are clear and functional, however.

In practice setting up a company to perform a special task and arranging activities through a government agency are often alternatives, provided a task does not involve the significant exercise of public powers as referred to in the Constitution. In this case state-owned companies can be used to circumvent the constraints imposed by fiscal policy rules. This can be done by making financial investments in companies that in practice end up covering the costs of special tasks, by allowing companies to book revenues that could have been considered state revenues or by borrowing money in the name of companies with a de facto state guarantee.

It is important to make sure that state-owned companies and the flexible operating possibilities they allow are not used as a means to circumvent the constraints imposed by the spending limits or other fiscal policy rules. Arranging activities in company form or through a company should always be based on an evaluation that this is the most effective way to organise activities. To prevent possibilities to circumvent rules, information concerning companies responsible for special tasks and other unlisted companies that are owned by the state should be compiled in a clear and comprehensive manner.

8.2.3 Local government finances and their relation to central government finances

Local government finances are linked to central government finances in many ways. Local authorities are broadly responsible for providing basic services in the social and health care sector and the education and culture sector and for implementing the rights that are prescribed in sections 16 and 19 of the Constitution regarding these

239 The share of financing reported in the commentary to the 2009 state budget proposal was 30 million euros.

240 See the 2009 state budget proposal, item 31.10.78 Certain transport infrastructure projects, justifications.

services. The state is ultimately responsible for financing services that are based on constitutional rights. Local authorities also take care of tasks having to do with the environment, infrastructure, business, sports and recreation, for example, and many of these tasks have a statutory basis at least in part. With regard to services that are up to Parliament's discretion, the state is responsible for seeing that any tasks and service obligations assigned to local authorities can be financed. Through legislation the state also has a significant influence on local government revenues. Although the state influences local authorities' expenditure and revenues through legislation, the essential point of departure in evaluating financial relations between central and local government is the provision in section 121 of the Constitution according to which municipalities' administration is based on the self-government of their residents.

Tax revenues and central government transfers make up the bulk of local authorities' revenues. According to statistics based on local authorities' financial statements, together they account for about 76 per cent of the total revenues booked by local authorities.[241] The biggest source of funds for local authorities is their share of income tax (15,437,688,000 euros in 2009) and the second biggest source is local authorities' share of corporate tax proceeds (1,198,772,000 euros in 2009). As a result of the financial crisis, in 2009 local authorities' corporate tax revenues remained low even though their share was increased. In 2009 central government transfers accounted for about 21 per cent of local authorities' revenues.[242]

In evaluating the current state of local government finances on the basis of information for 2009 and 2010, one must consider the exceptional measures that had to be taken as a result of the financial crisis and recession. Local authorities' financial position was improved by temporarily increasing their share of corporate tax in 2009–2011. The estimated effect of this was around 400 million euros a year. The lowering of employers' social security contributions in 2009 and the waiving of employers' contributions in 2010 eased local authorities' financial situation (about 80 million euros in 2009 and about 200 million euros in 2010). In 2010 the local tax rate rose by 0.4 percentage points on average, which will increase local authorities' revenues by about 320 million euros. An increase in the real-estate tax rate will increase revenues by nearly 190 million euros.[243]

Historically the significance of central government transfers to local government has declined. Figures 7 and 8 examine local authorities' tax revenues, government transfers and grants and other revenues in the financial structure of the local government sector in 1912–2008.

Central government transfers have stabilised at about one-fourth of local authorities' revenues while tax revenues make up slightly over 50 per cent.

Central government transfers' significance as a source of funds for local authorities varies considerably, however, and for most local authorities this is an extremely important source of funds.[244] The system of central government transfers is supplemented by the apportioning of tax revenues. In addition to central government transfers, the state pro-

241 Statistics Finland: Local authorities' finances and activities in 2009. This does not take into account changes in inventories or production for own use on the revenue side.

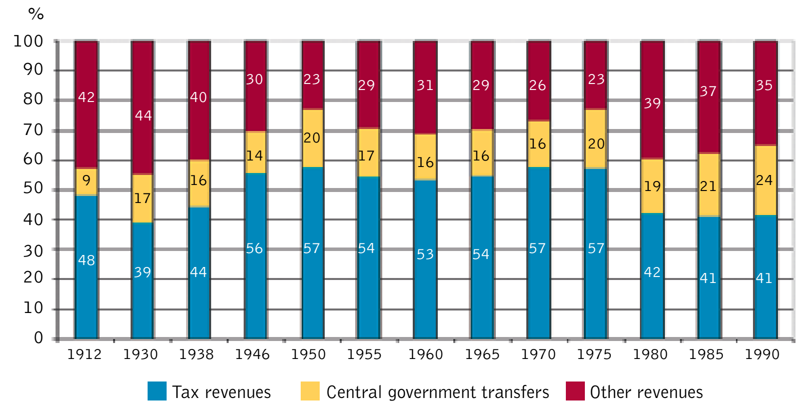
242 Statistics Finland: Local authorities' finances and activities in 2009. This does not take into account changes in inventories or production for own use on the revenue side. Calculations include only local authorities and not federations of municipalities.

243 Ministry of Finance: Stability programme update for Finland 2009. Ministry of Finance Publications 6a/2010.

244 Lehtonen, Lyytikäinen, Moisio: Kuntien rahoitus ja valtionosuusjärjestelmä: vaihtoehtoja uudistusten toteuttamiseksi, VATT studies 141, Helsinki, 2008, p. 2.

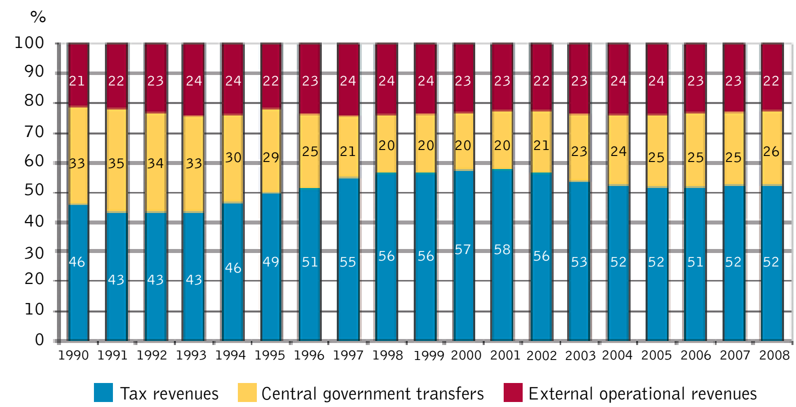
vides discretionary government grants to local authorities.

In evaluating the setting of fiscal policy objectives, it is important to remember that tax revenues, central government transfers and government grants are based on decision-making that takes place through legislation. The grounds for central government transfers and the general grounds for discretionary government grants to local authorities are prescribed in legislation and are included in the state budget. The state also decides on the forms of taxation and tax bases available to local authorities. On the other hand local authorities decide on tax rates within the limits set by legislation. Local authorities are free to decide on the municipal income tax rate, but decisions regarding tax deductions are up to the state. The state therefore has far-reaching power to make decisions that af-



Source: Oulasvirta 1996 and Loikkanen & Nivalainen 2010

FIGURE 7: Financial structure in the local government sector in 1912–1990



Source: Association of Finnish Local and Regional Authorities/Statistics Finland and Loikkanen & Nivalainen 2010

FIGURE 8: Financial structure in the local government sector in 1990–2008

fect local authorities' financial base, since in addition to tax revenues, some of the client charges that are collected by local authorities are based on legislation.

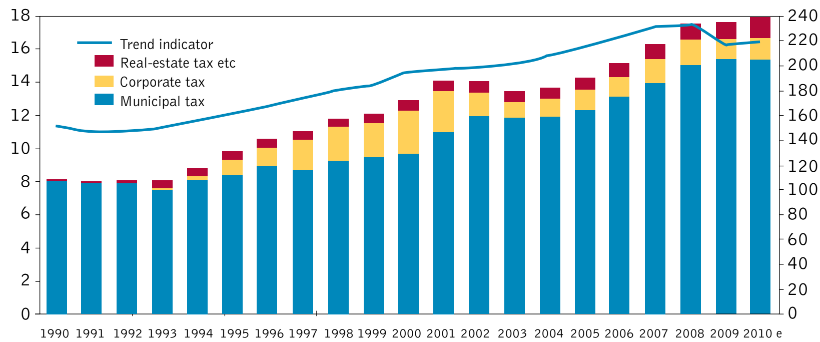
Figure 9 presents the development of local authorities' gross tax revenues and shows that these have reasonably followed business trends for the most part. The figure also shows that changes in the apportioning of corporate tax proceeds and other tax policy measures succeeded in keeping local authorities' tax revenues stable during the recession in 2008 and 2009.

Local government's share of public spending

The change in the structure of society and the building of the welfare state have expanded local authorities' tasks and increased demand for the services they produce. In the local government sector consumption expenditure in relation to GDP has consequently increased from less than 2 per cent in 1860 to about 15 per cent in 2008. The biggest factors behind the growth in local authorities' expenditure are the increase in public services and the fact that costs have risen faster for these services than in many other sectors.[245]

One can see from Figures 10 and 11 that local authorities' share of total public consumption expenditure has grown considerably. In discussion concerning rules-based fiscal policy, consumption expenditure has generally been considered the best place to apply constraints. If consumption expenditure gets out of hand, this is usually most harmful for fiscal policy objectives since such expenditure will have only a limited impact on future revenues and balancing finances. The requirement of efficiency and effectiveness to ensure the quality of public finances applies particularly to consumption expenditure.

Local government expenditure and growth in this expenditure are largely concentrated on tasks that have been assigned to local au-



Source: Association of Finnish Local and Regional Authorities/Statistics Finland and Loikkanen & Nivalainen 2010

FIGURE 9: Development of local authorities' different types of tax revenues and relation to business trends (billion euros and trend index)

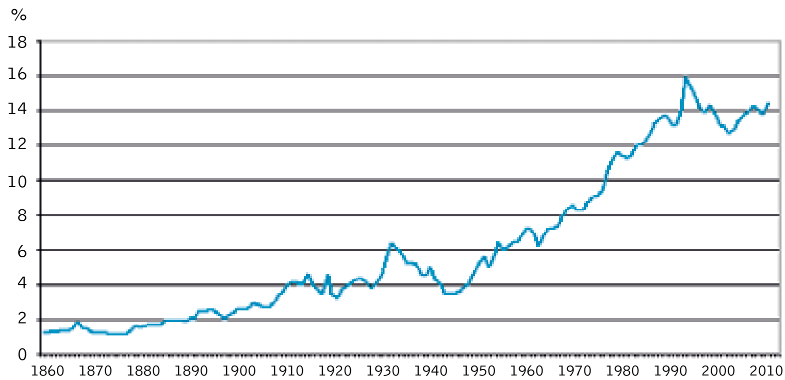
245 Ministry of Finance: Fiscal policy report on stable and sustainable local government finances. Ministry of Finance 42/2010, p. 23.

thorities by the state in special legislation. Local government expenditure is by no means entirely within local authorities' control but is based to a large extent on measures taken by central government.

Examining local authorities' consumption expenditure by function in a little more detail shows that health care, education and social welfare services are the biggest categories. Social welfare services' share has remained roughly on the same level while health care's share has risen. Meanwhile education's share has declined (Figure 12).

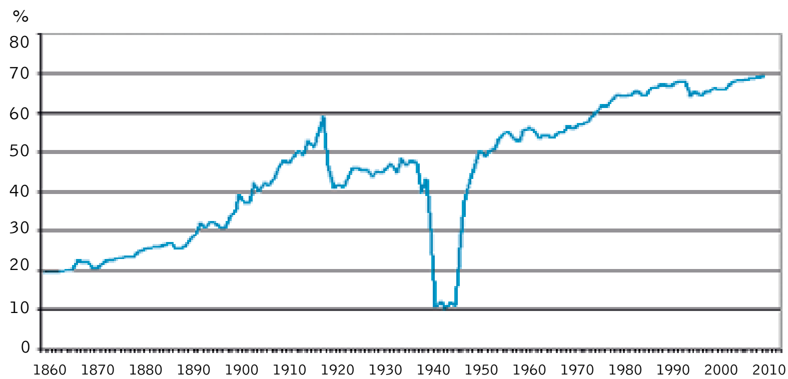
Expenditure has grown more rapidly in local government than in central government. Prices have also risen faster for local government than for the economy as a whole or central government, as Figure 13 shows.

According to calculations made by the National Audit Office on the basis of the national accounts, local authorities' real expenditure grew by 2.4 per cent a year on average during the period 1995–2009, while central government expenditure rose at an annual rate of about 0.5 per cent (see Table 6 in section 8.2.4).



Source: Loikkanen & Nivalainen 2010

FIGURE 10: Local authorities' consumption expenditure in relation to GDP



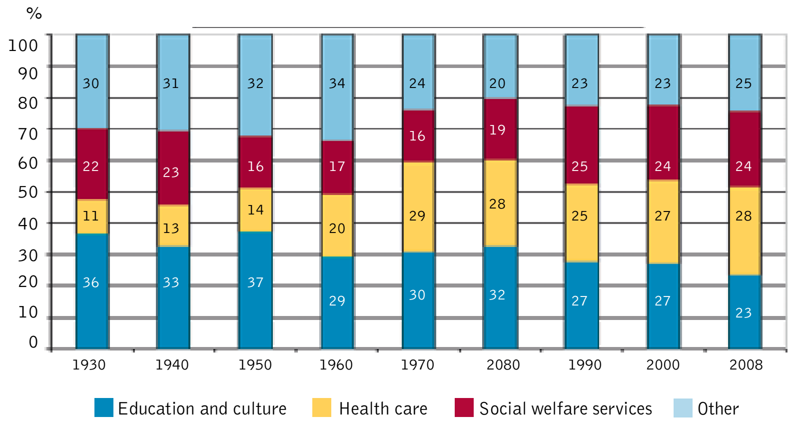
Source: Loikkanen & Nivalainen 2010

FIGURE 11: Local government sector's share of total public consumption expenditure 1860–2007

The balance of local government finances

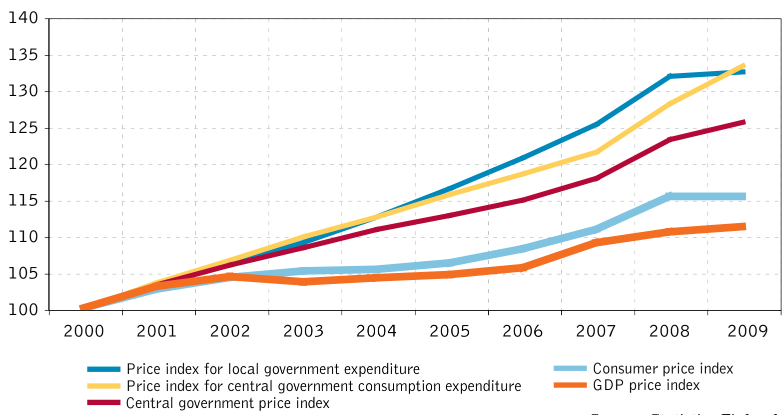
The relative balance of local government finances may prove artificial on closer inspection. Local authorities' debt has risen rapidly throughout the 2000s (Figure 15). Local government's share of EMU debt calculated according to the rules of Economic and Monetary Union is already significant from a fiscal policy viewpoint. Furthermore practices and arrangements in local authorities' accounting have concealed the development of deficits to some extent. In addition to rising debt, the difference between depreciation according to plan and booked depreciation has grown. In practice this means that local government revenues have not been adequate to cover all the investments required as a result of depreciation.

On the other hand, the current state of local government finances is improved to some extent by the fact that local authorities control considerable assets. Some of these are



Source: Loikkanen & Nivalainen 2010

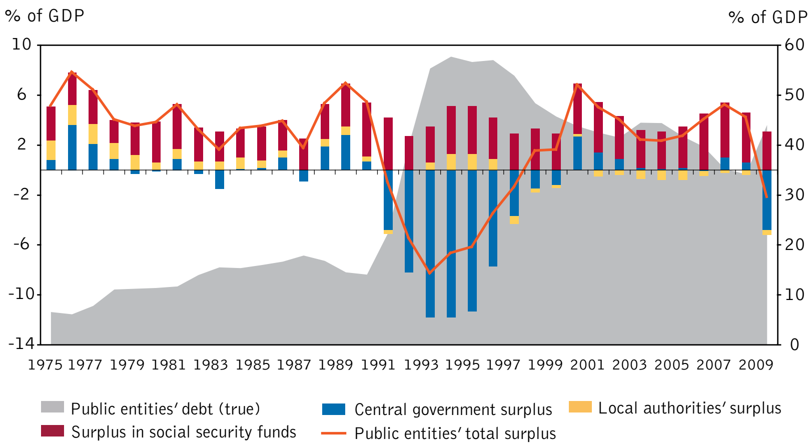
FIGURE 12: Different functions' share of total expenditure in the local government sector in 1930–2008



Source: Statistics Finland

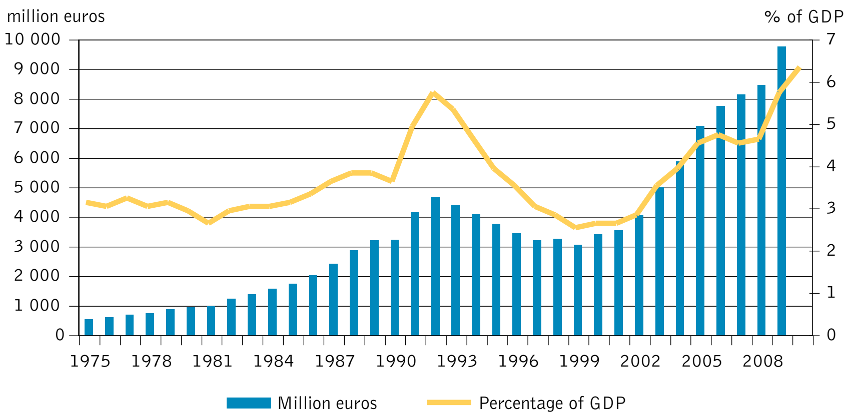
FIGURE 13: Development of different price indices since 2000, 2000=100

fixed assets required for the special needs of municipal service production and would be difficult to realise, but local authorities also have significant financial assets. Net financial worth or the difference between financial assets and liabilities provides a picture of essential matters regarding the current state of public debt and long-term sustainability. Table 4 shows that local authorities and federations of municipalities' net financial worth has fallen clearly in the 2000s. The annual margin in the table is an important indicator in evaluating the balance of local government finances. The annual margin by itself is not adequate to describe the balance of local government finances, however. The sustainability of local government finances can be examined by looking at the ratio between the annual margin and net expenditure on investments subject to depreciation. This de-



Source: Statistics Finland

FIGURE 14: Public entities' surplus/deficit and debt in 1975–2009 as a percentage of GDP



Source: Statistics Finland

FIGURE 15: Local government's EMU debt in 1975–2009 and projection for 2010, million euros and % of GDP

scribes the service network built by a local authority after subtracting grants received for this purpose. According to calculations made by the Association of Finnish Local and Regional Authorities, the ratio between the annual margin and net expenditure on investments subject to depreciation has weakened and the gap in local government finances is about six billion euros.

Future challenges for local government finances

The ageing of the population will present potentially significant challenges for the sustainability of public finances and economic policy in the coming years. Rising social and health care costs will particularly affect local government finances (Figure 16). The Ministry of Finance has estimated that local government will be responsible for about half of the sustainability gap in Finland's public finances.[246] Local government will bear the brunt of pressures on public finances resulting from changes in the population structure and the structure of the economy.

Dealing with the relation between central and local government in the spending limits

In the area of local government finances, central government transfers and discretionary government grants to local authorities are currently included in the spending limits.

The handling of central government transfers to local government in the spending limits system needs to be developed in order to ensure the transparency and coherent application of the spending limits. Central government transfers are granted to local authorities on the basis of calculated costs minus each local authority's share of financing. In calculating costs, factors describing the demand for services and special circumstances are taken into account.

The share of costs covered by central government transfers describes the relation between central and local government at the national level. The figure is currently 34.1 per cent for welfare and health care and 41.9 per cent for education and culture, including administration. Local authorities' share of costs is larger than central government's.

TABLE 4: ECONOMIC FIGURES FOR LOCAL AUTHORITIES AND FEDERATIONS OF MUNICIPALITIES IN 2001–2010, BILLION EUROS

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010*
Operational income	6.6	7.0	7.5	7.9	8.3	8.8	9.1	9.7	10.1	10.4
Operational expenditure	-21.6	-22.7	-23.8	-25.0	-26.3	-27.5	-28.9	-31.2	-32.5	33.5
Tax revenues	14.1	14.1	13.5	13.7	14.3	15.2	16.3	17.5	17.6	17.9
Central government transfers	3.7	3.9	4.3	4.7	5.1	5.5	5.8	6.4	6.9	7.5
Financial items, net	0.06	0.05	0.12	0.15	0.16	0.15	0.11	-0.13	0.20	0.14
Annual margin	1.95	2.26	1.58	1.44	1.48	2.10	2.39	2.40	2.31	2.42
Net financial worth	4.5	4.8	4.4	3.8	3.4	3.8	3.5	2.6	1.1	
Net worth			29.5	29.4	29.4	30.4	31.2	31.9	32.2	
Depreciation difference			0.48	0.59	0.66	0.69	0.72	1.04	1.10	

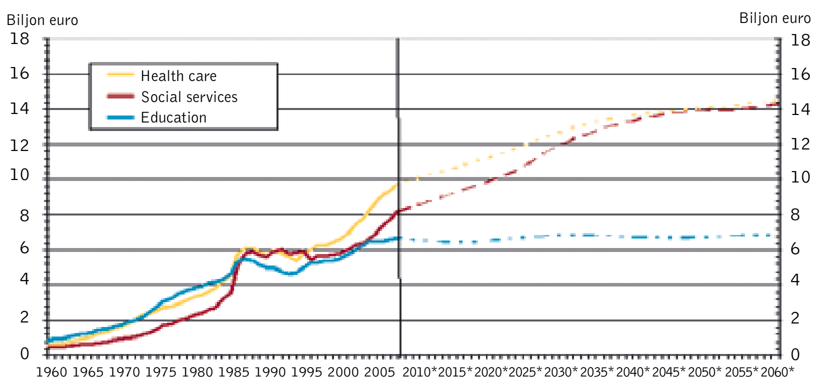
246 Ministry of Finance: Fiscal policy report on stable and sustainable local government finances. Ministry of Finance 42/2010, pp. 22–23.

The essential thing is that central government transfers to local government are paid according to a calculated cost level adjusted for factors related to the demand for services and special circumstances. These calculated costs are not the same as the actual costs to local authorities. The aim has been to provide incentives to improve productivity and economy, since local authorities cannot directly influence the costs on which central government transfers are based. The actual costs of producing services at the municipal or unit level do not have a direct influence on the amount of central government transfers. The shift to a calculatory system resulted in a significant curbing of growth in expenditure and costs while strengthening incentives to improve economy.[247]

In practice the system of central government transfers is a compromise between conflicting principles. The system should provide greater incentives to take measures that cut costs and improve efficiency.

Legislation regarding central government transfers to local government, currently the Act on Central Government Transfers to Local Government for Basic Public Services (1704/2009), the basic prices used in calculating central government transfers for the following fiscal year are issued in a Government decree. Some basic prices are calculated according to criteria that are spelled out in legislation. Others depend on decisions made in the state budget regarding the amount of funds. Changes in the quality and scope of tasks are taken into account in determining basic prices if a change is based on provisions in an act or decree or on the budget. In determining the basic price, attention is also paid to the change in the annual cost level according to the price index for basic public services. This price index is based on the change in prices weighted according to operational expenditure in the area of social and health care and education and culture.

Central government transfers and discretionary government grants to local authorities are included in the spending limits. With regard to central government transfers the fixed prices that are used in the spending limits system are adjusted according to the price index for basic public services.



Source: Loikkanen & Nivalainen 2010, Käär 1988 and Statistics Finland

FIGURE 16: Local authorities' total expenditure on health care, social services and education in 1960–2008 at 2003 prices and projection of cost pressures resulting from the change in the age structure in 2009–2060

247 See Oulasvirta: Kuntien valtionapujärjestelmä. Vertaileva arviointitutkimus kahdesta valtionapujärjestelmästä. Acta Universitatis Tamperensis series A Vol. 494, 1996, University of Tampere.

In the central government transfer system that was in effect before 2010, task-specific calculatory costs were approved each year for different tasks in the area of social and health care, as prescribed in the Act on Central Government Transfers, and unit prices for education and culture. Prices were adjusted in the spending limits with the help of the central government transfer index. Central government transfers were adjusted for changes in prices and costs according to principles prescribed in legislation.

Every fourth year costs are reapportioned between central and local government. This means checking basic prices and financing in the light of actual costs. According to the Act on Central Government Transfers to Local Government for Basic Public Services, during this process task-specific calculatory costs in the field of social and health care and prices in the field of education and culture were revised according to actual costs. In the previous system the share of costs covered by central government transfers was also set every fourth year.[248] Since 2006 costs have been reapportioned every fourth year, but before that legislation regarding the financing of education and culture required the regular reapportioning of costs every other year.

Costs were reapportioned on the basis of legislation preceding the 2009 Act on Central Government Transfers to Local Government for Basic Public Services in determining central government transfers for 2008 and the basis was actual costs in 2005. In reapportioning costs in 2008, calculatory costs and unit costs were increased according to the rise in actual costs. Slack index adjustments made in previous years to achieve central government cost-cutting objectives and tight fiscal discipline in local government were taken into account by lowering local authorities' share of costs. The legislative reform in 2006 abolished the possibility to provide compensation in central government transfers for a change in the cost level that is lower than the full index value for cost development, with the effect of tightening local government finances. Since the 2006 reform local government finances can be tightened by adjusting the share on a discretionary basis, taking all things into consideration.[249]

The reapportioning of costs in 2008 increased the amount of central government transfers to local government by 248 million euros compared to 2007.[250] The reapportioning of costs in 2005 led to a rise of 502 million euros in central government transfers. The 2004 spending limits decision reserved 295 million euros for the reapportioning of costs in 2005–2008. For fiscal policy reasons, i.e. to strengthen central government finances and reduce debt, the increase in central government transfers was spread over several years.[251] In the end the reserve was used up in three years. The reapportioning of costs in 2005 and the resulting increase in central government transfers particularly placed pressure on the spending limits system following the 2003 reform.

From the viewpoint of fiscal policy rules and the spending limits procedure, the significant thing about the reapportioning of costs is that the criteria used in calculating central government transfers – in real-

248 See Government proposal 174/2009 vp., p. 31.

249 See Government proposal 83/2007.

250 General commentary to the 2008 state budget proposal, basic public services budget review.

251 See Government proposal 181/2004.

ity standard costs – are revised every fourth year according to real cost development and cost levels. If the rise in costs has been quite strong, for different reasons, this causes the level of central government transfers to jump after each reapportioning. Owing to the fiscal policy need to tighten local government finances and stay within the spending limits, the revision of the cost level has in practice generally been spread out. This has often resulted in strong political criticism as well as criticism from local authorities. The revision of the cost level can lead to unpleasant surprises for the application of the spending limits. Cutting or spreading out the apportioning of costs has unpredictable and unexpected consequences for local government finances. On the basis of the 2009 Act on Central Government Transfers to Local Government for Basic Public Services, an effort has been made to ensure that provisions concerning the reapportioning of costs correspond to real practice.[252] This clearly improves the transparency and predictability of the system.

From local authorities' viewpoint, the reapportioning of costs is about sharing financial responsibility between central government and local government according to legislation. Local authorities' rising costs are due partly to the assigning of additional statutory tasks or changes in legislation that require a higher level of services. The unpredictability of the reapportioning of costs results from the underestimation of costs associated with new or expanded tasks or higher quality requirements for services arranged by local authorities when legislation is drafted and spending limits are set.

The spending limits procedure presents a risk that different ministries will place increased obligations on local authorities in drafting legislation, while central government's possibilities to arrange corresponding tasks or services itself are constrained by spending rules that place ceilings on expenditure. The current spending limits system has a possible "leak" in this respect: social policy and service objectives can be implemented by increasing local authorities' tasks without arranging the necessary funds to cover resulting costs. Since local government's share of costs is larger than central government's in the system of central government transfers to local government, the need to finance new statutory tasks places a greater burden on local government than on central government. This additional burden can be quite heavy before costs are reapportioned. When costs are reapportioned central government becomes responsible for financing these additional costs. Consequently the reapportioning of costs is likely to have a curbing effect on the expansion of tasks, which indirectly lead to increases in expenditure. This effect is not immediate, however, and can be overlooked in decision-making regarding the assignment and expansion of obligations. This diverges from decision-making concerning central government measures within the framework of the spending limits.

Costs are reapportioned on the basis of a comprehensive evaluation. This was also done under earlier legislation. According to the commentary to the government proposal, the current economic situation in local government and central government as well as the outlook and challenges for the coming years are also taken into consideration.[253] This provides a good and transparent foundation for combining the more general

252 See Government proposal 174/2009 vp., pp. 96–97.

253 Government proposal 174/2009 vp., pp. 96–97.

setting of fiscal policy objectives with the revision of central government transfers and the reapportioning of costs. The new legislation has not eliminated the basic problem, however, which is the underestimation of the cost level and the development of costs. This hampers the systematic management of central government and local government finances. At present, reliable estimates concerning the cost impacts of different obligations can only be made after the fact. An adequate and objective evaluation of total costs before legislation imposing obligations is drafted or included in the Government Programme would bring the necessary realism to the management of cost development.

The Basic Public Services Programme as a steering instrument connected to the spending limits

The relation between central government spending limits and local government finances is supplemented by the Basic Public Services Programme procedure. The Basic Public Services Programme has been required by legislation since 2008, with provisions contained in section 8 a of the Local Government Act (365/1995). The Basic Public Services Programme procedure refers to the Basic Public Services Programme and the basic public services budget review. The procedure is part of the negotiation process between central and local government and the drafting of the state budget. The Government Programme of Prime Minister Matti Vanhanen's first Cabinet called for the procedure to be established. The first Basic Public Services Programme was prepared in 2004. In practice the content of the procedure took shape before the relevant provisions were written into the Local Government Act. The procedure was developed to meet needs with regard to arranging the evaluation of basic public services, which local authorities are responsible for producing and arranging, and to integrate this with economic and financial relations between central and local government and the allocation of tasks. The Association of Finnish Local and Regional Authorities also hoped for a more stable and predictable local government policy on the part of central government with the help of the Basic Public Services Programme. Giving the programme a statutory basis was one of the association's key objectives.[254]

The Basic Public Services Programme is a significant cooperation tool between central and local government and is intended to facilitate the creation and coordination of local government policy. An essential goal of the Basic Public Services Programme is to review the current state of and outlook for local government finances as a whole and to coordinate the development of the division of labour between central government and local government so as to achieve balance between local authorities' tasks and financing. The Local Government Act calls for the Basic Public Services Programme to evaluate changes in local authorities' operating environment and demand for services as well as the development of local government finances and changes in local authorities' tasks and to prepare measures that are necessary to balance revenues and expenditure. Local government finances are evaluated as a whole, as part of general government finances, and by regional joint munici-

254 See the Association of Finnish Local and Regional Authorities memorandum of 6 February 2003 on the Basic Public Services Programme and budget.

pal boards. The financing required by local authorities to perform their statutory tasks, the development of these tasks and ways to increase productivity are also evaluated in the programme.

The purpose of the Basic Public Services Programme is to promote access to basic public services, to study means to ensure that services are financed in a sustainable and balanced way, to see that local authorities have sufficient resources to perform tasks (principle of adequate financing) and to evaluate measures to balance local authorities' obligations and financing. Another purpose is to develop legislation concerning basic public services and cooperation among the ministries that are responsible for preparing financing systems and to develop cooperation between central government and the local government sector.[255] The objective is for the Basic Public Services Programme procedure to serve as an instrument that will make it easier to manage services arranged by local authorities and financing for these services as a whole in policy-making.[256] The Basic Public Services Programme does in fact give a more comprehensive and systematic picture of local authorities' ability to arrange basic public services compared to procedures in the past. It allows more attention to be paid to the relation between local authorities' tasks and resources (principle of adequate financing).[257]

The Basic Public Services Programme is prepared and revised annually by a ministerial group chaired by the Minister of Finance, which also includes other ministers who are responsible for local government issues or legislation concerning services that are arranged by local authorities. The chairman and managing director of the Association of Finnish Local and Regional Authorities also participate in the ministerial group's work. The preparation of the Basic Public Services Programme takes place according to the timetable applying to the spending limits decision. On the basis of the programme key policies concerning the financing of basic public services and central government measures are contained in a separate part of the spending limits decision for the electoral term 2006–2010. Among the Government's different plans and programmes, the Basic Public Services Programme has been so thoroughly integrated into the spending limits procedure that it can be considered the strongest group steering instrument in central government and the public sector as a whole. The preparation of the Basic Public Services Programme in connection with the spending limits procedure has increased the programme's credibility and bindingness.[258] In practice there are still shortcomings in commitment, however.

The problem in the Basic Public Services Programme procedure is that the impacts of different legislative projects on local authorities' finances as a whole and for example pressures on local tax rates resulting from regulation are not evaluated adequately.[259] The National Audit Office has observed in audits that guidelines concerning the evaluation of the impacts of legislation are not implemented to a sufficient degree. For in-

255 See Government proposal 129/2007.

256 Government proposal 129/2007 vp.

257 Government proposal 129/2007 vp.

258 See Government proposal 129/2007 vp.

259 Ministry of Finance: Fiscal policy report on stable and sustainable local government finances. Ministry of Finance 42/2010, p. 52.

stance, the evaluation of legislation's productivity impacts and other impacts of a non-financial nature is far from adequate. With regard to the relation between central and local government finances, one thing that hampers the evaluation of impacts is the inconsistent and incommensurable way in which information is presented, so that it is not easy to form a picture of the overall impacts of provisions in different pieces of legislation.[260] The Basic Public Services Programme procedure is mainly information steering. In practice it does not appear sufficiently binding to meet the need to curb growth in expenditure.[261] The central government measures that have been written into the Basic Public Services Programme and the basic public services budget are covered by the central government spending limits as a rule, while the tasks and obligations assigned to local authorities are not. The spending limits system thus contains an incentive that makes it easier to assign expanded public tasks and obligations to local government rather than central government or at least presents a risk in this respect.

Another shortcoming in the Basic Public Services Programme procedure is that the programme and sectoral planning have still not been coordinated adequately. In past audits the National Audit Office has drawn attention to the existence of numerous sectoral and cross-sectoral programmes and other programme-based procedures and development projects in central government. These can easily conflict with one another and suffer in terms of effectiveness.

From the viewpoint of central government, the Basic Public Services Programme has made it possible to restrict growth in local authorities' tasks and expenditure. According to audit findings the programme has not led to adequate coordination in the drafting of legislation or the preparation of plans and policy objectives in different administrative sectors.

The content of the Basic Public Services Programme has started to place greater emphasis on the objective of evaluating means to raise productivity, as prescribed in the Local Government Act. The programme and the spending limits procedure are thus increasingly being used as an instrument to steer productivity in the local government sector as well. In addressing problems related to identifying and measuring productivity gains, the focus is shifting more towards the actual steering of productivity.[262]

Making productivity a significant issue in the Basic Public Services Programme is related to the fact that productivity in the public sector has a considerable impact on the development of the sustainability gap. The starting situation with regard to steering productivity is somewhat murky, however.

Productivity development in the local government sector does not appear very bright in the public sector productivity statistics collected by Statistics Finland. The development of total productivity has been negative throughout the 2000s, and the overall picture obtained from statistics describing productivity in education, health care and social services mainly shows a downward trend,

260 National Audit Office's draft performance audit report on the assessment of the financial impacts of legislative projects, Journal No 365/54/2008, National Audit Office 2010.

261 This was noted in the Ministry of Finance's Fiscal policy report on stable and sustainable local government finances, p. 53. The same observation was made in a study being conducted by the National Audit Office in cooperation with the University of Tampere concerning the spending limits procedure and the health and social services programme procedure as means to improve local authorities' productivity.

262 This is clearly visible in the content of the most recent Basic Public Services Programme. See Ministry of Finance: Basic Public Services Programme 2011–2014, Ministry of Finance Publications 21a/2010.

although there were signs of slight positive development in 2005 (Table 5).

The productivity indicator used by Statistics Finland measures volume changes in outputs and total inputs over time. This measuring method gives a lot of weight to the cost of producing outputs. In practice it does not take changes in the quality of services fully into account. Nor does it consider the effectiveness of the public services that are arranged by local authorities, i.e. whether services are ultimately beneficial for society and its individual members.

An example of the inadequate picture provided by productivity statistics comes from a study that was carried out by the Government Institute for Economic Research regarding productivity in services for the elderly, which considers the effect of treatment on coping skills.[263] Taking effectiveness into account raised the evaluation of productivity by about half a percentage point. The study also suggested that lowering costs per performance would weaken effectiveness. The study is based on information supplied by 21 local authorities concerning outputs, either produced by them or outsourced, and inputs in 2008 and 2009. This information was correlated with information on individuals' coping skills and factors influencing them. Measuring effectiveness and cost-effectiveness in public service production is hampered by the fact that local authorities and service producers classify services in different ways and total costs in a comparable form are unavailable.[264]

One problem regarding statistics on productivity in the public sector and particularly their utilisation is that, without supplementary information on effectiveness, productivity statistics and indicators can lead to the wrong

TABLE 5: DEVELOPMENT OF CERTAIN MUNICIPAL SERVICES AND TOTAL PRODUCTIVITY

		2001	2002	2003	2004	2005	2006	2007	2008
Education	Output	0,1	0,7	0,3	0,5	0,1	-0,1	-0,9	-1,4
	Total input	1,6	2,3	1,7	1,3	-0,4	-0,4	0,7	-0,7
	Total productivity	-1,5	-1,6	-1,4	-0,9	0,6	0,3	-1,6	-0,6
Health care services	Output	0,3	0,5	1,1	3,5	4,3	0,1	0,9	2,9
	Total input	3,8	3,5	3,0	5,7	4,8	1,7	2,6	3,9
	Total productivity	-3,4	-2,9	-1,8	-2,1	-0,5	-1,5	-1,6	-0,9
Social services	Output	-1,6	1,0	0,1	0,0	1,7	1,2	0,6	3,7
	Total input	3,9	2,9	0,8	1,3	1,6	2,6	1,8	4,2
	Total productivity	-5,3	-1,8	-0,7	-1,3	0,1	-1,3	-1,2	-0,5
Total	Output	-0,2	0,7	0,6	1,6	2,3	0,3	0,3	1,8
	Total input	3,1	2,9	2,0	3,2	2,3	1,2	1,8	2,5
	Total productivity	-3,2	-2,2	-1,4	-1,5	0,0	-0,9	-1,5	-0,7

Source: Statistics Finland, local government productivity statistics

263 Kangasharju Aki, Mikkola Teija, Mänttäri Tuomas, Tyni Tero ja Valta Maija: Vaikuttavuuden huomioon ottava tuottavuus vanhuspalveluissa, Government Institute for Economic Research, Study 160, VATT, Helsinki 2010.

264 Shortcomings in the availability of comparable data on the cost of services for the elderly were noted in a performance audit conducted by the National Audit Office on services for the elderly, particularly regular home care, National Audit Office performance audit reports 214/2010.

conclusions and recommendations. Labour productivity or the relation between volume changes in outputs and inputs may develop positively, and yet what is actually produced may have little real significance for society. In addition to the systematic examination of productivity, it is also necessary to examine effectiveness.

Taking economy and effectiveness into account reveals essential difficulties in managing productivity and curbing growth in expenditure in the local government sector. Generally speaking the quality, cost-efficiency and cost-effectiveness of public services in Finland are good by international standards.[265] This applies to many service systems for which local authorities are responsible. According to the OECD Programme for International Student Assessment (PISA), for example, Finland's education system is among the best in the world and has a relatively low cost level.[266] The effectiveness of health care in Finland is also high, if one compares outputs of services and treatment to the costs of the health care system.[267] On the other hand, differences between municipalities that have come to light in productivity studies together with local authorities' rising expenditure and costs as well as productivity statistics point to inefficiencies in local government finances and service production arranged by local authorities. In its review of Finland's economic policy, the OECD suggested that inefficiencies have in fact increased, but this was based mainly on the picture provided by productivity statistics.[268] Improving economy and productivity within this framework largely depends on resolving productivity problems at the local level. This in turn requires extensive information on concrete inefficiencies. If the service level is high and services enjoy broad support among citizens, productivity measures have their own limitations as far as curbing growth in expenditure is concerned. Curbing growth in expenditure requires keeping a firm grip on demand for services.

The objective in making the steering of local government productivity a key part of the Basic Public Services Programme and linking it to the spending limits and the steering of local authorities' productivity work is thus to respond to identified fiscal policy challenges and particularly to close the sustainability gap. The Basic Public Services Programme procedure has thus been given greater significance in the European Commission's communications and in the work of the EU's Economic Policy Committee as an instrument for steering the quality of public finances.

The Basic Public Services Programme, through its links to the spending limits procedure and the evaluation of the general development of public finances, is a suitable instrument by means of which macro-level fiscal policy objectives for the entire public sector can be turned into concrete measures in the practical steering and management of administration.

One general challenge in steering productivity is whether steering instruments can achieve the desired behavioural results and how behavioural results typically connected to a steering instrument support the achievement of objectives. A special challenge with regard to combining the achievement of fis-

265 OECD Economic Surveys: Finland 2010. Vol. 2010:4, pp. 71–72.

266 OECD: Economic policy reforms: Going for Growth 2009, OECD.

267 OECD: Health at a Glance, OECD 2009.

268 OECD Economic Surveys: Finland. Vol. 2010:4, pp. 71–72.

cal policy objectives and public management in Finland is to obtain the desired impacts in practice. There is a reasonable consensus in Finland concerning the challenges facing public finances and particularly local government finances. Making concrete measures with real impacts part of practical management has proved more difficult. The Basic Public Services Programme has emphasised the importance of increasing productivity in every sector. The programme has also emphasised the implementation of the PARAS project, which is aimed at restructuring local government and services. Differences among municipalities are substantial, however, and measures intended to achieve genuine improvements in productivity require a good information base, which programmes of a general nature currently do not provide.[269] Reports on the restructuring of local government and services suggest that municipalities with low efficiency have not taken adequate steps to develop productivity.[270] The PARAS project in itself includes quite complicated procedures and to some extent conflicting objectives and means. On the basis of different evaluations this can present a risk for the implementation of the project and objectives that have been set in the Basic Public Services Programme. In future more attention should be paid to practical implementation in the content and steering impacts of the Basic Public Services Programme and projects that are steered through it.[271] The demand for services and the effectiveness of services are also assuming a more crucial position from the viewpoint of achieving fiscal policy objectives.

Evaluation of the consideration of local government finances within the framework of Finland's fiscal policy rules

Finland's fiscal policy rules cover only a small part of public finances, even with regard to tasks and funds that are governed by legislation. The Basic Public Services Programme procedure prescribed in the Local Government Act in itself offers a sufficient statutory base for the implementation of the proposed directive. According to the picture formed by the National Audit Office, provisions concerning the Basic Public Services Programme need to be developed.

On the whole, shortcomings in the comprehensiveness of fiscal policy rules present significant risks for the successful management of fiscal policy. Owing to its narrow coverage, the spending limits system cannot adequately meet essential fiscal policy challenges now and in the coming years, which are to stabilise and ensure the sustainability of public finances.

Local government finances have traditionally been a stable part of public finances, with central government acting to smooth cyclical fluctuations. This principle is still applied as a policy objective. With regard to public expenditure, local government will be in the front line in meeting the challenges of an ageing population, and cyclical effects can also be observed in local government expenditure to some extent. Current balance requirements at the local government level appear to be pro-cyclical, which cannot be justified from the viewpoint of ef-

269 Criticism expressed with regard to the government productivity programme should be put to use in preparing a productivity programme for the local government sector. See National Audit Office performance audit report 207/2010, The preparation and management of the Government productivity programme, and the National Audit Office's annual activity report, R 20/2010 vp.

270 Vakkuri & Kallio & Tammi & Meklin & Helin: Matkalla kohti suuruuden ekonomiaa? Paras-ARTTU programme studies No. 3, 2010, Association of Finnish Local and Regional Authorities online publication Acta 218, Helsinki.

271 See Moisio & Loikkanen & Oulasvirta: Public Services at the Local Level – The Finnish Way in Antti Moisia (ed.): Local Public Sector in Transition: A Nordic Perspective, VATT Publications 56, VATT, Helsinki 2010, pp. 155–184.

fective fiscal policy. Furthermore, the size of local government finances in itself is an argument for including local government in the framework of fiscal policy rules. Recent international comparisons among the members of the OECD have shown that the stability of local government finances is indispensable for macroeconomic stability and the achievement of fiscal policy objectives. Fiscal policy rules covering local government can support the stability and sustainability of local government finances in Finland. With regard to financial relations between central and local government, and as a supplementary perspective to traditional economic theories, comparisons have also observed that coordinating public finances as a whole and particularly coordinating financial relations between central and local government within a fiscal policy framework, together with institutions that have been developed for this purpose, can improve countries' ability to recover from recession.[272] These points support the expansion of fiscal policy rules, developed on the basis of the spending limits procedure, to the relation between central and local government.

Owing to the wide range of tasks that local authorities perform, local government finances in Finland are not in line with what has been considered optimal in international recommendations and literature in the field of economics.[273] Resulting welfare losses may be intensified by the tightening of local taxation and future pressure to raise local tax rates. Local authorities have often resorted to raising local tax rates to compensate for increased cost pressures and weak revenue development. Between 1970 and 2008 the average local tax rate rose by five percentage points.[274] In 2005–2007 it rose by 0.75 percentage points to 18.5 per cent. In 2010 the local tax rate is expected to rise by 0.4 per cent on average, increasing local authorities' revenues by about 320 million euros.[275] These figures do not take into consideration the effects of tax deductions, however.

Since 1997 tax deductions have also applied to local taxes. Consequently the average effective tax rate, meaning the portion of earnings that must be paid in taxes, has not risen as much as the nominal tax rate. The nominal tax rate and the average effective tax rate have followed different paths. In recent years an effort has been made to compensate local authorities for lost revenues resulting from the application of deductions to local taxes. This compensation is excluded from the central government spending limits. The idea has been to keep the spending limits system from making it more difficult to implement a socially justified tax policy. As a whole the relation between local taxes, tax deductions, compensation and the system of central government transfers to local government is unclear and hard to understand.

The longer-term outlook for local government finances is clouded by the sustainability gap in general government finances. This is associated with the fiscal policy risk in the financial relation between central and local government. Since local authorities largely perform tasks assigned to them by central government but can to some extent balance finances by raising taxes, there is considerable upward pressure on local taxes. This does

272 See Vammalle & Charbit: "Fiscal Federalism, Recent Developments and Future Trends" in Antti Moisio (ed.): Local Public Sector in Transition: A Nordic Perspective, VATT Publications 56, VATT, Helsinki 2010, pp. 15–58.

273 See Loikkanen & Nivalainen 2010. See also VATT 2010.

274 See Loikkanen & Nivalainen 2010. See also VATT 2010.

275 Ministry of Finance: Stability programme update for Finland 2009, Ministry of Finance Publications 6a/2010.

not necessarily produce a justified and fair solution from the viewpoint of fiscal policy and society. The economic outlook for different regions and municipalities has diverged sharply, so that local authorities are not in an equal position from the viewpoint of raising tax rates. Current compensation systems are consequently inadequate.

The Ministry of Finance has estimated that without changes in current policies, local tax rates will rise by seven percentage points between now and 2030.[276] Local tax rates are generally higher in small municipalities that are in poorer shape financially, thus increasing the competitiveness and pull of larger and richer municipalities.[277] This can easily result in the inefficient allocation of resources and above all problems concerning fairness.

Dynamic balance models have been used to investigate ways to close the sustainability gap in public finances. Analyses performed by the Bank of Finland have found that tightening income taxes has many negative impacts on economic growth. The tightening of local taxes is one such negative impact.[278]

The question of expanding the spending limits system to local government has been addressed in national fiscal policy discussion regarding local government finances. The Government Programme of Prime Minister Mari Kiviniemi's Cabinet calls for a spending limit system to be drafted for local government finances in order to enable the management of cost trends over the medium-term and to ensure the availability of services in all parts of Finland.[279] Such a system was evaluated in a memorandum that was drafted by a Ministry of Finance working group in October 2010. Proposals are based largely on local authorities' own starting points and are still sketchy. According to the working group's proposals, curbing growth in local government expenditure requires a more binding steering model, and the need for and functioning of a spending limits system linked to the Basic Public Services Programme should be studied. The working group also proposed that spending limits and related mechanisms should be introduced at the level of individual local authorities as a financial steering instrument.[280]

In considering whether to include local government finances in the framework of fiscal policy rules, careful thought should be given to what fiscal policy rules are meant to steer. Experience with the central government spending limits procedure provides a foundation for this, along with international opinions and experience concerning different fiscal policy rules. The essential thing is for a spending limits system covering local government to be part of a broader fiscal policy framework and the setting of objective within this framework.

Following this reasoning and keeping in mind the past development of local government finances as well as future challenges, it is vital to steer the sustainability of public finances and, in order to ensure sustainability, the development of expenditure in different spheres of public finances, or in other words fiscal discipline. In its review of Finland's economic policy the OECD specifically emphasised the need to restrict growth in local authorities' expenditure.[281]

276 Ministry of Finance: Finland's Public Finances at a Crossroads – Approach to fiscal policy in the 2010s, Ministry of Finance Publications 8/2010.

277 Laine & Maiväli: Finland: Adjusting to an ageing population, ECFIN Country Focus, European Commission Directorate-General for Economic and Financial Affairs, 10 June 2010.

278 Concerning the Bank of Finland's calculations, see Kinnunen & Railavo: Politiikkasimulointeja julkisen talouden vahvistamisesta Suomessa, BoF Online 7/2010, Bank of Finland 2010.

279 Government statement on the Government Programme of Prime Minister Mari Kiviniemi's Government, Government statement 1/2010 vp., p. 4.

280 Ministry of Finance: Fiscal policy report on stable and sustainable local government finances, Ministry of Finance 42/2010 pp. 52–55.

281 OECD Economic Surveys: Finland, Vol. 2010:4, p. 71.

Ensuring the sustainability of public finances is ultimately about protecting taxpayers by keeping the tax burden reasonable. Therefore local taxes should be included in an examination of any framework for public finances based on fiscal policy objectives. Local authorities' expenditure is mostly linked to statutory tasks, with the relevant legislation being prepared under the direction of the Government. The grounds for local authorities' tax revenues are likewise based on legislation. Accordingly central government can influence local government finances within the current legal framework in essential respects.

On the basis of findings made in the National Audit Office's fiscal policy audit, a spending limits system covering local government should view growth in local authorities' expenditure and total expenditure at the macro level, i.e. expenditure ceilings should not be set for individual municipalities. The Danish system, in which expenditure ceilings for individual local authorities are negotiated between central and local government, has proved too inflexible in some respects, though conditions in Denmark and Finland naturally differ.[282] A large part of growth in local government expenditure is due to factors that local authorities can do nothing about. Such factors include bills for specialised medical and hospital care, national collective agreements, rising unemployment and social assistance costs and the expansion of local authorities' statutory tasks and obligations. Another consideration is diverging regional development and the prospect of widening gaps between municipalities in different parts of Finland. This has received serious attention in domestic research as well as the OECD's review of Finland's economic policy.[283]

Any objective regarding growth in local authorities' expenditure should be included in the financial relation between central and local government, i.e. central government transfers to local government and the apportioning of tax revenues as well as the division of tasks between central and local government.

At the macro level the development of local government finances should be included in the Basic Public Services Programme, which is connected to the central government spending limits procedure. An essential part of an expanded spending limits system would be sufficiently strong constraints on central government measures resulting in increased total expenditure at the local level, thereby placing upward pressure on taxes. New obligations could be prescribed within the general framework of constraints only by providing funding to cover resulting costs or by releasing local authorities from existing obligations.

Such a constraint could be implemented in two ways. One possibility would be to require that central government transfers cover a clearly higher share of costs in the case of new or expanded obligations, in which case the central government spending limits would provide a strong incentive to curb expenditure. An alternative would be to set a ceiling on any increase in costs based on the Government Programme. This ceiling could not be exceeded and would be monitored in connection with the Basic Public Services Programme and the drafting of legislation. It is essential to set clearer political priorities for statutory tasks and obligations in drafting legislation and to evaluate the impacts of legislation and legislative proposals much better than has been done up to now.

Stable development can also be promoted

282 See Jens Blom-Hansen's article "Local government in Denmark" in Moisio Antti (ed.): Local Public Sector in Transition, A Nordic Perspective, VATT Publications 56, VATT, Helsinki 2010, pp. 63–94, especially pp. 84–94.

283 OECD Economic Surveys: Finland, Vol. 2010:4.

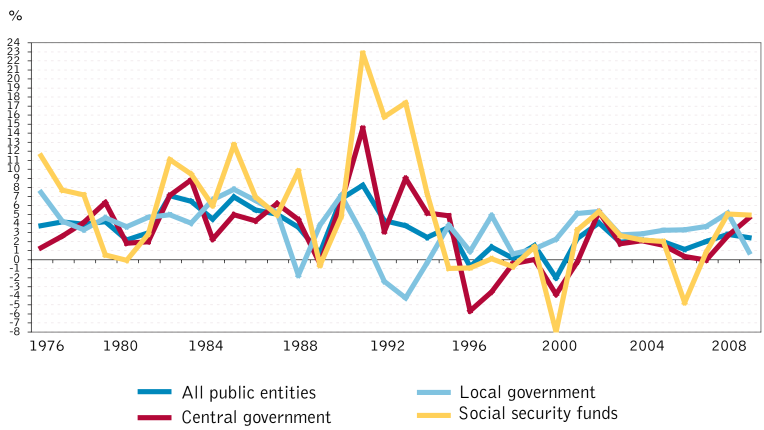
with the help of stricter provisions regarding the longer-term balance of local government finances in the Local Government Act. This could include requiring some kind of spending limits procedure at the local and regional level, together with the necessary monitoring mechanisms.

In the opinion of the National Audit Office, challenges regarding local government finances cannot be met unless the division of tasks between central and local government is reconsidered. In view of the ageing of the population, some local authorities' possibilities to perform their statutory tasks within the framework of the current financing and tax system are poor. With the social structure diverging, special arrangements will probably be needed to handle and finance statutory tasks in sparsely populated areas that are in decline.

8.2.4 Social security funds

Social security funds, which are responsible for pension and unemployment security and related statutory benefits, have experienced rapid growth in expenditure in recent years. In the historical development of social security funds, economic downturns and cyclical fluctuations have been reflected rapidly in expenditure (Table 6 and Figure 17).

The dependence of growth in social security funds' expenditure on cyclical fluctua-



Source: Statistics Finland

FIGURE 17: Growth in real total expenditure in the public sector, % change from previous year

TABLE 6: AVERAGE ANNUAL CHANGE IN REAL EXPENDITURE (AT 2005 PRICES)

	1976–2009	1976–1989	1995–2009	1999–2009	1999–2003	2004–2007	2007–2009
Total expenditure	3.17	4.26	1.54	1.75	1.47	1.72	2.30
Central government	2.93	3.88	0.52	1.19	0.50	0.89	2.30
Local government 1)	3.00	4.56	2.43	2.72	3.29	1.76	2.94
Social security	4.90	6.31	0.72	1.25	0.83	-0.03	3.51

1) Adjusted according to the price index for local government expenditure.

Source: Statistics Finland, Eurostat and National Audit Office's calculations

tions and anti-cyclicity are also visible in the accompanying figure, which shows growth in real expenditure in terms of the change from the previous year.

In the structure of Finland's public finances, social security funds are the part with a long-term surplus and constitute an important factor in net wealth. Largely thanks to social security funds, Finland's public finances appear in relatively good shape in international comparisons and according to the criteria of Economic and Monetary Union. Owing to the recession and the resulting rise in unemployment costs, social security funds' surplus is likely to fall to about 2.9 per cent of GDP in 2010. The current upswing will lead to an increase in total earnings, which together with rising social insurance contributions will increase funds' proceeds. Growth in employment pension costs will accelerate beginning in 2011, owing to index adjustments in employment pensions. Over the longer term growth in expenditure will be maintained by the ageing of the population and the retirement of the baby-boomers. Thus growth in expenditure as a whole is set to continue, even if unemployment-related expenditure were to turn down. The Ministry of Finance has estimated that social security funds' surplus will amount to about 3.1 per cent of GDP in 2011 and continue to rise in 2012.

Social security funds are a key element in the examination of public finances connected to the Stability and Growth Pact and therefore Finland's stability programme, for example. The development of social security funds is also examined in sustainability calculations, and they are taken into account in setting sustainability objectives for public finances as a whole. Social security funds' proceeds are also highly significant with regard to sustainability. Even a relatively small increase in returns considerably improves funds' position and reduces the sustainability gap.

Social security funds' expenditure includes insurance payments based on legislation. Their regulation does not take place in the state budget process but by enacting legislation. Changes in the criteria for the state's share of financing and some of the money paid into social security funds by the state are included in the central government spending limits, but otherwise fiscal policy objectives or constraints are not set for social security funds. Curbing growth in social security funds' expenditure should take place through legislation concerning pension and unemployment insurance. Any fiscal policy rules regarding social security funds cannot be spending rules that directly affect the budget but should concern funds' balance and the restriction of future obligations, and their key content could include index deflators written directly into legislation so as to maintain an appropriate level of expenditure or rules that act as triggers and require legislative measures concerning social security funds' expenditure upon specific conditions.

Social security funds are financed largely through tax-like charges. From taxpayers' viewpoint, social security funds' cost development and financing requirements are a significant area with regard to the setting of fiscal policy objectives and regulation, since they contribute to the overall tax rate. This kind of monitoring and regulation takes place and policies are outlined in connection with the spending limits decision and the state budget proposal, particularly in the general commentary.

From the viewpoint of fiscal policy objectives and rules as a whole, attention should be paid to social security funds in setting general fiscal policy objectives, from which the central government spending limits and deficit ceiling are derived.

8.3 Calculations concerning the sustainability of public finances

The sustainability of public finances refers to the ability to manage current debt and finance future expenditure. Future surpluses must therefore cover liabilities accumulated through past deficits. The sustainability gap is the difference between the current situation and a sustainable political and operating model. It tells how much public finances must be adjusted to achieve long-term sustainability, by cutting expenditure or raising taxes. The sustainability gap can also be reduced with the help of structural reforms.

8.3.1 Measuring the sustainability gap

The sustainability gap is generally analysed using a calculation framework based on debt-gap dynamics. At its simplest a change in the debt level depends on the difference between interest rates and economic growth and the primary balance in public finances. If the economy grows faster than the rise in interest rates, the debt level falls even if public finances record a primary deficit. Similarly, if the rise in interest rates exceeds economic growth, a primary surplus much be achieved in public finances. To monitor fiscal policy in the member states, the European Commission uses two indicators derived from the budget constraint to describe the sustainability gap, S1 and S2.[284] In analysing the stability of public finances in the member states, the sustainability gap is expressed as the required adjustment in the primary balance in public finances that will produce the desired debt level at the end of the period in question or keep debt at the starting level, assuming no changes in policy. A positive value describes the need to adjust public finances, while a negative value shows how much expenditure can be increased or taxes lowered without endangering the sustainability of public finances.

Indicator S2, which is used more often, is derived from a budget constraint over an infinite period. S2 describes the direct and permanent need to adjust a structural primary deficit to fulfil the intertemporal budget constraint over an infinite period, taking into consideration the rise in age-related expenditure. This means that the discounted sum of current and future revenues must cover the value of outstanding public debt and the discounted sum of current and future outlays, including additional expenditure arising from the ageing of the population. The primary balance of public finances must be large enough to cover debt management costs. The problem with this indicator is that it does not say when the primary balance can be large or small. The intertemporal budget constraint over an infinite period can be fulfilled at a very high debt level and thus with high interest costs as long as one can reasonably expect that a sufficient primary surplus will be achieved in the future.

The budget constraint can also be examined over a finite period. In this case a target is set for the level of public debt and a time is set by which this level must be achieved. The European Commission's S1 indicator de-

284 European Commission DG ECFIN: Sustainability Report 2009, European economy 9/2009.

scribes a direct and permanent adjustment to the current primary balance to reach a target debt of 60% of GDP by 2060, taking into consideration the rise in age-related expenditure during the same period. The finite period can be shorter or longer, but the debt target in S1 and the time by which debt must be reduced to this level come from the European Union's Stability and Growth Pact. The time horizon for S1 has been chosen so that costs arising from the ageing of the population can materialise.

Factors of sustainability indicators

In evaluating the sustainability gap, it is important to draw attention to the underlying reasons. Indicators describing sustainability can be examined in terms of different factors for this purpose. Three key factors in sustainability indicators are the initial financial position, the debt level in relation to GDP and cost pressures due to an ageing population. S1 depends on all three of these factors. S2, with its infinite time horizon, depends only on the need to adjust public finances based on the initial financial position and growth in expenditure due to an ageing population.

The need to adjust public finances resulting from the initial financial position is the difference between the cyclically adjusted primary balance and the primary balance needed to stabilise the debt level. The cyclically adjusted primary balance is the difference between revenues and expenditure in the public sector, excluding interest expenses, calculated at the trend level independent of cyclical fluctuations in GDP. This is thought to correspond to an economy's potential output if production factors are in full use.

The target level set for public debt and the time by which this target must be achieved only concern the S1 indicator. This component describes the additional need for adjustment that is required to achieve the target level. The shorter the time frame for achieving the target level, the greater the immediate need to adjust pubic finances. The longer the time frame, the less forcefully the S1 indicator influences political decision-making. If the initial debt level is higher than the target level, this factor increases the estimate of the sustainability gap. On the other hand, an initial level of debt that is lower than the target reduces the estimate of the sustainability gap. When sustainability calculations cover a finite period, it should be pointed out that demographic trends and economic growth potential after the chosen horizon do not affect the estimate of the sustainability gap.

Long-term changes in public expenditure, particularly cost pressures due to an ageing population, are the third factor behind sustainability calculations. The effect of this factor depends on demographic trends and the social security system in the country in question. The effects of this component on the sustainability gap are likely to differ between S1 and S2. This is because the larger the costs of an ageing population over the short or medium term, the larger the effect costs due to an ageing population have on S1 compared with S2. This is because growth in expenditure is examined up to 2060 in S1 but over an infinite period in S2.

Dividing sustainability indicators into three components gives a better picture of the factors underlying the sustainability gap. The indicators do not offer a direct answer to the question of what measures should be taken to adjust public finances so as to close the sustainability gap, however. It is generally thought that the sustainability gap tells how much the balance of public finances should be improved by cutting expenditure or raising taxes. The sustainability gap has sometimes been equated with the need to raise taxes, for example by the Bank of Finland. It should be noted that any measure or combination of measures chosen to adjust public finances will themselves influence the sustainability of public finances. For instance, a substantial increase in the tax rate could weaken economic growth and thus make it harder to close the sustainability gap. Closing the sustainability gap with structural reforms means that cuts in age-related spending or growth in an economy's potential output have to be adequate to meet the need to adjust public finances.

Uncertainties in measuring the sustainability gap

Indicators describing the sustainability gap are subject to considerable uncertainties. As was mentioned above, the cyclically adjusted balance of public finances in sustainability calculations is obtained with the help of potential output. Unlike gross production, potential output cannot be measured directly. Measuring potential output is a challenging task. Potential output can also be defined in different ways. In economics potential output means the maximum volume that can be produced using current technology at full employment without inflationary pressure. From a purely statistical viewpoint, potential output means trend GDP.

Statistical methods are aimed at separating a trend component from time series describing gross production that can be considered to describe potential output. The simplest statistical method to model the trend component is the Hodrick-Prescott (HP) filter. Potential output is equated with an invertible moving average from a GDP time series. The reliability of the HP filter is weak for the latest observations in the series, which are most essential for policy analysis. The reason is that the estimate is influenced by information concerning past and future trends. Closer to the present moment, observation-based information concerning the future is lacking. Consequently estimates become more uncertain.

In an approach based on the production function, potential output is determined with the help of the number of employed persons, the amount of capital and total productivity describing technological development using the Cobbs-Douglas production function, for example. Potential output calculated on the basis of the production function can be added to macroeconomic forecasts and different policy analyses since it includes macroeconomic quantities that can be predicted and measured. The level of potential output estimated using the production function method is the level at which production inputs are in full use and total productivity is in line with statistical trends.

Central banks, including the Bank of Finland, use dynamic stochastic general equilibrium (DSGE) models to analyse inflation, cyclical fluctuations and monetary policy. An estimate of potential output based on a DSGE model describes the production trend that could be expected if prices and pay were completely flexible.[285]

Estimating the cyclically adjusted primary balance requires an estimate of the output gap or the difference between GDP and potential output and an estimate of the effect of cyclical fluctuations on public sector expenditure and revenues.[286] The output gap is generally expressed as a percentage of

285 Haavio: Tuotantokuilu Suomessa, Kansantaloudellinen aikakausikirja, 105, 1/2009, pp. 21–33. Mishkin: Estimating potential output, speech at the Conference on Price Measurement for Monetary Policy, Federal Reserve Bank of Dallas, May 2007.

286 European Commission DG ECFIN: Sustainability Report 2009, European economy 9/2009.

potential output. A positive output gap describes an upturn and thus inflationary pressures in an economy. A negative output gap describes a downturn and the slack use of capacity in an economy. Estimates of production gaps calculated with DSGE models are often smaller than estimated obtained using statistical methods or the production function method. The picture given by different measures can also vary qualitatively depending on the measuring method used.[287]

The estimates of Finland output gap that have been made by the European Commission, the OECD and the Ministry of Finance are based on statistical methods and production function-based calculations. The Bank of Finland uses a DSGE model in its calculations. According to forecasts, Finland's output gap will remain clearly negative up to 2011 (Table 7). It should be noted that there are significant variations in estimates of Finland's output gap. The OECD's estimates of a negative output gap are exceptionally large compared to others. Variations reflect different concepts of the level of potential output. These concepts may change rapidly with changes in statistical data. It is possible that the size of a negative output gap is overestimated because potential output has been estimated at a lower level.

Large differences in output gap indicators are due to the exceptional nature of the current economic situation and variations in estimates of potential output. Finland's output gap has been strongly negative in estimates, reflecting the impacts of the financial crisis and the recession. Estimates of potential output have fallen in most forecasts. The level of potential output falls if structural unemployment increases and part of the potential labour pool disappears permanently from the labour market. The crisis will also have impacts on growth in potential output if risk premiums rise on financial markets. This would put a damper on investments and thus the economy's growth potential.[288]

Economic statistics such as the national accounts are often revised significantly later on. An estimate of the output gap may change considerably depending on when measurements are made. According to some research findings, problems regarding the reliability of statistical data are so large that it is practically impossible to use the output gap in real-time policy-making. For example, making seasonal adjustments causes changes and is quite sensitive to the method that is used to eliminate seasonal fluctuations from data. Estimating potential output plays a key role in measuring the output gap. The level of potential output involves a very high degree of uncertainty no matter what method

TABLE 7: ESTIMATES OF FINLAND'S OUTPUT GAP, SPRING 2010

	COUNCIL	OECD	IMF	MoF
2008	4.1	0.4	4.3	3.6
2009	-5.0	-8.9	-4.3	-5.0
2010	-4.6	-8.0	-3.7	-5.2
2011	-3.8	-6.6	-2.9	-4.3

Source: Council of Europe, OECD, IMF and update of Finland's stability programme 2009

287 Haavio: Tuotantokuilu Suomessa, Kansantaloudellinen aikakausikirja, 105, 1/2009, pp. 21–33. Mishkin: Estimating potential output, speech at the Conference on Price Measurement for Monetary Policy, Federal Reserve Bank of Dallas, May 2007.

288 Bank of Finland 2010. Economic outlook 1/2010, special issue on the euro and the economy, Helsinki. Ministry of Finance 2010. Revision of Finland's stability programme 2009. Ministry of Finance Publications 6a/2010.

is used. Uncertainties in calculating potential output are highlighted during sharp upturns and downturns. This uncertainty also influences the estimate of the cyclically adjusted primary balance of public finances on which sustainability calculations are based. Consequently such calculations should be viewed with caution. Research has suggested that estimates of the output gap should be presented in the form of fan charts so as to draw attention to uncertainties in policy-making.[289]

Problems in estimating cost pressures due to an ageing population are taken into account in sustainability calculations with the help of a mechanical pressure calculation. The European Commission's sustainability estimate is based on demographic and macroeconomic projections that have been made using uniform methods for all the member states. Population projections have lacked precision, however, and this creates uncertainty in estimating costs due to the ageing of the population. Furthermore the ageing population may remain healthier for a longer time compared with past generations. The lengthening of life expectancy is visible in rising age-related cost pressures in sustainability calculations if expenditure per person is projected using current cost and service structures. Uncertainty factors linked to the evaluation of the costs of an ageing population are discussed in section 8.2.3, which deals with the evaluation of sustainability based on a stochastic population forecast in a study that was conducted by the Research Institute of the Finnish Economy.

The sustainability of public finances can also be evaluated in terms of the primary balance required to close the sustainability gap. The required primary balance (RPB) represents the budget constraint necessary at the beginning of projections to ensure the sustainability of public finances, assuming that no changes are made in policy. This indicator describes the level of the primary balance that is needed to ensure sustainability and not the required adjustment in the primary balance as described by S1 and S2. The required primary balance is calculated as a cyclically adjusted average over the coming years. The required primary balance is calculated as a cyclically adjusted average over the coming years. When the required primary balance has been achieved, the sustainability gap indicator shrinks to zero (S2=0). RPB is a more stable indicator than the sustainability gap indicators. It is based solely on the current level of debt, the long-term change in the primary balance and the difference between economic growth and interest rates. Changes in the required primary balance result from structural changes such as pension reforms, demographic changes and changes that affect an economy's growth potential, for example.

8.3.2 The Ministry of Finance's sustainability scenario

The sustainability scenario in the 2009 stability programme update for Finland makes projections starting in 2015 and extending up to 2060. The scenario is based on the national population forecast, which differs to some extent from Eurostat's 2008 population forecast. Life expectancy increases by slightly over 2 years more in the national population forecast (Statistics Finland 2009) than in Eurostat's population forecast. Net immigration is also higher in the national population forecast. The macroeconomic assumptions used in the scenario are consistent with the

289 Koske & Pain: The usefulness of output gaps for policy analysis, OECD Economic department working paper no 621, July 2008. Murchison & Robbins: Fiscal policy and the business cycle: a new approach to identifying the interaction, Canadian Department of Finance Working Paper No. 2003–06.

baseline scenario jointly agreed in the working group dealing with the economic impacts of an ageing population under the EU Economic Policy Committee. These concern employment, unemployment, productivity and interest rates. The baseline scenario assumes that potential output will decline by just over 4% and that the employment rate will stabilise at 73% by 2025 and the unemployment rate at 6.5%. Nearly half of the expected contraction in potential output is expected to take place through a deterioration of employment and over half through a slowing of growth in productivity. Labour productivity is expected to increase by 1.9% a year in 2010–2019 and by 1.7% a year after that. The scenario looks for GDP to grow by around 1.8% a year over the entire period on average.

Based on the assumptions in the 2009 stability programme update, age-related expenditure will rise by 7 percentage points in relation to GDP in 2008–2060. This includes a rise of 1.9 percentage points by 2015 and 5.7 percentage points by 2030. Pension costs will grow fastest in the 2010s and will peak in 2030, after which pension costs will decline slightly in relation to GDP. The scenario assumes that non-age-related costs will remain stable in relation to GDP. Upward pressure on pension costs will be released by increasing contributions. Keeping the overall tax rate constant will allow other taxes to be reduced in the scenario.

The sustainability gap according to the baseline scenario is roughly 5.5% of GDP. This figure shows how much the balance of general government finances must be improved immediately in order to achieve a sustainable foundation. Uncertainty about the length and depth of the current economic crisis clouds the picture, however. In its reporting the Ministry of Finance points out that the sustainability indicator is highly sensitive to assumptions regarding the cyclically adjusted balance (structural balance) in the starting year. Owing to the current crisis, the cyclically adjusted balance is significantly weaker than in the projections that were presented in past years. The recession has thus had considerable impacts on the sustainability gap in public finances. As recently as autumn 2008, in connection with the stability programme update for Finland, the Ministry of Finance estimated a sustainability gap on the order of 3% of GDP.

In the Ministry of Finance's reporting the sustainability gap is expressed as the difference between the primary balance required to ensure sustainability and the expected primary balance in the starting year: S2 = RPB - PB. As was mentioned earlier, a more stable and less economically sensitive indicator is the target surplus that would close the sustainability gap (S2=0). In the baseline scenario, the surplus needed to ensure sustainability would be around 4% of total output in 2015. This has remained unchanged from the 2008 and 2007 programmes.

In its reporting the Ministry of Finance clearly draws attention to uncertainties in evaluating potential output and thus the output gap and to the fact that key macro-economic assumptions in the scenario are based on the Commission's calculations. Sustainability calculations are highly dependent on assumptions. Their sensitivity to underlying assumptions can be checked with the help of alternative scenarios. A more optimistic or pessimistic evaluation compared with the Ministry of Finance's projection concerning the cyclically adjusted balance since the crisis can be taken as the starting point. Different values can also be assigned to key macro-economic factors, such as long-term growth in GDP, interest rates or the development of productivity. Such a sensitivity analysis is not presented in connection with the scenario in the stability programme update. Instead sensitivity analysis looks at risks in economic development and their impact on public finances. One can draw conclusions regarding the impact of the strengthening or weakening of the initial balance of public finances on the estimate of the sustainability gap. The baseline scenario that was presented in spring 2010 in the 2009 stability programme update is based on the assumption that the global economy is gradually recovering. In stability programme updates the Ministry of Finance also presents the impacts of slower or faster economic growth compared to the baseline scenario on the balance of public finances and debt over the medium term. In alternative calculations the Ministry of Finance assumes output growth deviating by one percentage point in either direction from the baseline scenario. The impact of economic growth on public finances has been evaluated using OECD elasticity estimates. In the slower-growth scenario the general government deficit would be around 4% and the debt ratio would rise to nearly 60% of GDP in 2013. In the faster-growth scenario the general government financial position would be strengthened and would be in balance in 2013. Even so, the debt ratio would still climb to over 50% of GDP in 2013.[290] In its statement on Finland's stability programme update for 2009–2013[291], the Council of the European Union has noted that the Ministry of Finance's medium-term scenario is based on markedly favourable growth assumptions from 2011 on, and budgetary outcomes could turn out worse than projected later on. It is worth noting that the statement is based on the Commission's autumn 2009 forecast. The general outlook for Finland's economic development has changed considerably since then.

The stability programme update also includes a comparison with the previous year's programme and examines changes in forecasts. Changes in forecasts from 2008 to 2009 were largely due to the downturn, which was sharper than anticipated. Differences between the two updates are significant. The depth of the recession could not be foreseen on the basis of the information that was available when the 2008 update was prepared. It was not until February 2009 that the sharpness of the downturn and the drying up of exports were visible in the national accounts on which forecasts were based.

Reporting on the sustainability scenario in the stability programme update is quite meagre, making it more difficult to understand the scenario and the sensitivities in it. Of course stability programme updates are part of the Government's reporting to the European Commission and as such must meet strict formal requirements. A report that was published by the Ministry of Finance in spring 2010, entitled Finland's Public Finances at a Crossroads, proposed a fuller description of the factors underlying sustainability as well as a sensitivity analysis that would examine such factors as the role of increased productivity in welfare services in closing the sustainability gap.[292]

8.3.3 ETLA's sustainability calculation using a stochastic population forecast

The Research Institute of the Finnish Economy (ETLA) is conducting a study concerning the sustainability of public finances in Finland for the National Audit Office. The first stage of the study is an overall evaluation of

290 Ministry of Finance 2010. Revision of Finland's stability programme 2009. Ministry of Finance Publications 6a/2010.

291 Council opinion on the updated stability programme of Finland, 2009–2013, 2010/C 138/03.

292 Ministry of Finance 2010. Finland's Public Finances at a Crossroads - Approach to fiscal policy in the 2010s, Ministry of Finance Publications 8/2010.

sustainability based on a stochastic population forecast.[293]

According to research the elderly use health and care services more than younger cohorts on average. Since the elderly population is rising, one can assume that demand for these services will increase and consequently the production of services will increase. This logic is followed in practically every evaluation of future care services, with technical variations.

One should give serious thought, however, to a different view that has been presented in some studies, which suggest that there is not necessarily a connection between the age structure and the level of health and care services and that far-reaching conclusions regarding the future development of spending on these services cannot be drawn from the ageing of the population.

Evaluation of demand for health and care services in sustainability calculations

Demand calculations tend to be projections of the current situation rather than forecasts. Other factors besides population, such as growth in GDP, the development of medicine and technology, inflation in the health care sector and people's family situation, are obviously important. Studies often note that advances in medical technology mean higher treatment costs.[294] It would be more accurate to say that advances in technology produce cost savings in medicine. Additional spending takes place because of rising demand linked to the expansion of possible treatments, and this outweighs savings.[295]

A key weakness in demand calculations is the assumption of an unchanging age profile. According to Westerhout (2006), demand for care among women of child-bearing age does not remain the same if nativity declines. The gender ratio in older cohorts also changes, along with the possibility to receive home care from a spouse. Declining disability improves possibilities to receive care from children, but it is unclear whether there is a connection to ageing, even if the same background factors reduce disability and lengthen life expectancy. Age profiles can shift to a later stage in the life cycle, but again it is not clear how this is linked to ageing.

In ETLA's calculations public health and care costs rise less than in the sustainability calculations produced by the Ministry of Finance and the EU. ETLA's method is based on Finnish research and statistics that allow health and care costs to be connected to the age structure and proximity to death. The EU and the Ministry of Finance use a method mainly based on the age structure that allows comparisons among the member states. The key difference regards whether costs for different age groups remain fixed per person or change with age.

The importance of this difference between methods becomes clear if one considers the additional costs that result from the lengthening of life expectancy. Suppose that a person lives one year longer in the age group 80–84 years. Based solely on costs in this age group, the result is an estimated increase of 5,600 euros in health costs and 5,000 euros in care costs, giving a total of 10,600 euros. A method taking proximity to death into account produces an increase of 3,800 euros in health costs and 3,000 euros in care costs, or a total of 6,800 euros. Costs related to proximity to death do not rise but are deferred for

293 Lassila Jukka & Tarmo Valkonen 2008. Population ageing and fiscal sustainability of Finland: a stochastic analysis, Bank of Finland Research Discussion Papers, 28, 2008.

294 Kautto M., Häkkinen U., Laine V., Parkkinen P., Parpo A., Tuukkanen J., Vaarama M., Vihriälä V. & Volk R. 2006. Hoivan ja hoidon taloudellinen kestävyys. National Research and Development Centre for Welfare and Health.

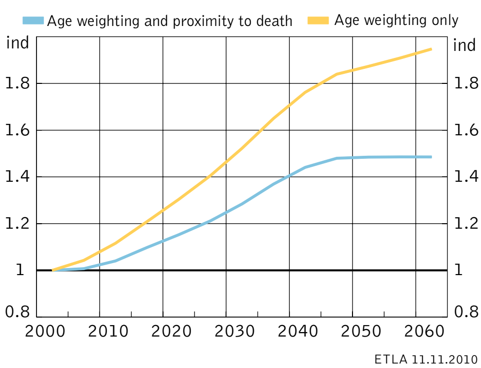
295 Krugman & Wells: The health care crisis and what to do about it. The New York Review of Books 53:5, 2006.

one year. In younger age groups the difference depending on the method of calculation is smaller but still along similar lines. In the oldest age groups the difference is larger: if a person lives one year longer in the age group 95+, the estimated increase based solely on costs in this age group is 5,500 euros in health costs and 25,500 euros in care costs, or 36,000 euros in all. A method taking proximity to death into account gives an increase of 1,200 euros in health costs and 21,000 euros in care costs, for a total of 22,200 euros.

Calculation methods applied to Statistics Finland's 2009 population forecast produce projections up to 2060 as shown in Figure 18. The level of public health and care costs at the beginning of the 2000s is denoted by 1. In ETLA's sustainability calculation costs increase by a factor of 1.5 up to 2050 and then level off. Using a simpler calculation method, costs nearly double.

Taking proximity to death into consideration in cost projections is in line with the lengthening of life expectancy: in future people are likely to remain in better health and require less care for a longer time.

One assumption in both calculation methods is that people in a particular age group will on average cause the same amount of costs as now. In the calculation method preferred by ETLA, these costs are lower because proximity to death has been taken into account, but the assumption is still there although it is not realistic and its use is based solely on the fact that it is difficult to devise a neutral alternative. The assumption that costs connected to proximity of death remain stable is likewise unrealistic, but again it is difficult to come up with an alternative. What is clear is that cost estimates are highly uncertain not only because of these assumptions but also because allowances have not been made for future advances in medicine, biotechnology and science in general.



Source: Lassila & Valkonen 2010

FIGURE 18: Effect of taking into consideration proximity to death on projections of health and care costs for 2060

Effects of the uncertainty of population forecasts

Additional uncertainty regarding cost estimates is linked to the evaluation of future population trends. The outlook has changed considerably since the beginning of the century and even since 2007. The effects of the uncertainty of population forecasts on health and care costs are shown in the following figures. Fluctuations are due entirely to population factors; the calculation methods are the same as above.

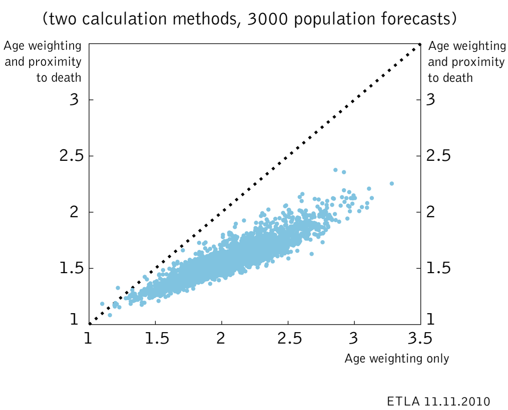
Figure 19 shows health and care costs in 2060 using two calculation methods. Each dot represents a population path combining two results. A total of 3,000 population paths have been simulated. The situation at the beginning of the 2000s is denoted by 1. In the model used by ETLA, dots are read on the vertical axis. The same value on the vertical axis is obtained if health and care costs are determined solely on the basis of age group trends, without taking proximity to death into account. The difference between the calculation methods is systematic. All but two of the dots fall below the diagonal. The model that takes proximity to death into account produces a lower rise in costs for practically every population path. If a regression line is drawn, it has a slope of about 0.7. In other words ETLA's method gives a figure than is 30 per cent lower than the other method on average.

Population changes slowly in relation to the economy and can therefore be forecast more accurately down the road. Long-range forecasting is still difficult, however. This is visible in how much forecasts of Finland's population have changed in the 2000s, particularly with regard to immigration, which is on the rise. Birth rate estimates have also risen slightly and life expectancy is clearly increasing.

In spring 2010 ETLA prepared a stochastic forecast together with Dr Juha Alho. Uncertainty mostly concerns observed and simulated errors in population forecasts.

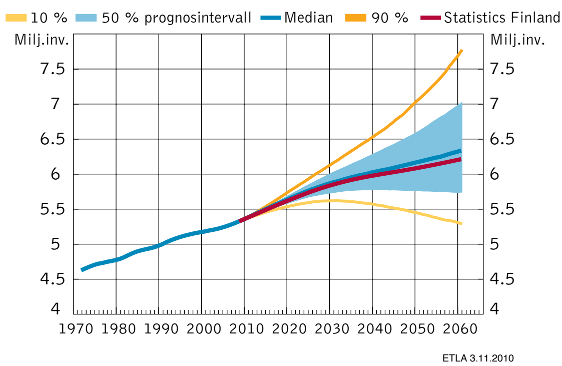
In Figure 20 population uncertainty is described in the form of a fan chart. The figure gives some idea of uncertainty according to the accuracy of past predictions. The blue area in the middle shows a 50 per cent prediction interval, which means that Finland's population will fall in the range of 5.75–7 million in 2060 with a probability of 50 per cent. The chance that it will exceed 7 million is 25 per cent, as is the chance that it will all below 5.75 million.

As Finland's population ages, pension costs and public health and care costs will rise while education costs will decline, if expenditure per capita develops according to current rules and practices. If the ageing of the population takes place according to Statistics Finland's 2009 population forecast and if there are no long-term surprises in pension funds' proceeds and interest rates, the current tax level will be insufficient to cover expenditure. The need to raise taxes can be expressed in terms of an immediate increase in the overall tax rate, after which the tax rate can be kept stable. The increase in public debt would vary according to fluctuations in expenditure, but at the end of the period the ratio would be 50 per cent of GDP. ETLA defines the sustainability gap as the increase in



Source: Lassila & Valkonen 2010

FIGURE 19: Effect of the uncertainty of population forecasts on projected health and care costs in 2060



Source: Lassila & Valkonen 2010

FIGURE 20: Population forecasts

taxation necessary to adjust public finances. ETLA's calculation gives an estimate of 2.5 per cent of GDP.

This estimate is based on the assumption that, after the financial crisis, the economy will get back on its ordinary growth track, in which a key factor is rising productivity. Growth in GDP also depends to some extent on the development of the working-age population, decisions influencing demand for labour and assumptions concerning unemployment and retirement. The impacts of the financial crisis on the sustainability of public finances are summarised in assumptions concerning the assets and liabilities of central government, local government and employment pension funds at the beginning of 2015.

An evaluation of sustainability was prepared using the FOG model development by ETLA in cooperation with the Ministry of Social Affairs and Health. Key assumptions underlying the calculation are shown in Table 8.

The assumptions in the table are similar to those in other evaluations of the sustainability of public finances in Finland for the most part. As was noted earlier, major changes have taken place in population forecasts in the 2000s. Although research concerning nativity, mortality and immigration has expanded, it has produced very little information that can be used in population forecasts.

In Table 9 the gross tax rate has been calculated assuming that central government debt remains around 50 per cent of GDP between 2015 and 2060.

ETLA's estimate of the sustainability of public finances before the financial crisis was presented in Lassila & Valkonen (2008). The median sustainability gap was 1.4 per cent of GDP. Now the figure has risen to 2.5 per cent. This change is not particularly large if one considers the uncertainty linked to estimating the sustainability gap. A 50 per cent confidence level allowing for uncertainty in population forecasts and returns on investment is about two percentage points wide and an 80 per cent confidence level is about four percentage points wide.[296]

In spite of uncertainty, the widening of the

TABLE 8: KEY ASSUMPTIONS

	2010–2060
Growth in labour productivity, %/yr	1.8
Real interest rate, %/yr	3.0
Real return on employment pension funds' investments, %/yr	3.9

	2010	2020	2030	2050	2060
persons 15–64 years old, 1.000	3 547	3 408	3 382	3 461	3 469
persons 65 and over, 1.000	944	1 290	1 525	1 681	1 787
persons 80 and over, 1.000	257	331	530	726	757

	2010–2014	2020–2024	2030–2034	2050–2054	2060–2064
Unemployment rate, %	6.6	5.3	5.3	5.3	5.3
Expected retirement age for a 25-year-old, change from 2004, years			1.3	2.3	3.0

Source: Lassila & Valkonen 2010

296 Keilman, 2005.

gap should be taken seriously. It shows that risks have increased significantly. In 2008 ETLA estimated that the overall tax rate in the 2030s could be 5 percentage points higher than now with a probability of 25 per cent. Lassila & Valkonen (2008) considered this need to raise taxes so large that the outcome could be substantial cuts in welfare services instead. The probability of such a need to raise taxes is now much higher. The estimate will be refined in later stages of ETLA's research project, but on the basis of previous studies it looks as if the overall tax rate in the 2030s could be 5 percentage points higher than now – or else welfare services will have to be cut significantly – with a probability of 30–40 per cent. In other words, although ETLA's estimate of the sustainability gap is lower than estimates presented by other organisations, it still indicates significant risk with regard to maintaining the welfare state in its current scope.

Some impact evaluations

Table 10 shows impacts on the sustainability gap using different assumptions concerning factors linked to economic growth, productivity in public services and the labour market.

TABLE 9: BASELINE SUSTAINABILITY CALCULATION (% OF GDP UNLESS OTHERWISE INDICATED)

	2008	2015	2020	2030	2060	Change 2015–2060
Age-related public expenditure						
pensions	10.7	113.8	14.5	15.3	15.3	1.5
health and care	7.0	8.5	8.8	9.3	9.7	1.2
education	5.4	6.2	6.1	6.2	6.2	0.0
other income transfers		5.1	5.1	5.1	4.8	-0.3
Gross tax rate	43.1	44.4	44.4	45.2	45.3	
Employees' pension charges, % of pay	21.8	24.8	25.9	26.6	26.1	
Sustainability gap		50-year horizon			100-year horizon	
entire public sector		2.5			3.0	
Employees' Pensions Act		4.0			4.0	

Source: Lassila & Valkonen 2010.

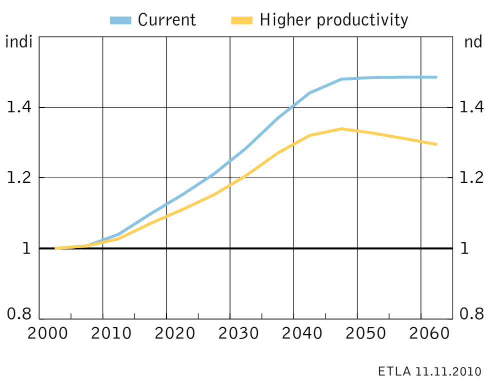
TABLE 10: IMPACT EVALUATIONS

Scenario (change from baseline)	Impact on sustainability gap, percentage points
economic growth speeds up by 1%/year	1.0
productivity in public services rises by 0.25%/year	1.0
young people enter the labour market one year earlier (without negative impacts on education and training)	0.3
unemployment rate is 1 percentage point lower	0.2

Source: Lassila & Valkonen 2010

Faster economic growth would reduce the sustainability gap. In the scenario faster growth would take place as a result of increased productivity rather than growth in employment. Increased productivity would also raise pay and thus pay-related expenditure in the public sector. The calculation assumes that income transfers will follow the development of earnings over the long term. If income transfers rise at a slower rate, there will be a bigger improvement in sustainability but a change in income distribution. ETLA's calculations assume that income transfers will remain equally important from the viewpoint of income distribution.

If productivity rose in public services and if the resulting savings were not used to increase public expenditure, the sustainability gap could be reduced significantly. The burden of health and care costs would change according to the following figure, for example. Figure 21 shows the amount of resources necessary to produce these services with the current level of productivity and with productivity rising by 0.25 per cent a year.



Source: Lassila & Valkonen 2010

FIGURE 21: Impact of growth in public service productivity on projected health and care costs

If labour market entry were speeded up by one year for young people, without negative impacts on education and learning, total labour input could be increased by over 1 per cent. This figure is small because on average young people would have lower productivity than the labour force as a whole. Gross production would increase by half a per cent and private consumption by about 1 per cent over time. Lower labour costs would boost exports, with a corresponding weakening of the terms of trade. Growth in labour input and reduced unemployment costs would improve the sustainability of public finances. The sustainability gap in the public sector as a whole (including the employees' pension system) would fall by 0.3 percentage points in relation to GDP. A lower unemployment rate would reduce unemployment costs while increasing gross production and the tax base.

Communication regarding sustainability calculations

The financial crisis that began in 2008 has had two significant impacts on sustainability estimates. First of all it has significance for the baseline, as the value of public assets falls and debt increases. This impact is not very big in Finland, since the debt situation is under control and no credibility problems are in sight, in spite of increasing liabilities. When debt increases in relation to GDP, the impact on the sustainability gap is comparable to a permanent tax increase necessary to manage a higher debt ratio. Growth in GDP can take care of part of this burden, but taxes must rise to cover the difference between real interest rates and economic growth. Using the assumptions in Table 8, a 10 percentage point rise in the debt ratio would require a 0.125 per cent rise in the overall tax rate.

How much the debt ratio will increase before the financial crisis can be considered over is still unknown. According to the current outlook, impacts on the sustainability gap will in any case be insubstantial compared to other factors.

In ETLA's view, the crisis plays a more significant role in reminding people why it is necessary to prepare for weaker development than expected and to ensure economic manoeuvring room in case a new crisis comes along. If population trends and returns on investment resulted in the need to raise the overall tax rate by more than five percentage points and then a major financial crisis occurred, the welfare state would truly be threatened.

Significant changes in sustainability estimates, always according to the baseline, are one indication of the uncertainty involved in sustainability estimates. This can easily be overlooked by attaching too much importance to the figures produced in sustainability calculations. Comparing evaluations of the need to adjust public finances to close the sustainability gap, ETLA is definitely more optimistic than the EU, the OECD and the IMF. The main reason is the different method used by ETLA to project health and care costs. Undue attention should not be focused on differences in cost estimates, however, since long-term calculations are always subject to a great deal of uncertainty.

Section 8.2.1 of this report described the sensitivity of sustainability calculations to the balance of public finances at the starting point. The recession has significantly influenced evaluations of the sustainability gap. The National Audit Office accordingly emphasises the importance of reporting and communication regarding sustainability calculations. In addition to an evaluation describing the need to adjust public finances, more attention should be drawn to the factors behind sustainability calculations. The sensitivity of indicators describing the sustainability gap to changes in the balance of public finances at the starting point means that when the recession bottoms out and medium-term economic prospects improve, the estimated sustainability gap will fall. This presents a serious risk that structural factors behind sustainability calculations will be overlooked in political decision-making.

Positive surprises over the short term, such as a brief spurt of economic growth or a windfall in tax revenues, are not sufficient to solve problems regarding the sustainability of public finances. The key message drawn from calculations is that the ability of the Finnish economy and state to weather another recession on the order of the recent financial crisis has significantly weakened.

8.4 Developing fiscal policy rules

8.4.1 Spending rules and balance objectives

In addition to spending rules, the Government Programme of Prime Minister Matti Vanhanen's second Cabinet included two objectives regarding the balance of central government finances. The first was to achieve a structural surplus corresponding to 1 per cent of GDP by the end of the electoral term. The second was to keep central government finances from showing a deficit of more than 2.5 per cent of GDP even in a weak economy.

Achieving the balance objectives that were set for the 2007–2010 electoral term would have required economic growth at a faster rate than forecast. According to the Ministry of Finance's forecasts at the beginning of the term, central government finances would probably have remained in deficit and thus fallen short of the structural surplus target. The autumn 2007 economic survey published by the Ministry of Finance noted that an average growth rate of 2 per cent was closest to the scenario suggested by estimates of growth in potential output. The ministry warned that this was not sufficient to achieve the Government's balance and employment targets. It added that an average growth rate of 2 per cent would result in a sustainability deficit of about 2 per cent of GDP in general government at the end of the electoral term in 2011. Estimates indicated that a cyclically adjusted surplus of over 4.5 per cent was needed to ensure the long-term sustainability of public finances. The autumn 2007 economic survey concluded that an average growth rate of 2 per cent would create a sustainability deficit of about 2 per cent of GDP in general government.

The tension this produced as soon as the Government Programme was approved could only have been released by attaining faster economic growth than forecast. In May 2007 the International Monetary Fund had already pointed out the risks involved in relying on stronger-than-projected growth, aided by as yet unspecified structural measures.[297]

As a result of the economic crisis, the Government Programme's objectives for employment and central government finances cannot be achieved. The Government policy session in spring 2009 concluded that objectives can temporarily be relaxed as long as measures are taken to strengthen public finances structurally. There was no way to foresee the crisis or its depth when the Government Programme was prepared in 2007. This underlines the need for flexible fiscal policy rules in a small open economy such as Finland's to withstand external shocks. Owing to the depth of the economic crisis, there were good reasons to deviate from the balance objectives in the Government Programme. It is worth noting, however, that decisions have not yet been made on structural reforms to strengthen public finances. The spending limits decision for 2011–2014, which was approved in spring 2010, stated that the Government would prepare a plan to stabilise public finances and close the sustainability gap by the budget session in

297 International Monetary Fund: Finland-2007 Article IV Consultation Concluding Statement of the Mission, 31 May 2007, IMF.

autumn 2010, after obtaining the results of tripartite consultations.

One problem in Finland's fiscal policy rules concerns the loose connection between balance objectives and central government spending limits. The spending limits in the Government Programme have not been derived from the balance objective in the Government Programme but have been set using political discretion. An incoming Government decides on expenditure ceilings for the entire electoral term. The first spending limits decision made by the current Government allowed a 1.3 billion euro increase in expenditure in 2011, as agreed in the Government Programme. The incoming Government's spending rules were based on the "technical spending limits" approved during the final year of the previous term, together with the increases and priorities set out in the Government Programme. The technical spending limits are supplemented by measures for which funds have been earmarked in budget items, and the total covered by the spending limits becomes the framework for the new term. The procedure emphasises the importance of the basic calculation that underlies the spending limits for the electoral term in each administrative sector.

Spending limits have not kept automatic stabilisers from functioning in a downturn, since they exclude cyclically sensitive expenditure. During the recession the spending limits procedure passed the test in this regard. The central government spending limits cover only about a third of total public expenditure, however. This is problematic for the sustainability of public finances, since cost pressures resulting from the ageing of the population will particularly affect local services and social security funds. Consequently, spending limits as a fiscal instrument can do only so much to ensure long-term sustainability. In evaluating Finland's fiscal policy regulation system and particularly the level of spending limits, it is important to take into consideration adjustment needs required for sustainability.

A key element in international organisations' recommendations concerning withdrawal strategies has been the strengthening of fiscal policy rules in order to increase credibility. In developing fiscal policy rules and setting objectives during the next electoral term, greater weight should be given to the sustainability of public finances.

8.4.2 Legislative needs

The National Audit Office's external audit findings draw attention to the question of whether legislation should contain provisions regarding the spending limits procedure and general government spending limits. One must distinguish between (1) whether the central government spending limits procedure should be mandatory as in Sweden and (2) whether fiscal policy rules or at least grounds and main principles concerning them should be included in legislation or what is referred to as a fiscal responsibility law in international discussion.[302] The evaluation should be based on better regulation principles as well as legislative principles based on the Constitution. Any solution must fit Finland's legal system. Attention should be paid to perspectives regarding the effectiveness of fiscal policy and rules. The Commission's proposal for a directive

302 A good survey is provided in International Monetary Fund: Fiscal Rules - Anchoring Expectations for Sustainable Public Finances, IMF 2009. See also Lienert: Should Advanced Countries Adopt a Fiscal Responsibility Law, IMF Working Paper WP/10/254.

CALCULATING AN EXPENDITURE CEILING USING A NUMERICAL RULE [298]

Although the size of the budget – and thus the level of spending limits – is ultimately a political decision, a numerical rule can be used in setting an expenditure ceiling. A numerical rule clarifies principles, assumptions and other fiscal policy objectives that may influence the level of spending. Particularly from the viewpoint of the sustainability of central government finances, it is useful to show a connection between expenditure covered by spending limits, revenues and a budget balance rule, such as a deficit or debt ratio. [299]

To allow room for fiscal policy manoeuvre, a numerical rule gives a fuzzy picture and is merely a tool in setting spending limits. A numerical rule depends on estimates of revenues, which are inevitably uncertain. On the other hand, the revenue forecasts that are used in the spending limits procedure are subject to uncertainty whether a numerical rule is used or not.

For example, spending limits for year t+n Êt+n that are in line with the revenue forecast for the year Rt+n and the target budget balance BTt+n can be expressed as follows:

$$\hat{E}_{t+n} = R_{t+n} + \Delta T_{t+n} - BT_{t+n} \quad - E^{0C}{}_{t+n}$$

In the formula ΔT_{t+n} represents changes caused by tax reforms that have not been included in the revenue forecast and $E^{0C}{}_{t+n}$ estimated expenditure excluded from the spending limits. It is simpler to specify maximum expenditure in relation to forecast GDP. To avoid pro-cyclicity one can use potential GDP. [300]

$$\hat{E}_{t+n} = \beta \times BKT^{POT}{}_{t+n}$$

If β is constant, the level of the spending limits rises in step with tax revenues. If tax policy changes, the level of expenditure or β must be reevaluated. Another assumption is that no changes will be made in expenditure not covered by the spending limits.

In Sweden expenditure ceilings are set using a rule in which the level of expenditure[301] does not depend on growth in revenues or GDP but rises at a steady pace (φ):

$$\Delta\hat{E} = \varphi.$$

A rule that allows expenditure to rise at a steady pace is very simple and increases predictability regarding the funds needed for public expenditure.

on requirements for budgetary frameworks likewise has a bearing on the evaluation of the need for regulation.[303] An international comparison of practices and experience in different countries offers additional insights.

According to a dataset compiled by the International Monetary Fund, in about a fifth of advanced economies with fiscal policy rules, these are included in or based on legislation. Fiscal responsibility laws also appear to be spreading.[304] A strong legal framework appears conducive to long-term planning and continuity and thus enhances credibility and anchors expectations. Accountability procedures, real fiscal consolidation and enforcement mechanisms are more important for

298 See Calmfors: Fiscal policy to stabilize the domestic economy in the EMU: What can we learn from monetary policy? CESifo Economic Studies, 2003, 49:3, pp. 319–353.

299 The EMU deficit ceiling of 3 per cent of GDP is an example of a balance rule.

300 Potential output refers to the level of GDP that could be achieved with full employment and with production factors utilized to capacity.

301 In the equation $\Delta\hat{E}$ denotes the change in spending limits' scope.

303 Proposal for a Council Directive on requirements for budgetary frameworks of the Member States, COM (2010) 523 final.

304 International Monetary Fund: Fiscal Rules - Anchoring Expectations for Sustainable Public Finances, IMF 2009, p. 11.

credibility than the legal basis or position in the legislative hierarchy. One strength of fiscal policy rules based on legislation is continuity, particularly in the face of political instability.

Fiscal policy rules set out in the constitution are rare. In the European Union and western Europe in general, constitutional mandates for fiscal policy rules are found only in a few countries (including Germany, Switzerland and Poland). In France a project is under way to include a deficit rule pertaining to central government and general government in the constitution, as in Germany.

Because of the similarity between our legal and social systems, an interesting case for Finland is Sweden, which is often cited as a good example in fiscal policy discussion. In Sweden provisions concerning expenditure ceilings are contained in the Budget Act (1996:1059). Provisions regarding the procedure for setting expenditure ceiling were reformed in 2009 (2009:1444) and supplemented in 2010. The Budget Act does not contain fiscal policy rules but prescribes the procedure for setting expenditure ceilings and for reporting on the achievement of objectives. Furthermore, section 39 calls for the Government to submit a surplus target to Parliament, covering the entire general government sector. This provision was added when the Budget Act was reformed in 2010 (2010:716). The Budget Act and expenditure ceilings place constraints on the Government in drafting the budget. If there is a risk of exceeding the expenditure ceiling, according to section 42 of the Budget Act the Government must take all the measures within its power and submit the necessary proposals to Parliament. The Parliament Act also provides for the submission of a bill finalising the budget and outlining fiscal policy each spring. Binding multi-year expenditure ceilings are decided in connection with the budget, but these too are intended mainly for the Government and guide preparation.

The Commission's proposal for a directive on requirements for budgetary frameworks does not call for the inclusion of fiscal policy rules in legislation. On the basis of principles applying to the national implementation of directives that have been established in the EU legal system, the implementation of the directive should nevertheless have a clear legal basis. The opinion formed by the National Audit Office in the course of the audit is that it would be sufficient to add provisions to the State Budget Decree and the Government decision concerning the principles to be followed in preparing spending limits proposals, budget proposals and operational and financial plans concerning fiscal policy rules according to the directive. To include local government in the fiscal policy framework, adding provisions regarding the Basic Public Services Programme to the Local Government Act should be sufficient to comply with the directive.

Strong political commitment to rules together with openness and adequate sanctions in case of unjustified deviations are essential for the success of fiscal policy rules. The reputational cost of reneging on rule-based policies and the obligation to explain any deviations should outweigh the short-term benefits of breaking rules. The question is ultimately about the importance society attaches to stable and sustainable finances and how this is evaluated in public discussion.

In light of the above points, there is no special need for legislation concerning the spending limits procedure as part of the central government financial planning system. Moreover, there is no call for provisions concerning matters that do not fit in the legislative framework prescribed in the Constitution. Legislation does not have to be enacted concerning central government's internal planning. It is a different matter if planning obligations are to be extended to self-governing actors.

Provisions in the Constitution concerning central government finances make no reference to the possibility of enacting fiscal policy rules that would constrain parliamentary decision-making on the budget. Any legislation would thus have to concern the Government and the preparation of the budget, as in Sweden's Budget Act.

The advantage of enacting provisions regarding the spending limits procedure and fiscal policy rules is that using society's strongest and noblest steering instrument, an act of Parliament, delivers a normative message regarding the responsible management of public finances.

There is a significant and structural sustainability gap in Finland's public finances. The need to close this gap will place considerable upward pressure on local taxes unless reforms are made in the tax system and the way services are produced and financed.[305] This must be kept in mind in evaluating the need to develop fiscal policy rules and their legislative basis.

One weakness and risk associated with spending rules is that they are restricted to the electoral term. The temporal scope of fiscal policy rules should be lengthened so that they can extend to the following electoral term and function on a rolling basis. In security and defence policy, the Government report procedure has made it possible to obtain a longer-term commitment from Parliament when far-reaching decisions are needed. A similar procedure could also be used to facilitate fiscal policy-making. Instead of a spending limits report, at the beginning of the coming electoral term the Government could submit an expanded fiscal policy report, which in addition to spending limits and an outline of the Government's economic and fiscal policies would include a longer-term programme for improving the sustainability of public finances, together with fiscal policy rules stretching past the end of the term.[306] This report could be revised in mid-term and extended to the following term at this stage. Rolling spending limits decisions could be made annually within such a longer-term framework and would not necessarily have to be submitted to Parliament in the form of a report according to the current procedure, in which the Finance Committee must issue a report in response.[307]

In the opinion of the National Audit Office, ensuring the sustainability of public finances requires sizable legislative measures and reforms to anchor growth. These must also be coordinated properly. An evaluation must be made concerning what resources will be necessary over the longer term to produce public services and benefits that are safeguarded as subjective rights in the Constitution, and these must be distinguished from resources that are necessary to implement ordinary legislation. Next one must evaluate how constitutional obligations can be managed in changing circumstances and what needs to be altered regarding the level and scope of other public policies, services and benefits. Planning must be based on dynamic impacts so that proper resources can be provided for investments and proactive measures that will

305 See section 8.2 for details.

306 This would include a plan to stabilize public finances and close the sustainability gap as mentioned in Ministry of Finance report 20/2010.

307 Ministry of Finance report 9/2008 vp.

genuinely reduce spending and cost pressures as well as functions designed to protect and promote economic growth and competitiveness. This demands exceptionally broad planning and preparation reaching across sectoral boundaries.

In this situation an act to ensure the sustainability of public finances, covering the planning of central government finances as well as relations between central and local government and the setting of fiscal policy objectives, could be a justified and useful solution. Such an act would apply to the preparation of the budget and would steer preparation and the drafting of legislation in different administrative sectors. Provisions in Sweden concerning the setting of fiscal policy objectives and the expenditure ceiling procedure could serve as a model. The content of the act could in some respects reflect the Act on the Restructuring of Local Government and Services. An act to ensure the sustainability of public finances would contain fiscal policy rules guiding the preparation of the budget, the Basic Public Services Programme, the planning of central government transfers to local government and the apportioning of tax revenues. If the Government wished to submit a budget proposal that is not in line with the act, it would also have to propose an amendment to the act. This would not prevent a majority Government from changing a fiscal policy rule with the backing of a majority of Parliament, but the process would force the Government to justify any deviation. These would have to be weighed publicly and the reputational costs associated with weak justifications would rise.[308] The effect would be to improve fiscal policy stability.

The National Audit Office finds good reason to consider legislation to ensure the sustainability of public finances. Alternatively provisions could be added to the State Budget Act and to the Local Government Act regarding the Basic Public Services Programme, modelled on budget provisions in Sweden. Some other means could also be used to create a procedure that would allow strategic objectives and related fiscal policy rules to extend beyond the electoral term. These are indispensable to stabilise public finances and close the sustainability gap in Finland.

308 According to the IMF's analyses and recommendations, this is essential for the functioning of fiscal policy rules. See International Monetary Fund: Fiscal Rules- Anchoring Expectations for Sustainable Public Finances, IMF 2009.

9 External control and fiscal policy institutions

9.1 Summary

The European Commission, the OECD and the IMF emphasise the importance of the external evaluation of compliance with fiscal policy rules. Independent evaluation improves economic policy discussion and thus the functioning of democracy. In many countries an independent body has in fact been established to evaluate fiscal policy. The OECD has recommended that such a body, independent of the Government and the Ministry of Finance, should be established in Finland. In this regard Sweden's Fiscal Policy Council has been cited as a good practice in international discussion.

The independent evaluation of fiscal policy is useful for the functioning of democracy and the effectiveness of fiscal policy only if it is performed systematically and with the necessary expertise. This requires adequate resources.

The central government spending limits are more or less a closed book outside the Ministry of Finance and parliamentary committees and organs, thus limiting possibilities for public discussion. The relative lack of interest in macroeconomics and economic policy among independent academic researchers in Finland is problematic. Only a small number of experts focus on the intricacies of economic policy and public finances.

On the basis of the National Audit Office's evaluation, there is a need to strengthen expert evaluation that is not linked to the preparation of policy measures. This also applies to the evaluation of the costs and benefits of major legislative, reform and investment projects. This task could be performed by existing research organisations such as the Government Institute for Economic Research. Strengthening external evaluation and research concerning fiscal policy would be useful in the view of the National Audit Office.

The National Audit Office considers that the most important thing is to increase the transparency of decision-making and related public discussion in Finland. An essential element is to increase research concerning economic policy options within the framework of existing institutions. This includes giving universities incentives and possibilities to conduct fiscal policy research and participate in fiscal policy debate.

The National Audit Office has designated the evaluation and effectiveness of the fiscal policy information base and compliance with fiscal policy rules as a permanent audit area. In the external audit of fiscal policy under the Constitution, the National Audit Office also utilises external research as well as an expert body with links to the National Audit Office's Scientific Council.

9.2 The need for external control and evaluation

The significance of the external control of compliance with fiscal policy rules as a means to ensure the sustainability of public finances is stressed in reports issued by the European Commission and the OECD. According to international comparisons, additional independent bodies are being established to evaluate fiscal policy. Although rule-based fiscal policy has increased in the European Union as a whole, control has remained limited or lax.[309] The external control of fiscal policy rules is also important to ensure openness and transparency, which facilitates public discussion.

The spending limits procedure is a crucial fiscal policy instrument in Finland. Failure to comply with spending rules does not result in sanctions under the current system, but breaking rules leads to a weakening of confidence in fiscal policy and a possible weakening of economic development. Responsibility for monitoring the implementation of spending limits has been left almost entirely to the Ministry of Finance, which prepares spending limits decisions and budget proposals. Planning, preparation, implementation and evaluation are all in the hands of the same organisation and to a large extent the same people. The risk in this case is a narrowing of perspectives and a lessening of objectivity in presenting information. Another risk pointed out by international organisations is the possibility that spending rules will be circumvented by using arrangements that weaken the transparency of central government finances and financial management.

Knowledge concerning the spending limits procedure is scarce outside the Ministry of Finance, and this restricts informed discussion about Finland's fiscal policy framework and the achievement of fiscal policy objectives. The current system's lack of transparency accentuates the problem. Increasing knowledge regarding fiscal policy rules and arranging external control are vital to facilitate public discussion in Finland.

As a member of the EU, Finland participates in multilateral monitoring (Stability and Growth Pact, excessive deficit procedure) focusing particularly on the stability of public finances and sustainability. Cooperation at the OECD and IMF level also revolves around fiscal policy and the current state of public finances to a large extent. Domestic monitoring has been quite meagre up to now, however.

309 See European Commission, DG ECFIN: Public Finances in the EMU 2009; European Commission: Recommendation for a Council Opinion on the updated stability programme of Finland, 2009-2013; OECD Economic Surveys, Finland, Volume 2010/4, April 2010; Restoring Fiscal Sustainability: Lessons for the Public Sector, OECD Public Governance Committee, Working Party of Senior Budget Officials, OECD 2010. The International Monetary Fund's dataset of fiscal policy rules and International Monetary Fund: Fiscal Rules-Anchoring Expectations for Sustainable Public Finances, IMF 2009.

9.3 Independent fiscal policy institutions

In the economic literature fiscal policy institutions have been suggested as a solution to the failings of the political decision-making process. In the background are some of the same points that are brought with reference to independent central banks and monetary policy. Various models regarding the structure and mandate of such an institution have been presented in the literature.

The fiscal policy councils that are currently in operation in Europe differ in terms of tasks and influence. Finland's Economic Council facilitates cooperation between the Government, the Bank of Finland and major interest groups. It examines major economic and social issues in order to promote discussion leading up to economic policy decisions. In addition to the Prime Minister, the Economic Council includes 10–20 members appointed by the Government. Some of these are also Cabinet members.[310]

Belgium has a High Council of Finance, which is composed of outside advisers, representatives of regional and local authorities, civil servants and central bank directors. Formally the council is headed by the Prime Minister. The council's task is to monitor the development of public finances and make recommendations for medium- and long-term fiscal policy objectives. Recommendations are considered influential especially at the regional level.

Denmark's Economic Council, which plays a similar role, is an independent advisory body chaired by three top experts, generally professors. Experts are appointed by the Government and must be impartial. The chairs prepare a semiannual report evaluating trends and economic policy, together with recommendations. The report is submitted to the Government, which must respond. The Economic Council's reports receive considerable attention in the media and are considered to have a substantial influence on policy. Germany's Council of Economic Experts is likewise appointed by the Government. Its members are independent economists with academic or other experience. The council prepares a yearly report that analyses economic development from different angles but does not contain policy recommendations. The Government must respond to the report, but it is generally viewed as not having much weight.[311]

The Austrian Institute for Economic Research (WIFO) is an independent body that is funded by the federal government, the states and cooperation partners. It is supervised by a scientific committee made up of independent experts from universities in Austria and abroad as well as representatives of international organisations. WIFO conducts extensive economic research and produces information on the economy for the Ministry of Finance. The assumptions and forecasts underlying the budget are all produced by WIFO. Its forecasts have not been overly cautious but have compared well with those produced by different financial and research organisations. Austria also has a Government

310 Website of the Prime Minister's Office: http://www.vnk.fi/hankkeet/talousneuvosto/fi.jsp, 16.12.2010.

311 Calmfors: Fiscal policy to stabilize the domestic economy in the EMU: What can we learn from monetary policy? CESifo Economic Studies, 2003, 49:3.

Debt Committee that takes part in discussion on fiscal policy and promotes economic and tax reforms. The 15-member committee publishes a yearly report presenting its views on the budget, the current state of the economy and areas in need of reform.

Sweden's Fiscal Policy Council, which was established in 2007, comprises eight impartial members who study the Government's fiscal policy in relation to fundamental objectives regarding long-term sustainability, the budget surplus, expenditure ceilings and cyclical trends. Objectives regarding sustainable economic growth and employment are also taken into account. In addition the council is intended to evaluate the clarity of the Government's economic policy proposals and the quality of the reasoning behind them and to stimulate social discussion on economic policy. The council drafts a report in the light of which Parliament can examine fiscal policies adopted by the Government.[312] The National Institute of Economic Research, which operates under the Ministry of Finance, makes forecasts and analyses domestic and international economic development. Another government agency, the National Financial Management Authority, monitors the implementation of the budget.

The Netherlands has several independent institutions that have their own role in fiscal policy: the Central Planning Bureau (CPB), Statistics Netherlands, the Netherlands Court of Audit and the National Advisory Group on Budgetary Principles. As an independent expert body the CPB plays a key role in economic and fiscal policy-making in the Netherlands, since its forecasts concerning economic growth, price and wage trends and the current state of public finances are used as a foundation in the budgeting process. The CPB also performs analyses at the request of other organisations. Before general elections the CPB analyses political parties' election programmes from the viewpoint of public finances, macroeconomic development and purchasing power. Analyses are based on the same underlying assumptions, so that the economic impacts of different party programmes can be compared. This practice increases transparency: parties must explain their proposals in enough detail so that real costs and benefits become evident. The CPB does not steer the setting of fiscal policy objectives; this task is performed by an advisory group composed of representatives appointed by ministries and expert bodies such as the CPB and the central bank. Recent reforms of Dutch spending rules were based on the recommendations made by the advisory group.[313] In its economic survey of Finland in spring 2010 the OECD recommended that Finland establish its own fiscal policy council. External monitoring and evaluation are useful only if they are based on solid expertise. Commanding the expertise necessary to analyse the spending limits system requires broad and detailed knowledge of central government finances in all their complexity. A Ministry of Finance working group supported the introduction of external evaluation provided the necessary expertise can be ensured. In connection with its report on public finances in spring 2010, the Ministry of Finance repeated its view that independent external evaluation would be useful in terms of the credibility of fiscal policy rules, commitment

312 Sweden's Fiscal Policy Council's website is www.finanspolitiskaradet.se

313 Ministry of Finance: Fiscal Policy Rules and the Reform of Spending Limits in Finland. Ministry of Finance Publications 5a/2007, pp. 101-102.

to them and the functioning of informal sanctions drawing public attention to any breach of rules.

Sweden's Fiscal Policy Council serves mainly to stimulate public discussion. Compared to Sweden, Finland has little analytical and critical discussion that gets to the root of the matter. Experts who focus on economic development and policy form a small group that is largely confined to research institutes.

The lack of interest in macroeconomic issues and economic policy among independent researchers is problematic. Creating an external evaluation procedure outside an institutional framework would not necessarily signify any great change compared with the current situation, in which evaluation takes place mainly through self-initiated discussion. An external evaluation institution can be regarded as a far-reaching development measure and in time would lead to the expansion of research regarding public finances and the strengthening of expertise.

The question of a separate fiscal policy institution or council should be studied from the viewpoint of tasks. Independent institutions can offer an impartial analysis of economic development and put a price tag on different policy options. The National Audit Office and the Parliamentary Audit Committee have noted, most recently in autumn 2010, that better information is needed concerning the cost-benefits and cost-effectiveness of transport infrastructure projects, for example.[314] Existing research institutions may be the logical place to perform this task, and the essential thing is to commission appropriate impact assessments in the preparation stage.

The National Audit Office concurs with international evaluations concerning the usefulness of competent independent monitoring and evaluation for the credibility and effectiveness of fiscal policy, public discussion as part of the democratic process and the proper exercise of Parliament's fiscal power. As Finland's supreme audit institution under the Constitution, the National Audit Office's also has the task of evaluating the effectiveness of fiscal policy and the reliability and adequacy of Parliament's fiscal policy information base. The external monitoring of the presentation of a true and fair view of the state's financial position and its development is likewise the National Audit Office's task. In this way the National Audit Office can both serve as a fiscal policy institution and supplement such an institution's activities.

The National Audit Office in performing its constitutional tasks will continue to evaluate whether the fiscal policy information base and openness have been adequate, whether Parliament and the public have been supplied a true and fair view in essential respects, and whether fiscal policy rules have been obeyed.

One conclusion drawn on the basis of the audit and the analysis of the current situation and needs is that priority should be given to strengthening the openness of fiscal policy decision-making and reporting on the achievement of fiscal policy objectives in Finland.

Increasing openness, discussion and research within the framework of existing institutions are primary tasks. For its part the National Audit Office will continue to allocate resources and expertise to the external audit of the fiscal policy information base, compliance with rules and the achievement

314 See the National Audit Office's report to Parliament R 20/2010 vp, a performance audit report on the matter and Audit Committee report 8/2010 vp.

of objectives and for this purpose will utilise the findings of researchers and an eventual expert council. As long as the primary tasks mentioned above are fulfilled, the National Audit Office is positively disposed to the establishment of a fiscal policy council. Adequate resources, access to information and expertise are crucial for its success.

The National Audit Office has designated the reliability and effectiveness of the fiscal policy information base and compliance with fiscal policy rules as a permanent audit area. The aim of this report is to cover the entire electoral term according to the OECD's Best Practices for Budget Transparency.

10 The National Audit Office's recommendations

The National Audit Office has audited the effectiveness of the central government spending limits procedure as a fiscal policy instrument during the 2007–2010 electoral term. The main question was whether objectives regarding the spending limits procedure and the spending rules that have been set within this framework have been achieved and how well fiscal policy rules have functioned. The audit evaluated the central government spending limits from the viewpoint of achieving fiscal policy objectives, i.e. effectiveness. It also looked at the functioning of the spending limits procedure from the perspective of good governance by examining the procedure in terms of openness and transparency. This report is part of the National Audit Office's external audit of fiscal policy.

The audit did not evaluate how well the Government has achieved its economic policy objectives as a whole or how successful individual economic and fiscal policy measures have been. Nor did the audit evaluate the impacts of the central government spending limits and rule-based fiscal policy on effectiveness in other areas of social policy.

On the basis of the audit the National Audit Office notes that the central government spending limits procedure has been successful, but the transparency and openness of the management of central government and general government finances could be improved by taking various practical measures. Despite the success of the spending limits procedure, the financial foundation of the welfare state in its current scope is in serious danger. The National Audit Office specifically presents the following conclusions and recommendations:

1 The spending limits procedure has succeeded in curbing growth in central government expenditure within its sphere and facilitates systematic financial management

Spending limits were not exceeded during the electoral term 2007–2010. The spending limits procedure has curbed growth in central government expenditure. Growth in central government expenditure has been slower than in the case of local government expenditure and social security funds, for example. The curbing effect on budget expenditure was significant during the last boom. As a result Finland's central government finances and economy were in a relatively good position to weather the recession. The spending limits system has thus achieved its main objective, which is to curb growth in central government expenditure, and has supported economic stability.

The audit evaluated information on compliance with spending limits using financial audit calculations. It also evaluated the openness and adequacy of reporting on compliance with spending limits in the Report on the Final Central Government Accounts. Up to now reporting on compliance with spending limits and the implementation of spending rules has been sketchy and difficult to understand if one is unfamiliar with the budget process.

In the opinion of the National Audit Office, to increase transparency the Report on the Final Central Government Accounts should clearly indicate what appropriations in the government proposal are covered by spending limits. Furthermore, with regard to supplementary budgets as well as appropriations added by Parliament, appropriations should be broken down according to whether or not they were covered by spending limits. In this way an outsider could easily check whether the appropriations in the final budget comply with the revised spending limits for the year.

The audit indicated that it is still difficult for an outsider to monitor compliance with spending limits, although information regarding price and structural adjustments in connection with spending limits decisions has been improved. On the basis of the National Audit Office's findings, there is no reason to assume that the calculation made by the Ministry of Finance contains errors or gaps, however. The National Audit Office recommends that special attention should be paid to improving the transparency of the spending limits procedure in documentation related to the preparation of spending limits and the budget during the next electoral term. A reduction in the number of indices used in adjusting prices could be considered, however, and price adjustment could be simplified otherwise as well.

The audit indicated that, in addition to curbing growth in central government expenditure, the spending limits have made operational and financial planning more systematic, long-term and coherent. This has a positive impact on the stability and quality of financial management.

2 Cyclical sensitivity has been taken into account by excluding certain types of expenditure from the spending limits. The impacts of tax subsidies should be carefully and critically evaluated

From a cyclical viewpoint the spending limits procedure passed the test of the recession. Since cyclically sensitive expenditure is excluded from spending limits in Finland, commitment to spending limits has not kept automatic stabilizers from functioning. The binding nature of the system could provide a perverse incentive to shift stimulus measures outside the spending limits, however.

Budget expenditure outside the spending limits has in fact risen, mainly as a result of counter-cyclical and stimulus measures. During the recession expenditure outside the spending limits was increased not only by automatic stabilizers but also by financial investments. Additional transport investments totalling about 110 million euros were financed by state-owned companies and unincorporated state enterprise, which are not covered by spending limits. This reflects the shortage of funds for transport investments inside the spending limits and underlines the need to clarify the relation between expenditure included in the spending limits and expenditure excluded from the spending limits. It is even possible to circumvent the spending limits through state-owned companies. In 2009 and 2010 the Housing Fund of Finland provided off-budget subsidies and interest support totalling around 200 million euros a year.

Tax subsidies constitute a significant "outlay" that is excluded from the spending limits. A new study by the Government Institute for Economic Research found that tax subsidies have increased in the 2000s. The spending limits procedure provides an incentive to use tax subsidies to achieve social policy objectives, since they are not subject to the monitoring and control that takes place in the spending limits procedure. Alongside the spending limits procedure, the monitoring of tax subsidies should be augmented both in connection with decision-making and after the fact. Tax subsidies should only be used as a policy tool when this is justified on the basis of the functioning and effectiveness of the tax system as a whole and an assessment of a subsidy's impacts. Such an assessment must also take behavioural impacts into account.

3 *Objectives regarding the balance of central government finances had to be relaxed, but this was justifiable*

In addition to spending limits, the Government Programme of Prime Minister Matti Vanhanen's second Cabinet included two objectives regarding the balance of central government finances. One aim was to achieve a structural surplus corresponding to 1 per cent of GDP by the end of the electoral term. The Government also declared that central government finances must never show a deficit of more than 2.5 per cent of GDP even in a weak economy. The Government Programme pointed out that this required faster economic growth and higher productivity than forecasts suggested. Another objective was to raise the employment rate and reduce structural unemployment. The Government spoke of bringing unemployment down below 5 per cent on a permanent basis.

As a result of the economic crisis, the Government Programme's objectives for employment and central government finances cannot be achieved. The Government policy session in spring 2009 concluded that objectives can temporarily be relaxed as long as measures are taken to strengthen public finances structurally. There was no way to foresee the crisis or its depth when the Government Programme was prepared in 2007. This underlines the need for flexible fiscal policy rules in a small open economy such as Finland's to withstand external shocks. Owing to the depth of the economic crisis, there were good reasons to deviate from the balance objectives in the Government Programme. Spending cuts in the midst of the recession would have unnecessarily deepened the downturn. The deficit rose largely as a result of automatic stabilizers, and the strict application of a deficit ceiling would have prevented these from functioning properly. According to the Government Programme, the Government should have made decisions to strengthen finances.

The connection between balance objectives and central government spending limits is loose. The spending limits in the Government Programme have not been derived from the balance objective in the Government Programme but have been set using political discretion. Another question is how well balance objectives have been formulated and dimensioned. The spending limits procedure does not have consistent and credible mechanisms to implement a deficit rule. The wording used in the Government Programme and preparatory documents suggests that the deficit ceiling was meant to be applied even in a sharp downturn. The National Audit Office concurs with criticism voiced by the OECD and the IMF, according to which fiscal policy rules need to include more flexibility in a small open economy such as Finland's. The thrust of this criticism is that the implementation of objectives was significantly tied to economic growth. In a small open economy, however, there is limited scope to influence economic growth using fiscal policy means.

From the viewpoint of risk management, fiscal policy rules adopted during the preparation of the Government Programme should be based on the scenario that is considered most likely by several forecasters. This should be taken into consideration in the dimensioning of fiscal policy for the coming electoral term.

4 *The key objective of ensuring the sustainability of public finances has not been achieved*

The objective of the spending limits procedure and rules-based spending policy was to ensure the sustainability of central government and general government finances. At the end of the electoral term, central government finances show a clear deficit and local government finances are also in the red. The surplus in public finances is entirely attributable to social security funds. Nor is any essential change in sight. The Government Programme's objective of ensuring sustainability and making provisions to meet the challenges of an ageing population has not been achieved.

The audit examined sustainability calculations and the available picture of the current state of public finances and central government's financial position as well as risks associated with sustainability. To test the information base concerning the sustainability of public finances and evaluate the impacts of uncertainties in sustainability calculations, the National Audit Office asked the Research Institute of the Finnish Economy (ETLA) to study the sustainability gap.

ETLA's sustainability calculation, which is based on a stochastic population forecast, takes into consideration the uncertainty of population forecasts. In addition the calculation of health and care costs is based on the age structure and mortality. With this method health and care costs increase less than in calculations based solely on the age structure. Preventive medicine and measures aimed at helping people stay fit, if successful, have significant possibilities in curbing cost pressures. On the other hand, curbing cost pressures in the care sector also requires breaking the link between the rise in the level of revenues and growth in demand for public services.

According to the estimate presented by ETLA in the study that it conducted for the National Audit Office, the sustainability gap is 2.5 per cent of GDP. A confidence interval of 50 per cent related to population forecasts and returns on investment is about two percentage points wide and a confidence interval of 80 per cent about four percentage points wide. In spite of uncertainty, the possibility of a change in the estimate of the sustainability gap for the worse must be taken seriously. The forecast will be refined in later stages of the project, but on the basis of previous studies it appears that the tax rate in the 2030s could be five percentage points higher or else welfare services will have to be cut back significantly, with a probability of 30–40 per cent. If for example population trends and returns on investment led to a course of development in which the need to increase the tax rate would be likely to exceed five percentage points and a major financial crisis occurred, the welfare state would truly be threatened. Although ETLA's estimate of the sustainability gap is smaller that other institutions' estimates, it points to significant risks in maintaining the welfare state in its current scope.

The audit revealed the sensitivity of sustainability calculations to the balance of public finances at the starting point. Consequently the recession has significantly affected evaluations of the sustainability of public finances. According to the current outlook, the effects of the recession on the sustainability gap will, however, be insubstantial in comparison with other factors. The National Audit Office therefore emphasizes the importance of reporting and communication regarding sustainability calculations. In addition to an evaluation describing the need to adjust public finances, attention must be drawn more clearly to the factors behind sustainability calculations. The sensibility of indicators describing the sustainability gap to changes in the balance of public finances at the starting point means that when the recession bottoms out and medium-term economic prospects improve, the estimate of the sustainability gap in public finances will fall. This will present a serious risk that attention will not be paid to structural factors behind sustainability calculations in political decision-making.

The crisis plays a more significant role in reminding people why it is necessary to prepare for weaker development than expected and to ensure economic manoeuvring room in case a new crisis comes along. Positive surprises over the short term, such as a brief spurt of economic growth or a windfall in tax revenues, are not sufficient to solve problems regarding the sustainability of public finances. The key message drawn from calculations is that the ability of the Finnish economy and state to weather another recession on the order of the recent financial crisis has significantly weakened. In the opinion of the National Audit Office, this must be given strong and serious thought in considering fiscal policy objectives and means for the electoral period 2011–2014.

5 The spending limits are too narrow in scope. They should be expanded to cover public finances as a whole

Central government spending limits cover only about one-third of total public expenditure. This causes problems for the sustainability of public finances, since cost pressures resulting from the ageing of the population will particularly affect local services and social security funds. Consequently, spending limits can do only so much to ensure long-term sustainability. In the opinion of the National Audit Office, it is important to take into consideration adjustment needs required for sustainability in evaluating Finland's fiscal policy regulation system and particularly the level of spending limits. In developing fiscal policy rules and in setting objectives during the next electoral term, greater weight should be given to the sustainability of public finances.

From the viewpoint of curbing growth in public expenditure and thereby achieving sustainability, the National Audit Office believes that spending limits should be expanded to cover public finances as a whole. Local government and social security funds would be included as separate categories in general government spending limits. Local government spending limits should be linked to the Basic Public Services Programme and the relation between central and local government finances. It is also necessary to limit the total financial burden placed on local government as a result of central government measures and regulation.

6 There is considerable upward pressure on local taxes – local authorities will probably be unable to manage tasks with current financing

During the 2007–2010 electoral term central government has taken many measures aimed at strengthening local government finances. Measures have also prevented local tax revenues from collapsing. Consequently local government finances have remained a relatively stable part of public finances. Local government expenditure has continued to rise at a rapid pace, however, and municipalities' debt level has increased as well. Meanwhile the difference between depreciation according to plan, which roughly reflects the amount of investment needed to maintain the public service structure, and actual depreciation has likewise increased, pointing to a structural weakness in local government finances. Local government accounts for a large part of public consumption expenditure. Local government will also be in the front line in meeting the challenges of an ageing population. With the current division of tasks and financing system, according to estimates local government accounts for about half of the sustainability gap in public finances.

To sum up, local government faces significant risks. There is considerable upward pressure on local taxes. There is a significant probability that local authorities will be unable to manage all the tasks for which they are currently responsible.

The division of tasks between central and local government and the financing system deserves attention in this regard. Regional differences are also very large and this calls for new measures and approaches in arranging financial relations between central and local government.

7 The need for and propriety of off-budget funds should be studied

Off-budget funds constitute a noteworthy deviation from Parliament's budgetary power, and no clear picture has been provided of off-budget funds as a whole. The only off-budget fund that is covered by spending limits (and this indirectly) is the State Pension Fund, which has been reclassified as part of the employment pension institutions sector. In view of development it is reasonable to ask whether existing off-budget funds are needed and whether there are grounds for the performance of permanent tasks through off-budget funds as prescribed in section 87 of the Constitution. During the next electoral term each off-budget fund should be evaluated to determine whether it is indispensable for the effective performance of tasks and if necessary activities and finances should be brought within the scope of the budget.

Off-budget funds that are not integrated into the budget economy should be covered by spending limits. The Housing Fund of Finland and the Fund for Agricultural Development are of special interest in this respect.

8 Rule-based fiscal policy using the spending limits procedure should continue during the next electoral term

The spending limits procedure has brought stability and a more systematic approach to central government finances. In the opinion of the National Audit Office, on the basis of the useful experience gained with rule-based fiscal policy, continuing the application of fiscal policy rules in Finland is justified. The spending limits procedure provides a clear framework for fiscal policy rules and a model for further development. The spending limits procedure should continue with additional refinements and reforms and should be expanded to public finances as a whole.

Since the risk that the sustainability gap presents with regard to the continuity and financing of the welfare state is great, addressing the sustainability gap should be made a key priority of economic and fiscal policy as well as legislative work during the next electoral term. This has a bearing on both tax and spending policy and should be kept in mind in the dimensioning of fiscal policy. Measures aimed at strengthening economic growth, the improvement of productivity in both the public and private sector, and measures promoting participation in the labour market, health and working capacity are also an important part of a stability programme. In this respect continuity in the broad objectives and lines of fiscal policy from one electoral term to the next is importance. Continuity improves credibility and makes it easier for households and businesses to plan for the future.

9 *The openness of the administrative preparation of spending limits should be improved – the planning cycle should be strongly pared down*

The administrative preparation of spending limits has been arranged well and the division of labour between the Ministry of Finance and sectoral ministries is clear. In the opinion of the National Audit Office, the preparation of spending limits functions properly but is hampered by a tight timetable. The rushed pact in the general planning cycle weakens the quality of the preparation of spending limits as well as economic planning and activities in the ministries in general. When one plan is finished, the next one is already on the drawing board. The National Audit Office therefore considers it important to reduce the number of different plans and sectoral plan systems, even if these are mandatory, and to streamline operational guidance in central government as a whole. The preparation of spending limits is part of the preparation of the budget, and because of the procedures that have been adopted, ministries actually wind up budgeting twice.

Criticism was voiced in sectoral ministries that the Ministry of Finance examines proposals at the item level in practice and that this prevents ministries from allocating resources within the framework of sectoral spending limits, which was the original idea. Examination at the item level also restricts possibilities for reallocations and reforms. The fact that the Ministry of Finance does not allow savings in one item to be reallocated to reforms in other parts of an administrative sector has especially drawn criticism. The Ministry of Finance for its part has generally presented clear and acceptable grounds for its practice. The Ministry of Finance has not approved automatic savings due to external factors as reallocable savings, nor can a one-off saving be used to raise the level of expenditure in another item. The most significant criticism is that the Ministry of Finance does not provide any explanation for overruling a sectoral ministry's positions at the item level. In the new spending limits and budget data system, the Ministry of Finance should also explain its reasoning and provide justifications at the item level for the sectoral ministry's use.

The National Audit Office believes that the quality and openness of the spending limits procedure can be improved if the criteria for approving reallocations are published in advance, for example in the Ministry of Finance's regulations concerning the preparation of spending limits proposals or its guidelines on this matter. The Ministry of Finance should also make a strong commitment to these principles. Other ministries' responsibility for allocating resources in their own administrative sectors and for taking into consideration cross-sectoral needs should be strengthened.

The item-based expenditure calculation that underlies the spending limits should be published. In the opinion of the National Audit Office, spending limits proposals and the item-based expenditure calculation could be published as soon as the spending limits decision has been approved. This would also improve possibilities to conduct research and engage in public discussion regarding the principles that guide fiscal policy and budgeting.

The link between the Government Programme and the preparation of spending limits is difficult to verify. The preparation of spending limits is directly connected to the Government Programme, but the examination and preparation of the budget at the item level separate financial planning from policy planning. The Prime Minister's Office is responsible for monitoring the Government Programme, but cooperation between the Ministry of Finance and the Prime Minister's Office is essential for the monitoring of appropriations. Cross-sectorality is a challenge in monitoring the implementation of the Government Programme and the spending limits. Differences in linkages between the preparation and monitoring of the Government Programme and the planning of spending limits were observed in ministries. In some ministries planning with regard to the Government Programme takes place separately from the planning of spending limits. In some ministries planning with regard to the Government Programme takes place separately from the planning of spending limits, which presents a risk that the ministry's internal view of coherence between measures and appropriations will remain insufficient. Cross-sectoral issues should be examined at every stage in the spending limits preparation process, starting with internal preparation at ministries. The audit found signs of tension between the spending limits and sectoral policies in the Government Programme, and in some cases ministry personnel feel that the spending limits impede the implementation of the Government Programme. Special attention should be paid to approximating fiscal policy frameworks and social policy contents in a realistic way during the coming electoral term.

The administrative preparation of spending limits should focus more on macroeconomic objectives. This is necessary to implement a genuine framework approach and to avoid what amounts to drawing up the budget twice.

The coordination of the spending limits procedure and the drafting of legislation should be improved to assure the implementation of the principles of better regulation and the evaluation of impacts that is required for this purpose in legislative projects that have been outlined in the spending limits procedure. In drafting legislation attention should be paid in a more consistent and coherent manner to the fiscal policy objectives on which the spending limits are based so that legislation will not present a risk to the sustainability of public finances.

10 The information base for the first spending limits decision is vitally important

The first spending limits decision of the electoral term is crucially important for the entire four-year period in terms of overall dimensioning as well as the financing of different functions. The timetable for preparing the decision is very tight. In the opinion of the National Audit Office, the preparation of the first spending limits decision should be given more time and the reasoning underlying the decision should be more transparent. An incoming Government's first spending limits decision is based on the "technical spending limits" approved in the final year of the preceding term, together with the increases and priorities set out in the Government Programme. The technical spending limits are supplemented by measures for which funds have been earmarked in budget calculations, and the total covered by the spending limits becomes the framework for the new term. The procedure followed in setting spending limits for the electoral term emphasizes the importance of the basic calculation that underlies the spending limits for the electoral term in each administrative sector.

Consideration should be given to improving the information base available in conducting government negotiations and preparing the first spending limits decision by conducting a broader spending review including experts from different fields at the end of the electoral term. Basic calculations should draw clearer attention to expenditure based on the Constitution, other legislation, previous legal commitments and other permanent tasks and should do a better job presenting assumptions and forecasts together with the possible impacts of different scenarios.

The bulk of expenditure in the budget and consequently the spending limits procedure is tied to statutory tasks. Consequently reallocating appropriations often requires political decisions even with regard to transfers inside an administrative sector. Real room for manoeuvre is therefore quite small. In this connection it should be pointed out that some legislation is quite old. Expenditure structures and the need for them should be reevaluated from time to time. The current way of operating in which an increase in appropriations resulting from new needs comes on top of the old expenditure structure according to the focuses in the Government Programme is not appropriate from the viewpoint of the sustainability of public finances. It would make more sense to explore possibilities to carry out reforms without increasing the level of expenditure. As a result of the pattern that developed in years of rapid economic growth, the old expenditure structure is dragged along from one electoral term to the next, because priorities are not set. Genuine reallocations would also require opening administrative sectors' basic calculations. If the sectoral ministries were free to act within the framework of the spending limits for their own administrative sector, without the Ministry of Finance's examination at the item level, ideally priorities would be revised as necessary throughout the electoral term. This would include the constant evaluation of whether legislation is up to date and necessary. Interviews with officials from sectoral ministries indicated that examination at the item level is inflexible and that a more general evaluation would be welcome in the case of ministries that mainly have operational expenditure, while changing statutory expenditure necessarily requires political approval.

11 In its economic forecasts the Ministry of Finance has succeeded as well as other Finnish forecasters

The accuracy of the Ministry of Finance's economic forecasts stands comparison with those made by other Finnish forecasters. From the viewpoint of transparency it is important that reporting on the preparation of fiscal policy forms a clear picture of the impact of macroeconomic development and fiscal policy measures on central government revenues and expenditure.

In the opinion of the National Audit Office, consistent justifications and careful risk analysis remain primary aims in developing forecasting and reporting, even though clear improvement has taken place. The Ministry of Finance should make it a permanent practice to produce and maintain the kind of documents that were prepared in response to a position taken by the Parliamentary Audit Committee on the basis of a study concerning the accuracy of tax revenue forecasts that was commissioned by the committee. However, the economic survey on which spending limits are based and the Government's budget proposal together with background materials already form an extensive whole, and for this reason the production of additional material is not deemed necessary. The increasing amount of background material produced in connection with the preparation of spending limits and the budget was also pointed out in interviews that were conducted by the National Audit Office at sectoral ministries. Instead of producing additional materials, the emphasis in development work should be on explaining the methods and assumptions behind forecasts. The description of the procedure for preparing revenue projections that was published on the Ministry of Finance's website in March 2010 is a key part of this work.

The Ministry of Finance has successfully set about reforming the way it presents the reasoning and assumptions behind tax revenue forecasts, as well as uncertainties. It has also calculated the total value of tax subsidies at Parliament's request. The budget commentary presents information on tax subsidies under tax revenue items. These reforms should lead to permanent practices and give some idea of how uncertainties related to other key fiscal policy information and associated risks should be presented. It is also necessary to put together a more complete and systematic picture of the total amount and development of hidden liabilities at the central government level as well as the development of financial liabilities and net assets in general government.

12 The openness of fiscal policy-making and the expert evaluation and analytical discussion of fiscal policy should be increased

The link between the central government spending limits and the broader setting of fiscal policy objectives should be presented more clearly and unambiguously. In this respect and in justifications it is necessary to give a more transparent description of assumptions concerning the causal relations between spending policy and intended outcomes.

Knowledge concerning the spending limits procedure is scarce outside the Ministry of Finance, and this restricts informed discussion about Finland's fiscal policy framework and the achievement of fiscal policy objectives. The current system's lack of transparency accentuates the problem. Increasing knowledge regarding fiscal policy rules and arranging external control are vital to facilitate public discussion in Finland.

Scientific research regarding economic and fiscal policy options, their impacts and the relation between operational alternatives and long-term fiscal policy objectives should be increased. Finland also needs more systematic research on the effectiveness of fiscal policy and different subareas. The ex post evaluation of effectiveness should be independent and separate from applied research aimed at presenting policy recommendations according to an agenda set in advance.

The National Audit Office believes that establishing a fiscal policy council could improve public evaluation and discussion, but this requires the allocation of adequate resources and expertise. What is more important than establishing a new institution is to increase the transparency of the reasoning and assumptions used in decision-making, to improve research into effectiveness and to facilitate public discussion and the involvement of experts in discussion within the framework of existing institutions.

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ISSN 1798-6427 (Print)