



Separate report of the National Audit Office to Parliament: Fiscal policy evaluation report 2017



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To Parliament

The National Audit Office monitors and evaluates fiscal policy in its role as an independent national fiscal policy evaluation body under the Stability Pact (Fiscal Compact) and within the meaning of European Union law. Provisions on the evaluation task are laid down in the Act on the National Audit Office of Finland (676/2000) and the Act on the Implementation and Application of the Provisions Governed by the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union and on Requirements Concerning Multiannual Budgetary Frameworks (869/2012, the “Fiscal Policy Act”).

Fiscal policy evaluation comprises the assessment of the setting and implementation of the fiscal policy rules steering the fiscal policy. It covers monitoring of the compliance with the Medium-Term Objective (MTO) and the related correction mechanism, monitoring of the preparation and implementation of the General Government Fiscal Plan and monitoring of compliance with the Stability and Growth Pact. It also covers the assessment of whether the macroeconomic forecasts influencing fiscal policy decisions are realistic as well as the ex-post assessment of the reliability of the forecasts in the manner laid down in the Government Decree on the General Government Fiscal Plan (120/2014, as amended by decree 601/2017)¹. By evaluating the fiscal policy, the National Audit Office promotes transparency and intelligibility of regulations as well as stable and sustainable general government finances.

Under section 6 of the Act on the National Audit Office of Finland, the National Audit Office hereby presents Parliament with this separate report on its fiscal policy evaluation for the 2017 parliamentary session.

Helsinki, 14 December 2017

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This fiscal policy evaluation report includes a preliminary assessment on compliance with fiscal policy rules and the achievement of the Government's goals in 2017 and 2018. It also covers the overall steering of general government finances, the fiscal policy framework, compliance with general government spending limits and adherence to the Stability and Growth Pact.

According to the assessment of the National Audit Office, the general government fiscal position will not improve during the current parliamentary term in the manner envisaged by the Government, despite accelerated economic growth. According to the calculations based on the Ministry of Finance forecast, general government structural balance, from which the impact of the cyclical component on the fiscal position has been eliminated, will weaken in 2017 and 2018. Furthermore, the nominal fiscal position will not achieve the balance target during the current parliamentary term due to slower-than-envisaged improvement of general government finances.

The 2017 supplementary budgets comply with the spending limits rule. The 2018 budget proposal contains an exception to the spending limits rule, which concerns transfer of the funding of the Finnish Broadcasting Company outside the spending limits. In the view of the National Audit Office, the transfer will weaken the credibility of the spending limits system. Incorporating the appropriation of EUR 18.6 billion earmarked for county financing in the general government spending limits will present challenges to the compliance with the spending limits in 2019, the last year of the current parliamentary term, and, consequently, with the overall spending limits for the parliamentary term.

According to the preliminary estimates, Finland will be in compliance with the preventive arm and the corrective arm of the Stability and Growth Pact in 2017. When consideration is given to the flexibility factors granted by the European Commission, Finland will also be in compliance with the two arms in 2018. According to the forecast produced by the Ministry of Finance, the change in the structural balance in 2018 will be about 0.2 percentage points smaller than what is required, even when consideration is given to the flexibility factors.

The National Audit Office deems the Government's objectives to reduce the sustainability gap through structural reforms important. The health and social services reform offers an important opportunity to promote this goal. However, the effects on the sustainability gap of the Government proposals in spring 2017 regarding the health, social services and regional government reform were very vague. Further preparation of the reforms also enables making effective decisions in terms of general government finances. In August 2017, the Government decided to start the preparation of a family leave reform and a business subsidy reform, which can be considered well-justified measures to improve employment and productivity.

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1 Fiscal policy objectives and their achievement

The National Audit Office has assessed the achievement of the Government's fiscal policy targets and compliance with the Government spending limits, as well as carried out a preliminary assessment on compliance with the Stability and Growth Pact in 2017 and 2018. In this report, the National Audit Office assesses the achievement of the objectives based on the autumn 2017 forecast by the Ministry of Finance, the preliminary budget proposal and the 2018 draft budgetary plan.

1.1 Summary of the findings

After a period of slow economic growth, the Finnish economy has started to grow. In 2016, the economy grew by 1.9%, and the Ministry of Finance is forecasting a growth of around 2.9% for 2017. The forecast for 2018 is growth of 2.1%. The forecasts became clearly more positive in 2017, as the forecasts in autumn 2016 still anticipated a growth of some one per cent throughout the parliamentary term.

General government finances have substantially improved in 2017 due to the recovery of the economy. According to the national accounts, the general government deficit is projected to reduce to 1.2% in relation to GDP. The improvement in the general government fiscal position is particularly due to higher-than-anticipated growth in tax revenue. Despite the improved economic growth, the general government fiscal position will not improve enough for the binding budgetary targets of the Government to be reached. Of the subsectors of general government, general government finances, in particular, will remain below the budgetary target.

According to the preliminary assessment, the medium-term objective set by the Government, structural balance of at least -0.5% in relation to GDP, will not be achieved during the current parliamentary term either.

The 2017 supplementary budgets are within the general government spending limits. The 2018 budget proposal includes an exception to the spending limits rule: the appropriation for the State Television and Radio Fund will be transferred outside the spending limits.

1.2 Compliance with national fiscal policy rules

The Government is not expected to reach the target it has set for the general government fiscal position

A fiscal deficit, rapid growth of debt and a medium-term sustainability risk were the problems faced by the general government finances at the start of the parliamentary term. Under its programme, the Government set as its targets to level off public indebtedness and to cover the sustainability gap of EUR 10 billion through spending cuts, measures supporting growth and structural reforms.

The Government is committed to the medium-term target which is based on structural balance terms. The target confirmed by the Government in autumn 2016 is to achieve a structural balance of at least -0.5% in relation to GDP by the end of the current parliamentary term in 2019. The medium-term target is part of the common coordination of fiscal policy in the EU, and also part of the national legislation, as it is included in the Fiscal Policy Act.

In the first General Government Fiscal Plan for the parliamentary term 2015–2018, the Government laid out binding budgetary targets for general government subsectors. These targets are defined in accordance with the net lending (difference between revenue and expenditure) recorded in the national accounts. According to the targets, an overall balance in general government revenue and expenditure should be achieved by 2019. According to the plan, the deficit of central and local government finances should be 0.5 per cent of the GDP. Employment pension funds should show a surplus of one per cent in relation to GDP, and other social security funds should be in balance in overall terms. These targets were confirmed in the General Government Fiscal Plan for 2018–2021 that was prepared as a result of the Government's mid-term review.

In addition to the targets set for 2019, the spring 2017 General Government Fiscal Plan presented multi-annual nominal target paths for the general government subsectors. The target paths were set in such a manner that their achievement would ensure achievement of the level of structural balance laid down in the medium-term objective.

Even though the status of general government finances has improved in stages during the parliamentary term, the set target for general government balance will not be achieved during this parliamentary term or the forecast period following it. In 2017, the general government deficit that is in accordance with net lending is expected to reduce by approximately EUR 1.2 billion compared to the 2016 level, to approximately -1.2% in relation to GDP in 2017. According to the forecast produced by the Ministry of Finance, the general government balance will reduce to approximately -1.4% in 2018. Of the subsectors of general government, general government finances, in particular, will show a deficit.

The structural balance of public finances is expected to be -0.8% in relation to GDP in 2017. Thus, the structural balance will remain 0.3 percentage points below the objective confirmed by the Government. According to the forecast, the structural balance will continue to weaken in 2018 to approximately -1.3% in relation to GDP. According to the forecast, the structural balance will not improve in 2019, which means that the Government will not reach its medium-term objective during this parliamentary term.

The improvement in the nominal fiscal position mentioned above has not influenced the structural balance, as the structural balance has weakened particularly due to the improved economic situation. Fig. 1 presents the development of the nominal balance according to the forecast produced by the Ministry of Finance and development of the structural balance in relation to the targets set by the Government.

The Government will remain below its targets for both nominal fiscal position and structural balance

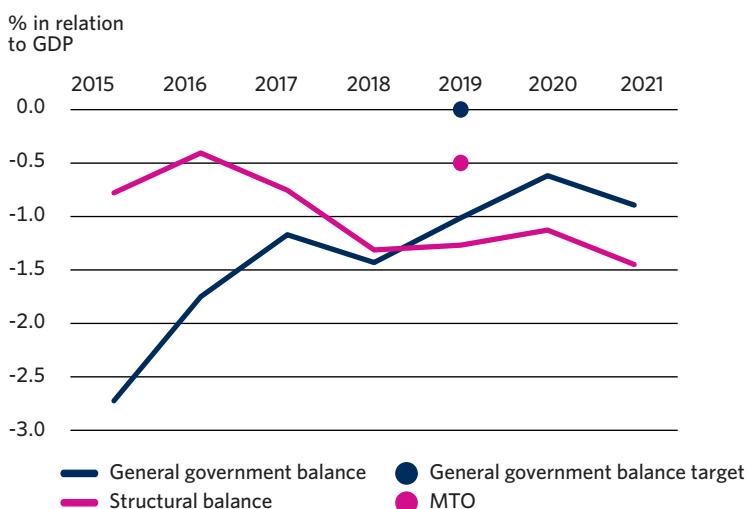


Figure 1: Nominal balance and structural balance of general government finances in 2015-2021. Source: Statistics Finland and Ministry of Finance

Estimate on the state of general government finances has rapidly improved

Finland's general government finances have substantially improved in 2017. In spring 2017, the Ministry of Finance forecasted that the general government balance would be approximately -2.3% in relation to GDP in 2017, but the estimate of the structural balance in the forecast given in the autumn was reduced by around EUR 2.5 billion from the forecast given in the spring. The improved structural balance estimate is due to the improved economic situation and resulting higher-than-anticipated growth in tax revenue. The tax revenue in 2017 is some EUR 2.4 billion higher than anticipated in the spring 2017 forecast. Direct taxes, in particular, increased from 2016. The estimate of the general government expenditure in 2017 is only around EUR 100 million lower than forecasted in spring 2017.

The general government fiscal position will greatly improve in 2017 due to the increased tax revenue, even though the Government's fiscal policy is mostly expansionary. The Competitiveness Pact will improve the general government finances by around EUR 1.2 billion. This estimate includes improvements caused by social security contributions and changes to the tax basis, as well as savings introduced by holiday bonus cuts and longer working hours.

According to the forecast produced by the Ministry of Finance, the general government balance will reduce to approximately -1.4% in 2018. The weakening of the general government fiscal position is the result of the weakened fiscal position of the local government and social security funds.

Fiscal position of the state will remain below the set goal

The central government finances are still showing a clear deficit. According to the national accounts, net lending, which describes the difference between revenue and expenditure, was EUR -5.8 billion or approximately -2.7% in relation to GDP in 2016. According to the forecast produced by the Ministry of Finance, the deficit will be reduced by around 700 million euros in 2017 and further by around EUR 500 million in 2018. The deficit has reduced due to the favourable economic situation. State revenue has increased due to the higher than anticipated tax revenue and the stable development of expenditure.

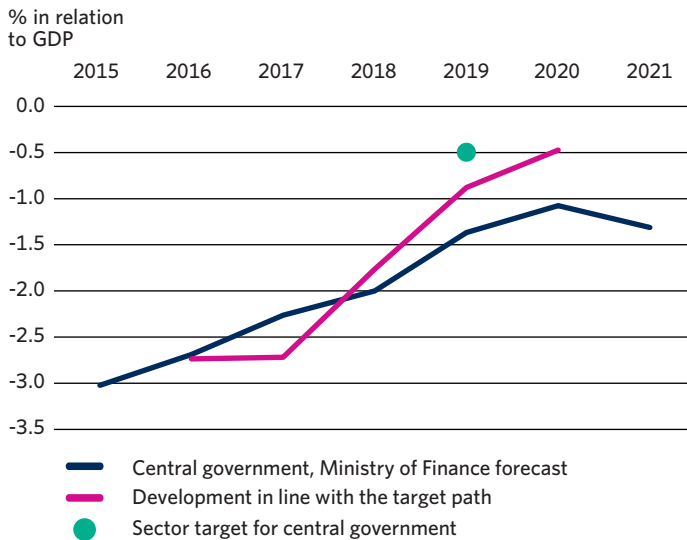


Figure 2: Central government fiscal position according to the forecast by the Ministry of Finance and according to the target path of the Government, as well as the general government goal for 2019

Even though the forecast produced by the Ministry of Finance anticipates that the deficit according to the national accounts will reduce, the target level of -0.5% set by the Government will not be reached; instead, the deficit will remain at approximately -1.4% in relation to GDP in 2019. Fig. 2 presents the central government fiscal position according to the independent forecast by the Ministry of Finance and the target path set by the Government. The figure shows that the central government fiscal position is developing better than the target path in 2017. Even though the deficit will continue to reduce during the forecast period, it will not reduce enough for the target path level to be reached. Therefore, the central government fiscal position will not reach the target level of -0.5% in relation to GDP in 2019.

The state budget will also show a deficit in 2018. Immediate adjustment measures for the central government fiscal position are included in the central government spending limits and the 2018 budget proposal. The Government's 2018 budget proposal proposes a reduction on the taxation of earned income by a total of around EUR 470 million. Part of the tax relief will be realised with a tax scale index adjustment and part with income taxation reliefs. According to the budget proposal, the state budget deficit will be some EUR 3 billion in 2018.

Central government finances, in particular, will remain below the set goal

Development of local government finances will be better than the target path

The deficit of local government finances has somewhat reduced in 2016 and 2017. Furthermore, local government finances benefited from the higher-than-anticipated growth in tax revenue, and the deficit was further reduced by the holiday bonus cuts included in the Competitiveness Pact.

The deficit of local government finances is expected to grow to some extent in 2018, however. According to the forecast produced by the Ministry of Finance, the fiscal position of local government finances will weaken by around 0.2 percentage points in 2018. The estimate on the deficit of local government finances will be revised as municipalities' own actions are specified, however.

According to the autumn 2017 forecast, development of the local government fiscal balance will be somewhat more favourable than the set target path in spring 2017, as described in Fig. 3. Despite a weakening of the fiscal position in 2018, local government finances are expected to reach the set target level in 2019.

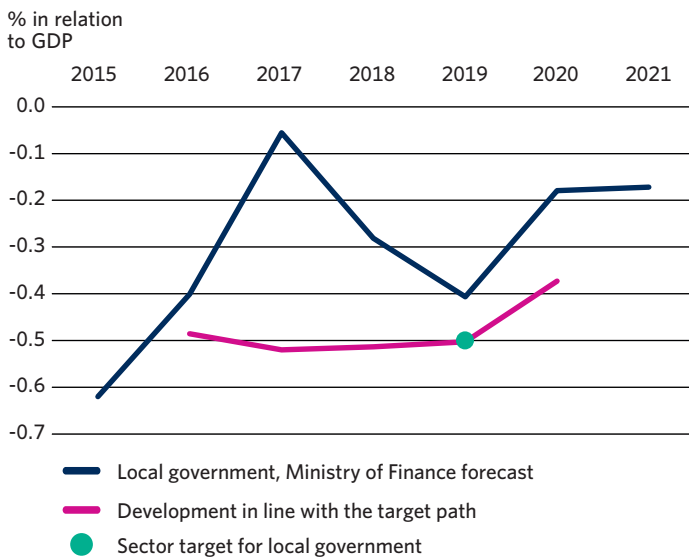


Figure 3: Local government fiscal position according to the forecast by the Ministry of Finance and according to the target path of the Government, as well as the local government goal for 2019

The status of local government finances will continue to improve at the end of the forecast period, partially due to the fact that the responsibility for providing social and health care services will be transferred from municipalities to the eighteen provinces to be established in 2020.

Surplus of social security funds has reduced

The surplus of social security funds has reduced during this parliamentary term. The reduction in surplus is due to a reduction in the surplus of employment pension institutions as the result of an increase in pension expenditure and the low interest rate level that reduces the revenue. According to the forecast produced by the Ministry of Finance, the surplus of social security funds will be reduced from 1.3% to approximately 0.8% in 2019. Even though the surplus of social security funds will reduce slower than the set target path, they will still remain below the set surplus goal of 1% in 2019. The development of the fiscal position of social security funds in relation to the set target path is presented in Fig. 4.

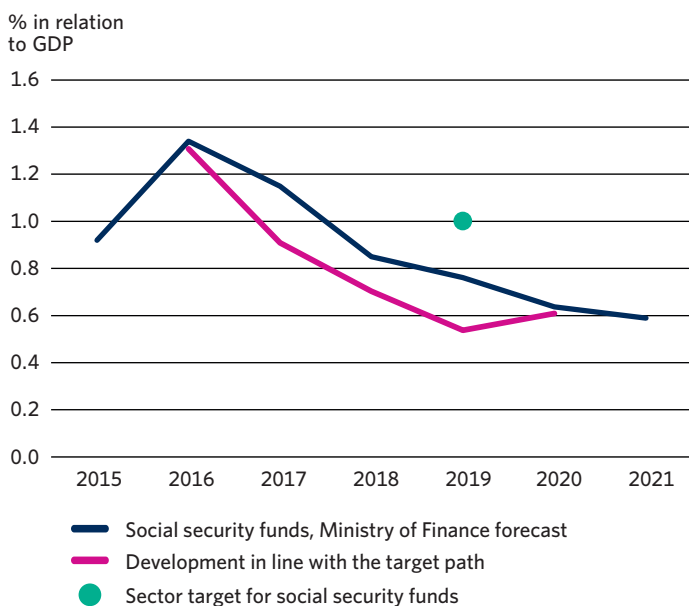


Figure 4: Social security funds' fiscal position according to the forecast by the Ministry of Finance and according to the target path of the Government, as well as the goal for social security funds in 2019

Even though the social security funds' surplus has reduced, one should note that the financial assets of employment pension funds, which form a key part of the social security funds, have experienced brisk growth lately. The financial assets of the employment pension funds increased by almost 9% or by some EUR 16 billion from the end of 2015 to the middle of 2017.

General government debt ratio started to decline

General government debt increased by 2.8 billion euros in 2016 to a total of EUR 136 billion at the end of 2016. As the general government fiscal position will show a deficit until the end of the parliamentary term, the growth of general government debt will also continue.

However, in 2017 the debt-to-GDP ratio reduced by some 0.7 percentage points from 2016, mainly due to the fast GDP growth. According to the forecast produced by the Ministry of Finance, the debt ratio will continue to decline in 2018 and 2019, on the basis of which the Government will likely reach the debt ratio decline target laid down in the Government Programme.

Growth of general government debt will continue

1.3 Progress of structural reforms

The National Audit Office deems the Government's objectives to reduce the sustainability gap important. The health and social services reform offers an important opportunity to promote this goal. According to sensitivity analyses produced by the Ministry of Finance, permanent (up until 2060) annual productivity growth of 0.5% in public health and social services production would reduce the sustainability gap by 1.2 percentage points in relation to the GDP.

However, the effects on the sustainability gap of the Government proposals in spring 2017 regarding the social welfare and health care reform and the regional government reform were very vague. Therefore, when the reforms were referred for further preparation in summer 2017, according to the NAOF's estimate, this did not affect negatively the prospects of general government finances. Further preparation of the reforms also enables making effective decisions in terms of general government finances. Overall, reaching of the cost-containment target of EUR 3 billion set by the Government by the end of the 2020s is unlikely, in light of the current information available and the wide objective setting of the reform. The savings target would mean achievement of a sustainability gap impact of 1.5 percentage points in the course of ten years and savings of around 13% from social and health care service expenses in 2029 in relation to the expenditure in the basic forecast.

International comparative data does not suggest that the current Finnish social and health care system is expensive, which in part makes the set goals even more challenging. This does not mean that there is no room for improvement in the current system, however. The proposed regional financial steering and funding model broadly supports achievement of the savings goal. The transfer of the responsibility for arranging social and health care services to larger entities than at present, which is part of the health and social services reform, supports realisation of the existing potential for improvement within the framework set by decisions on the number and size of the regions.

As the reforms also aim to improve accessibility of services and to narrow health gaps, the savings target is very high also in the long term. At present, there are major uncertainties connected to the achievement of the sustainability gap target set for the reform, which increases the importance of consideration when making decisions on high-risk areas during the further preparations, careful monitoring of the impact of the reform, as well as the readiness to make changes and take further action, including any actions

Further preparation of the reforms enables making effective decisions in terms of general government finances

Regional financial steering and funding model broadly supports achievement of the savings goal

influencing the social and health care expenditure that are not included in the scope of the reform at present. Such actions could be implemented in connection with the reform of the multi-channel funding model, for example, and by finding as effective means as possible to influence the development of service needs.

According to the Government Programme, the goal is to reduce local government expenditure by EUR 1 billion by reducing the number of local government tasks and obligations. Later, the reforms were extended to cover the entire government sector, and the results were envisaged to be reviewed in the spending limits discussion in 2017. However, this review did not produce more than a general list of themes with only rough savings targets. Currently, the target year for the reform impacts has been set far in the future, towards the end of 2020s. Overall, the impact of the reform supporting general government finances still remains vague.

In August 2017, the Government made a decision on the implementation of two reforms outside the Government Programme. The family leave reform is envisaged to also involve reviewing early childhood education and labour market issues in addition to family leaves. The requirement set for the preparatory work, according to which the reform must involve measures that will boost employment pursuant to the Ministry of Finance's estimate, is appropriate. However, some of the requirements set for the preparatory work may impede the finding of the most effective solution. The decision that the policy pursuant to which parents are entitled to care for their children at home until they reach the age of three years must be kept within the allowance scheme will limit the number of alternative solutions available for consideration.

In connection with the preparation of the 2018 budget, the Government also decided to start the preparation of the business subsidy reform. The goals set for the work, allocating subsidies in a manner that will promote productivity and the reduction of distortion in competition, point at the right direction. However, the National Audit Office considers it important that the preparatory work is not limited to the reallocation of the subsidies, but reducing the total amount of subsidies should also be genuinely considered.

1.4 Spending rule laid out in the Government programme and spending limits for the 2016–2019 parliamentary term

The spending rule laid out in the Government Programme² (hereinafter the “spending rule”) and the spending limits for the parliamentary term are an essential part of Finland’s national fiscal policy framework. In its programme, the Government has pledged to observe an expenditure rule set in the Government Programme under which the 2019 expenditure under the limits should, in real terms, be EUR 1.2 billion lower than the expenditure under the technical spending limits (the last spending limits laid out during the 2011–2015 parliamentary term) approved on 2 April 2015.

In Finland, the spending limits procedure sets a ceiling for approximately 80% of central government budget expenditure. The spending limits are valid for a period of four years, i.e. for the duration of the parliamentary term. The purpose of the spending rule is to limit the total expenditure payable by the taxpayers. Consequently, when neutral changes are made in the Budget, corresponding adjustments may be made in the spending limits of the parliamentary term.

The spending limits are revised not only in connection with the decisions made in the spring of each year, but also in connection with the preparation of the preliminary budget plan and supplementary budget plans. The spending limits are annually revised based on the next year’s price and cost level in the general government spending limits decision that is part of the General Government Fiscal Plan. Structural changes to the overall expenditure ceiling can change the timing of expenditure items during the parliamentary term, reallocate the spending limits and add additional spending limits to the budget due to additional expenditure or a reduction in expenditure items outside the spending limits. The adjustments to the spending limits make the spending limit system less transparent, which is why verifying compliance with the Government spending limits rule is challenging.

The National Audit Office annually submits reports on compliance with the overall spending limits, as well as monitors expenditure and tax subsidies outside the spending limits. This is to ensure that no changes that violate the spending rule are made and that the leeway budgeted in the spending limits, i.e. the supplementary budget reserve and unallocated reserves, are not exceeded, and that the expenditure or tax subsidies outside the spending limits do not become inappropriately high as a result of the spending limits.

In the spring 2017 fiscal policy evaluation report, the National Audit Office reported its observations on the preparation of the spending limits in 2016 as a whole. No defects in compliance with the Government spending rule during the first year of the parliamentary term, 2016, were observed, but it was noted that the transfer of the appropriations made to the Finnish Broadcasting Company YLE outside the spending limits in 2018 may pose a risk to compliance with the parliamentary term spending limits³.

Regional government reform raises the general government spending limits to a new level

In the General Government Fiscal Plan 2018–2021, a total of EUR 18.6 billion has been budgeted to regional government funding in 2019. However, the changes to the funding of the regional government will be transferred to 2020 because of a revised reform schedule. Most of the expenditure items arising from the preparation and implementation of the regional government reform, EUR 181 million, have been budgeted to the 2018 budget proposal.

Planned changes to the central government spending limits due to the regional government reform are described in the General Government Fiscal Plan 2018–2021. As the preparation of the regional government reform spending limits will be transferred to the next parliamentary term, the revisions of the general government spending limits will take place in the preparation of the next Government's first spending limit decision according to the policies laid down in the new Government Programme. Due to the change of parliamentary term, major adjustments of the general government spending limits can be made without the risk of non-compliance with the spending limits, as the spending limits or the expenditure benchmark for the new parliamentary term have not been set yet. Due to the revised schedule of the preparation of the spending limits for the regional government reform, the risks are related more to the functionality of the spending limits procedure as an expenditure rule than to compliance with the spending limits. Attention must be paid to retaining the spending limits procedure as a functional expenditure rule in the preparation of the spending limits for the next parliamentary term.

The plan is to base around two thirds of the funding for the regional government on the new spending limits expenditure that is based on earned income and corporation tax revenue transferred from municipalities. According to the Ministry of Finance, this is a neutral system change from the perspective of taxpayers. However, a risk from the perspective of general government expenditure as a whole is that the local government expenditure do not diminish in relation to the transferred tax revenue and the increase of general government expenditure.

Attention must be paid to functionality of the spending limits procedure as an expenditure limit

The General Government Fiscal Plan 2018–2021 includes a plan of transferring compensations to municipalities arising from tax cuts from outside the spending limits as part of the regional government funding. According to the Government Programme of Prime Minister Juha Sipilä’s Government, however, the tax compensations will be budgeted outside the spending limits. The National Audit Office concludes that the fact that there is some ambiguity as to which appropriations are included in the spending limits and which are not reduces credibility of the spending limits procedure.

For the spending limits to function properly as an expenditure limit, changes that do not increase the spending limit level, such as the reallocation of spending limits within the spending limits system or using provisions budgeted in the first spending limits decision of the parliamentary term during the budgeting of additional expenditure, are the recommended budget changes. The plan is to cover around one third of the funding for the regional government with appropriations transferred from other spending limit items.

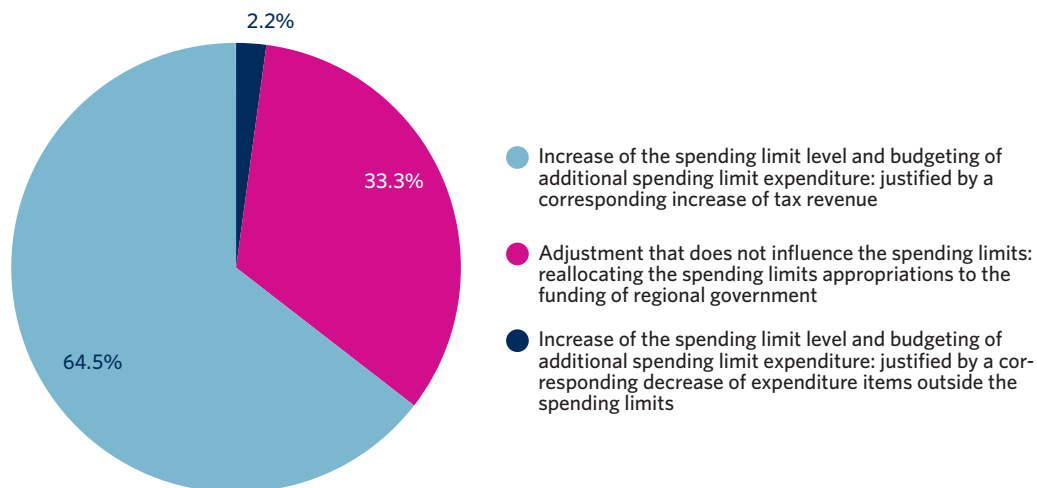


Figure 5: Planned spending limits procedure to increase regional government funding in the general government spending limits. Source: General Government Fiscal Plan 2018–2021 and NAOF’s spending limits calculation

The plan laid down in the General Government Fiscal Plan 2018–2021 was to reallocate the spending limit appropriations to the funding of regional government mostly within the spending limits of the administrative sector of the Ministry of Finance. The spending limits of the administrative sector of the Ministry of Finance laid down in the General Government Fiscal Plan 2018–2021 include not only the new appropriations required by the regional government reform but also a new internal spending limit appropriation of the administrative sector with an unlimited intended

use. If the administrative sector's internal appropriation is used in the spending limits procedure, its intended use should be clearly indicated in order to ensure transparency of the spending limits procedure.

Expenditure outside the spending limits

Since 2004, the budget expenditure has been divided into spending limits expenditure and expenditure outside the spending limits. Cyclical expenditure, such as unemployment security and pay security, are included in the expenditure outside the spending limits. Debt interest payments, compensations to municipalities arising from tax cuts and financial investments are also included in expenditure outside the spending limits. Some of the expenditure items outside the spending limits are pass-through items, which means that there is specific revenue that corresponds the expenditure in the budget. Expenditure corresponding to revenue from the EU and the revenue generated by the Veikkaus Company are examples of such expenditure items. A total of about EUR 3.6 billion of pass-through items were classified as expenditure outside the spending limits in 2018.

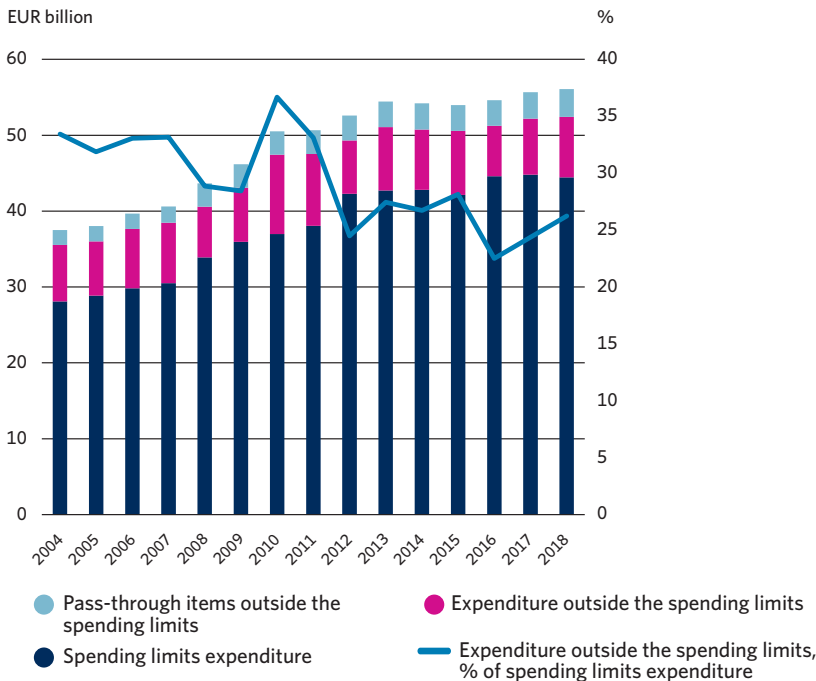


Figure 6: Budget expenditure 2004–2018 divided into spending limits expenditure and expenditure outside the spending limits (EUR billion, left axis) and ratio of the expenditure outside the spending limits to the spending limits expenditure (% , right axis). Source: State budget proposals 2004-2018

The largest expenditure items outside the spending limits, EUR 4.9 billion in 2018, are unemployment security, housing allowance and pay security. These expenditure items function as an automatic stabiliser, which means that they are expected to increase in a downturn and decrease during a period of economic growth. The expenditure have increased since 2012. In 2018, the expenditure will mainly increase due to an increase of the housing allowance. The comparison of the expenditure during the different years is made more difficult because several decisions to change the level of unemployment security and housing allowance have been made. The savings or expenditure caused by these decisions adjust the spending limits so that increased expenditure decreases the spending limit, and on the other hand savings raises the spending limit. Yet, the overall level of expenditure may rise outside the spending limits depending on the economic situation without causing any change to the spending limit level.

The National Audit Office pays attention to information on spending limit adjustments given. Only a little and fragmented information on spending limit adjustments is given. The effect of the adjustments on the impact of discretionary measures is thus difficult to assess. For example, the 2018 budget proposal states that an adjustment regarding mandatory activation of unemployed job-seekers (the “active model”) would reduce the unemployment security, housing allowance and income support expenditure outside the spending limits. In the budget, reduced expenditure has only been budgeted for unemployment security, while the housing allowance and income support expenditure increase. The spending limits will be raised by EUR 8.9 million as the result of a calculation where the savings and additional expenses arising from the active model have been deducted from one another. The calculation cannot be repeated with the available budget data. The estimate on the impact of the active model is indicative, which means that additional expenditure or savings may still be specified. Information about adjustments should be clarified and made more consistent, and any uncertainties in the information should be clearly indicated.

Most of the expenditure items outside the spending limits consist of unemployment security, housing allowance and pay security

Information on structural spending limit adjustments is given in a fragmented manner

Other expenditure items outside the spending limits include compensations made to municipalities for tax changes, interest expenditure on general government debt, financial investments and transfers to the State Television and Radio Fund. Compensations made to municipalities for tax changes have steadily increased during the parliamentary term. Interest expenditure on general government debt has continued to decrease due to the exceptionally low interest rate level. Financial investments have remained at a high level. Financial investments are outside the spending limits, because they are expected to retain their value. In addition to revenue targets, societal objectives are also often set for financial investments.

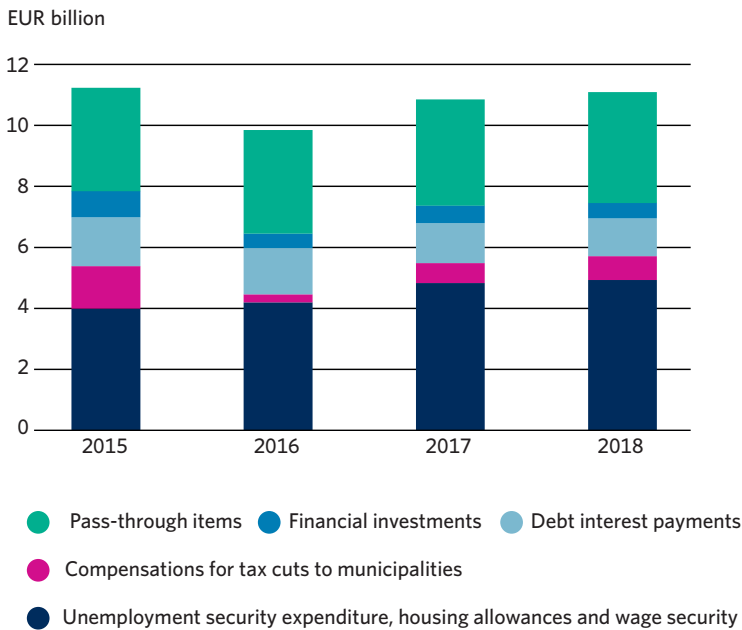


Figure 7: Expenditure outside the spending limits 2015-2018.

Source: State budget proposals 2015-2018

A parliamentary working group set by the Minister of Transport and Communications assessed the tasks and funding of the Finnish Broadcasting Company. In its memorandum published in 2016, the working group proposed that the funding of the Finnish Broadcasting Company should be kept outside the general government spending limits. According to the working group, keeping the public service tax outside the general government spending limits is justified to ensure independence of the Finnish Broadcasting Company. The 2018 General Government Fiscal Plan states that as an exception to the spending limits rule laid down in the Government Programme, the appropriation for the State Television and Radio Fund will be transferred outside the spending limits, as proposed by the parliamentary working group. In the view of the National Audit Office, this deviation from the spending limits rule laid down in the Government Programme deteriorates the credibility of the spending limits system. The justification given by the working group in its memorandum on the transfer of the appropriation for the State Television and Radio Fund outside the spending limits influencing the independence of the Finnish Broadcasting Company remains unclear. Transfers to funds outside the budget are spending limits expenditure items, but the State Television and Radio Fund is now an exception to this rule. There are regulations on the use of the assets in the fund in the Act on the State Television and Radio Fund, and the fund is managed by the Finnish Communications Regulatory Authority (FICORA). The Government makes a decision on division of the fund's assets for different purposes in its annual allocation scheme.

A deviation from the spending limits rule laid down in the Government Programme deteriorates the credibility of the spending limits system

2 Compliance with the Stability and Growth Pact

Finland is committed to compliance with the rules of the EU Stability and Growth Pact. Finland is also committed to compliance with the Fiscal Compact. In this chapter, the National Audit Office presents compliance with the rules of the preventive arm in 2017 and 2018.

The preventive arm of the Stability and Growth Pact assesses compliance with the medium-term objective (MTO) and progress towards it. The assessment is based on changes in structural balance and the expenditure benchmark. The corrective arm of the Pact assesses compliance with the deficit and debt criteria. Finland's performance is assessed as part of the preventive arm of the Pact and, thus, Finland must comply with the obligations of the preventive arm. According to a preliminary assessment produced by the National Audit Office, Finland will be in compliance with the criteria of both the preventive arm and the corrective arm in 2017 and 2018.

The National Audit Office's assessment of the compliance with the Stability and Growth Pact is based on the draft budgetary plan for 2018 by the Ministry of Finance. The National Audit Office has independently verified the calculation of the structural balance on the basis of the materials supplied by the Ministry of Finance. Furthermore, the National Audit Office has calculated, in accordance with the expenditure benchmark, the trends in total general government spending on the basis of the draft budgetary plan. The calculations are mainly based on the methods presented by the European Commission in the report *Vade Mecum* on the Stability and Growth Pact.⁴ The National Audit Office's calculations are presented in the workbook appended to this report.

2.1 Assessing the preventive arm

In accordance with the preventive arm of the Stability and Growth Pact, the Medium-Term Objective (MTO) is always set for three years at a time in terms of structural balance. Setting the MTO is also required by national law, in the Fiscal Policy Act (869/2012). The structural balance describes the general government budgetary position in relation to the value of the gross domestic product when the impact of business cycles, one-offs and temporary measures has been eliminated from the general government fiscal position. In autumn 2016, the Government confirmed that Finland's MTO is to achieve a structural balance of -0.5% in relation to GDP.

Achievement of the MTO is assessed on the basis of two separate pillars. Firstly, it is studied whether the MTO has been achieved or whether Finland has proceeded in the required manner towards the MTO. In the expenditure benchmark, the second pillar of the preventive arm, growth of general government expenditure is examined in relation to the limit set for the spending (the expenditure limit).

Structural balance will deteriorate in 2017 and 2018

The first pillar of the preventive arm concerns the level of structural balance or the adjustment path leading to the MTO. In 2017, the structural balance is expected to remain at -0.8 percent in relation to GDP or 0.3 percentage points from the set target level. Fig. 8 shows the National Audit Office's estimate of the level of structural balance in 2016–2018. The figure also includes a comparison with the estimate presented in the National Audit Office's assessment of spring 2017.

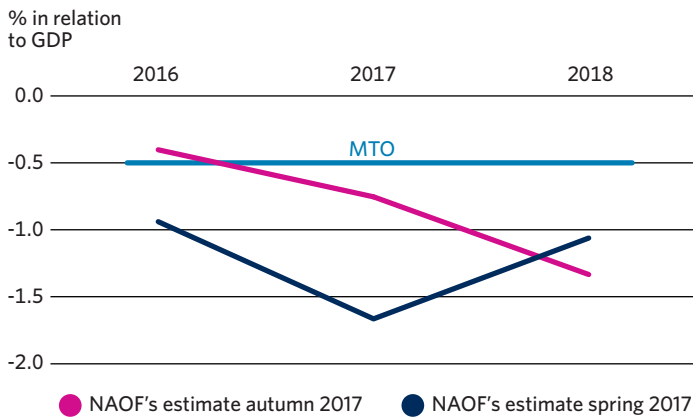


Figure 8: Level of structural balance 2016–2018. Source: Ministry of Finance and the National Audit Office

According to the autumn forecast of the National Audit Office, the structural balance was -0.4% in relation to GDP in 2016. Therefore, assessed retrospectively, Finland achieved the MTO. The assessment improved by 0.5 percentage points when compared to the spring 2017 estimate due to both strengthening of the nominal fiscal position by 0.2 percentage points and an increase of the output gap estimate compared to the spring forecast. The augmented output gap increases the estimate of the part of the balance that is dependent on the business cycles.

The assessment of the 2017 structural balance also clearly improved from the spring. The forecast by the Ministry of Finance on general government net lending improved by around 1.2 percentage points from the spring forecast. The improvement in the nominal balance does not, however, fully translate to the structural balance, because as the economic situation improved in Finland, the estimated output gap contracted. The 2018 structural balance estimate, on the other hand, somewhat decreased from the National Audit Office's spring assessment. Even though the forecast by the Ministry of Finance on the general government deficit for 2018 has somewhat improved, the contraction of the output gap due to the improved business cycle increases the structural balance.

Key issues in the assessment of the structural balance pillar include the structural balance and its change. In the Stability and Growth Pact set of rules, the annual change in structural balance is compared with the required adjustment towards the MTO set by the Council. According to the autumn forecasts, the structural balance for 2017 will decrease by around 0.4 percentage points compared with the 2016 level. The structural balance will continue to decrease in 2018, according to the forecast by 0.6 percentage points from the previous year. Fig. 9 shows the change in structural balance divided into the change in nominal balance and the change in the cyclical component of the balance. In 2017 and 2018, the structural balance will deteriorate particularly due to the improved business cycle and the resulting contraction of the output gap.

In 2017 and 2018, the structural balance will deteriorate due to contraction of the output gap

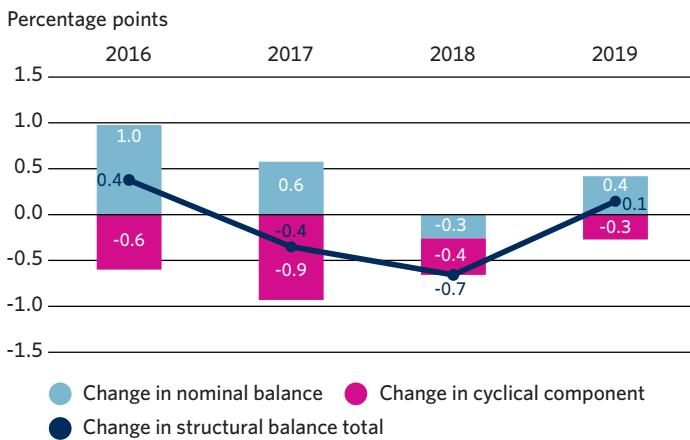


Figure 9: Change in structural balance divided into the change in nominal balance and the change in the cyclical component of the balance.

According to recommendations by the Council of the European Union in July 2017, the structural balance is allowed to deteriorate by 0.5 percentage points in 2017. The recommendation for 2018 is achievement of the MTO when taking into account granted flexibility based on the implementation of structural reforms, investments and exceptional events⁵. Finland has been granted with flexibility of 0.6 percentage points in relation to GDP for 2017–2019 on the basis of the structural reform and investment clauses.

The National Audit Office has conducted an independent assessment of the required adjustment for 2017 and 2018 that is based on improvement of the structural balance. Assessed retrospectively, the MTO was exceeded by 0.1 percentage points in 2016. Furthermore, Finland has been granted with flexibility of a total of 0.6 percentage points with respect to the original requirements. Therefore, according to the assessment by the National Audit Office, the structural balance could reduce by 0.7 percentage points in 2017. According to the forecasts, the structural balance will only reduce by some 0.4 percentage points, which means that according to the preliminary assessment, Finland will be in compliance with the structural balance pillar in 2017.

According to the preliminary assessment, Finland will be in compliance with the structural balance pillar in 2017

Taking into account the flexibility of 0.6 percentage points that was granted for Finland, the structural balance may deteriorate to -1.1 in relation to GDP in 2018. This means that the structural balance may deteriorate by 0.3 percentage points from 2017. According to the estimate, the structural balance will deteriorate more than that, but the deviation between the required level and the assessed level is not significant. A deviation is considered significant when it deviates by at least 0.5 percentage points, either from the MTO or the adjustment path leading to the MTO. A significant deviation may be formed either over one year or cumulatively over two consecutive years. In the latter case, the limit for a significant deviation is 0.25% in relation to GDP. Fig. 10 shows the National Audit Office's estimate of the change in structural balance in relation to the required change (allowed deterioration) based on the autumn 2017 calculations.

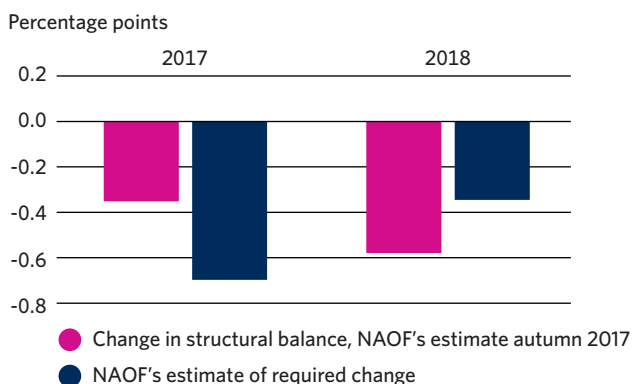


Figure 10: Change of structural balance and estimate of required change

Structural balance adjustment requirement

The preventive arm of the Stability and Growth Pact is based on the MTO, determined on the basis of the structural balance towards which each Member State must adjust their finances each year. The required adjustment, i.e. the required change in the structural balance, is described in a matrix in the Communication on Flexibility, confirmed by the Economic and Financial Affairs Council (Ecofin).⁶ The matrix takes into account the Member State's business cycle, debt ratio and sustainability risk of general government finances. In addition to the above, exceptional circumstances as well as short-term costs of implementing structural reforms and certain co-financed investments, provided that these are considered to have an impact either on the sustainability of public finances or the growth potential in the medium term are taken into account when determining the adjustment requirement (the "structural reform clause" and the "investment clause"). Furthermore, the adjustment requirement is updated as the estimate of the structural balance changes so that the Member State will not be required to surpass the MTO.

In the 2017 draft budgetary plan, Finland proposed flexibility for the adjustment requirement on the basis of the structural reform and investment clauses. As the justification for the utilisation of the structural reform clause, Finland gave the structural reforms of the Finnish Government, such as the pension reform and the Competitiveness Pact. The justification for the utilisation of the investment clause is largely the same as for the utilisation of the structural reform clause.

Flexibility of a total of 0.6 percentage points in relation to GDP was granted on the basis of these clauses for 2017–2019. The granted flexibility has a major impact on Finland's required change in structural balance. The required change is lower, which also loosens the limit set in the expenditure benchmark.

General government expenditure increases within the expenditure benchmark framework

The second pillar of the preventive arm, the expenditure benchmark, examines the trends in total general government expenditure in relation to the reference growth rate set for the spending.

In calculation under the expenditure benchmark, the cyclical component of the unemployment expenditure, debt interest payments and spending arising from EU programmes that are funded directly from EU subsidies are deducted from total general government expenditure. These expenditure items are considered to be such that they cannot be influenced through economic policy. In investment expenditure, a four-year average is examined, which means that the rules allow an increase in investments during the year under review. Furthermore, the expenditure benchmark allows an increase in spending, provided that the increase in expenditure is funded with a corresponding increase in revenue. Table 1 shows the National Audit Office's calculations concerning compliance with the expenditure benchmark in 2017 and 2018. One-offs have also been taken into account in the calculation of the expenditure benchmark as part of the overall assessment.

The limit for expenditure calculated in compliance with the expenditure benchmark depends on achievement of the MTO. If the MTO has been achieved, the expenditure growth may be in line with the potential output growth in the medium term. If the MTO has not been achieved, the allowed expenditure growth rate is set in a manner that will support achievement of the MTO. In such a case, a convergence margin will be calculated for the Member State based on the amount of general government expenditure and the structural balance adjustment requirement. The convergence margin will be deducted from the average potential output growth rate.

Table 1: Finland's total general government expenditure, related adjustments and the applicable expenditure benchmark in 2016-2018, as calculated by the National Audit Office

	2016	2017	2018
Expenditure benchmark items, EUR billion			
Total general government expenditure	120.3	121.0	123.3
- Debt interest payments	2.3	2.2	2.0
- Expenditure arising from EU programmes, fully compensated by income from EU funds	1.2	1.1	1.1
- Fixed capital (gross)	8.6	8.8	9.3
+ Average for fixed capital (over four years)	8.4	8.5	8.7
- Cyclical changes in unemployment expenditure	0.8	0.7	0.5
+ One-off expenditure items	0	0	0
= AEA1 Adjusted expenditure aggregate 1	115.9	116.8	119.0
- Revenue measures mandated by law	0.1	0.1	0.1
Effect of discretionary measures on revenue	0.5	-1.6	-0.7
One-off revenue items	0.0	0.0	-0.2
- Effect of discretionary measures on revenue, incl. one-off revenue items	0.5	-1.6	-0.6
= AEA2 Adjusted expenditure aggregate (AEA2)	115.4	118.3	119.5
Growth in general government expenditure			
Nominal growth in total spending (calculated in accordance with the expenditure benchmark), %	0.4	2.0	2.4
GDP deflator	1.3	0.9	1.2
Real growth in total spending (calculated in accordance with the expenditure benchmark), %	-0.9	1.1	
Applied expenditure benchmark, NAOF's estimate, real	0.3	1.4	1.1
Applied expenditure benchmark, NAOF's estimate, nominal			2.3
Deviation			
Deviation, EUR billion	1.3	0.3	0.0
GDP, EUR billion	216	224	232
Deviation in relation to GDP	0.6	0.2	0.0
Is the deviation significant (< -0.5)?		No	No
Cumulative deviation		0.4	0.1
Is the cumulative deviation significant (< -0.25)?		No	No

According to calculations by the National Audit Office that are based on the forecast by the Ministry of Finance, nominal growth of adjusted total public expenditure in accordance with the expenditure benchmark will be 2% in 2017 and 2.4% in 2018. The real growth will be 1.1% during both years. In the assessment of compliance with the expenditure benchmark, the expenditure growth is compared with the expenditure growth limit. The National Audit Office has calculated for the years 2017 and 2018 an independent assessment of the expenditure growth limit that is based on the National Audit Office's estimate of the structural balance and its adjustment requirement. According to the assessment, the growth in expenditure under the expenditure benchmark will remain below the growth limit in 2017. Thus, Finland will be in compliance with the expenditure benchmark in 2017. In 2018, the expenditure growth will follow the growth limit, which means that according to the preliminary assessment, Finland will be in compliance with the expenditure benchmark also in 2018, even though there will be the risk of a deviation.

Fig. 11 shows the difference between the expenditure limit and the total expenditure calculated in compliance with the expenditure benchmark in euro in relation to GDP. If the difference is positive, the expenditure benchmark has been followed and if the difference is negative, there has been a deviation from the expenditure benchmark. If the deviation is less than -0.5 percentage points, the deviation from the expenditure benchmark is considered significant. If the difference is on average less than -0.25 percentage points in the course of two years, the deviation is also considered significant.

Anticipated growth in expenditure will remain below the set limit in 2017

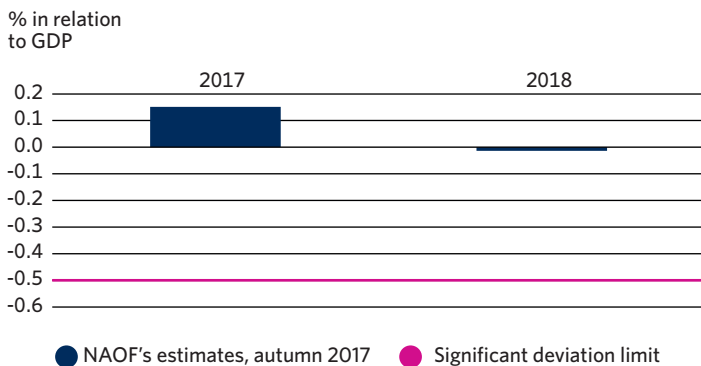


Figure 11: The difference between the expenditure calculated in accordance with the expenditure benchmark and the expenditure limit in euros, in relation to GDP. Source: Calculations by the Ministry of Finance and the National Audit Office

Compliance with the expenditure benchmark during both years under review, 2017 and 2018, is based on the flexibility from the required change of structural balance that has been granted to Finland. The expenditure benchmark limit would be clearly stricter if the limit was solely the rate of growth in potential output in the medium-term that is the basis of the expenditure benchmark.

Rules of the preventive arm of the SGP will be followed in 2017 and 2018

According to a preliminary estimate, Finland will be in compliance with both pillars of the preventive arm of the Stability and Growth Pact in 2017. A deviation in the structural balance pillar is forming for 2018, but it will not be significant. The structural balance target path laid down in the spring Stability Programme will not be reached in 2018, either. The National Audit Office notes that without the flexibility granted by the Commission in May 2017 with respect to the criteria of the preventive arm, there would be a deviation in both the structural balance pillar and the expenditure benchmark pillar in 2017.

Without the flexibility granted by the Commission to Finland, there would be a deviation in both the structural balance pillar and the expenditure benchmark pillar in 2017

Role of the expenditure benchmark in assessment of compliance with the preventive arm of the Stability and Growth Pact

The goal of the preventive arm of the Stability and Growth Pact is to ensure stability of general government finances in the short and medium term. The preventive arm focuses on the medium-term objective (MTO), set based on the structural balance. When determining the structural balance, the impact of business cycles and one-offs is eliminated from the general government fiscal position. The structural balance is a theoretical concept, and numerous uncertainties are related to its measurement (NAOF spring 2017⁷, NAOF autumn 2016⁸, Pellervo Economic Research PTT 2016⁹).

Due to the uncertainties, achievement of the MTO is also assessed with the expenditure benchmark. The expenditure benchmark is one of the legislative amendments made in 2011 (the “six pack”). The European Commission has strengthened the role of the expenditure benchmark in the assessment of compliance with the rules (report of the Economic and Financial Committee on 29 November 2016). According to the country-specific recommendations confirmed by the Council in July 2017, the structural balance adjustment requirement is given as allowed growth rate of nominal expenditure in compliance with the expenditure benchmark in the case of Italy and France, for example.

The assessment of the compliance with the expenditure benchmark consists of two parts. Firstly, the overall general government net expenditure is calculated. Secondly, a reference growth rate for the expenditure is calculated, and the actual development of net expenditure is compared to the reference growth rate. The reference growth rate is based on medium-term potential output growth as a ten-year average so that the assessment includes observations from before the year under review and after the year under review. A convergence margin is deducted from the calculated average potential output growth rate. The convergence margin takes into account the ratio of general government expenditure to GDP and the adjustment requirement required from the structural balance.

Fig. 12 presents the development of general government net expenditure calculated in compliance with the expenditure benchmark, the average potential output growth rate and an assessment of the level of structural balance based on the Ministry of Finance forecast of autumn 2017. The figure

shows that the structural balance deteriorated at the beginning of the period under review when the general government net expenditure grew faster than the potential growth rate. In 2014–2016, growth of the general government net expenditure was slower than the potential growth rate. The structural balance improved during these years. Therefore, a growth rate according to the expenditure benchmark should support the achievement of the structural balance objective.

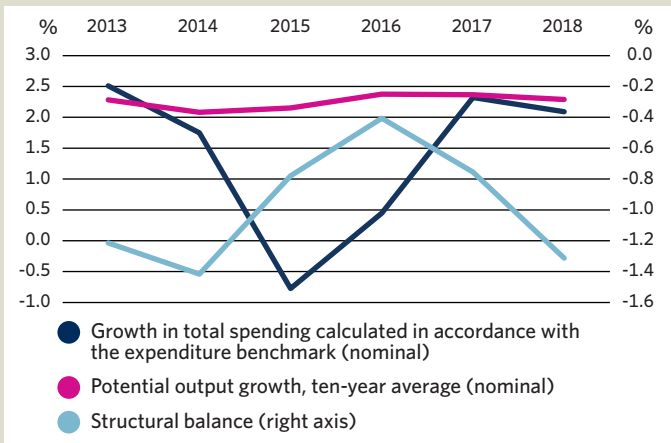


Figure 12: Potential output growth rate in the medium term, development of general government net expenditure calculated in compliance with the expenditure benchmark and structural balance

One must take into account the fact that no interpretation on compliance with the expenditure benchmark can be made based on this figure. According to the rules, the potential output growth rate in the medium term is calculated based on the forecast of the spring preceding the year under review, whereas the potential output growth rate in the figure is based on the autumn 2017 forecast by the Ministry of Finance. Furthermore, the convergence margin influences the limit used in the assessment of compliance with the expenditure benchmark, whereas the figure compares the expenditure with the potential growth without the impact of the convergence margin. There was a stricter expenditure limit that took into account the convergence margin for Finland for the years 2015 and 2016.

Change in taxes collected weakens the structural balance

A one-off that influences the general government deficit will be realised in 2018 when the collection of value added tax on the import of goods from customers included in the VAT register will be transferred from the Finnish Customs to the Finnish Tax Administration as of the beginning of 2018. The characteristics of one-offs and their impact on the assessment of fiscal policy rules are described on page 40. The fact that the collection of VAT will be transferred to the Tax Administration will influence the payment dates of VAT to be paid by companies on import and will thus reduce the state tax revenue once by approximately EUR 184 million. The reduction of tax revenue will occur during the year in which the reform enters into force, and the reform will also cause an annual loss of interest when compared to the current practice.

The change in taxes collected will weaken the deficit in 2018. This is not a discretionary deterioration of balance as laid down in the definition of one-offs by the Commission; instead, it is generated as a by-product of the tax collection reform and the revenue impact clearly has a one-off effect, even though the change in tax collection practice is permanent. The reform complies with the definition of a one-off, and its impact will be taken into account in the assessment of compliance with the structural balance and the expenditure benchmark in 2018. The annual loss of interest linked to the reform is not part of the one-off impact. Taking into account the loss of tax revenue as a one-off item improves the structural balance by 0.1 percentage points in relation to GDP. Furthermore, taking into account the one-off in the calculation in compliance with the expenditure benchmark improves the assessment on compliance with the expenditure benchmark.

One-offs have only rarely been taken into account in the assessment of the compliance with the structural balance and the expenditure benchmark in the past few years. In the view of the National Audit Office, they should be assessed in a more systematic manner to ensure that one-offs included in both expenditure and revenue are comprehensively identified.

One-offs should be assessed in a more systematic manner

One-offs

One-offs are measures that only have a temporary effect on the general government fiscal position through revenue or expenditure. One-offs must be taken into account as part of structural balance and expenditure benchmark calculations, so they have their significance in the assessment of fiscal policy rules. The structural balance is calculated by reducing one-offs from the cyclically adjusted balance, and in expenditure benchmark calculations, one-offs are taken into account as part of the overall assessment.

The identification of one-offs is not an unambiguous process, which is why the European Commission has offered guiding principles to be used as an aid when determining them. Firstly, one-offs cannot lead to a permanent change of the budget balance. Secondly, a measure cannot be deemed a one-off based on a law or decision; instead, its one-off nature must be assessed based on the economic nature of the measure. Thirdly, volatile revenue and expenditure items are not to be deemed one-offs. For example, tax revenue includes fluctuation that is not cyclical and that is usually not interpreted as a one-off, and the cyclical adjustment of the general government balance takes into account changes related to business cycles in revenue and expenditure. Fourthly, discretionary measures that increase the deficit cannot, as a general rule, be deemed one-offs. The goal is to avoid situations in which a decision-maker would have an incentive to deem a structural change that weakens the structural balance as a temporary circumstance. Finally, a one-off is only to be taken into account if the impact of the one-off or the combined impact of several similar one-offs on the general government balance is, when rounded off, at least 0.1% in relation to GDP.

Changes to revenue or expenditure that are considered one-offs can be caused by, for instance, a permanent change of tax legislation, a permanent or exceptional change in the timing of a recurring revenue or expenditure item, and an exceptional event, such as a natural catastrophe. As a general rule, investments cannot be considered one-offs, but negative investments, i.e. the sales of capital goods (and other real assets), can be considered one-offs with certain limitations. For more detailed information on one-offs, please see the Commission publication Report on Public Finances in EMU 2015.¹⁰

2.2 Corrective arm

The corrective arm of the Stability and Growth Pact assesses compliance with the deficit and debt criteria. According to the deficit criterion, the general government nominal deficit may not exceed 3% in relation to GDP, while pursuant to the debt criterion, the general government gross debt may be at most 60% in relation to GDP.

According to Statistics Finland, the general government deficit reduced to 1.7% in relation to GDP in 2016. According to the autumn forecast produced by the Ministry of Finance, the deficit will be reduced to 1.2% in relation to GDP this year. The deficit is expected to somewhat increase in 2018, to 1.4% in relation to GDP, but the deficit will still remain clearly below the limit of 3% until the end of the forecast period, i.e. until 2021, as described in Table 2. General government finances have been improved due to accelerated economic growth and the adjustment measures carried out by the Government. According to a preliminary estimate, Finland will be in compliance with the deficit criterion in 2017 and 2018.

The deficit will remain clearly below the limit of 3%

The general government gross debt exceeded the limit of 60% in 2014 and was at its highest, 63.6% in relation to GDP, in 2015. According to the revised preliminary figures published by Statistics Finland, the general government debt reduced to 63.1% in relation to GDP last year. The Ministry of Finance expects the debt ratio to continue to reduce in 2017 and throughout the entire forecast period, until 2021. Even though the debt in euro will continue to grow, the estimate of the higher-than-expected growth of the GDP will reduce the debt ratio. Development of the debt ratio will be more favourable than estimated by the European Commission or the Ministry of Finance in the spring.

As the nominal debt ratio has exceeded the limit of 60%, the Commission has estimated compliance with the debt criterion in its reports in accordance with Article 126(3), the latest of which was published in spring 2017.¹¹ Compliance with the debt criterion is reviewed on the basis of the nominal debt ratio and on the basis of cyclically adjusted debt, backward- and forward-looking criteria, and other relevant factors. So far, the Commission has come to the conclusion that Finland complies with the debt criterion.

The backward-looking criterion assesses whether the debt ratio has reduced to a sufficient extent in the past three years. The forward-looking criterion assesses whether the debt ratio will be reduced to a sufficient extent in the following two years. The cyclically adjusted debt criterion takes into account the impact of business cycles on the debt ratio. According to an assessment by the National Audit Office, Finland will comply with the forward-looking criterion in 2017, the backward-looking criterion in 2018 and the cyclically adjusted debt criterion during both years. Therefore, one can state that Finland will comply with the debt criterion in 2017 and 2018.

Compliance with the debt criterion is based on a downward trend and reduction of the debt ratio. However, the nominal debt ratio will exceed the limit of 60% also in the years to come, and compliance with the debt criterion would be compromised if the debt ratio started to grow. As the business cycle improves, the cyclically adjusted debt ratio will increase, and according to the forecast, it will be higher than the nominal debt ratio in 2018. The cyclically adjusted debt ratio has remained below the limit of 60% during periods of slow economic growth, which has been one of the criteria used for compliance with the debt criterion.

The calculations on compliance with the backward- and forward-looking criteria and the cyclically adjusted debt ratio are presented in the workbook appended to this report.

Compliance with the debt criterion is based on a reduction of the debt ratio

Table 2: General government deficit and debt 2014–2021, % in relation to GDP. Source: Statistics Finland, Ministry of Finance

	2014	2015	2016	2017	2018	2019	2020	2021
General government deficit	-3.2	-2.7	-1.7	-1.2	-1.4	-1.0	-0.9	-1.2
General government debt	60.2	63.6	63.1	62.5	61.9	61.1	60.2	59.9

3 Fiscal stance

The nominal balance of general government has clearly improved in 2017. However, the reduction of the deficit does not directly reflect the strictness of fiscal policy. The structural balance will deteriorate in both the current year 2017 and in 2018. Therefore, when measured by the change in structural balance, fiscal policy is expansionary in 2017 and 2018, and the increase in the nominal balance has mainly been due to the improved business cycle.

The National Audit Office has assessed the fiscal stance in 2015–2018. The assessments are based on calculations made using two alternative methods, which are based on the autumn 2017 forecast by the Ministry of Finance and thus only include fiscal policy measures on which decisions have already been made. In both cases, the indicator used is studied in relation to the business cycle. The methods are described in detail on pages 48–49. The business cycle indicator has been calculated based on a method jointly agreed in the EU so that the indicator takes into account both the output gap level and its change. Thus, the business cycle indicator is not as sensitive to changes between forecasts as an indicator that is solely based on the output gap level.

According to the National Audit Office's assessment, the fiscal policy in 2015 and 2016 has been contractionary. It will change into expansionary in 2017 and 2018 when the business cycle becomes positive. Fiscal policy should assist in evening out the impact of economic cycles. Expansionary fiscal policy during a period of economic growth can have a pro-cyclical impact, i.e. can further promote the economic growth. During a period of strong economic growth, fiscal policy should be tightened to prevent overheating of the economy.

Fig. 13 presents an assessment of the fiscal stance based on a change in the structural primary balance. The structural primary balance describes the general government fiscal position without the impact of interest payments, one-offs and the business cycle. According to the assessment, the fiscal policy in 2015 and 2016 was somewhat contractionary. The fiscal policy will change into expansionary in 2017 and 2018. As the business cycle indicator will become positive in 2017 due to the increase in economic growth, the fiscal policy will be pro-cyclical, i.e. promote the business cycle.

In 2015 and 2016 fiscal policy was contractionary; in 2017 and 2018 it will be expansionary

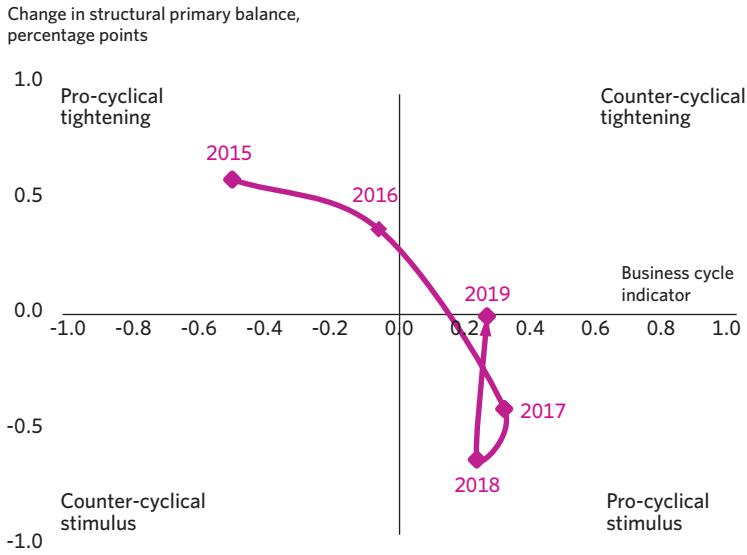


Figure 13: Fiscal stance assessed on the basis of the change in structural primary balance. Source: the Ministry of Finance and the National Audit Office

Fig. 14 presents an assessment of the fiscal stance based on discretionary measures, which supports the assessment of the fiscal policy becoming expansionary. The combined impact of discretionary measures in 2017 remains fairly neutral. However, the fiscal policy will change into clearly expansionary in 2018. An issue that must be taken into account in the case of the year 2018 is that the calculations only include the measures that were known with sufficient detail in autumn 2017. Therefore, the assessment of the fiscal stance will be updated.

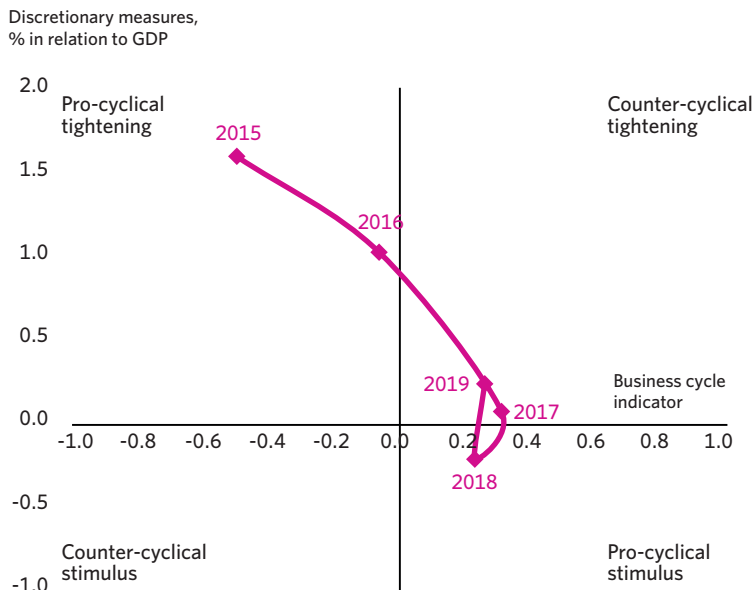


Figure 14: Fiscal stance on the basis of discretionary measures.
Source: the Ministry of Finance and the National Audit Office

The Ministry of Finance has also assessed the fiscal stance (Economic Survey, autumn 2017, p. 64). The National Audit Office takes a positive view on the fact that the Ministry of Finance also provides an assessment on the effectiveness of the fiscal policy as part of the assessment of the achievement of the budgetary targets. The assessments of the National Audit Office and the Ministry of Finance are mostly similar, but the assessments on effectiveness of the fiscal policy in 2017, particularly those based on the discretionary measures, are fairly susceptible to assumptions on the scope of the discretionary expenditure measures. The parties have used differing assumptions on unemployment expenditure, which has a minor effect on the assessment of the fiscal policy framework in 2017.

Furthermore, one must take into account the fact that making accurate, real time assessments on the fiscal stance is challenging. All of the alternative methods include significant methodical uncertainties, and the assessment of the business cycle status is updated as the forecasts are updated. For example, in 2017 tax revenue grew faster than expected, which is why the economic growth in 2016 and 2017 was faster than anticipated. Therefore, the assessments on the fiscal stance changed from the assessments given by the National Audit Office in autumn 2016.

Assessing the fiscal stance

Assessing the fiscal stance by means of change in structural primary balance, SPB

Structural primary balance (SPB) describes the cyclically adjusted fiscal balance without interest expenditure. Cyclical adjustment eliminates from the nominal balance the impact of the business cycle on general government expenditure and revenue. Any one-offs are eliminated from the primary balance in the process. A change in structural primary balance from which interest expenditure and the effect of the cycle have been eliminated gives a better idea of the impact of discretionary fiscal policy on the general government fiscal balance than a review based on changes in nominal balance. If the structural primary balance has improved, fiscal policy is considered to have been contractionary. If the structural balance has weakened, fiscal policy has been expansionary.

Assessing fiscal stance on the basis of discretionary measures, DFE

The discretionary nature of the fiscal policy (discretionary fiscal effort, DFE) can also be examined by dividing discretionary policy into revenue-side and expenditure-side measures.¹²

As regards general government revenue, discretionary measures that increase or decrease tax revenue in relation to GDP are examined. If the discretionary measures have increased revenue, the policy has been contractionary, and if the revenue has decreased, the policy has been expansionary.

In the case of general government expenditure, it is more difficult to give an equally straightforward definition of the discretionary measures. In the case of expenditure, the focus is on total general government expenditure from which interest expenditure and cyclical unemployment expenditure are eliminated. The change in total general government expenditure from which the impact of interest expenditure and cyclical unemployment expenditure is eliminated is compared with the growth rate of potential output. According to this interpretation, if the expenditure has grown more rapidly than the potential output, fiscal policy has been expansionary, and if the expenditure has grown more slowly than the potential output, fiscal policy has been contractionary.

The discretionary fiscal effort (DFE) is examined as the difference between the discretionary measures directed at revenue and expenditure. If the difference is negative, the fiscal policy has been expansionary and if the difference is positive, the fiscal policy has been contractionary.

Business cycle indicator

The expansionary or contractionary nature of fiscal policy can only be assessed if an assessment of the business cycle is available. Carnot an Castro (2014)¹³ define business cycle indicator as a average of the normalised level of the output gap and changes therein. Thus, the business cycle indicator is not as sensitive to forecast revisions as an indicator that is solely based on the output gap.

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