

## Fiscal policy evaluation assessment on the management of general government finances

The statutory task of the National Audit Office is to supervise compliance with the Fiscal Policy Act (869/2012) and the provisions issued under it (such as the Decree on the General Government Fiscal Plan 120/2014, as amended by decree 601/2017), as part of the auditing of central government finances. In order to carry out its supervisory task, the National Audit Office has assessed Finland's draft budgetary plan and the material used as a basis for it, including the Government's budget proposal for the year 2018, from the perspective of these provisions. The budget proposal was submitted to Parliament on 19 September 2017, and Finland's draft budgetary plan for 2018 was presented on 5 October 2017.

The present memorandum contains the main findings of the National Audit Office's preliminary assessment of the general government finances in 2017 and 2018. The draft budgetary plan and the budget proposal for 2018 are also considered in the memorandum. The assessment is based on an independent economic forecast produced by the Ministry of Finance. The National Audit Office presented its previous assessment in the fiscal policy monitoring report published on 15 June 2017. The National Audit Office will also publish a more comprehensive fiscal policy evaluation report as a separate report to Parliament in December 2017.

As part of its fiscal policy evaluation task, the National Audit Office assesses the setting and observance of national rules and objectives steering fiscal policy, compliance with central government spending limits and the Stability and Growth Pact, and the overall steering of general government finances from the perspective of those rules. Pursuant to the Fiscal Policy Act, the National Audit Office is responsible for monitoring compliance with the fiscal policy correction mechanism and, once it has been initiated, assessing the adequacy of the corrective measures. The fiscal policy evaluation task 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 macroeconomic and fiscal forecasts. Starting 2017, these assessments will be performed on a regular basis pursuant to the Decree on the General Government Fiscal Plan.

### Summary of the assessment

According to the assessment of the National Audit Office, the general government fiscal position will not improve during the current parliamentary term in line with the targets set by the Government, despite faster than anticipated 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. The nominal general government balance will also not achieve its target during the current parliamentary term due to slower-than- envisaged consolidation of central government finances. The 2017 supplementary budgets comply with the spending rule. The 2018 budget proposal contains an exception to the spending rule, which concerns the funding of the Finnish Broadcasting Company. Incorporating the appropriation of EUR 18.6 billion earmarked for county financing in the central 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 a preliminary estimate, Finland will be in compliance with the preventive arm and the corrective arm of the Stability and Growth Pact in 2017. When taking into account the flexibility 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, there will be a deviation of 0.2 percentage points from the required adjustment of the structural balance, even when the flexibility clauses are taken into account.

The National Audit Office estimates that the Ministry of Finance forecasts used as a basis for the draft budgetary plan are realistic. The substantial change in the forecast, compared with spring 2017, is justified in the light of the latest statistical data on the economic situation. The forecasts made by the Ministry of Finance are also in line with the figures presented by other forecasting institutes.

### **Government's fiscal policy targets and general government finances**

The medium-term objective set by the Government for general government finances, i.e. structural balance of at least -0.5% in ratio to GDP, will not be achieved during the current parliamentary term. On the basis of the Ministry of Finance forecasts, general government structural balance will remain at around -0.8% in ratio to GDP in 2017 and will continue to weaken to around -1.3% in 2018.

The aim of the Government is to balance general government finances by 2019. To this end, the Government has set binding subsector targets, pursuant to which the deficit of central and local government finances should not exceed 0.5 per cent of the gross domestic product, employment pension funds should show a surplus of one per cent in relation to gross domestic product, and other social security funds should be in balance in overall terms.

General government finances have substantially improved in 2017. General government deficit is projected to reduce to 1.2% in ratio to GDP in 2017. The improvement in the general government fiscal position is particularly due to higher-than-anticipated growth in tax revenue. Of the subsectors of general government both the central government and local government deficits will contract during 2017, and the central government deficit will continue to decrease in 2018. The surplus of the social security funds is expected to slightly decrease in 2017.

According to the assessment of the National Audit Office, the improvement in the general government fiscal position results from the stronger-than-expected economic growth, which is particularly reflected in the improvement in the central government deficit. Although central government finances have developed more favourably in 2017 compared with the target path set in spring 2017, the central government will still fall behind the target path in 2018 and 2019. The National Audit Office draws attention to the fact that the structural problems impacting the Finnish economy still remain unresolved, although the economic growth has slightly reduced the general government deficit. According to the assessment of the National Audit Office, fiscal stance will change from contractionary to slightly expansionary in 2017 and will remain expansionary in 2018. Considering the current economic situation and structural problems, the National Audit Office is of the view that the Government could pursue tighter fiscal policy.

The 2017 supplementary budgets are within the central government spending limits. The 2018 budget proposal contains an exception to the spending rule. Incorporating the appropriation of EUR 18.6 billion earmarked for county financing in the central 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. In its General Government Fiscal Plan for 2017-2020, the Government has lowered, as part of the adjustment measures, the spending limits for the parliamentary term by EUR 80 million both in 2017 and 2018 and by EUR 120 million in 2019. Despite this measure, the central government deficit will not achieve the target set for it. It would be essential that the spending rule, which is an important steering instrument, could better support the achievement of the targets set by the Government for central government finances.

## Compliance with the fiscal policy rules of the EU

The preventive arm of the Stability and Growth Pact reviews compliance with the medium-term objective (MTO) and progress towards it. The review is based on the development of the structural balance and the expenditure benchmark. Finland's performance is reviewed as part of the preventive arm of the Pact and, thus, Finland must comply with the obligations of the preventive arm.

Structural balance describes the fiscal position in ratio to GDP, from which the impact of economic cycles and one-off measures has been eliminated. The MTO set by the Government is to achieve a structural balance of -0.5% in ratio to GDP at a minimum. In the Stability and Growth Pact, the annual change in structural balance is compared with the required adjustment towards the MTO set by the Commission. Finland has benefitted from the flexibility offered by the Pact: in accordance with the structural reform and investment clauses, Finland has been granted with flexibility of 0.6 percentage points in ratio to GDP for 2017-2019 with respect to the original requirements.

Structural balance is predicted to be around -0.8% in ratio to GDP in 2017, which is 0.4 percentage points weaker compared to the previous year. Despite this, Finland will meet the structural balance criterion in 2017 since, according to NAOF's estimate, Finland's fiscal position could reduce to -1.1% in ratio to GDP in 2017 and still remain within the requirements of the Stability and Growth Pact. According to the Ministry of Finance forecast, Finland will also comply with the structural balance criterion in 2018. The estimate of the level of structural balance and the required adjustment is presented in Table 1. The second pillar of the preventive arm is the expenditure benchmark, which sets the reference growth rate for general government expenditure. According to the autumn estimate of the National Audit Office, Finland will comply with the expenditure benchmark in 2017 and 2018. The results of the expenditure benchmark calculation are presented in Table 2.

The corrective arm of the Stability and Growth Pact reviews compliance with the deficit and debt criteria. According to the deficit criterion, the general government nominal deficit may not exceed 3% in ratio to GDP, while pursuant to the debt criterion, the general government gross debt may be at most 60% of GDP. According to the autumn 2017 forecast produced by the Ministry of Finance, the general government deficit will be -1.2% in ratio to GDP in 2017 and -1.4% in 2018. Thus, Finland will comply with the deficit criterion in 2017 and 2018.

The general government gross debt exceeded the 60% limit in 2014. According to the revised preliminary figures published by Statistics Finland, the debt ratio decreased by 0.5 percentage points to 63.1% in ratio to GDP in 2016, and according to the Ministry of Finance forecast, the debt ratio will continue to decrease in 2017 and 2018. Fulfilment of the debt criterion is also reviewed on the basis of cyclically adjusted debt, backward- and forward-looking criteria, and other relevant factors. These criteria also indicate that Finland will be in compliance with the debt criterion in 2017 and 2018.

## Impact of the structural reforms on general government finances

The impacts of the spring 2017 Government proposals for health, social services and regional government reforms on the sustainability gap were very vague. Therefore, when the reforms were referred for further preparation in summer 2017, according to 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, the savings target of EUR 3 billion set by the Government for the health, social services and regional government reforms was not realistic based on the current knowledge. Compared with other EU Member States, Finland's health and social services expenditure is not particularly high, and the sustainability challenge resulting from ageing is not exceptionally substantial. Even at the baseline, the quality of health and social services is considered in general good, and since the reforms aim to improve accessibility to services and narrow health gaps, the savings target will also be high in the long term.

According to the Government Programme, the aim is to reduce local government expenditure by one billion euros by reducing the number of local government tasks and obligations. Later, the reforms were extended to cover the entire public 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 impacts of the reforms supporting general government finances still remain 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 finding the most effective solution. The decision that the policy pursuant to which parents are entitled to care for their child at home until the child reaches 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 objectives set for the preparatory work point at the right direction. However, the National Audit Office considers it important that the preparatory work is not limited to re-targeting of the subsidies, but reducing the total amount of business subsidies should also be genuinely considered.

### **Assessment of the forecasts underlying the draft budgetary plan**

Under the Fiscal Policy Act (869/2012) and the Budgetary Frameworks Directive (2011/85/EU), Member States must ensure that the planning of general government finances is based on realistic macroeconomic and fiscal forecasts. In addition, according to the Government Decree on the General Government Fiscal Plan (120/2014, as amended by decree 601/2017), in the preparation of economic forecasts, the Ministry of Finance must take into consideration the conclusions of the National Audit Office on the macroeconomic and fiscal forecasts produced by the Ministry.

The budget proposal and the draft budgetary plan are based on a cyclical forecast and an assessment of medium-term and long-term economic growth produced by the Ministry of Finance. For 2018, the Ministry of Finance is forecasting a GDP growth of 2.1%. The spending limit decisions made in spring were based on a growth estimate of 1.0%. The improvement in the growth rate for 2018 results from the turn at least in the short-term economic development. The decrease in Finland's export share in world trade seems to have halted in 2017, and export has started to clearly grow. In addition to export, the foundation of the economic growth envisaged for 2018 also seems to have expanded due to the upwards-revised growth estimates concerning domestic consumption and investments. Revising the forecast upwards due to the changes in the economic situation is justified, and the forecast can be considered realistic. The Ministry of Finance forecast is also in line with the figures presented by other forecasting institutes.

**Table 1. General government structural balance, the required adjustment (acceptable deviation) and deviation. NAOF's calculations (based on the information supplied by the Ministry of Finance).**

	2016	2017	2018
Structural balance, % in ratio to GDP	-0.4	-0.8	-1.3
Change, % in ratio to GDP		-0.4	-0.6
NAOF's estimate of the required adjustment, % in ratio to GDP*		-0.7	-0.3
Deviation from the required adjustment, % in ratio to GDP		-0.3	0.2
<b>Is the deviation significant (&gt;0.5)?**</b>		<b>No</b>	<b>No</b>
Cumulative deviation (two-year average)		-0.2	-0.1
<b>Is the cumulative deviation significant (&gt;0.25)?**</b>		<b>No</b>	<b>No</b>

\*The estimate is based on NAOF's structural balance calculations. In the required adjustment, the flexibility granted in accordance with the structural reform and investment clauses, 0.6 percentage points, has been taken into account.

\*\*In the case of structural balance, a significant deviation is a deviation of at least 0.5 percentage points from the requirements for the preceding year or 0.25 percentage points per year for the two preceding years.

**Table 2. Growth in general government expenditure, the applied expenditure benchmark and deviation. NAOF's calculations (based on the information supplied by the Ministry of Finance).**

	2016	2017	2018
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	
NAOF's estimate of the applicable expenditure benchmark rate (real)	0.3	1.4	1.1
NAOF's estimate of the applicable expenditure benchmark rate (nominal)*			2.3
Deviation			
Deviation, EUR billion	1.3	0.3	0.0
GDP, EUR billion	215.6	223.9	232.2
Deviation in ratio to GDP, %**	0.6	0.2	0.0
<b>Is the deviation significant (&lt;-0.5)?***</b>		<b>No</b>	<b>No</b>
Cumulative deviation		0.4	0.1
<b>Is the cumulative deviation significant (&lt;-0.25)?***</b>		<b>No</b>	<b>No</b>

\*In the estimate for 2018, the nominal growth in spending is compared with the nominal expenditure benchmark. In the preceding years, the figures compared are real figures.

\*\*A positive figure means that the expenditure is lower than what is permitted under the expenditure benchmark, while a negative figure means that the limit has been exceeded.

\*\*\*In the case of the expenditure benchmark, significant deviation means a deviation (in euro terms) which in ratio to GDP is less than -0.5% for the preceding year or -0.25% per year for the two preceding years.