National Audit Office's separate report to Parliament: Interim Report on Fiscal Policy Evaluation for the Parliamentary Term of 2015–2018

National Audit Office´s reports to Parliament

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To Parliament

As part of its task laid down in the Constitution of Finland, the National Audit Office (NAOF) audits the preparation and implementation of fiscal policy. The National Audit Office also 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 of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, the implementation of Treaty provisions of a legislative nature as well as requirements concerning multi-annual budgetary frameworks (Fiscal Policy Act; 869/2012)[1].

The evaluation comprises the assessment of the setting and implementation of the rules steering the fiscal policy. By evaluating fiscal policy, the National Audit Office promotes transparent and easy-to-understand regulation and stable and sustainable general government finances. As part of its fiscal policy evaluation task, the National Audit Office is responsible for monitoring the preparation and implementation of the General Government Fiscal Plan, for ensuring the reliability of macroeconomic forecasts and for evaluating compliance with the Stability and Growth Pact. The National Audit Office also monitors compliance with the medium-term objective (MTO) and its correction mechanism.

Under section 6 of the Act on the National Audit Office of Finland, the National Audit Office presents this interim fiscal policy evaluation report on the 2015–2018 parliamentary term to the 2016 parliamentary session.

Helsinki 29 November 2016

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Auditor General

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Main content

This separate report to Parliament contains the interim fiscal policy evaluation report on the 2015–2018 parliamentary term prepared by the National Audit Office. The report covers the overall steering of general government finances, fiscal policy framework for the parliamentary term, adherence to central government spending limits and compliance with the Stability and Growth Pact during the early part of the current parliamentary term. An estimate of the entire parliamentary term is also provided.

Overall steering of general government finances has been put on a more consolidated basis during the current parliamentary term. This is based on the Decree on the General Government Fiscal Plan, under which the steering of general government finances must be put on a more comprehensive and long-term basis. This is also manifested in the Programme of Prime Minister Juha Sipilä's Government.

The National Audit Office takes a positive view of the fact that the long-term impacts of economic policy and the challenges to the Finnish economy posed by structural factors are taken into account in fiscal policy planning. The process of consolidating general government finances with ten billion euros will extend beyond the current parliamentary term. This requires that all parties involved are committed to a long-term economic policy.

The savings targets laid out by the Government have meant strict spending limits for central government finances. Strict spending limits are one reason why the economic growth has been stimulated through means outside the spending limits (increases in tax subsidies, financial investments and guarantee commitments). The National Audit Office reminds that general government liabilities and the risks associated with them should be monitored as a whole and in relation to the rest of the economy.

According to forecasts, the decisions made by autumn 2016 are not enough to achieve the sub-sector budgetary targets set out by the Government. It will be particularly difficult to achieve the budgetary targets laid out for central government. If achieved, the targets would ensure the balancing of general government finances and help to put the debt-to-GDP ratio on a downward trend. The

Government can only achieve the targets it has set by continuing its efforts to strengthen the general government fiscal position and especially the central government fiscal position.

General guidelines and the most important targets for the tax policy are laid out in the Government Programme. The National Audit Office recommends that there should be a comprehensive assessment of the future of the tax policy and the tax system of the future during the latter half of the parliamentary term.

The central government spending limits and the spending limits rule contained in them are the most important instruments for steering national fiscal policy. According the observations of the National Audit Office, the Government has been in compliance with the central government spending limits in 2015. The central government spending limits are an important steering instrument and should therefore be in accordance with the targets laid out for central government finances.

Finland was in compliance with the Stability and Growth Pact in 2015. According to a preliminary assessment produced by the National Audit Office, Finland is in compliance with the preventive arm also in 2016 but may be in breach of the debt rule of the corrective arm. According to an assessment of the National Audit Office, there is a risk of a significant deviation from the requirements of the preventive arm in 2017.

The National Audit Office draws attention to the functioning of the preventive arm of the Stability and Growth Pact. The preventive arm contains a degree of flexibility, which means that more consideration can be given to the special characteristics of the economy in the definition of the required adjustment. In Finland's case, flexibility of the rules and the permitted deviations from the requirements are leading to a situation where compliance with the preventive arm has not provided an adequate safety margin for the criteria of the corrective arm, as Finland's general government debt-to-GDP ratio has exceeded the permitted 60 per cent limit.

Contents

1 Fiscal policy objectives and achieving them

As part of its statutory fiscal policy evaluation task, the National Audit Office has assessed the overall steering of general government finances, as well as compliance with central government spending limits and the Stability and Growth Pact in the 2015–2018 parliamentary term. In this report the National Audit Office presents the fiscal policy findings at the half-way point of the parliamentary term.

1.1 Summary of the findings

Additional adjustment measures are needed if the Government is to achieve its targets

Putting the general government debt on a downward trend and balancing the economy after many years of negative growth are the main challenges for the 2015–2018 parliamentary term. Slow economic growth and the need to introduce structural reforms are hampering the efforts to adjust general government finances on a short-term basis. There is little room for manoeuvre in general government finances, which means that it is impossible to stimulate economic growth by increasing public-sector demand and the fiscal policy objectives laid out in the General Government Fiscal Plan cannot be achieved without additional adjustment measures. The short-term costs arising from structural reforms will also make it more difficult to introduce adjustments in general government finances.

The fiscal policy framework for the current parliamentary term is based on the views of the long-term outlook for Finland's general government finances prevailing at the time when the Government Programme was prepared. In addition to putting the debt-to-GDP ratio on a downward trend and balancing general government finances, the Government also aims to close the sustainability gap. In order to meet these objectives, the Government has introduced and is planning to introduce spending cuts and structural reforms the aim of which is to slow down growth in expenditure and to support economic growth.

Adjustments in general government finances during the early part of the government term have been one factor slowing down economic growth. The measures already introduced will mean that the fiscal stance will remain neutral or slightly contractionary in the next few years. According to an assessment of the National Audit Office, the fiscal stance can be considered adequate if the economic growth remains reasonably modest until the end of the current parliamentary term. However, the National Audit Office draws attention to the fact that unless additional adjustment measures are introduced, the Government will be unable to achieve the target it has set for central government fiscal position and the balance target laid out for general government finances. Any additional adjustments made in order to achieve the targets may slow down economic growth during the last years of the current parliamentary term.

The spending cut targets have kept the central government spending limits fairly tight and the spending limits for 2017–2019 were lowered in 2016. Strict spending limits are one reason why the economic growth has been stimulated through means outside the spending limits (increases in tax subsidies, financial investments and guarantee commitments). General government liabilities and the risks associated with them should be monitored as a whole and in relation to the rest of the economy. Taxation should also be made more clearly structured.

There is a risk of a significant deviation from the requirements of the preventive arm during the current parliamentary term

So far, Finland has been in compliance with the preventive arm of the Stability and Growth Pact and according to an in-year assessment by the National Audit Office, this will remain the case in 2016. According to forecasts, there is a risk of a significant deviation from the requirements laid out in the preventive arm during the current parliamentary term and as a result, the Government may have to take corrective action. According to the forecasts, Finland needs to introduce additional adjustment measures if it wants to achieve the structural balance target of -0.5 per cent approved by the Government during the current parliamentary term.

Finland remains in compliance with the deficit rule of the corrective arm of the Stability and Growth Pact. According to the forecasts, general government deficit will remain below the three per cent limit and will decrease to about 1.5 per cent of the GDP in 2019. However, the debt-to-GDP ratio exceeded the 60 per cent limit in 2014. Cyclically adjusted debt-to-GDP ratio will also exceed the 60 per cent limit in 2016. When the Commission considers whether to launch the excessive deficit procedure it takes into account all relevant factors.

The structural policy programme of the Government and its policy aimed at stimulating employment are important tools in the efforts to ensure the sustainability of general government finances. Measures changing economic structures and stimulating long-term economic growth often cause costs in the short-term. Such short-term costs associated with the reforms now underway should be incorporated into the overall economic policy.

The measures that will help the Government to achieve the targets laid out in the reform programmes are still incomplete. The structural reforms planned by the Government are extensive and they should be implemented without delay. Successful implementation of the reforms will require that the principles of good statute-drafting are adhered to.

Structural reforms should be implemented without delay

1.2 Compliance with national fiscal policy rules

In the Programme of Prime Minister Juha Sipilä's Government, general government finances are discussed from an overall perspective. In the previous parliamentary terms, the focus in the Government Programmes has been on central government finances. The shift in the focus is based on the Decree on the General Government Fiscal Plan[2], under which the steering of general government finances must be on a more comprehensive and long-term basis.

The National Audit Office is of the view that most of the fiscal policy targets laid out by the Government will be achieved. It is forecast that the growth of the debt-to-GDP ratio will stop during the current parliamentary term. However, central government deficit and thus also the general government deficit will remain substantially higher than targeted if no additional adjustment measures are introduced.

Economic policy targets laid out by the Government

Steering of general government finances is on a more consolidated basis

The aim of Prime Minister Juha Sipilä's Government is to put Finland on a path of sustainable growth and higher employment rate and to secure the funding base for public services and social security. The aim of the Government's economic programme is to put the debt-to-GDP ratio on a downward trend by the end of the parliamentary term and stop the amount of debt from increasing by the year 2021. The targets apply to all aspects of general government indebtedness.

The binding sub-sectoral targets for general government finances announced by the Government are enough for achieving the medium-term objective (structural balance of -0.5 per cent). In its programme, the Government has not set any annual targets for central government deficit, the achievement of which could be assessed. In the previous parliamentary terms, the weakening of the economic situation made it difficult to achieve the budgetary targets. In the first General Government Fiscal Plan for the parliamentary term 2015–2018, the Government laid out binding budgetary targets for general government sub-sectors. These targets are defined in accordance with the net lending (difference between revenue and expenditure) entered 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 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.

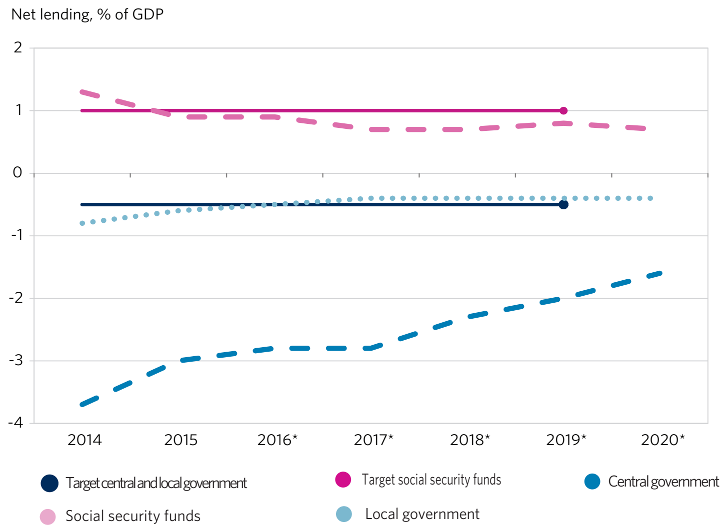
In its programme, the Government laid out an adjustment programme aimed at consolidating general government finances, which would have a major impact on all sectors of Finnish society. In net terms, the measures would consolidate general government finances by about four billion euros by 2019. The Government has announced that if it proves impossible to achieve all the savings allocated to an administrative branch, it will make savings in other areas of the administrative branch in question. After the publishing of the original list as part of the Government Programme, there have been changes to the proposed adjustment measures and the estimates of their impacts have become more specific during the drafting process. For example, the savings that will be generated by freezing index adjustments are now smaller than what was envisaged by the Government, a result of slower price increases. In order to achieve the adjustment targets set out in its programme, the Government introduced new spending cuts in autumn 2015 and spring 2016.

The measures contained in the adjustment programme are directed at different sectors of Finnish society

During the current parliamentary term, the deficit in central government finances is expected to be considerably higher than what has been targeted. The target can only be achieved if central government finances are consolidated by an additional 1.5 per cent in relation to the gross domestic product by the year 2019. According to the Ministry of Finance forecast published in autumn 2016, the general government deficit is expected to be substantially lower in 2019 than what was estimated in spring 2015 before the new parliamentary term. Spending cuts are expected to improve the general government fiscal balance by 0.7 percentage points by 2019. According to the estimates published in autumn 2016, the fiscal balance target of -0.5 per cent set for local government will be achieved by 2019.

During the current parliamentary term, the deficit in central government finances is expected to be considerably higher that what has been targeted

According to the Ministry of Finance forecast, the measures introduced by the autumn 2016 are not enough for achieving the sectoral fiscal position targets. This is especially the case with the budgetary target set for central government finances. If realised, the targets would ensure the achievement of the medium-term objective and help to put the debt-to-GDP ratio on a downward trend. The Government can only achieve its target of balancing general government finances by 2019 by continuing its efforts to consolidate the general government fiscal position and especially the central government fiscal position.



Source: National Audit Offices calculations (based on the information supplied by the Ministry of Finance)

Figure 1: Budgetary targets for general government sub-sectors and forecasts.

According to forecasts, the target of putting the debt-to-GDP ratio on a downward trend will be achieved

It is forecast that the Government will achieve its aim of putting the debt-to-GDP ratio on a downward trend. The spending cuts have also helped to slow down the widening of the general government deficit relative to gross domestic product and growth of the debt-to-GDP ratio. In 2015, general government debt accounted for 63.6 per cent of the gross domestic product. According to the forecast produced by the Ministry of Finance in autumn 2016, the debt ratio will start decreasing in 2019.

Spending limits rule laid out in the Government programme and spending limits for the 2016–2018 parliamentary term

The National Audit Office evaluates compliance with the spending limits on an annual basis and monitors trends in budget expenditure and tax subsidies outside the spending limits. This helps to ensure that there is no inappropriate growth in expenditure or tax subsidies outside the spending limits as a result of the spending limits. The National Audit Office has not found any inadequacies in compliance with the spending limits procedure.

The spending limits rule laid out in the Government Programme and the central government spending limits are an essential part of Finland's national fiscal framework. In Finland, the central government spending limits are laid out each year for the following four years on the basis of the current cost and price levels.[3] When price and structural adjustments are made to the spending limits during the parliamentary term, the spending limits system becomes less transparent and it is difficult for outsiders to monitor compliance with the spending limits rule.

In its programme, the Government has pledged to observe a spending limits rule under which the 2019 expenditure under the limits should, in real terms, be 1.2 billion euros 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. Under the Government Programme, the cuts will affect all types of expenditure, including transfers. In spring 2016, the Government lowered the spending limits for the parliamentary term by 80 million euros both for 2017 and 2018 and by 120 million euros for 2019. The tightening is a small one and will only mean a reduction of 0.2 per cent in the overall spending limits for 2017. As a whole, the spending limits rule will help to reduce central government spending.

The spending limits rule of Prime Minister Juha Sipilä's Government is largely similar to the spending limits rules of the previous Governments. Unlike in previous Government Programmes, there is no promise not to use tax subsidies for circumventing the spending limits. Instead, it is stated that all changes in taxation are treated in the same manner if they have a similar impact on general government finances. The use of tax subsidies should be viewed critically and introduction of new subsidies should be avoided.

It is also noteworthy that in its spending limits rule, the Government undertakes to cover the entire sustainability gap of ten billion euros by implementing the required savings and decisions during the government term. The effectiveness of the short-term savings and structural reforms will be evaluated annually as part of the spending limits discussion.

The Government has pledged to close the sustainability gap of ten billion euros during its term

Long-term impacts of the economic policy (including the impacts on the sustainability gap) should be considered in the annual planning. At the same time, the impacts of the economic policy on the sustainability gap can only be assessed if the planned measures are concrete in nature. When the agreements on the conclusions of the sustainability gap reviews and decisions on any further measures are made, it must be ensured that the legislation concerning the reforms can be processed in accordance with the principles of good statute-drafting. This would contribute to a smoother decision-making process during the parliamentary term.

Adherence to spending limits during the parliamentary term

In spring 2016, the National Audit Office published the spending limits calculations for 2015 produced by its Fiscal Policy Evaluation. No inadequacies concerning adherence to the spending limits were noted.[4] Prime Minister Juha Sipilä's Government took office after the approval of the first amendment to the supplementary budget for 2015. This means that the second, third and fourth supplementary budgets for the budget year 2015 were submitted to Parliament during the term of Prime Minister Juha Sipilä's Government. When the Government took office, the unallocated reserve within the spending limits had been reduced to 30 million euros. The Government decided to introduce a new supplementary budget provision of 300 million euros, which was in addition to the provision of 200 million included in the first supplementary budget.

Central government spending limits have been adhered to during the current parliamentary term

The Government's spending limits rule is based on a political commitment. The purpose of the spending limits system is to slow down the growth of the tax burden. The introduction of a new full-amount supplementary budget provision in the middle of a budget year is not a good way to provide more room for manoeuvre within the spending limits from the perspective of the credibility of the spending limits rule. The new supplementary budget provision increased the nominal spending limits by about 270 million euros. The 2015 spending limits would have been exceeded unless the new supplementary budget provision had been introduced by the new Government. In order to slow down the increase in the tax burden, the next Government should be left with an adequate unallocated reserve at the end of the parliamentary term.

The purpose of the spending limits system is to slow down the growth in tax burden

A reserve of about 500 million euros was available for the 2015 supplementary budgets and in the end, a total of 292 million of this sum was actually used. Of the remaining 208 million euros, a total of 200 million euros was carried over to 2016.

The National Audit Office has monitored compliance with the 2016 spending limits up to the second supplementary budget proposal submitted to Parliament on 26 May 2016.[5] The biggest factors contributing to an increase in spending limits expenditure in the 2016 state budget proposal were the transfer of the local authority tax compensation (1.4 billion euros) and the appropriations for the Radio and Television Fund (0.5 billion euros) from outside the spending limits to the spending limits. The National Audit Office noticed in its spending limits calculations that additional spending limits appropriations totalling nearly one billion euros have been budgeted in the period between the state budget proposal and the second supplementary budget, increasing the total from 44.1 billion euros to 45.1 billion. In accordance with the principles governing the spending limits procedure, a total of 412 million euros of the increase of 951 million has been achieved by using reserves included in the 2016 spending limits. According to the 2015 General Government Fiscal Plan, the 2016 spending limits included a supplementary budget provision of 300 million euros and an unallocated reserve of 206 million. In the second supplementary budget for 2016, a total of 94 million euros of the reserves was left.

The remainder of the increase in the spending limits expenditure (539 million euros) is based on price and structural adjustments in the spending limits. The spending limits in the 2016 state budget proposal amounted to 44.6 billion euros but in the proposal for the second supplementary budget it had grown to 45.2 billion. The two most important structural adjustments increasing the 2016 spending limits were the cancellation of the pensioners' housing allowance reform in the amendment to the state budget proposal (205.5 million euros) and the carrying over of an unallocated reserve of 200 million euros from 2015 to 2016. According to the audit findings, all structural adjustments had been made in accordance with the principles governing the spending limits procedure. However, the use of the additional supplementary budget provision of 300 million euros for 2015 made it possible to budget additional spending limits expenditure of 200 million for 2016. The provision carried over from 2015 was mostly spent on the expenditure arising from the reception of asylum seekers and the management of the risks arising from state cash fund investments.

In the 2016 General Government Fiscal Plan, the Government lowered, as part of the adjustment measures, the spending limits for the parliamentary term by 80 million euros for 2017 and 2018 and by 120 million euros for 2019. Lowering of the framework spending (unlike increasing it) is possible during a parliamentary term without weakening the credibility of the spending limits.

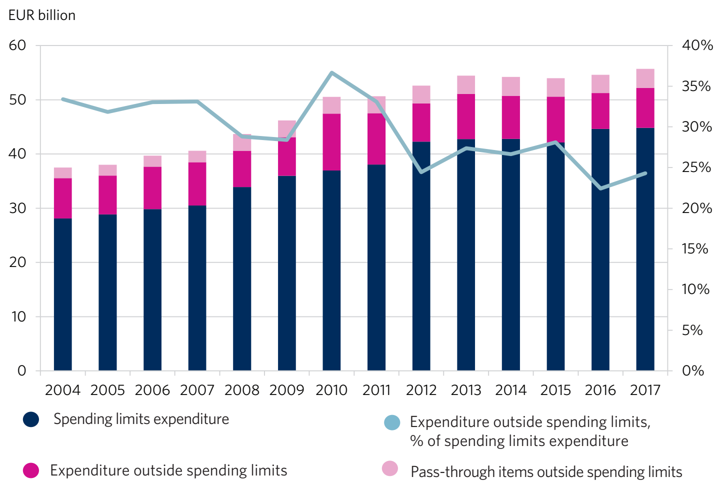
Expenditure outside spending limits

Since 2004, the state budget expenditure has been divided into spending limits expenditure and expenditure outside the spending limits. Cyclical expenditure, such as allowances arising from the unemployment situation and income security, are included in the expenditure outside the spending limits. Debt interest payments, compensations to municipalities arising from tax cuts and expenditure generated by financial investments are also outside the spending limits. Some of the expenditure items outside the spending limits are different types of pass-through items, which means that the revenue offsetting the expenditure in question is also allocated in the budget.

A total of 10.0 billion euros was budgeted for 2016 as expenditure outside the spending limits, which was about 1.9 billion less than the amount budgeted for 2015. The reasons for the reduction were mainly of technical nature. The compensations to municipalities arising from tax cuts generated during the previous parliamentary terms and the funding for the Finnish Broadcasting Corporation were made part of the spending limits at the start of the current parliamentary term.

The largest single items for expenditure outside the spending limits are unemployment security, housing allowance and pay security. This expenditure functions as an automatic stabiliser, which means that it is expected to increase in a downturn and decrease during a period of economic growth. Cyclical expenditure amounted to about 4.3 billion euros in 2016.

Other important expenditure items outside the spending limits are debt interest payments (about 2.3 billion euros) and financial investments. Interest on central government debt has remained unusually low, which has reduced interest payments even though the debt itself has increased.



Source: State budget proposals 2004–2017

Figure 2: Spending limits expenditure and expenditure outside the spending limits 2004–2017.

A total of 470 million euros was appropriated to financial investments in the 2016 state budget, which was 400 million less than in the year before. The main reason for the decrease was a reduction in the refinancing of exports and the fact that one-off growth inputs made in the previous parliamentary term had been eliminated from the budget. In a new item, a total of 140 million euros in development cooperation financial investments was added to the 2016 state budget. Most of the financial investments are one-off loans, expenditure arising from the purchase of shares and other securities and investments in limited liability companies comparable to shares.

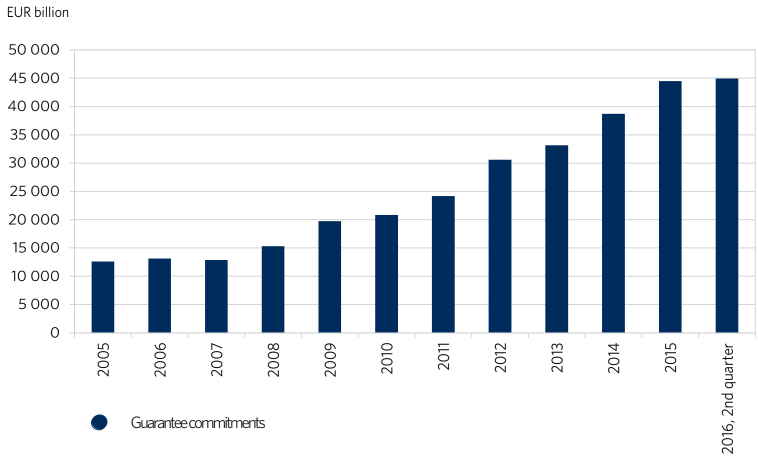
Financial investment expenditure has been high for many years

Most financial investments are expected to retain their value. As the financial investment expenditure has remained at a high level for many years, it is important to assess whether they will retain their value or do they include expenditure that could be categorised as state aid or regular expenditure. It is also important to monitor the risks in the financial markets and the trends in state investments, guarantees and liabilities as a whole.

State liabilities

Growth in guarantees has increased state risk associated with liabilities

Central government debt, pension liabilities, guarantees and contractual liabilities account for most of the state liabilities. An estimate of the state liabilities is presented as part of the risk reports compiled by the Ministry of Finance on the basis of nominal values. In addition to central government debt, a substantial rise in guarantees has also caused the liabilities to increase. Guarantees have almost doubled in five years. There was a particularly sharp rise in guarantees provided by Finnvera in 2015. During the second quarter of 2016, guarantees totalled almost 50 billion euros. The growth can partially be explained by the policies laid out in the Government Programme under which the export financing elements and the level of funding should be set at least at the level of the main competitor countries. The assumption is that as more guarantees have been provided, the risks associated with state liabilities have also increased during normal economic fluctuations.



Source: Statistics Finland

Figure 3: State guarantee commitments at the end of the year.

1.3 Local government finances

The Government has pledged to reduce local government expenditure

As part of the balancing of general government finances, the Government undertakes to reduce local government tasks and obligations by one billion euros. The Government will not impose any new tasks or obligations on municipalities during the parliamentary term. If there are any cuts in the central government transfers to municipalities, the Government will reduce local government tasks in the same proportion. The Government is also committed to reducing local government expenditure by means of an expenditure limit applying to local government finances.

Local government, the most important parts of which are the municipalities and joint municipal authorities, has shown a deficit since 2001, as indicated by the net lending entered in the national accounts. The sector still showed a deficit in 2015 as net borrowing totalled 1.3 billion euros or 0.6 per cent of the gross domestic product. The deficit was smaller than in the previous year and it seems that the accelerating growth in the deficit during the early years of this decade has stopped. Chronic local government deficits have led to a rapid growth in the debt burden. Over the past 15 years, local government debt has risen from less than four billion euros to nearly 18 billion. At the same time, the debt-to-GDP ratio has increased from 2.5 to 8.6 per cent. It is noteworthy that the deficits in the local government sector also persisted during the period of rapid economic growth in the first decade of the 2000s. Like today, the efforts to improve the debt ratio during those years were largely unsuccessful.

Impacts of the Government Programme on local government finances

Under the Programme of Prime Minister Juha Sipilä's Government, local government finances will be consolidated as part of structural reforms and as part of the general government adjustment programme. The aim of both lines of action is to reduce local government expenditure but with a different time span. The adjustment programme should start producing savings in local government finances by the year 2019. The savings generated through structural reforms are expected to be realised in full by the year 2030.

The Government has tightened the local government expenditure limit

Under the budgetary target laid out for the municipalities by the Government, the local government deficit should not exceed 0.5 per cent of the gross domestic product in 2019. In autumn 2015, the Government set an expenditure limit under which there would be a limit to changes in local government expenditure arising from central government measures. Under the expenditure limit, Government measures should reduce local government expenditure by at least 540 million euros by the year 2019, compared with the estimate made before the parliamentary term. In its spring 2016 General Government Fiscal Plan, the Government set the expenditure limit at 770 million euros. In addition to setting an expenditure limit, the Government will also consolidate local government finances by providing municipalities with an opportunity to collect more revenue through charges. The local government expenditure limit and the Government measures consolidating local government finances make it easier to achieve the budgetary target. According to the Ministry of Finance forecast published in autumn 2016, the local government sector will achieve the budgetary target set for it.

The work aimed at reducing local government obligations is continuing

The envisaged cuts in local government costs, as laid out in the Government Programme, is a continuation to the work aimed at reviewing and reducing local government obligations, which was started during the previous parliamentary term. With the adjustment measures laid out in the Government Programme, municipalities are expected to achieve savings through relaxed staffing requirements in services, fewer planning obligations, higher charges and fees, as well as efficiency improvements. The ultimate impact of the measures consolidating local government finances will, however, also depend on how extensively they will be implemented by municipalities and joint municipal authorities. Municipalities are free to decide whether they will continue to offer services as before even though they are no longer obliged to do so or state funding is withdrawn. This means that there is a risk that the savings targets are not achieved. As laid down in the existing legislation, all new and expanding local government tasks and obligations will be fully covered by central government transfers, which will compensate for the impact of the changes on local government fiscal position. Transfer of the financing of the management of long-term unemployment to municipalities and the Act on Supporting the Functional Capacity of the Older Population and on Social and Health Services for Older Persons have been the most important of the new tasks and obligations causing additional costs to municipalities.

The action plan concerning the reduction of local government tasks and obligations was discussed in the Cabinet Committee on Economic Policy in February 2016. The long-term savings impacts of the programme were put at 432 million euros, which is well below the targeted savings of one billion. In order to achieve the target, the Government has decided to expand the reform to cover the entire public sector. The results will be reviewed in the spending limits discussion in 2017.

The anticipated impacts of the social and health care reform (SOTE reform) and regional government reform on the local government sector

The responsibility for the costs arising from social and health care, rescue services and environmental health care will be transferred from municipalities to regions in 2019. The costs resulting from the tasks transferred from the municipalities to regions account for one third of the total local government expenditure and 57 per cent of the consumption-related expenditure. According to an estimate produced by the Ministry of Finance, 60 per cent of the local income tax and 40 per cent of the revenue generated by municipal corporation tax will be transferred to regions. The central government transfers that are estimated to cover social and health care will also be made part of regional government funding. There are substantial differences between municipalities in the costs arising from the tasks to be transferred to regions and the tasks that will remain a local government responsibility.

The SOTE reform and the regional government reform are intended to generate savings of three billion euros by the year 2030. It is estimated that most of the savings will arise from functions that are the responsibility of local government. The system of central government transfers should also be overhauled in connection with the reform.

Transferring the responsibility for providing social and health care from municipalities to regions has significant impacts on local government tasks and finances. The impacts are particularly strongly felt in the financing of local government operations in which the structure of revenue and expenditure will change completely. It is important to note that while local government operating revenue and expenditure will be almost halved, the surpluses and deficits in municipalities' balance sheets and their assets and debts will remain more or less unchanged.

In the long term, individual municipalities will no longer have to shoulder the costs arising from the ageing and morbidity of the population and the risks to local government finances resulting from them. With the introduction of the reform, municipalities will be relieved of a substantial amount of costs in which they have only had a limited say until now. The costs arising from specialised health care have been the most important such expenditure item. Providing specialised care has been the responsibility of joint municipal authorities and not of individual municipalities.

With the introduction of these structural reforms, a large proportion of the age-related expenditure that puts the long-term balance of general government finances at risk will be transferred from municipalities to regions. This reduces the role of fiscal balance in the local government sector from the perspective of general government finances as a whole and compliance with fiscal policy rules.

The process of making the service provision more efficient must continue so that the municipal sector can manage the obligations imposed on it without a significant weakening of its financial position. Structural reforms are also needed so that the pressures on local income tax rates can be eased.

1.4 Fiscal stance for 2015–2018 parliamentary term

Consolidation of general government finances depends on economic growth and spending cuts

A fiscal deficit, rapid growth of debts and a medium-term sustainability risk were the problems facing general government finances at the start of the parliamentary term. Under its programme, the Government of Prime Minister Juha Sipilä aims to put the debt-to-GDP ratio on a downward trend and cover the sustainability gap of 10 billion euros through spending cuts, measures supporting growth and structural reforms. If achieved, the net spending cuts will help to consolidate general government finances by four billion euros by 2019 and help Finland to balance its general government finances by the same year. It is also stated in the Government Programme that the overall tax rate will not rise during the current parliamentary term. This means that achieving the targets in a situation characterised by slow economic growth will largely depend on spending cuts.

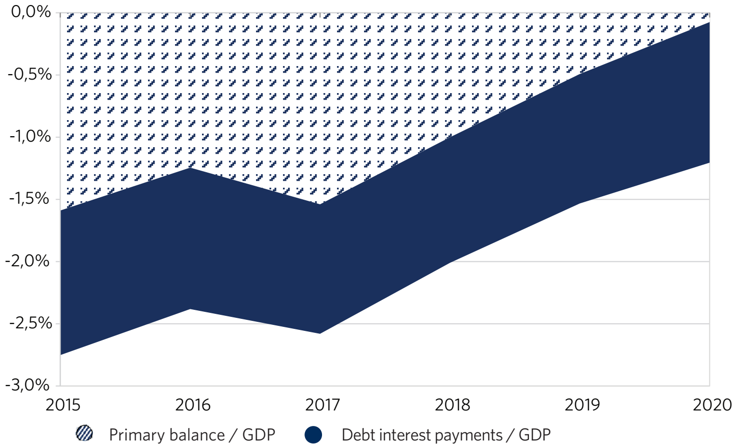
Under the rules and objectives guiding the management of general government finances, adjustment measures must be taken during the parliamentary term. Furthermore, the structural fiscal position of general government in 2016 is about 0.7 percentage points weaker than the medium-term objective of -0.5 per cent approved by the Government. According to the Ministry of Finance forecast published in autumn 2016, the decisions already made will not be enough for achieving the budgetary targets set by the Government. The targets can only be achieved and the debt-to-GDP ratio put on a downward trend if the revenue is increased or additional spending cuts are made.

The downturn affecting the Finnish economy between 2012 and 2014 ended at the start of the parliamentary term as a weak plus of 0.2 per cent was recorded in the gross domestic product for the year 2015. The GDP growth is expected to remain fairly modest (at about one per cent) until the year 2020. According to the National Audit Office, the fiscal policy pursued between 2012 and 2014 was mainly expansionary, as a result of which the general government fiscal position has weakened and there has been a rapid growth in the debt-to-GDP ratio. Both the rules laid down in the Stability and Growth Pact and the targets set out by the Government require that the fiscal position should be improved.

Fiscal policy helps to even out impacts of economic cycles

From the perspective of the consolidation of general government finances, weak growth is a problem because it should be possible to use fiscal policy as an instrument for evening out the impacts of economic cycles. Strict fiscal discipline during a downturn may have a pro-cyclical impact and lead to a protracted downturn and stifle the first signs of economic growth. During a period of strong economic growth, fiscal policy should be tightened to prevent overheating of the economy. As Finland has only recently, after a long downturn, entered a period of economic growth, the fiscal policy should be fairly neutral.

According to the Ministry of Finance forecast published in autumn 2016, the nominal general government fiscal balance is expected to remain at around -2.5 per cent in 2016 and 2017. However, according to the forecast, the deficit will shrink towards the end of the parliamentary term and stand at 1.5 per cent in 2019. A reduction in nominal fiscal deficit does not directly reflect the tightness of the fiscal policy. Division of the nominal general government fiscal balance into primary balance and debt interest payments shows that the proportion of debt interest payments of the deficit will grow towards the end of the parliamentary term, while the proportion of the primary balance will decrease. The primary balance will decrease by about 1.5 billion euros by the year 2019, while the interest payments will remain more or less unchanged throughout the parliamentary term. Figure 4 shows the division of the nominal balance into primary balance and debt interest payments, as forecast by the Ministry of Finance. It should be noted, however, that even if the primary balance decreased to about -0.5 per cent by the year 2019, achieving the structural balance target would require that the primary balance can be turned into a surplus by the end of the parliamentary term.



Source: Ministry of Finance

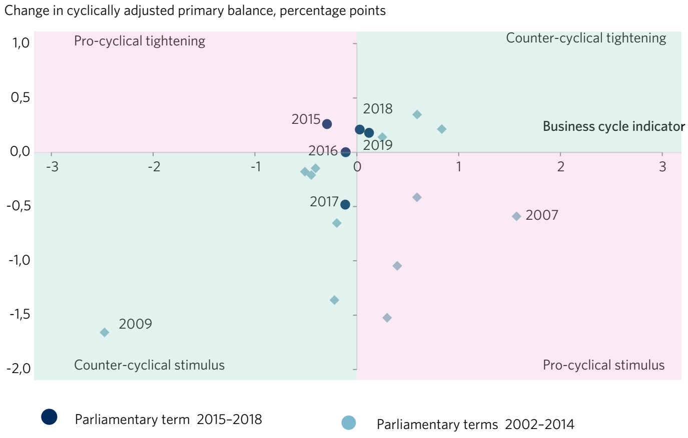
Figure 4: General government fiscal balance, as divided into primary balance and debt interest payments in 2015–2020, according to the forecast by the Ministry of Finance. The figures are relative to GDP.

The National Audit Office has assessed the fiscal stance during the current parliamentary term with two alternative methods: by assessing changes in structural primary balance and on the basis of discretionary measures. The methods are described in detail in Box 1. The calculations are based on the autumn 2016 forecast by the Ministry of Finance, which means that only the fiscal policy measures on which decisions have been made are included.

Fiscal stance will become contractionary at the end of the parliamentary term

According to the calculations of the National Audit Office, the fiscal policy pursued between 2002 and 2014 supported growth or was neutral, when assessed on the basis of both methods. In 2015, the measures aimed at adjusting general government finances became slightly contractionary. It should be remembered, however, that the growth in 2015 was weaker than expected.

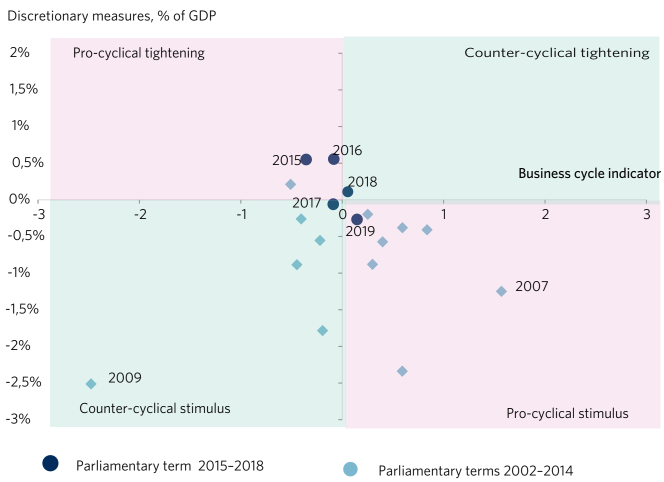
During the current parliamentary term, a slow economic recovery is expected and the economy is predicted to grow at a modest rate. When measured with changes in structural primary balance, fiscal policy is neutral in 2016, will become expansionary in 2017 and will become slightly contractionary in 2018.



Source: Ministry of Finance and National Audit Office's calculations

Figure 5: Fiscal stance, as assessed on the basis of change in structural primary balance.

From the perspective of discretionary measures, fiscal policy is slightly contractionary in 2016. The tax cuts planned for 2017 are expansionary whereas the spending cuts planned for the same year are contractionary, which means that the fiscal policy framework will be fairly neutral. Fiscal policy will also remain fairly neutral in 2018 and 2019.



Source: Ministry of Finance and National Audit Office's calculations

Figure 6: Fiscal stance, as assessed on the basis of discretionary measu-res.

Additional adjustment measures will tighten fiscal policy still further

The estimates of the fiscal stance presented here are based on the autumn 2016 forecast by the Ministry of Finance and the draft budgetaryary plan. Only the measures on which decisions have already been made are included. This means that as the outlook becomes more accurate and the discretionary measures more specific, the estimates of the fiscal policy framework will also become more detailed. According to the Ministry of Finance forecast, Finland's negative output gap will narrow during the period covered by the forecast, while at the same time, GDP growth will pick up slowly. Based on both indicators, the fiscal stance can be considered appropriate when consideration is given to the slow recovery of the Finnish economy. However, it should be remembered that achieving the savings and budgetary targets set out by the Government and meeting the requirements laid down in the EU rules would require additional adjustment measures during the current parliamentary term and thus a more contractionary fiscal policy.

BOX 1. ASSESSING THE FISCAL POLICY FRAMEWORK

Assessing the fiscal policy framework by means of change in structural primary balance, ΔSPB

Structural primary balance (SPB) describes the cyclically adjusted fiscal balance without interest expenditure. Cyclical adjustment eliminates from the nominal balance the impact of the economic cycle on general government expenditure and revenue. Any one-off items are also excluded from the primary balance. A change in structural primary balance gives a better idea of the impact of a discretionary fiscal policy on general government fiscal balance than a review based on changes in nominal balance.

If the structural primary balance has improved, the fiscal policy is considered to have been contractionary. If the structural balance has weakened, the fiscal policy has been expansionary.

Assessing fiscal policy framework on the basis of discretionary measures, DFE

Discretionary fiscal policy (*discretionary fiscal effort*, DFE) can also be assessed by dividing discretionary policy into revenue-side and expenditure-side measures.[6]

As regards general government revenue, discretionary revenues are defined as discretionary measures increasing or decreasing tax revenue in relation to GDP. If the discretionary measures have increased revenue, the policy has been contractionary, and if the revenue has decreased, the policy has been expansionary.

In general government expenditure, it is more difficult to give an equally straightforward definition of the discretionary measures. In 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. If the expenditure has grown more rapidly than potential output, the fiscal policy has been expansionary. If the expenditure has growth more slowly than potential output, the 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 it is positive, the policy has been contractionary.

Business cycle indicator

The expansionary or contractionary nature of the economic policy can only be assessed if an assessment of the business cycle is available. Carnot and Castro (2014)[7] define the business cycle indicator as a average of the normalised level of the output gap and changes in it. Thus, the business cycle indicator is not as sensitive to forecast revisions as an indicator that is solely based on the output gap.

1.5 Forecasts behind economic planning

Macroeconomic forecasts play an important role in the planning and decision-making concerning general government finances. The forecasts give a detailed picture of the prevailing economic situation and future trends in the tax bases and they can be used for assessing the impacts of fiscal policy on the economy. Because of the exceptionally weak growth of the Finnish economy, the forecasts used as a basis for general government economic planning have proved to be optimistic. Financial policy framework should be based on a cautious estimate of medium-term economic growth prospects.

The forecasts used as a basis for General Government Fiscal Plans have proved optimistic

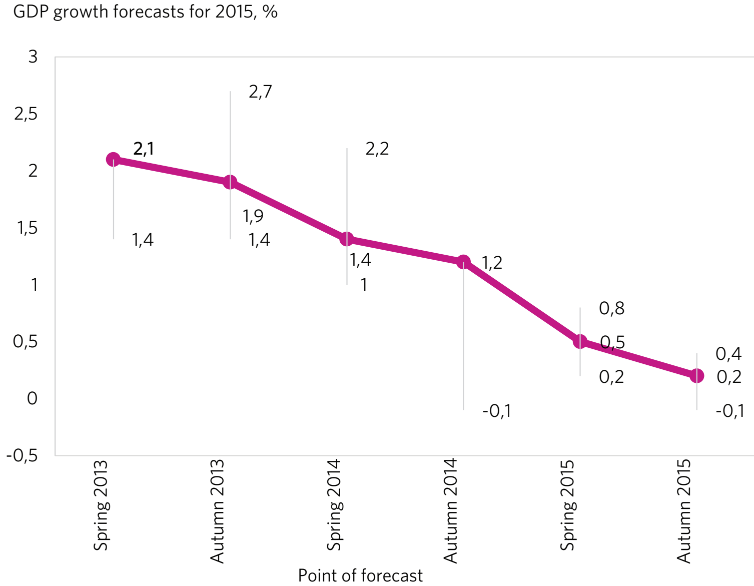
The National Audit Office issued an audit report on the forecasts behind the state budget proposals between 1997 and 2014 in spring 2016.[8] A statistical analysis carried out by the National Audit Office shows that the economic forecasts prepared by the Ministry of Finance as a basis for fiscal policy were not statistically biased.

According to a comparison of the forecast errors, the economic forecasts produced by the Ministry of Finance have been at least as accurate as those produced by other important forecasting institutes. Forecasting in foreign trade and investments has been particularly difficult in all forecasts reviewed in the audit. The frequent underestimation of foreign trade seems to derive from the exceptionally significant and systematic evolution of the statistics used as a basis for the forecasts. The uncertainty of the statistical base has also made it more difficult to forecast investments.

The economic forecasts produced by the Ministry of Finance have been at least as accurate as those produced by other important forecasting institutes

According to the audit findings, the Ministry of Finance has systematically underestimated both revenue and expenditure in its forecasts on general government finances. Except for social security funds, expenditure underestimations have been slightly higher than revenue underestimations. The forecast errors concerning net lending (difference between revenue and expenditure) are, however, not statistically significant for general government as a whole.

Finnish GDP growth turned positive during the first year of the current parliamentary term. It is difficult to determine the turning point and for example in 2015 the growth was slower than expected. Figure 7 shows the Ministry of Finance forecasts for Finnish GDP growth in 2015 and the variation between forecasts published by different forecasting institutes. The estimates of economic growth in 2015 became more pessimistic at the turn of the years 2014 and 2015. The growth forecast used as a basis for the 2015 state budget proposal was prepared in autumn 2014 when the forecast produced by the Ministry of Finance was the most positive of the different forecasts. According to preliminary data on national accounts published in July 2016, Finnish gross domestic product grew by 0.2 per cent in 2015.

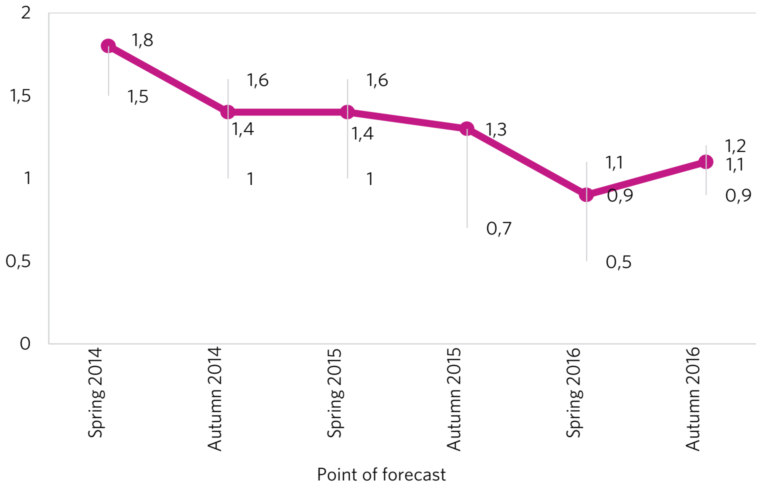


Sources: Ministry of Finance, Bank of Finland, Research Institute of the Finnish Economy, PTT, Labour Institute for Economic Research, European Commission, International Monetary Fund (IMF)

Figure 7: The Ministry of Finance forecasts for Finnish GDP growth in 2015 and the variation between different forecasting institutes at different times.

Figure 8 shows the Ministry of Finance forecast for Finnish GDP growth in 2016 and the variation between forecasts published by different forecasting institutes. The growth forecasts for 2016 have remained stable. However, the growth is expected to be slower than what was predicted in the autumn 2015 forecast, which was used as a basis for the state budget proposal for 2016. The forecast presented by the Ministry of Finance in autumn 2015 was also the most positive of the forecasts published at the time.

GDP growth forecasts for 2016, %



Sources: Ministry of Finance, Bank of Finland, Research Institute of the Finnish Economy, PTT, Labour Institute for Economic Research, European Commission, International Monetary Fund (IMF)

Figure 8: The Ministry of Finance forecasts for Finnish GDP growth in 2016 and the variation between different forecasting institutes at different times.

The growth forecasts prepared by the Ministry of Finance for the state budget proposals for 2015 and 2016 were more optimistic than the forecasts produced by other institutes at the time. There is no such optimism in the forecast made for the 2017 state budget proposal.

The figures above show the great degree of variation between different forecasts. The economic outlook always involves uncertainties and for this reason, consideration should also be given to the possibility of weaker-than-expected growth when forecasts are prepared and fiscal policy planned. There should not be excessive attention on the accuracy of point forecasts because from the perspective of fiscal policy planning and fiscal policy framework, it is more important to focus on medium-term and long-term analysis.

In fiscal policy planning, it is important to focus on medium-term analysis

2 Compliance with the Stability and Growth Pact

Finland has pledged to comply with the fiscal policy rules of the Stability and Growth Pact, as laid down in the *Fiscal Compact*. This interim report on the 2015–2018 parliamentary term covers compliance with the fiscal policy rules of the EU during the current parliamentary term. This report presents in-year analysis for 2016 and ex ante analysis for 2017 and 2018. The calculations produced by the National Audit Office in autumn 2016 are based on the autumn 2016 forecast prepared by the Ministry of Finance and the draft budgetary plan. The National Audit Office has verified the structural balance calculations of the Ministry of Finance. The National Audit Office did not find any inadequacies in the calculations of the Ministry of Finance.

Finland has set -0.5 per cent in relation to GDP as its medium-term objective

In accordance with the preventive arm of the Stability and Growth Pact, a *medium-term objective* (MTO) is set in terms of structural balance. The setting of the medium-term objective is also incorporated in the Finnish legislation on the basis of the Fiscal Policy Act (869/2012). Under the medium-term objective approved by the Government in autumn 2015, Finland aims to have a structural balance of at least -0.5 per cent. A deficit criterion of three per cent and a debt criterion of 60 per cent are the criteria laid down in the corrective arm of the Stability and Growth Pact.

Finland is subject to the preventive arm of the pact. However, this parliamentary term Finland may be in breach of the criteria laid down in both the preventive arm and the corrective arm. The National Audit Office has already highlighted possible non-compliance with the criteria in its earlier reports.[9]

Finland remains in compliance with the rules of the preventive arm

The preventive arm comprises two pillars: medium-term objective and expenditure benchmark. According to the in-year assessment by the National Audit Office, Finland will remain in compliance with both pillars of the preventive arm in 2016. However, the National Audit Office estimates that, based on the forecasts, there is a risk of a significant deviation in both pillars during the current parliamentary term. According to the forecast, in 2017 there is a deviation of about one percentage point from what is required in the structural balance pillar. The National Audit Office also draws attention to the fact that Finland's structural balance in 2016 is about 0.7 percentage points weaker than the MTO of -0.5 percent and that no correction is expected during the current parliamentary term. Until now, Finland has been in compliance with the expenditure benchmark of the preventive arm. The expenditure growth limit for Finland is tightening and the calculations of the National Audit Office indicate that Finland will also be in breach of the expenditure benchmark during the current parliamentary term.

General government debt has exceeded the 60 per cent threshold

Finland remains in compliance with the three per cent deficit rule laid down in the corrective arm. However, according to the information published by Statistics Finland on 30 September 2016, Finland already exceeded the 60 per cent limit in 2014. Cyclically adjusted debt-to-GDP ratio will also exceed the 60 per cent limit in 2016. The growth in general government debt ratio is only expected to stop in 2019.

Compliance with the rules is also assessed by the European Commission on a regular basis. The Commission assesses compliance with the preventive arm in spring (on the basis of the stability programme) and in autumn (on the basis of the draft budgetary plan). The latest assessment of the Commission concerning compliance with the criteria of the preventive arm was published on 26 May 2016 in connection with the assessment of the stability programme. The Commission was of the view that Finland remains in compliance with the criteria of the preventive arm. The Commission assesses compliance with the criteria of the corrective arm in the reports issued under Article 126(3). The latest Commission report prepared on the basis of the Article 126(3) was published on 18 May 2016 and according to it, Finland remains in compliance with the corrective arm of the Stability and Growth Pact when consideration is given to all relevant factors. The Commission may, however, launch excessive deficit procedure for Finland during this parliamentary term.

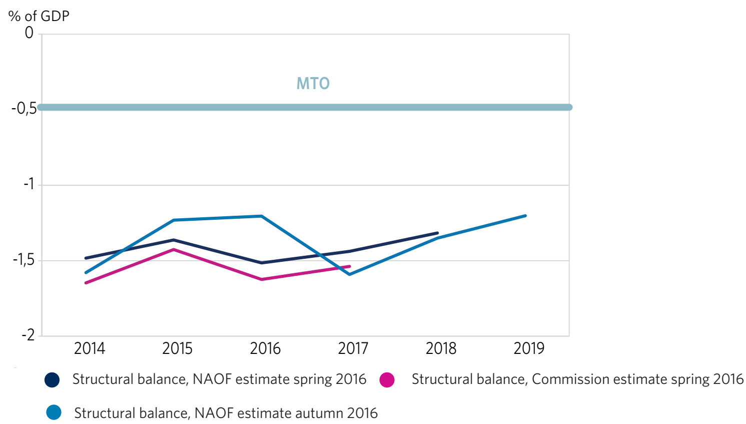
2.1 Preventive arm

In accordance with the preventive arm of the Stability and Growth Pact, the *medium-term objective* (MTO) is set for three years at a time in terms of structural balance. Structural balance is defined as the cyclically adjusted general government balance net off one-off and other temporary measures.

Compliance with the medium-term objective is reviewed on the basis of two separate pillars that complement each other. Firstly, it is examined whether the medium-term objective has been achieved or whether the required change in structural balance has been achieved. As laid down in the expenditure benchmark (second pillar of the preventive arm), the growth in general government expenditure is compared with the expenditure limit set on it.

Structural balance pillar

In 2016, Finland's structural balance is -1.2 per cent, which is about 0.7 percentage points from the MTO of -0.5 per cent. The structural balance estimate produced by the National Audit Office is shown in Figure 9. The estimates presented by the National Audit Office and the European Commission in spring 2016 are also shown for comparison. The figure shows that the structural balance estimates produced by the National Audit Office and the Commission in spring 2016 were similar.



Source Ministry of Finance and National Audit Office's calculations

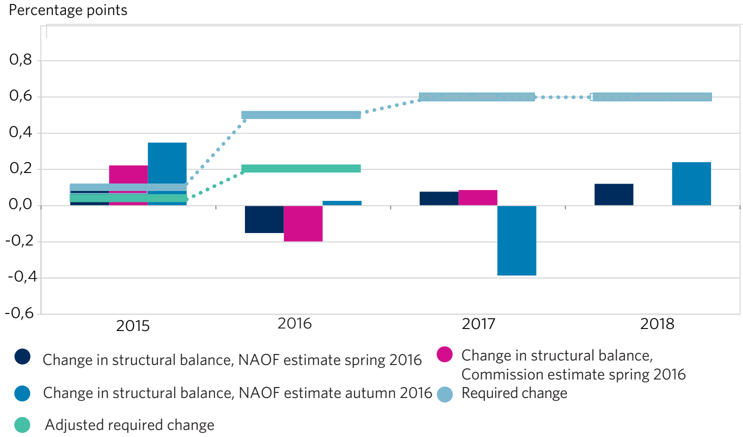
Figure 9: Finland's structural balance between 2014 and 2019.

The figure also shows that the estimate for 2016 structural balance made by NAOF in autumn 2016 has improved from spring 2016. The main reason for the change has been an improvement in nominal balance. The fact that the economic outlook in the autumn was slightly weaker than in the spring has also helped to improve the structural balance. At the same time, however, the structural balance forecast for 2017 is weaker than what was estimated in spring. The estimate for the 2017 structural balance is weakened by the forecast for nominal balance, in which there has been a weakening of about 0.5 percentage points from the spring 2016 forecast. At the same time, however, the weakening of the economic forecast does not mean that the weakening of the nominal balance will result in an equally weak structural balance. According to the forecast, there will be a slight improvement in the structural balance in 2018.

Finland is not expected to achieve the medium-term objective approved by the Government during the current parliamentary term. According to the estimates made in autumn 2016, structural balance will remain between 0.5 and 1 percentage points below the MTO throughout the forecast period.

As Finland has not achieved its medium-term objective, the actual or forecast change in structural balance relative to the required change is assessed on in the EU fiscal framework. The definition of the required change is described in more detail in chapter 2.3 of this report. The National Audit Office concluded in spring 2016 that Finland achieved the required change in structural balance in 2015. The assessment concerning compliance with the preventive arm in 2016 will be prepared in spring 2017. According to the calculations made in autumn 2016, the structural balance will remain at 2015 levels. Thus, the change is zero, which means a deviation of about 0.5 percentage points from the required change. However, as regards the change required for 2016, consideration will be given to the additional general government expenditure arising from the refugee crisis. According to the estimate produced by the Ministry of Finance in autumn 2016, these costs would account for about 0.3 per cent of the Finnish gross domestic product in 2016. If the costs arising from the refugee crisis will be as anticipated, the deviation from the structural balance will not be significant and Finland will also remain in compliance with the structural balance pillar in 2016.

In 2017, the change required in structural balance will be 0.6 percentage points. It is, however, forecast that the structural balance will weaken by about 0.4 percentage points in 2017. Thus, there is a risk that in 2017 the deviation from the structural balance pillar will be as much as one per cent. According to the draft budgetary plan presented by the Ministry of Finance in autumn 2016, the competitiveness pact is such a significant structural reform that it can serve as justification for the deviation in 2017.



Source: Ministry of Finance and National Audit Office's calculations

Figure 10: Required and actual change in structural balance between 2015 and 2018.

Structural balance estimate is sensitive to changes in the deficit and economic outlook

In the EU fiscal framework, the change in the structural balance is assessed, rather the the level of it. Finland remains in compliance with the preventive arm even though the level of structural balance is not close to the MTO approved by the Government. It should be noted that the estimate of the structural balance is sensitive to changes in the level of nominal balance and in the economic cycle. For Finland, compliance with the rules has been partly due to the revisions in the estimates for the structural balance between forecasting rounds. Both the history and forecasts of the structural balance are updated, which is relevant to the assessment of the actual changes. The National Audit Office has drawn attention to the risk of a significant deviation in many of its previous reports. The Government has also recognised the risk of a significant deviation in the structural balance pillar in 2017 in its General Government Fiscal Plan published in spring 2016. Thus, the Government should take measures to correct the deviation.

However, the significant deviation has not realised for Finland. This is partly due to contractionary economic policy, and partly due to revisions in the strucutural balance estimates between forecasting rounds. The flexibility in the framework has also made it easier to comply with the rules.

Expenditure benchmark pillar

In the *expenditure benchmark*, the second pillar of the preventive arm, the change in total general government expenditure is compared to the reference growth rate set for the spending.

There is a risk of a significant deviation in the expenditure benchmark in 2017

The National Audit Office assessed Finland's compliance with the expenditure benchmark in spring 2016. The assessment was based on the figures contained in the stability programme submitted to the European Commission by the Ministry of Finance. According to the calculations of the National Audit Office, Finland was in compliance with the expenditure benchmark by a wide margin in 2015 and, according to preliminary estimates, this will also remain the case in 2016. However, in spring 2016, the National Audit Office drew attention to the fact that the expenditure benchmark for Finland will be tightened and that there will be a significant deviation from the expenditure benchmark during the current parliamentary term. The National Audit Office updated its estimate of compliance with the expenditure benchmark on the basis of the draft budgetary plan supplied by the Ministry of Finance in autumn 2016. According to the updated estimate, Finland remains in compliance with the expenditure benchmark in 2016 but there is a risk of a significant deviation already 2017.

Under the expenditure benchmark, the cyclical part of the unemployment expenditure, debt interest payments and the spending arising from EU programmes that are funded directly from EU aid are eliminated from total general government spending. This expenditure is considered to be of such nature that it cannot be influenced through economic policy. In investment expenditure, the four-year average is examined, which means that the rules allow an increase in investments during the year in review. The expenditure benchmark also allows an increase in spending if the increases are funded with corresponding increases in revenue. Table 1 shows NAOF's calculations of compliance with the expenditure benchmark between 2015 and 2018.

Table 1: Finland's total general government expenditure, adjustments to it and the applicable expenditure benchmark in 2015–2018, as calculated by

the National Audit Office.

	Expenditure benchmark figures, EUR billion	2015	2016	2017	2018
1	**Total general government expenditure**	**120.7**	**122.4**	**123.1**	**124.8**
-2	Interest expenditure	2.4	2.4	2.3	2.3
-3	Expenditure arising from EU programmes, fully compensated by EU funds revenue	1.1	1.1	1.1	1.2
-4	Cyclical in unemployment expenditure	1.0	0.9	0.9	0.5
-5a	Gross fixed capital formation	8.3	8.6	8.8	9.0
+5b	Four year average of gross fixed capital formation	8.3	8.5	8.6	8.7
= AEA1	**Adjusted expenditure aggregate (AEA1)**	**116.1**	**117.7**	**118.6**	**120.6**
- 6	Discretionary revenue measures, DRM	0.6	0.6	-1.4	-0.3
- 7	Expenditure financed from earmarked revenue	0.05	0.06	0.08	0.05
= AEA2	**Adjusted expenditure aggregate (AEA2)**	**115.4**	**117.0**	**119.9**	**120.8**
Growth in total general government expenditure					
	Nominal growth in total expenditure	0.4%	0.8%	1.9%	1.9%
	GDP deflator	1.4%	1.3%	1.0%	1.1%
	Real growth in total expenditure (calculated in accordance with the expenditure benchmark)	**-1.0%**	**-0.5%**	**0.9%**	**0.8%**
	Applicable expenditure benchmark	**0.6%**	**-0.1%**	**-0.8%**	**-0.7%***
Significant deviation					
	Difference between rate of growth of total expenditure and expenditure benchmark (in percentage points)	1.6%	0.4%	-1.7%	-1.5%
	Deviation, EUR billion	1.8	0.4	-2.0	-1.8
	GDP, EUR billion	209	213	218	223
	Deviation in relation to GDP (%)**	0.9%	0.2%	-0.9%	-0.8%
	Is the deviation significant (<-0.5)?* **	**No**	**No**	**Yes**	**Yes**
	Cumulative deviation	0.7%	0.5%	-0.4%	-0.9 %
	Is the cumulative deviation significant (<-0.25)?* **	**No**	**No**	**Yes**	**Yes**

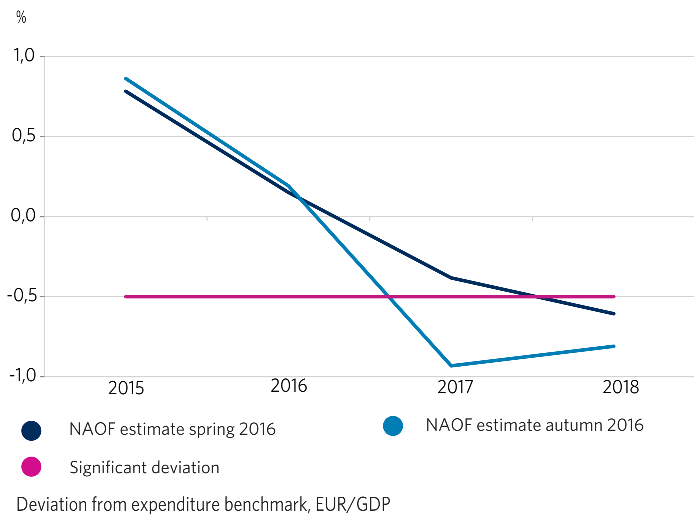
Source: Ministery of Finance and National Audit Office's calculations

* The estimate of the expenditure benchmark applicable to 2018 is based on a preliminary estimate by the National Audit Office. The expenditure benchmark applicable to 2018 will be based on the forecast produced by the Commission in spring 2017.

** 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.

***Significant deviation means a deviation (in euro terms) that in relation to GDP is less than -0.5 per cent for the preceding year or, in cumulative terms, for the two preceding years.

The change in adjusted general government expenditure is compared with the reference growth rate set for it. The reference growth rate is set on the basis of the potential medium-term growth rate, the size of the public sector and the required change in structural balance. Within the framework, the difference between the expenditure benchmark and total general government expenditure is converted into euros and proportioned to the gross domestic product. If this ratio is negative, it means that general government expenditure has increased more rapidly than what would have been permitted under the expenditure benchmark. If the deviation is less than -0.5 percentage points, the deviation from the expenditure benchmark is considered significant. Figure 11 shows the difference between the expenditure calculated in accordance with the expenditure benchmark and the permitted growth in expenditure in euros. The figure shows that based on the estimates made in autumn 2016, the deviation from the expenditure benchmark will become significant already 2017.



Source: Ministry of Finance and National Audit Office's calculations

Figure 11: The difference between the expenditure calculated in accordance with the expenditure benchmark and the expenditure limit in euros, in relation to gross domestic product.

The deviation in 2017 is a result of a tighter limit and the fact that real growth in expenditure will be faster than what was forecast in spring. Slow growth in potential output and the higher required change in strcutural balance will tighten the expenditure benchmark limit. Compared with the estimates made in spring 2016, expenditure in 2017 will be increased in real terms by a larger-than-expected decrease in tax revenue set aside for discretionary measures and the downward adjustment of the GDP deflator forecast

Focus in the examination of the expenditure benchmark is on the trends in total general government expenditure and the growth potential of the economy. According to the estimate produced by the National Audit Office, Finland may be in breach of the expenditure benchmark as a result of a tighter expenditure limit and not because of an exceptionally rapid growth in general government expenditure. Furthermore, the fact that inflation is expected to be muted makes it more difficult to adhere to the expenditure benchmark. This means that Finland can achieve its medium-term objective only if there is a considerable slowing down in real growth in general government expenditure.

Overall assessment

As described above, compliance with the preventive arm is assessed on the basis of two pillars. Both in terms of the structural balance and the expenditure benchmark, the Commission defines a significant deviation as a deviation of 0.5 percentage points from the requirements laid down under a pillar for the preceding year or in a cumulatively for the two preceding years.

Compliance with the rules is assessed in accordance with the matrix described in Table 2. When a Member State achieves the target laid down for both pillars, it is in compliance with the rules. In a situation where a Member State is in compliance with one of the pillars or there is an deviation in both of them, compliance with the rules is examined on a basis of an overall assessment. In the overall assessment, consideration is given to the methodological differences between the pillars and the assumptions behind the methods, especially with respect to GDP growth and price trends. Methodological differences between structural balance and the expenditure benchmark are described in Box 2. When both pillars have a significant deviation as set out in the definition, the relevant significant deviation is the one appearing in the requirements of the preventive arm. In such cases, too, an overall assessment of the causes of the significant deviation will be made.

Structural balance pillar / Expenditure benchmark pillar	Rule has been complied with	Deviation	Significant deviation
Rule has been complied with	Rules has been complied with	Overall assessment	Overall assessment
Deviation	Overall assessment	Overall assessment	Overall assessment
Significant deviation	Overall assessment	Overall assessment	Significant deviation

Table 2: Compliance with the preventive arm.

According to an ex-post assessment produced by the National Audit Office in spring 2016, Finland was in compliance with both pillars of the preventive arm in 2015. According to an in-year examination, there is a risk of a deviation from the structural balance requirements in 2016. However, according to the forecast, the deviation will not be significant when consideration is given to the additional general government expenditure arising from the refugee crisis. According to preliminary estimates, Finland will remain in compliance with the expenditure benchmark in 2016. However, according to the preliminary estimates, there is a risk of a significant deviation in both pillars of the preventive arm in 2017. Table 3 describes NAOF's estimate of compliance with the preventive arm in the current parliamentary term.

	Structural balance	Expenditure benchmark	Overall assessment
2015	Rule is complied with	Rule is complied with	Rules have been complied with
2016	Deviation is not significant	Rule is complied with	Overall assessment
2017	Risk of significant deviation	Risk of significant deviation	Significant deviation? Overall assessment
2018	Risk of significant deviation	Risk of significant deviation	Significant deviation? Overall assessment

Table 3: Finland's compliance with the preventive arm between 2015 and 2018, as estimated by the National Audit Office.

BOX 2. OVERALL ASSESSMENT

The purpose of the overall assessment is to examine the methodological differences between structural balance and expenditure benchmark and background assumptions and whether the deviation concerning one or both pillars can be explained with factors that could not have been influenced through short-term economic policy. Factors to be considered include updates of the economic outlook in relation to forecasts, accuracy of inflationary expectations and changes in interest rates.

The assessment based on changes in the structural balance is produced using a *top down* method. The estimate of the structural balance is based on an assessment of the division of general government structural balance into nominal and cyclical parts. The cyclical part is defined as a product of the output gap and the semi-elasticity of the general government revenue and expenditure of output gap. The National Audit Office calculates the output gap using the production function methodology jointly agreed in the European Union.[10]

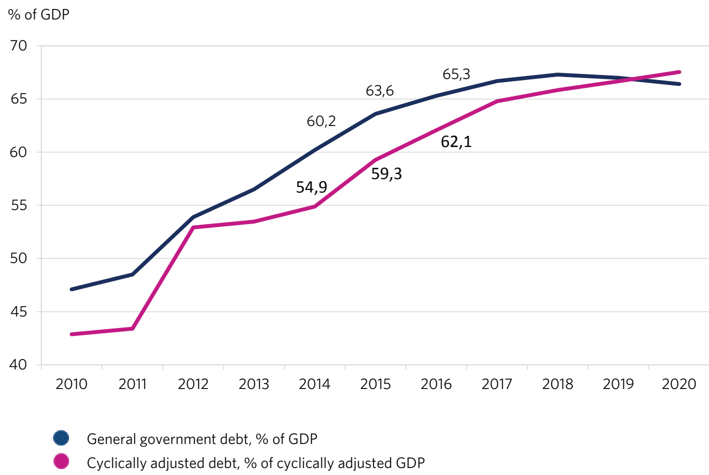
The structural balance estimate is sensitive to changes in the observed balance and cyclical balance. If the economy faces a downbound inflation shock (price rises are slower than anticipated) tax revenue will remain lower than anticipated. At the same time, general government expenditure is not as sensitive to inflation shocks or changes in economic outlook. The cyclical part is updated as output gap estimates are updated between forecasting rounds. This means that the structural balance estimates are extremely sensitive to cyclical changes and sometimes there are substantial changes in them between forecasting rounds.

The expenditure benchmark is a *bottom up* review. The assessment of the structural fiscal position on the basis of the expenditure benchmark links the potential output growth used as a reference for expenditure and the price trends to the spring forecast of the preceding year. This means that short-term changes in business cycle or inflation are not relevant when compliance with the expenditure benchmark is assessed. Thus, expenditure benchmark is not as sensitive an indicator as the structural balance. It also takes into account discretionary changes in revenue and does not limit the growth in general government expenditure if a corresponding revenue increase can be allocated.

2.2 Corrective arm

A debt criterion of 60 per cent and a deficit criterion of three per cent are the criteria laid down in the corrective arm of the Stability and Growth Pact.

Over the past ten years, Finland's general government debt-to-GDP ratio has increased from about 40 per cent to 63.6 per cent (in 2015). This means that Finland has exceeded the 60 per cent limit laid out in the EU Treaties. Cyclically adjusted debt-to-GDP ratio will also exceed the 60 per cent limit in 2016. Figure 12 shows the trend in the debt ratio, as described in the statistics published by Statistics Finland on 30 September 2016 and the Ministry of Finance forecast. The figure also shows the ratio of cyclically adjusted debt to cyclically adjusted gross domestic product, as calculated by the National Audit Office.



Source: Ministry of Finance and National Audit Office's calculations

Figure 12: General government debt ratio and cyclically adjusted debt ratio.

The main reason for the increase in the debt ratio has been the deficit in general government finances, which has persisted since 2009. The deficit reached its peak in 2014 when, according to Statistics Finland, it amounted to 3.2 per cent of the gross domestic product. It should be noted that social security funds are part of general government in Finland and that, until now, the employment pension funds have kept them in surplus. However, Finland cannot amortise debts by using the surplus generated by employment pension funds, which means that the ratio of gross general government debt to GDP actually grows more rapidly than the annual net borrowing of general government. It should be noted, however, that social security funds have also accumulated assets, which are, however, not considered when the trends in gross indebtedness are examined. The debt ratio has also been increased by slow GDP growth.

The Commission has assessed Finnish compliance with the debt ratio requirements in its reports prepared under Article 126(3). The latest report was published on 18 May 2016. Based on the stability programme submitted by Finland to the Commission in spring 2016 and the Commission's spring forecast, the Commission states in its report that Finland exceeded the 60 per cent debt limit in 2015. However, when considering the launching of the excessive deficit procedure (EDP), the Commission takes into account a number of relevant factors such as the medium-term economic outlook, structural reforms and compliance with the preventive arm. For 2015, Finland was considered to comply with teh debt criterion due to the weak economic growth. The Commission will publish its next assessment of the compliance with the debt criterion in November 2016.

Finland remains in compliance with the three per cent deficit criterion

Finland remains in compliance with the three per cent deficit criterion. In 2014, the deficit amounted to 3.2 per cent. The Commission's interpretation was that the excess is small and temporary, which means that no EDP procedure for Finland was launched in 2015. According to the Ministry of Finance forecast, the deficit will remain under the three per cent limit until the end of the forecasting period (the year 2020).

2.3 Flexibility in the framework

The aim of the preventive arm of the Stability and Growth Pact is to ensure the medium-term sustainability of general government finances and to ensure a safety margin for the three per cent deficit criterion and the 60 per cent debt criterion. In the assessment of the criteria of the preventive arm, consideration is given to such factors as economic growth, debt ratio and sustainability risk, as well as completed and planned structural reforms and investments.

Flexibility of the rules means that consideration can be given to country-specific characteristics

The flexibility built in the framework means that better consideration can be given to country-specific characteristics than if there was only an estimate of the achievement of the medium-term objective. Flexibility also means that consideration can be given to serious economic difficulties and exceptional circumstances, such as the refugee crisis, which started in 2015. This means that excessive tightening of general government finances is not necessary during crises. Flexibility also allows the implementation of structural reforms.

Flexibility makes the rules more difficult to understand, less credible and less transparent

However, the flexibility decreases clarity, credibility and transparency of the framework. Even though Finland remains in compliance with the criteria of the preventive arm Finland's structural balance is well below the MTO. In the examination of the structural balance, the focus is on change rather than the level and for this reason, setting -0.5 per cent as the medium-term objective for structural balance has not guaranteed sufficient distance to the criteria of the corrective arm. In Finland's case, flexibility of the rules and the permitted deviations from them are leading to a situation where compliance with the preventive arm has not provided an adequate safety margin for the criteria of the corrective arm. According to the information published by Statistics Finland on 30 September 2016, Finland's debt ratio already exceeded the 60 per cent limit in 2014. For this reason, the National Audit Office considers problematic the interpretation of the Commission according to which compliance with the preventive arm supports compliance with the debt criterion of the corrective arm. The flexibility incorporated in the rules and its role to Finland are examined in more detail below.

Flexibility communication

In a situation where a Member State has not achieved its medium-term objective, it must, within the regulatory framework, be on the adjustment path towards the objective. In practice, the Commission defines the change towards the objective required for each year on the basis of its spring forecast of the previous year. In January 2015, the European Commission issued what is known as the flexibility communication[11], in which it specified the factors relevant to the change required in structural balance. The communication also clarifies the consideration of structural reforms or certain co-funded public investments aimed at balancing general government finances within the regulatory framework.

Economic growth, debt ratio and the sustainability risk had already been taken into account in adjustment requirements before January 2015.[12] The new matrix lays down more specific provisions on the scope of the change and it has been in effect since the assessment of the 2016 stability programmes.[13] Table 4 describes in more detail the criteria for setting the change towards MTO, as required in the preventive arm.

Table 4: Determining the required change in structural balance.

		Required annual adjustment		
	Criterion	Debt below 60% and no sustainability risk	Debt above 60% or sustainability risk	
Exceptionally bad times	Real growth < 0 or output gap < -4	No adjustment needed		
Very bad times	-4 ≤ output gap < -3	0	0.25	
Bad times	-3 ≤ output gap < -1.5	0 if growth below potential; 0.25 if growth above potential	0.25 if growth below potential; 0.5 if growth above potential	2016 required adjustment = 0.5
Normal times	-1.5 ≤ output gap < -1.5	0.5	> 0.5	2017 and 2018 required adjustment = 0.6
Good times	Output gap ≥ 1.5	> 0.5 if growth below potential; ≥ 0.75 if growth above potential	≥ 0.75 if growth below potential; ≥ 1 if growth above potential	

Finland has benefited from this flexibility built in the regulations as it means that less adjustment has been required during the current economic downturn. The change required in 2015 was 0.1 percentage points (on account of serious economic difficulties).[14] Table 4 shows that the change required for 2016 is 0.5 percentage points. The change set for 2017 and the anticipated change required for 2018 is 0.6 percentage points. Tighter requirements are based on the picking up of economic growth and the sustainability risk, which in turn is the result of the size of the debt ratio.

In its flexibility communication, the Commission also specified its criteria for structural reforms and certain co-funded investments. Structural reforms and co-funded investments[15] may be taken into account in the requirements of the preventive arm if they have a verifiable impact on the sustainability of general government finances or medium-term growth potential.

The reforms carried out under the structural reform clause must be major, have long-term positive budgetary effects and be fully implemented. The costs arising during the implementation of the reform can be taken into account in the c required change in the structural balance if the certain conditions are met.[16] In order to benefit from the structural reform clause, a Member State must present the calculations of the costs arising during the early stage of the reform and estimates of its long-term impacts on the consolidation of general government finances. The Member State must submit its estimate as part of the stability programme submitted to the Commission in spring.

As regards investments, the flexibility applies to investments co-funded by a Member State and the EU, which have a verifiable impact on medium-term potential growth. The terms and conditions concerning the use of the investment clause are largely identical with those applied to structural reforms.[17] Furthermore, the deviation from the adjustment path leading to the medium-term objective must result from co-funded investments that are in accordance with the definition laid out in the investment clause.

Finland has not introduced any structural reforms that are considered within the framework of the preventive arm. In the draft budgetary plan presented by the Ministry of Finance in autumn 2016, it is proposed that the competitiveness pact between the Government and social partners should be considered as a significant structural reform that meets the criteria of the structural reform clause. The Ministry of Finance also proposes that the pension reform that will enter into force at the start of 2017 should be considered as a reform meeting the requirements specified in the clause.

In the opinion of the National Audit Office, the competitiveness pact does not fully meet the requirements for structural reforms specified in the structural reform clause. Even though the purpose of the competitiveness pact is to provide a stronger basis for economic growth, the reform has not yet been fully implemented and the meeting of all technical requirements concerning the contract cannot be assessed on a proactive basis. As regards the pension reform, the National Audit Office is of the view that even though the calculations of the Ministry of Finance suggest that it contributes to the sustainability of general government finances, it does not involve any such early-stage implementation expenditure on the basis of which a deviation from the adjustment path leading to the medium-term objective could be justified.

In the opinion of the National Audit Office, the social and health care reform (SOTE reform) and the regional government reform might be considered as a structural reform because one central objective of the reforms is to keep the expenditure generated by social and health care services under control. The implementation of the SOTE reform will start in 2019 and thus its effectiveness as a means of balancing general government finances can only be examined in the next parliamentary term at the earliest.

Impact of higher refugee costs on general government finances

On 29 October 2015, the Commission issued a communication[18] under which the additional expenditure arising from the refugee crisis, which started in 2015, can be taken into account in the assessment of the criteria of the preventive arm in 2015 and 2016. According to the Commission, the refugee crisis is an exceptional circumstance beyond the Member States' control. This means that the additional central government expenditure arising from the refugee crisis in 2015 and 2016 can be taken into account when the criteria of the preventive arm are assessed.

The Commission estimated that the additional expenditure incurred by Finland as a result of the refugee crisis in 2015 was between 0.05 and 0.1 per cent of the gross domestic product. According to a preliminary estimate produced by the Ministry of Finance, the additional expenditure caused by the refugee crisis in 2016 would be about 0.3 per cent of the gross domestic product. Thus, the required change for 2016 would be adjusted to 0.2 percentage points. However, a reliable assessment of the costs arising from the refugee crisis in 2016 can only be produced in 2017.

2.4 Procedure resulting from non-compliance with the Stability and Growth Pact

There are procedures that may be launched if a Member State is in breach of the Stability and Growth Pact. Non-compliance with the preventive arm will result in *significant deviation procedure* (SDP). Non-compliance with the criteria of the corrective arm (three per cent deficit criterion or 60 per cent debt criterion) will result in *excessive deficit procedure* (EDP). So far, the Commission has not launched a SDP procedure for any Member State. There is a EDP procedure underway for six Member States.

Significant deviation procedure

The Commission assesses compliance with the preventive arm for the year on an ex post basis. If there is a significant deviation from the requirements of the preventive arm as far as the actual figures are concerned, the Commission may launch the significant deviation procedure.

In practice, the procedure is as follows. If the Commission notices a significant deviation from the requirements of the preventive arm, it addresses a warning to the Member State, as laid down in Article 121(4).[19] One month after the warning issued by the Commission, the Council will assess the situation and prepare a recommendation to the Member State in question listing the required corrective measures and setting out a new adjustment path towards the medium-term objective. The Member State in question has five months or (in the case of an exceptionally significant deviation) three months to introduce measures to correct the deviation. The Member State must report on the measures that it has carried out to the Council within a specific deadline. If the Member State has not taken any measures or the measures are, in the Council's view, (repeatedly) inadequate, the Council may impose a sanction on the Member State corresponding to a 0.2 per cent interest-bearing deposit in relation to the gross domestic product of the preceding year.

Excessive deficit procedure

In a situation, where there is a risk of non-compliance with the deficit criterion or the deficit or debt criterion has been breached, the Commission will, in a report produced under Article 126(3), assess the issues on the basis of which the Member State can be considered to be in compliance or in non-compliance with the criteria. In its assessment, the Commission with take into account the nominal excess of the criteria and all relevant factors.

Even if the criteria of the corrective arm are very clear, there is some room for interpretation in the compliance with the regulations. As regards the deficit criterion, the procedure can be launched on the basis of actual or anticipated figures. In a situation where the deficit exceeds the three per cent limit, the Commission will examine whether the excess is small, temporary or exceptional. The excess is considered temporary if the deficit will fall below the three per cent limit, as forecast by the Commission. The Commission has not given any specific definition for a small excess. An exceptional excess is a situation where the deficit ratio has grown as a result of a severe economic downturn or factors not arising from the Member State's economic policy.

For the debt criterion, the EDP procedure can only be launched on the basis of outturn data after the debt ratio has exceeded the 60 per cent limit. There is also a degree of flexibility in the compliance with the debt criterion. When considering the launching of the debt criterion procedure, the Commission will take into account the financial aid operations impacting the debt (solidarity transfers to other Member States), cyclically adjusted debt level and compliance with the preventive arm. The Commission will also assess other relevant factors, which are

- medium-term economic outlook, which comprises assessments of potential output and economic trends, as well as net savings in the private sector
- Assessment of compliance with the preventive arm or assessment of the achievement of the structural fiscal position that is in accordance with the medium-term objective or improvement of the structural fiscal position towards the agreed objective
- Assessment of the trend in debt ratio in the medium term
- Other relevant factors, which are based on the observations presented by the Commission or the Member State in question.

If the Commission, after considering all relevant factors, reaches the conclusion that the Member State is in breach of the criteria of the corrective arm, it will submit a recommendation to the Council for launching the EDP procedure. The Council addresses a recommendation to the Member State in question with measures and timetables and the Member State in question must take the measures laid out in the recommendation in order to correct its deviation. The Member State in question has between three and six months to demonstrate that it has taken the required action.

If the Council concludes that the measures taken by the Member State are repeatedly inadequate the EDP procedure may be taken to the last stage (sanctions procedure). The sanctions procedure is in the form of an interest-bearing deposit, which is 0.2 per cent of the gross domestic product of the Member State subject to the sanctions procedure. However, so far the Commission has not imposed sanctions on any Member State.

The Commission has launched the EDP procedure against a total of 26 Member States, six of which are still subject to the procedure (Croatia, Portugal, France, Greece, Spain and Britain). Estonia and Sweden are the only Member States for which the procedure has never been launched. The Commission launched the EDP procedure for Finland in spring 2010 on the basis of an anticipated deficit ratio but it terminated the procedure in 2011 after the actual deficit ratio for 2010 was less than three per cent.[20]

3 Principal measures aimed at balancing general government finances

One of the main objectives of the Government's economic policy is to close the sustainability gap. The Government aims to achieve this by introducing structural reforms, by supporting economic growth and employment and by means of taxation.

3.1 Progress of structural reforms

Sustainability gap impacts of the structural reforms will be assessed

Under its programme, the Government of Prime Minister aims to introduce structural policy reforms that will have an economic impact of at least four billion euros. These reforms include the social and health care reform, cuts in local government expenditure, regional government reform, Tulevaisuuden kunta (municipalities of the future) reform, central government reform and the pension reform, which was prepared during the terms of the previous Governments. The Government promised that the impacts of the reforms on the sustainability gap will be assessed before any legislative proposals are submitted to Parliament.

In addition to generating domestic debate, the structural reforms have also been extensively discussed in the recommendations for Finland presented by international organisations. For example the need to introduce changes in the pension system and the need to keep social and health care costs under control have been included in the annual country-specific recommendations issued as part of the European Semester, Article IV recommendations issued by the International Monetary Fund (IMF) and the recommendations contained in the country reports of the OECD. The need to introduce labour market reforms have also been extensively discussed in the publications. The development needs have included more flexible pay formation and linking it to productivity improvements and introducing a broad range of new incentives to increase the supply of work (such as shortening the duration of unemployment security).

Pension reform

The previous Government submitted the legislative proposals concerning the pension reform to Parliament in September 2015. The proposals had been prepared on a tripartite basis during the term of the previous Government. The proposals were approved in November 2015 and the pension reform will enter into force at the start of 2017. Raising the minimum retirement age, tying the minimum retirement age to life expectancy, changes to pension accrual regulations and replacing the part-time pension with a new partial old-age pension are some of the most important parts of the reform. The reform will also affect the level of disability pensions and allow the employment pension investments to become more share-weighted. In the protocol of signature included in the pension reform agreement, it was also agreed that there will be a conditional increase of one year in the age limit for the right to additional days as part of the unemployment security.

In accordance with the Government Programme, the Government proposal included an estimate of the sustainability impacts of the reform, according to which it will narrow the sustainability gap by about one percentage point. The narrowing will be based on a reduction in general government pension expenditure and an increase in the gross domestic product resulting from a higher employment rate. The estimates concerning the decrease in pension expenditure and employment impacts are based on extensive calculations produced by the Finnish Centre for Pensions.[21] The sustainability gap estimate contained in the Government proposal corresponds to the impact assessment produced by the Research Institute of the Finnish Economy (Etla) on the basis of a different calculation model.[22] According to the sensitivity analysis contained in Etla's assessment, the sustainability gap impact of the pension reform in relation to the old pension legislation largely depends on the general trends concerning the preferred retirement age and the future of the additional days arrangement.

The uncertainty concerning the sustainability gap calculations should be clearly presented

No sensitivity analysis has been published on the sustainability gap estimate contained in the Government proposal. As the sustainability gap estimate is sensitive to background assumptions concerning long-term economic trends, the uncertainty concerning the calculations should be highlighted in the reports on the estimate. The need concerns the sustainability gap estimate as a whole and the reporting on the reforms impacting the sustainability gap. From the perspective of the transparency of the risk position of general government finances, comprehensive sensitivity analyses on the impacts of important structural reforms should be available so that the likely variation of the impacts can be determined.

The pension reform process resulted in a package that will have a long-term positive impact on general government fiscal balance. Of the structural reforms introduced in recent years, the pension reform is the one that is expected to have the largest impacts. Most of the impacts of the 2017 pension reform will be on a long term, which is typical of structural reforms. Confidence in longer-term impacts will also give more room to introduce short-term fiscal policy solutions.

The pension reform may cause short-term pressure on expenditure

However, consideration should also be given to the short-term costs arising from structural reforms. The pension reform, too, contains elements that may cause cost pressures in the short term as the savings will only become reality at a later date. Disability pensions will rise and the flexible terms of the new partial old-age pension may make it a popular pension alternative. These features and the uncertainties concerning the assumptions contained in the impact assessments highlight the importance of a continuous and systematic monitoring of the reform.

Social and health care reform and regional government reform

It was agreed in the Government Programme that as part of the social and health care reform, the provision of social and health care services will become the responsibility of a maximum of 19 autonomous areas that will be larger than municipalities. As regards service production, it was stated that the SOTE regions will provide the services themselves or purchase them from private or third-sector operators. Funding options were left open but it was stated that the aim is to change over to a single-channel system. According to its programme, the Government will also study the details of a model based on free choice.

In April 2016, the Government made policy decisions on a number of areas included in the SOTE reform. As regards the funding model, it was decided to adopt a model based on state funding (in practice state income taxation) and no preparations will be made during the current parliamentary term to introduce a regional right of taxation. Each of the 18 autonomous areas (regions) would be responsible for organising their SOTE services. It was also decided that the organisation and provision of the services would be assigned to separate actors and that the services offered on a market-basis must be in company form. This would include the SOTE units in regional ownership, most of which operate as part of the freedom of choice scheme. The Government also agreed on the regional state administration reform, on coordinating regional state administration with regional government and the scope of regions' tasks.

The proposed legislation on the social and health care reform and regional government reform were submitted for comments in August 2016. The proposals contained assessments of the economic impacts of the reforms at different levels of general government finances. The targeted savings impact is three billion euros compared with forecast development by the year 2029. Savings would be achieved by improving the cost-effectiveness of larger SOTE organiser units in institutional services, basic-level services and specialised health care. Substantial savings are also expected through more extensive digitalisation and electronic services.

However, the savings will not be automatic and achieving them would require changes in operating practices at regional level and efficient use of the changes. Based on the legislative proposals for regional government and funding arrangements, the state funding would be under strict economic guidance so that savings can be achieved, while at the same time there would also be legislation on separate state aid for situations were a region is facing financial problems. The Government has also made a policy decision on a client charge reform, under which the charges will be adjusted. However, unreasonable increases in charges may not be introduced.

According to the Government Programme, the aim of the social and health care reform is to narrow health gaps and keep costs under control. Regional government reform was later included in the same package. As a result, the set of measures now also covers the regional government reform. It is later policy decisions, the Government also specified that the social and health care reform would include a model based on extensive freedom of choice.

The scope of the reforms and their timetables may cause problems

In principle, planning several wide-ranging reforms simultaneously is not a problem because reforms covering different sectors can support each other. However, the scale of the process may cause problems in terms of the risk position of general government finances and cost trends, especially when consideration is given to the timetables set for the reforms. For example, from the perspective of the objective of cost control, it is essential that the right model for implementing the freedom of choice scheme is selected. There may also be situations where it must be decided whether to give priority to the narrowing of health gaps or cost control, both basic objectives of the reform. Assessment and management of the costs arising from the changes and transitional measures required as part of the reform will also pose challenges.

Changes in economic and population age structures and the need to narrow the sustainability gap make structural reforms necessary. Measures aimed at implementing challenging reforms are essential because delaying structural reforms will mean more adjustments in general government finances in the future. However, assessing the impact of structural reforms is difficult and there are fundamental problems concerning the assessment of the sustainability gap. Nevertheless, impact assessments should be carried out whenever possible. Consideration should be given to such issues as the direction and degree of uncertainty of the changes taking place during different time spans. Moreover, in addition to descriptions of the probable trends, there should also be calculations of realistic alternatives. A clear and unequivocal target-setting in the reforms supports the preparation of impact assessments and provides them with more weight in decision-making.

3.2 Supporting employment and competitiveness

Competitiveness, employment and public service provision are at the centre of the economic policy of Prime Minister Juha Sipilä's Government. The Government aims to provide a stronger basis for employment and economic growth by means of taxation and by taking measures supporting economic competitiveness and productivity. The focus is also on reforms concerning pay formation in the labour market.

During its term of office, the Government aims to provide more incentives to work, make the provision of employment more attractive, improve the effectiveness of the labour administration and strengthen Finland's competitiveness. The reforms are intended to consolidate general government finances by more than one billion euros, increase the employment rate and achieve significant improvements in employment. In order to achieve its aims, the Government will promote the necessary structural reforms in a dialogue with social partners. The reforms play a major role in the Government's efforts to balance general government finances and achieve its budgetary targets.

In its programme, the Government states that it aims to conclude contract, the Competitiveness Pact, with social partners in support of the decisions accelerating Finland's economic recovery and improving employment. The Government estimated that if the Competitiveness Pact is not concluded, additional adjustment measures totalling 1.5 billion euros would be needed to consolidate general government finances. The competitiveness pact was concluded in February 2016 and in accordance with its terms, the Government cancelled the additional adjustment measures totalling 1.5 billion. These measures would have been introduced if no agreement had been reached. Under the competitiveness pact, annual working hours will be extended by 24 hours and holiday bonuses of public-sector workers will be cut. Employers' social security contributions will also be reduced and partially compensated through increases in employees' contributions. The Government will also support the contract by introducing tax cuts.

The Ministry of Finance estimates that the contract will decrease unit labour costs by about four per cent. As a whole, the competitiveness pact and the tax cuts and cuts in social security contributions connected with it will weaken the general government fiscal position by slightly more than one billion euros between 2017 and 2019 each year and more than 800 million from 2020 onwards if no consideration is given to the positive impacts generated by a higher employment rate.

The Competitiveness Pact will weaken general government fiscal position in the short run

The National Audit Office considers it justified that the Government promotes the balancing of general government finances and well-being by supporting employment and growth. However, the competitiveness pact will significantly weaken the general government fiscal position. If there are no substantial improvements in the employment situation, the contract will make it more difficult to achieve the objective set for general government deficit and the medium-term objective set for structural deficit.

The strategic projects listed in the Government Programme also include strengthening of competitiveness by providing businesses and entrepreneurs with better operating prerequisites and promotion of employment. In 2016, the most important Government measures from the perspective of businesses are legislative reforms and dismantling of regulation. As part of its efforts to dismantle regulation, the Government has relaxed shopping hour restrictions, which has already had a positive impact on employment. Employment can also be stimulated and structural unemployment reduced by eliminating incentive traps preventing people from accepting work and by reforming the unemployment security system. The pension reform that will enter into force in 2017 is also expected to increase the employment rate and reduce pension expenditure. The projects will be financed without increasing total expenditure.

Assessing the impact of the reforms will require concrete measures

The Government has set out clear and verifiable targets in its programme. Implementing the reforms and monitoring their effectiveness will require concrete measures and thorough impact assessments so that the necessary legislation can be processed in accordance with the principles of good statute-drafting.

3.3 Improvements in Tax system

In its programme, the Government set the strengthening of growth, entrepreneurship and employment as the objectives of its tax policy. Despite the targets concerning the adjustment of general government finances, the Government will not increase the overall tax rate during the current parliamentary term. This means that the combined effects of tax-related measures on general government finances should be neutral at 2019 level. Under its programme, the Government also aims to ease taxation of labour and to finance the cuts by increasing environmental taxes. The Government aims to improve Finland's competitiveness by reforming taxation on entrepreneurship, ownership and investments.

The Government aims to increase the employment rate by eliminating incentive traps through harmonisation of social security and taxation, by extending the scope of the domestic work credit and by increasing the compensation percentage. In its programme, the Government prepares to introduce substantial additional cuts in taxes on earned income in support of pay settlements improving employment and competitiveness.

At the start of the parliamentary term, the room for manoeuvre in tax policy was limited by central government deficit and the need for fiscal adjustments. Even though the intention was to introduce the tax cuts set out in the Government Programme in support of general government finances gradually during the government term, most of the changes in taxation planned by Juha Sipilä's Government were put into effect early on. The most important change in the tax bases in 2016 reducing the tax revenue was the increase in earned income tax credit, which helped to ease the taxation of earned income, especially among small-income and middle-income individuals. With the conclusion of the competitiveness pact, taxation of earned income will be lowered in 2017. The changes in employees' social security contributions will help to reduce the taxation of earned income, in addition to which the Government pledged to reduce taxation of earned income, depending on the scope of the contract.

The tax system and its future should be assessed as a whole

General tax policy guidelines and the most important targets concerning the tax policy are laid out in the Government Programme. However, the development of the tax system as a whole is not discussed in the document. The National Audit Office recommends that there should be a comprehensive assessment of the future of the tax policy and the tax system of the future during the latter half of the parliamentary term.

The National Audit Office notes with satisfaction that supporting employment and economic growth are included in the Government's tax policy objectives. At the same time, according to the economic theory, the tax system should be simple, neutral and in accordance with overall needs of the national economy. The policy decision of the Government under which there will not be any increases in the overall tax rate limits the Government's chances to make adjustments in general government finances. The National Audit Office carried out fiscal policy audits covering the tax system in 2014.[23]

Tax subsidies

Tax subsidies make the tax system more complicated and thus also more ineffective

Tax subsidies mean deviations from the normal taxation structure. The purpose of tax subsidies is to support specific activities or groups of taxpayers through deductions, tax exemptions, reduced tax rates, tax rebates or provisions postponing tax payments. The spending limits may lead to impractical use of tax subsidies if the limits prevent the use of direct aid. For this reason, it is important to monitor the number of tax subsidies. The increase in tax subsidies should be viewed critically and they should be avoided as they tend to complicate the tax system and make it inefficient.

According to the 2017 state budget proposal, a total of 185 different tax subsidies were identified in 2016, while for the year 2017, the number is 186. There have been few changes in the level of tax subsidies in recent years. Only about two thirds of all tax subsidies can be calculated in euro terms, a result of absence of information and measuring problems. As regards the subsidies that have been calculated, the total amount of tax subsidies for 2015 was estimated at 24.2 billion euros and the figure is expected to reach about 24.6 billion in 2016.

According to an estimate produced by VATT Institute for Economic Research, tax subsidies in the 2017 state budget proposal total about 25.3 billion euros of which 16.5 billion are state tax subsidies. In 2017, the total number of tax subsidies will be increased by the introduction of a higher earned income tax credit, which is included in the competitiveness pact. A reduction in the deductibility of housing loans will decrease the total sum of tax subsidies. The entrepreneur deduction and the forest gift deduction will become new tax subsidies. At the same time, the tax subsidy arising from the higher depreciation of productive investments will expire at the close of 2016 as the subsidy programme comes to an end. It should be noted, however, that abolishing a tax subsidy will not mean a corresponding increase in tax revenue.

Assessment of the impacts of tax subsidies should be more systematic

Since 2012, the Government's annual report has contained an assessment of the impacts of tax subsidies. The impact assessments should be more systematic. The existing practice, in which the impact is only assessed each year to the extent that research information is available, is not enough for examining the impact of the subsidies in a systematic manner. In the view of the National Audit Office, a more systematic approach is also needed so that subsidies that are considered ineffective could be eliminated.

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11 Making the best use of the flexibility within the existing rules of the stability and growth pact. 31 January 2015.

12 The old matrix is presented in the document Vade Mecum on the Stability and Growth Pact 2013.

13 The Commission sets the required change in structural balance for the following year on the basis of its spring forecast for the current year. This means that the change required for 2016 was set on the basis of the spring 2015 forecast and the change required for 2017 on the basis of the spring 2016 forecast.

14 The change required for 2015 was set on the basis of the old matrix as part of the Commission's spring 2014 forecast.

15 Co-funded investments refer to the projects jointly financed by a Member State and EFSI (European Fund for Strategic Investment). EFSI is a joint project of the Commission and the European Investment Bank, in which the aim is to encourage investments in the EU. The investments may also be co-funded by a Member State and the EU when they concern structural fund, external border or other cohesion policy programmes.

16 The detailed conditions are laid out in the memorandum Commonly agreed position on Flexibility in the Stability and Growth Pact.

17 The detailed conditions are laid out in the memorandum Commonly agreed position on Flexibility in the Stability and Growth Pact.

18 Orientation for the SGP treatment of refugee-related budgetary costs. 29 October 2015.

19 It should be noted that the SDP procedure will probably be launched if, on the basis of an ex-post examination, it is determined that there is a significant deviation in both pillars of the preventive arm. Before a decision is made to launch the procedure, the Commission will, however, prepare an overall assessment covering both pillars of the preventive arm.

20 According to preliminary figures published in spring 2010, Finland's general government net lending would have been -4.1 per cent of the gross domestic product in 2010. In accordance with the first stage of the EDP procedure, the Commission assessed relevant factors its report prepared under Article 126(3) and published on 12 May 2010. In its report, the Commission expressed the view that the excess of the debt criterion was temporary and due to exceptional circumstances but not small. However, the actual deficit for 2010 was much smaller (-2.5 per cent), and on 12 July 2011 the Council decided, at the recommendation of the Commission, to terminate the EDP procedure for Finland in its report on the basis of Article 126(12).

21 See for example, Reipas K. and Sankala M. (2015): Projections on the effects of the 2017 earnings-related pension reform: assessments based on the Government bill Finnish Centre for Pensions, reports 05/2015.

22 Lassila, J., Määttänen, N. and Valkonen, T (2015): Työeläkeuudistus 2017: vaikutukset työuriin, tulonjakoon ja julkisen talouden kestävyyteen. Valtioneuvoston selvitys- ja tutkimustoiminnan julkaisuja 1/2015.

23 See for example, National Audit Office Fiscal policy audit report. Economic effects of changes in taxation - tax system 15/2014 (in Finnish, with English abstract), and National Audit OfficeFiscal policy audit report. Economic effects of changes in taxation - corporate and capital taxation 13/2014 (in Finnish, with English abstract).

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