



National Audit Office's separate report to Parliament: Fiscal policy monitoring report 2015



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To Parliament

As part of its task laid down in the Constitution of Finland, the National Audit Office 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 and Growth Pact (fiscal policy agreement) and within the meaning of European Union law. Provisions on the evaluation tasks 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 and on multi-annual budgetary frameworks (Fiscal Policy Act; 869/2012). Evaluation comprises the assessment of the setting and implementation of the fiscal policy 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 adherence to the medium-term budgetary objective (MTO) and its correction mechanism.

Under section 6 of the Act on the National Audit Office of Finland, the National Audit Office hereby presents Parliament with this separate report on its principle findings with respect to fiscal policy evaluation for the 2015 parliamentary session.

Helsinki 8 September 2015

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This separate report to Parliament contains the fiscal policy evaluation report 2015 of the National Audit Office. The report covers the steering of general government finances as a whole, adherence to central government spending limits and adherence to the Stability and Growth Pact.

The National Audit Office takes positive note of the fact that the steering of general government finances is on a more consolidated basis. 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 reflected in the Government Programme of Prime Minister Juha Sipilä. Until now, Government Programmes have focused on central government finances and the issues affecting general government finances as a whole have not been discussed in the document.

The National Audit Office takes positive note of the fact that the setting of fiscal policy objectives is now linked with the long-term prospects of general government finances. The planned consolidation of general government finances by 10 billion euros will cover a sufficiently long period as it extends beyond one parliamentary term. This requires commitment to a long-term fiscal and economic policy, which will pose new challenges to fiscal policy decision-making, in which the focus has until now been on parliamentary terms.

The Finnish economy is in need of wide-ranging structural reforms. The Government of Prime Minister Juha Sipilä is continuing the structural reforms launched in the previous parliamentary term. Under the Government Programme, before legislative proposals are submitted and implemented, the effects on the sustainability gap sought with the reforms should be assessed. 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 on the basis of the principles of good statute drafting. This would help to ensure that the decisions will be made during the current parliamentary term.

According to the observations made by the National Audit Office as part of fiscal policy evaluation, the expenditure within central government spending limits in the final budget was about 34 million below the 2014 spending limits. The National Audit Office notes that the 2015 spending limits were prepared on the basis of a strict budgetary framework.

Expenditure outside the spending limits has remained stable despite the economic downturn. The National Audit Office notes that in the preparation of the 2015 spending limits, financial investments have been used for expenditure resembling grants. The Government should refrain from this.

The National Audit Office has assessed compliance with the Stability and Growth Pact on the basis of an overall assessment. The conclusion of the National Audit Office is that Finland was in compliance with the preventive arm in 2014. This conclusion is based on the fact that Finland was in compliance with the expenditure benchmark pillar with a clear margin, despite the existence of a significant deviation in the structural balance pillar. According to the assessment of the National Audit Office, deterioration of the structural balance may be the result of the lower than expected tax revenue and the growth in cyclical unemployment expenditure. At the same time, however, total public sector expenditure in Finland has grown substantially more slowly than permitted under the expenditure benchmark. Thus, the National Audit Office is of the view that compliance with the preventive arm is due to the moderate growth in total expenditure.

The National Audit Office has also assessed compliance with the corrective arm of the Stability and Growth Pact. In the view of the National Audit Office, it is not yet necessary to initiate excessive deficit procedure for Finland as we are only slightly in excess of the nominal deficit. If the adjustment of general government finances will proceed as laid out in the Government Programme, the deviation may be temporary. However, the effects of the measures laid out in the new Government Programme should only be assessed in autumn 2015 when the Government decides on the first General Government Fiscal Plan for the parliamentary term. Finland al-

so remains in compliance with the debt criterion laid down in the corrective arm. However, forecasts indicate that Finland will be in breach of the debt criterion in 2016.

The National Audit Office would like to draw attention to the functioning of the preventive arm of the Stability and Growth Pact in a prolonged economic downturn. The flexibility elements of the preventive arm, in which consideration is given to such factors as economic circumstances and structural reforms, are useful instruments for ensuring that it will not become necessary to introduce strong economic adjustment measures in a downturn. As a result, Finland will soon be in a situation where compliance with the preventive arm will not provide us with sufficient margin for the criteria laid down in the corrective arm.

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1 Steering of general government finances as a whole

The National Audit Office takes positive note of the fact that the steering of general government finances is on a more consolidated basis. 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 reflected in the Government Programme of Prime Minister Juha Sipilä's Government in which general government finances are discussed from an overall perspective. Until now, Government Programmes have focused on central government finances and the issues affecting general government finances as a whole have not been discussed in the document. The National Audit Office takes positive note of the fact that the setting of fiscal policy objectives is now linked with the long-term prospects of general government finances. The planned consolidation of general government finances by 10 billion euros will cover a sufficiently long period as it extends beyond one parliamentary term. This requires commitment to a long-term fiscal and economic policy, which will pose new challenges to fiscal policy decision-making, in which the focus has until now been on parliamentary terms.

The Finnish economy is in need of wide-ranging structural reforms. The important structural reforms were already initiated by the previous Government. Even though the objectives of the structural policy programme laid out during the 2011–2015 parliamentary term were sound it proved difficult to transform the objectives into sufficiently concrete measures that would have allowed the achievement of the objectives.

The Government of Prime Minister Juha Sipilä is continuing the structural reforms launched in the previous parliamentary term. Implementation of the reforms and monitoring their effectiveness require concrete measures and detailed effectiveness assessment. Under the Government Programme, before legislative proposals are submitted and implemented the effects on the sustainability gap sought with the reforms should be assessed. 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 on the basis of the principles of good statute drafting. This would help to ensure that the decisions will be made during the current parliamentary term.

Steering of general government finances is on a more consolidated basis

1.1 General government fiscal plan for 2016–2019

The decisions made during the 2011–2015 parliamentary term significantly strengthened the steering of general government finances. This is the result of the national implementation of the Budgetary Frameworks Directive 2011/85/EU, which was followed by the Decree on the General Government Fiscal Plan (120/2014) in February 2014. Under the decree, steering of general government finances must be put on a more comprehensive and long-term basis. The General Government Fiscal Plan must contain the sections on central government finances, local government finances and statutory employment pension institutions as well as other social security funds.

The Government approved the General Government Fiscal Plan for 2016–2019 on 2 April 2015. This was the last such plan for the 2011–2015 parliamentary term and is defined as a technical plan as it does not contain any new decisions. It also serves as Finland's stability programme. The technical plan provides the basis for the first General Government Fiscal Plan of the 2015–2019 parliamentary term. The new government will decide on the first General Government Fiscal Plan for the parliamentary term in autumn 2015.

The advantage of the general government fiscal plan procedure is that it forces the Government to examine general government finances as a whole. Ever since its first fiscal policy audit report on the parliamentary term, which was submitted to Parliament in 2011, the National Audit Office has highlighted the need for a steering system covering all aspects of general government finances that is similar to the General Government Fiscal Plan (K 20/2010 vp.). The general government fiscal plan procedure provides better tools for steering general government finances as a whole and for solving problems facing general government finances.

In its first General Government Fiscal Plan for the parliamentary term, the Government should set out its objectives for central government finances, local government finances and all aspects of general government finances. Each general government sector should have its own fiscal position objectives that support the achievement of the medium-term objective set for general government finances as a whole. The General Government Fiscal Plan should also lay out the measures for achieving these objectives. The achievement of the objectives is evaluated each spring in connec-

The National Audit Office has recommended the introduction of a steering system covering all aspects of general government finances

tion with the review of the General Government Fiscal Plan. The requires concrete measures and detailed effectiveness assessment.

Under the Fiscal Policy Act (869/2012), the Fiscal Compact and the legislation on economic policy steering, the National Audit Office evaluates the knowledge base, preparation and implementation of the General Government Fiscal Plan. In the fiscal policy evaluation performed by the National Audit Office, consideration is given to the preparation of the General Government Fiscal Plan in accordance with the relevant statutes, to ensuring that the plan conforms with the Fiscal Compact and the Stability and Growth Pact and to whether the General Government Fiscal Plan can help to achieve the stability and sustainability objectives laid out for general government finances. In fiscal policy evaluation, the National Audit Office also assesses the reliability of the official macroeconomic forecasts prepared by the Ministry of Finance that are used as the basis for the General Government Fiscal Plan.

The National Audit Office monitors the preparation and implementation of the general government fiscal plan

Central government finances

The central government spending limits are laid out in the General Government Fiscal Plan and they must be consistent with the fiscal position objective laid out for central government finances. This objective will be set for the first time in the first General Government Fiscal Plan for the 2016–2019 parliamentary term in autumn 2015. The spending limits decision made in spring 2015 is based on the spending limits for the parliamentary term, which has been revised for the period 2016–2019. In the revised decision, consideration has been given to the decisions made, price and structural adjustments and the economic forecast published in spring 2015. The spending limits decision provides a foundation for the discretionary measures during the 2015–2019 parliamentary term and thus it does not contain any new policies.

The fiscal balance objective for central government finances is laid out in the first general government fiscal plan for the parliamentary term

Local government finances

Macroeconomic steering of local government finances is done by means of the General Government Fiscal Plan. The section of the General Government Fiscal Plan covering local government finances contains a review of the state of local government finances and the effects of the measures taken by the state on local government finances. This review is supplemented by the local government finance programme. The matters concerning local government finances laid out in the *General Government Fiscal Plan for 2016–2019* are contained in the local government finance programme. The

technical local government finance programme does not lay out any fiscal position objective for local government finances or any euro limit to the changes in local government expenditure arising from state measures that would be consistent with the fiscal position objective. The new government will lay out these objectives in the first General Government Fiscal Plan for the parliamentary term in autumn 2015.

The purpose of the local government finance programme is to assess the state of local government finances and the way in which municipalities can cope with the task of organising basic services. Macroeconomic objectives, such as the objective for fiscal balance in local government finances are not directly binding on self-governing municipalities or joint municipal authorities. The financial management of these entities is steered by the Local Government Act. The stricter provisions concerning financial management laid down in the new local government act will, however, support the achievement of macroeconomic objectives at local government level. In its fiscal policy audit and evaluation report on the 2011–2014 parliamentary term (K 20/2014 vp.), the National Audit Office drew attention to the fact that the euro limit to the changes in local government expenditure arising from state measures is not enough to stabilise local government finances as the difficulties facing municipalities are the result of tasks assigned to them in earlier years. For this reason, the reduction in the number of local government tasks and obligations by one billion euros set out as a target in the structural policy programme for the 2011–2015 parliamentary term should be completed during the 2015–2019 parliamentary term.

The state of local government finances and adherence to the financing principle are assessed in the local government finance programme

Social security funds

The General Government Fiscal Plan for 2016–2019 also covers the social security funds, which in Finland are part of the public sector. The first General Government Fiscal Plan for the parliamentary term, which will be prepared in autumn 2015, will also lay out a fiscal position objective for social security funds. The objective will support the achievement of the structural deficit target set out for general government finances as a whole.

Finland's economic situation is more severe than what was forecast in late 2014 and in early 2015. One indication of this is the fact that in 2014 Finland was in breach of the three-per cent limit laid down for general government deficit in Article 126 of the Treaty on the Functioning of the European Union and Protocol (No 12) to the Treaty. Ministry of Finance, Bank of Finland and the European Commission were not able to predict this in their forecasts

Finland's economic situation is more severe than presented in the forecasts

published in late 2014. Breaching of the deficit rule was mainly the result of the growth in expenditure but the revenue has also been lower than expected. It should also be pointed out that the expenditure of the social security funds also increased. This means that the surplus of the social security funds has decreased. A surplus in social security funds has enabled Finland to adhere to the deficit rule in recent years.

Implementation of the structural policy programme introduced by the Government during the 2011–2015 parliamentary term would have facilitated the stabilisation of general government finances and supported compliance with EU rules. As reforms only have a long-term effect, implementing the programme at the end of the parliamentary term would not have made any difference to the observed deficit trends in 2014.

1.2 Objectives laid out in the Government Programme

In previous parliamentary terms, Government Programmes have focused on central government finances and the issues affecting general government finances as a whole have not been discussed in the document. The Government Programme of Prime Minister Juha Sipilä discusses general government finances from an overall perspective. 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.

Fiscal policy framework for 2015–2019 parliamentary term

Unlike the Government Programmes laid out in the two previous parliamentary terms, the programme of Prime Minister Juha Sipilä's Government does not state that the Government aims for faster than predicted growth. The National Audit Office takes positive note of this change. Instead, the figures presented in the Government Programme are based on the Ministry of Finance estimate of the general government sustainability gap, which in spring 2015 was five per cent of GDP or about 10 billion euros.

The sustainability gap indicates how much the general government fiscal position should improve so that general government debt can be kept under control. The estimate of the sustainability gap is a scenario calculation showing the impact of the existing expenditure and revenue structure on general government finances in a situation where no measures to adjust general government finances are taken. The estimates are on a long-term basis, and thus they are extremely sensitive to changes in background assumptions.

The calculation is particularly sensitive to changes in general government fiscal balance it uses as a basis. This means that when the downturn eases and medium-term economic prospects start to improve, the sustainability gap in general government finances is expected to narrow and, correspondingly, when the medium-term outlook worsens, the sustainability gap is expected to grow. For this reason, the National Audit Office emphasises that these calculations should be taken with reservations and instead of giving too much attention to individual score values, the focus should be on the factors behind the calculations. Especially the estimates concerning the trends in health care expenditure have a substantial impact

Fiscal policy framework is based on the estimate of the sustainability gap produced by the Ministry of Finance

Estimates concerning the sustainability gap involve a great deal of uncertainty

on these calculations. Trends in health care costs are affected by trends in the need for care and support and improvements in service productivity. The uncertainties concerning the calculations should also be clearly presented in the reporting on the estimates.

The latest estimates of the sustainability gap in Finland's general government finances vary between two and seven per cent. ETLA (Research Institute of the Finnish Economy) has produced the lowest estimate (2–2.5 per cent of GDP), while OECD has supplied the most pessimistic figure (7 per cent). There is, however, no disagreement about the existence of the sustainability gap among the forecasting bodies. The Ministry of Finance estimate of the sustainability of Finland's general government finances has been prepared in accordance with the methods and calculating principles jointly agreed in the EU, which are publicly available. For this reason, the National Audit Office is of the view that there are good grounds for using the Ministry of Finance's sustainability calculation in the assessment of the long-term adjustment need in general government finances.

The National Audit Office takes positive note of the fact that the setting of fiscal policy targets is now linked with the long-term prospects of general government finances. Preparing the Government Programme on the basis of short-term or medium-term outlook may lead to a failure as was seen during the 2011–2015 parliamentary term. In its fiscal policy audit and monitoring report on the 2011–2014 parliamentary term, which was presented in December 2014, the National Audit Office recommended that in the planning and setting of the framework of the fiscal policy for the 2015–2019 parliamentary term, consideration should be given to the long-term outlook of the Finnish economy and the structural factors affecting the economy (K 20/2014 vp.). Consideration should also be given to whether the measures could be timed so that they do not unnecessarily weaken the basis for economic growth.

The Government monitors the adequacy of the measures aimed at closing the sustainability gap of ten billion euros each year as part of its spending limits discussions and makes the decisions on any additional measures required. The National Audit Office takes positive note of the fact that the measures will have a long-term impact even though the Government plans to take the necessary decisions during the 2015–2019 parliamentary term. The fact that the estimate of the scale of the required measures is available at the start of the parliamentary term is also a positive development.

The short-term adjustment of four billion euros planned for the 2015–2019 parliamentary term will affect all areas of general government finances. A total of 3.3 billion euros of the adjust-

The National Audit Office takes a positive note of the fact that the Government Programme is linked with the long-term economic outlook

The National Audit Office takes positive note of the fact that the consolidation of general government finances extends beyond a single parliamentary term

ment is directed at expenditure and 0.7 billion at revenue. More extensive adjustment might have a negative impact on economic growth. During the 2011–2015 parliamentary term the net adjustment of central government expenditure alone amounted to about three billion euros. The National Audit Office takes positive note of the fact that the planned consolidation of general government finances by 10 billion euros will cover a sufficiently long period as it extends beyond one parliamentary term. This requires commitment to a long-term fiscal and economic policy, which will pose new challenges to fiscal policy decision-making, in which the focus has until now been on parliamentary terms.

In its programme, the Government pledges to keep the total tax rate unchanged during the current parliamentary term. According to the forecasts made in spring 2015, Finland's tax-to-GDP ratio during the 2015–2019 parliamentary term will remain at about 44 per cent if the tax basis remains unchanged. Even though, in international comparisons, Finland's tax rate is fairly high there is no evidence that increases in some types of tax would not lead to a reduction in tax revenue. Only weak economic growth is forecast for the 2015–2019 parliamentary term, which means that economic growth will not help to reduce the tax rate and, consequently, provide room for tax increases in relation to what is stated in the Government Programme. Correspondingly, a decrease in GDP would mean that taxes should be lowered so that the tax rate would remain unchanged.

It is important to note that what is laid out in the Government Programme does not prevent improvements in the tax system. By committing itself to the objective, the Government would also be able to make changes in the tax structure. In the view of the National Audit Office, it would be important to develop the tax system as a whole. There was no simplification of the Finnish tax system during the 2011–2015 parliamentary term and no systematic consideration was given to the tax system as a whole in the changes to the tax basis. In the view of the National Audit Office, it is especially important to take a critical view of the use of tax subsidies. Assessing tax subsidies is also important in the efforts to reduce the number of tax subsidies as they complicate the tax system and may result in inefficiency.

The Government has laid out an ambitious timetable for improving Finland's competitiveness and aims to achieve its goal with a social contract that would result in lower unit labour costs. A social contract or a similar labour market solution improving cost competitiveness, flexibility of the labour market and quality of working life would provide a stronger basis for economic growth,

It is important to develop the tax system on an overall basis

A social contract would provide a stronger basis for economic growth, employment and stabilisation of general government finances

employment and stabilisation of general government finances. According to the Government Programme, if there is no social contract, additional adjustment totalling 1.5 billion euros will be introduced during the 2015–2019 parliamentary term. In that case the short-term adjustment measures to be introduced during the parliamentary term would be in a substantially larger scale. In the view of the National Audit Office, the short-term adjustment amounting to nearly six billion euros is substantial. The adjustment measures could slow down economic growth more than different parties have estimated in their effectiveness assessments if the fiscal policy multipliers are higher than those presented in the calculations. No estimates of the fiscal policy multipliers applicable to Finland have been published in recent years.

Moreover, short-term adjustment measures would not solve the structural problems facing the Finnish economy. In the view of the National Audit Office, the emphasis should be on structural reforms. In its latest survey of Finland, OECD also highlights the need for structural reforms (OECD Economic Surveys, Finland, February 2014).

Structural reforms

The Finnish economy is in need of wide-ranging structural reforms. In addition to short-term adjustment measures, the Government also intends to introduce structural reforms that would consolidate general government finances by four billion euros. This includes the social welfare and health care (SOTE) reform (three billion euros) and the reduction in the number of local government tasks and obligations steering the implementation of the tasks by one billion euros. In the 2011–2015 parliamentary term, the measures were introduced too late and the implementation process was extremely slow. As a result, the Government ran out of time.

The 19 SOTE areas proposed in the Government Programme would seem to be too high a number for ensuring the consolidation of general government finances by three billion euros. Moreover, cost savings of three billion euros will not be achieved through organisational overhaul alone. Sufficiently radical overhaul of the multichannel funding system is an absolute prerequisite for achieving the targeted savings of three billion euros. Achieving the target is not impossible but it requires that the reform is planned and implemented so that costs can be kept under control in the long term.

The Government failed in its attempts to reduce the number of local government tasks and obligations in the 2011–2015 parliamentary term. Under the Government Programme, the proposals prepared in the ministries concerning the reduction in the number of the tasks must be detailed and justified, and must contain

Consolidating general government finances by three billion euros with the help of a SOTE reform is an ambitious target

Giving structural reforms concrete shape and conducting detailed effectiveness assessments are important so that the reforms can be put into effect

the concrete measures necessary to ensure that the expected economic effects. This will help to ensure that the estimated economic impacts can be achieved. Under the Government Programme, before legislative proposals are submitted and implemented the effects on the sustainability gap sought with the reforms should be assessed. The Government has pledged to prepare an action plan detailing the tasks and obligations to be abolished by the budget session in autumn 2015. The Government will also present first concrete proposals in the autumn.

It is important to give the measures concrete shape so that their impact on the sustainability gap can be assessed and monitored. Even though the objectives of the structural policy programme laid out during the 2011–2015 parliamentary term were sound it proved difficult to transform them into sufficiently concrete measures that would have allowed the achievement of the objectives. It is important to focus on giving the measures concrete shape and on conducting detailed effectiveness assessments as in earlier years the process of assessing the effects of the reforms in local government finances has been difficult and the results of the work inadequate.

Under the Government Programme there will not be any new local government tasks in the 2015–2019 parliamentary period. The act under which all new local government tasks will be financed by the state in full by means of central government transfers will remain in force. If there are any cuts in these central government transfers, the Government will reduce local government tasks in the same proportion. The National Audit Office takes positive note of this decision.

The National Audit Office would like to draw attention to the low level of investments. Growth in capital base has a significant impact on the growth potential of the economy. For this reason, it is important to draw attention to the slowdown in investments resulting from the economic downturn and changes in the economic structure. There are general references to promoting investments in the Government Programme. In order to strengthen the growth potential of the economy, Finland should introduce structural reforms that improve overall productivity and more efficient allocation of resources in the market. These include reforms increasing the mobility of the workforce and its expertise and reforms that help to allocate resources to new and more efficient areas. Measures promoting efficient use of ICT and innovations in different sectors are also important factors contributing to higher productivity.

Municipalities will not be given new tasks during the current parliamentary term

Government's spending limits rule

The Government undertakes 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.

The spending limits rule of Prime Minister Juha Sipilä's Government is largely similar to the spending limits rules of the previous Governments. The National Audit Office would, however, like to draw attention to a number of details.

Unlike in previous 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 similar impact on general government finances. In the opinion of the National Audit Office, the use of tax subsidies should be viewed critically and they should be avoided. The number of tax subsidies should also be reduced so that the tax system can be simplified.

In its report *Talouspolitiikan lähtökohdat 2015–2019*, the Ministry of Finance proposes a tax rule for the spending limits system. Together with the fiscal position target for central government finances, the tax rule would have provided a consistent basis for discretionary tax changes during the government term. The tax rule would have included tax subsidies.

In the opinion of the National Audit Office, a tax rule covering tax subsidies would have provided a good basis for developing the spending limits system. The National Audit Office is of the view that the rule would have made tax subsidies less attractive. Even though there has been a reduction in the number of tax subsidies in recent years they are still numerous. A total of 188 different tax subsidies were identified in 2014. About one third of all tax subsidies cannot be calculated in euro terms. To the extent that the tax subsidies can be calculated, they totalled about 24 billion euros in 2014. Tax subsidies make the tax system complicated and can result in inefficiency. For this reason a detailed assessment of the effectiveness of the tax subsidies is necessary as this would make it easier to reduce the number of tax subsidies.

It is also noteworthy that in its spending limits rule, the Government undertakes to implement the savings and decisions necessary to cover the entire sustainability gap of ten billion euros during the government term. The effectiveness of the short-term

There is no mention of the avoidance of the use of tax subsidies in the Government's spending limits rule

The tax rule would have provided a useful instrument in the development of the spending limits system

savings and structural reforms will be monitored annually as part of the spending limits discussion. This requires concrete decisions so that their impacts on the sustainability gap can be assessed. 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 on the basis of the principles of good statute drafting. This would help to ensure that the decisions will be made during the current parliamentary term.

In the Government's spending limits rule, off-budget funds are not included in the spending limits and budgetary framework. The National Audit Office has recommended that the expenditure paid from off-budget funds should be included in the spending limits rule (K 21/2010 vp. and K 2/2013 vp.). In its report *Valtiontalouden kehysjärjestelmän kehittäminen vaalikaudelle 2015–2019*, the Ministry of Finance also recommends that the expenditure paid from off-budget funds should be included in the spending limits (VM 23/2015).

Government has not included off-budget funds in its spending limits

2 Compliance with Government spending limits

According to the observations made by the National Audit Office as part of fiscal policy monitoring, the expenditure within central government spending limits in the final budget remained about 34 million below the 2014 spending limits. Thus, the estimate presented in the Government's annual report for 2014 that the actual spending was about 34 million euros below the spending limits can be considered correct. According to the Government Programme, a total of 34 million euros can be carried over to 2015, notwithstanding the spending limits rule.

In Finland, central government spending limits are in real terms and for this reason price and structural adjustments are made to them during the parliamentary term. This makes the spending limits system opaque and it is difficult for outsiders to monitor the implementation of the spending limits rule. For this reason, the National Audit Office has evaluated compliance with the spending limits on an annual basis.

According to the observations of the National Audit Office, the structural adjustments made as part of the spending limits preparations in 2014 were in accordance with the principles governing the spending limits procedure. Furthermore, the spending limits decisions and the General Strategy and Outlook also provide adequate details of the grounds for structural adjustments and the manner in which they are allocated to individual items. More than half of all price and cost level adjustments made to the spending limits in the spending limits preparations in 2014 were of statutory nature.

According to the observations of the National Audit Office, the spending limits expenditure which the savings concerned has not been specified in the spending limits decisions for 2013–2016 or 2014–2017. From the perspective of a transparent spending limits procedure, the savings in framework spending corresponding to the lowering of the spending limits should be on a item-specific basis.

The National Audit Office would like to draw attention to the fact that the 2015 spending limits were prepared on the basis of a strict budgetary framework. Adherence to the framework seems to be more difficult in the preparations of the 2015 spending limits than in the previous years. Adherence to the 2015 spending limits involves procedures that are different from the procedures observed in earlier years. The unallocated reserve for the year 2015 laid out in the *General Government Fiscal Plan for 2015–2018* was

Central government spending limits were not exceeded in 2014

The 2015 spending limits were prepared on the basis of a strict budgetary framework

negative. This was because the structural adjustment including the revenue from the sales of shares had not been carried out simultaneously with the budgeting of supplementary expenditure but as part of the next stage of the budget preparation process. In order to ensure a transparent spending limits procedure, spending limits adjustments and the budgeting of appropriations associated with them should be carried out symmetrically in the same stage of the budget preparation process.

In the structural adjustment made as part of the preparation of the 2015 state budget, the renovation grants, which had previously been included in the spending limits expenditure, were transferred to the State Housing Fund and the spending limits were lowered by 25 million euros. As the renovation grants are no longer included in the spending limits, they can be increased notwithstanding the spending limits. The National Audit Office is of the view that including the State Housing Fund in the spending limits would be desirable from the perspective of adherence to the limits.

The budget expenditure is 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. Expenditure outside the spending limits has, however, remained stable despite the economic downturn. At the same time, however, the financial investments, which are considered expenditure outside the spending limits, have remained at high level since 2009. The National Audit Office would like to draw attention to the fact that in the preparation of the 2015 spending limits, financial investments have been used for expenditure resembling grants. The Government should refrain from this.

Expenditure outside the spending limits has remained stable despite the economic downturn.

2.1 Assessing compliance with central government spending limits

In the National Audit Office, responsibility for monitoring compliance with the spending limits is the responsibility of the Performance Audit and Fiscal Policy Audit Department. Assessment of the spending limits calculations include the repetition of the calculation of the spending limits and the unallocated reserve at different stages of the budget preparation process. In order to ensure adherence to spending limits, the final spending limits of each year are also compared with the budget outturn statement. Openness and transparency of the reporting on compliance with the spending limits and adherence to them are used as the assessment criteria.

The National Audit Office has used spending limits decisions, budget proposals and the budgets as well as the material used in the preparation of the documents, and the outturn statement of the final central government accounts in its calculations. The last spending limits decision concerning the 2015 spending limits is included in the *general government fiscal plan for 2015–2018*. The preparation material supplied to the National Audit Office by the Ministry of Finance includes the breakdown of the budget appropriations into spending limits expenditure and the expenditure outside the spending limits and a description of the price and structural adjustments made to the spending limits in each stage of the budget preparation process.

The correctness of the price adjustments made to the spending limits is verified by allocating price adjustments to main titles and, if possible, to items. The justification of the structural adjustments made to the spending limits are compared with the Government Programme of Prime Minister Jyrki Katainen's Government and the principles governing the spending limits procedure laid out in the Ministry of Finance's manual on spending limits procedure.

The calculation of the 2014 and 2015 spending limits included in this report extends from the first spending limits decision of Prime Minister Jyrki Katainen's Government (*Tarkistetut valtiontalouden kehykset vuosille 2012–2015*) to the final 2014 budget and, for the year 2015, the first supplementary budget finalised on 24 February 2015.

One purpose of fiscal policy evaluation is to assess adherence to central government spending limits

2.2 Calculating the 2014 spending limits

According to the observations made by the National Audit Office as part of fiscal policy monitoring, the expenditure within central government spending limits in the final 2014 budget remained about 34 million euros below the 2014 spending limits. Thus, the estimate presented in the Government's annual report for 2014 that the actual spending was about 34 million euros below the spending limits can be considered correct. According to the Government Programme, a total of 34 million euros can be carried over to 2015, notwithstanding the spending limits rule.

The National Audit Office has also compared the 2014 spending limits with the outturn detailed in the final accounts. The spending limits rule does not restrict expenditure under the final accounts. By making the comparison between final accounts, the National Audit Office has endeavoured to verify the fundamental purpose of the expenditure benchmark contained in the spending limits, i.e. the successful curbing of central government expenditure. According to the budgetary outturn statement for 2014, appropriations were 611.9 million euros under the budget. According to the calculations of the National Audit Office, spending limits expenditure accounted for 432.4 million euros and expenditure outside the spending limits for 179.6 million of this total, indicating that the budgetary framework had also been complied with in terms of budgetary outturn.

According to the observations of the National Audit Office, the adjustments made to the 2014 spending limits are, in essential parts, in accordance with the principles governing the spending limits procedure. The grounds for the adjustments in the 2014 spending limits have been examined from the first spending limits decision of the 2011–2014 parliamentary term (*Valtiontalouden tarkistettujen kehykset vuosille 2012–2015*).

In euro terms, the largest increase (about two billion euros) to the 2014 spending limits was made on 5 October 2011, at the start of the parliamentary term as part of the first spending limits decision of the Government of Prime Minister Jyrki Katainen, which covered the period 2012–2015. Most of the change was the result of the transfer of the item 33.40.60 (state share of the expenditure arising from the National Pensions Act and other acts) from outside the spending limits into the spending limits. This move increased spending limits expenditure by about three billion euros.

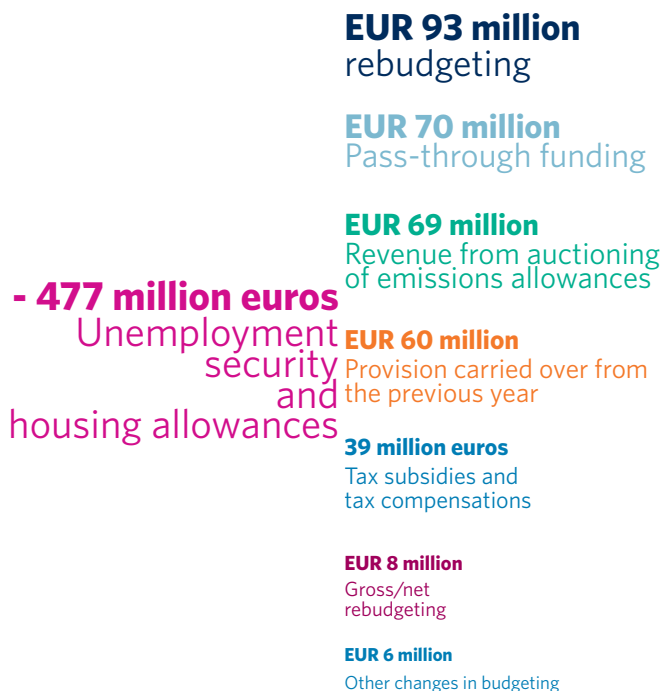
In 2014, spending was 34 million euros below the limits

The adjustments made to the spending limits are in accordance with the principles governing the spending limits system

In its Government Programme, the Government also agreed to increase spending by about 600 million euros. Increases in spending limits were offset by spending cuts of about two billion euros.

The Government made structural adjustments to the 2014 spending limits as part of its spending limits decisions and as part of the preparation of the 2014 budget proposal, amendment to the budget proposal and the first and third supplementary budget proposal. Structural adjustments to the 2014 spending limits were also made as part of the preparation of the 2012 and 2013 budgets and the preparation of the *general government fiscal plan for 2015–2018* and the 2015 budget.

The structural adjustments made to the 2014 spending limits reduced framework spending by a total of 131.5 million euros from the first spending limits decision of the parliamentary term. According to the calculations of the National Audit Office, structural adjustments reducing framework spending totalled about 0.6 billion euros, while adjustments increasing framework spending totalled about 0.5 billion euros. Most of the structural adjustments reducing framework spending were the result of the fact that in framework spending consideration was given to the changes in the justification concerning the items covering unemployment security and housing allowance outside the spending limits. At the same time, structural adjustments increasing framework spending were made on the basis of rebudgeting of appropriations, budgeting of supplementary expenditure in accordance with the share of off-budget funding providers and the channelling of the revenue generated by auctioning of emissions allowances to development cooperation projects. Structural adjustments also included the use of an unallocated reserve of 60 million euros carried over from the previous year to non-recurring projects. Figure 1 presents the justification of structural adjustments to the spending framework in the 2014 spending limits.



Effect of structural changes on spending framework -131 million euros

Source: *Spending limits decisions 2012–2015, 2013–2016 and 2014–2017 and 2014 budget proposals and supplementary budget proposals.*

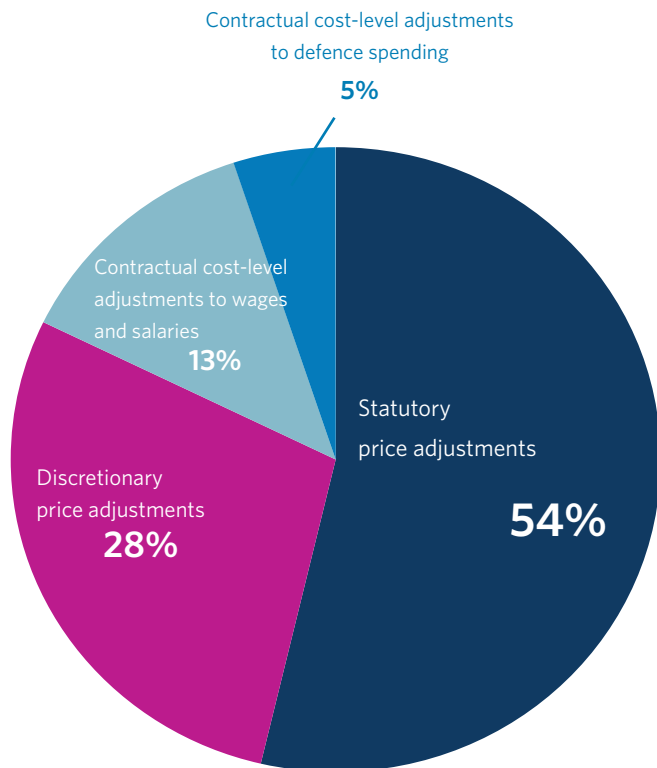
Figure 1: Justification of structural adjustments to the 2014 spending limits, breakdown in euros

According to the observations of the National Audit Office, structural adjustments had been made in accordance with the principles governing the spending limits procedure. Furthermore, the spending limits decisions and the General Strategy and Outlook also provide adequate details of the grounds for structural adjustments and the manner in which they are allocated to individual items.

The biggest price and cost level adjustment to the 2014 spending limits was made as part of the changeover to the 2013 price level in the spending limits decision for the period 2013–2016. The second biggest price adjustment (about 0.7 billion) was made as part of the changeover to the 2014 price level in the spending limits decision for the period 2014–2017. The increase of the cost level to the 2014 price level was adjusted in accordance with the new price forecasts as part of the preparation of the 2014 budget. More than half of all price and cost level adjustments (about 0.8 billion euros) were statutory price adjustments. During the preparation of the 2014 spending limits, statutory index increases were frozen in the administrative branch of the Ministry of Education and Cul-

The largest price and cost level adjustments were made as part of the changeover to 2013 price levels

ture, central government transfers to local government, state funding of universities' operations and child allowances. Corresponding sums were deducted from yearly price adjustments.



Source: Spending limits decisions 2012–2015, 2013–2016 and 2014–2017 and 2014 budget proposals and supplementary budget proposals.

Figure 2: Breakdown of price adjustments in the 2014 spending limits

As part of the preparations of the 2013–2016 and 2014–2017 spending limits decisions, the Government lowered the 2014 framework spending by about 0.7 billion euros. Lowering of the framework spending (unlike increasing it) is possible during a parliamentary term without weakening the credibility of the spending limits. In the justification of the discretionary decision to lower the framework spending, it is stated that the overall budgetary framework will be lowered in accordance with the savings in framework spending. According to the observations of the National Audit Office, the framework spending in which the savings were made was not specified in the spending limits decisions for the periods 2013–2016 and 2014–2017. From the perspective of a transparent spending limits procedure, the savings in framework spending corresponding to the lowering of the spending limits should be on a item-specific basis.

2.3 Calculating the 2015 spending limits

Adherence to the 2015 spending limits has been monitored up to the first supplementary budget finalised on 24 February 2015. The period extending from the *general government fiscal plan for 2015–2018* to the adherence to the 2015 spending framework involves procedures that differ from the procedures observed earlier during the 2011–2014 parliamentary term. Adherence to the spending limits seems to have been more difficult in 2015 than in the previous years.

The fact that the unallocated reserve became negative during the preparation of the *general government fiscal plan for 2015–2018* and the use of the revenue from the sales of shares for covering supplementary expenditure are two examples of the deviations from previous practices. As stated in the National Audit Office’s fiscal policy audit and monitoring report on the 2011–2014 parliamentary term, the unallocated reserve was negative because the Government decided to use 150 million euros of revenue from the sales of shares for funding the growth package. From the perspective of the calculation of the spending limits, the problem was that the structural adjustment increasing the spending framework that would have included the revenue from the sale of shares had not been carried out simultaneously with the budgeting of supplementary expenditure but only during the next stage of the budget preparation process. In order to ensure a transparent spending limits procedure, spending limits adjustments and the budgeting of appropriations associated with them should be carried out symmetrically in the same stage of the budget preparation process.

In its fiscal policy audit and monitoring report on the 2011–2014 parliamentary term, the National Audit Office expressed the view that the Ministry of Finance interprets the spending limits rule in a flexible manner when it considers the sales of Sampo shares as sales of state-owned shares even though it is Solidium Oy that is selling the shares. The National Audit Office also concluded that the spending limits system should have clear rules for handling the assets held by the state in companies and the items of the companies. The National Audit Office also draws attention to the fact that the transfer of revenue from Solidium involves risks from the perspective of the development and maintenance of balance sheet assets considered as national wealth. Excessive transfers of revenue are not appropriate from the economic perspective (Audit report of the National Audit Office 6/2015).

Adherence to spending limits has been more difficult in 2015

In its publication *Valtiontalouden kehysjärjestelmän kehittäminen vaalikaudelle 2015–2018*, the Ministry of Finance states that the rule concerning the revenue from the sale of shares is outdated as a result of the weakening of the central government finances. In fact, the rule was not longer included in the spending limits rule of the Government Programme of Prime Minister Juha Sipilä's Government. The National Audit Office takes positive note of this decision.

According to the observations of the National Audit Office, the use of the unallocated reserve carried over from 2014 had not been itemised in the justification of structural adjustments to the 2015 supplementary budget proposal. According to the justification of the structural adjustments, the unallocated reserve carried over from the previous year is used for non-recurring expenditure. If the item breakdown is not given, it is not possible to verify the non-recurring character of the expenditure. The itemised breakdown of the unallocated reserve that is carried over from 2013 to 2014 was detailed in the 2014 supplementary budget.

In the structural adjustment made as part of the preparation of the 2015 state budget, the renovation grants, which had previously been included in the spending limits expenditure, were transferred to the State Housing Fund and the spending limits were lowered by 25 million euros. As the renovation grants are not longer included in the spending limits, they can be increased notwithstanding the spending limits. The National Audit Office is of the view that including the State Housing Fund in the spending limits would be desirable from the perspective of adherence to the limits. The National Audit Office has already recommended that the expenditure paid from off-budget funds should be included in the spending limits rule (K 2/2013 vp.). In its report *Valtiontalouden kehysjärjestelmän kehittäminen vaalikaudelle 2015–2019*, the Ministry of Finance also recommends that the expenditure paid from the funds should be included in the spending limits (VM 23/2015). However, this recommendation has not been considered in the spending limits rule of Prime Minister Juha Sipilä's Government.

In the first supplementary budget for 2015, spending framework was increased by 19.1 million euros, which corresponded to the revenue generated by auctioning of emissions allowances. According to the justification of the structural adjustments, corresponding expenditure was budgeted for development cooperation projects on item 24.30.66 (development cooperation). The explanation and context of item 24.30.66 shows that as the appropriations on the item were increased by 19.1 million euros, they were also cut by about 15 million euros with a one-off savings decision. However, as the spending framework was not reduced in accord-

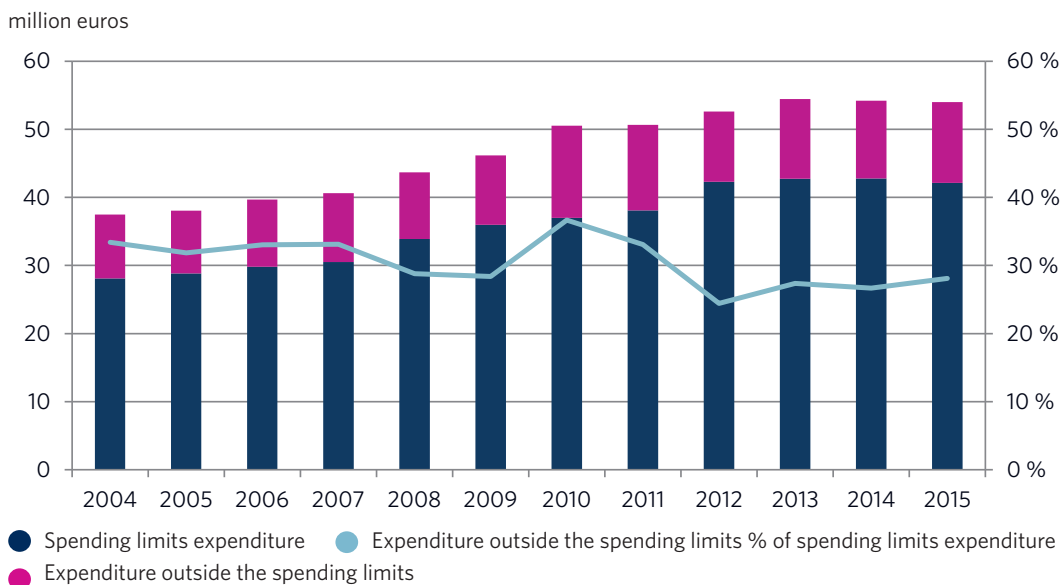
National Audit Office takes positive note of the fact that the rule governing the sale of shares is not included in the Government's spending limits rule

The National Audit Office is of the view that including the State Housing Fund in the spending limits would be desirable from the perspective of adherence to the limits

ance with the cuts in it, the Government was able to increase other appropriations under the spending limits with the same amount in the supplementary budget. Thus, the overall impression given by this procedure is that the revenue from auctioning of emissions allowances was allocated to expenditure other than development cooperation in a manner that was contrary to what had been laid out in the Government Programme. In the first and third supplementary budgets for 2014, the revenue from auctioning of emissions allowances was budgeted as development cooperation expenditure in a clearer manner.

2.4 Expenditure outside spending limits

The budget expenditure is 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 changes 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. Expenditure corresponding the revenue from the EU and the revenue generated by the national lottery are examples of such expenditure. The budget also contains VAT revenue offsetting the VAT expenditure outside the spending limits. Such items classified as expenditure outside the spending limits totalled about 3.5 billion euros in 2014 and about 3.4 billion euros in 2015. Figure 3 shows the trends in spending limits expenditure and expenditure outside the spending limits between 2004 and 2015.



Source: Budget proposals.

Figure 3: Spending limits expenditure and expenditure outside the spending limits between 2004 and 2015

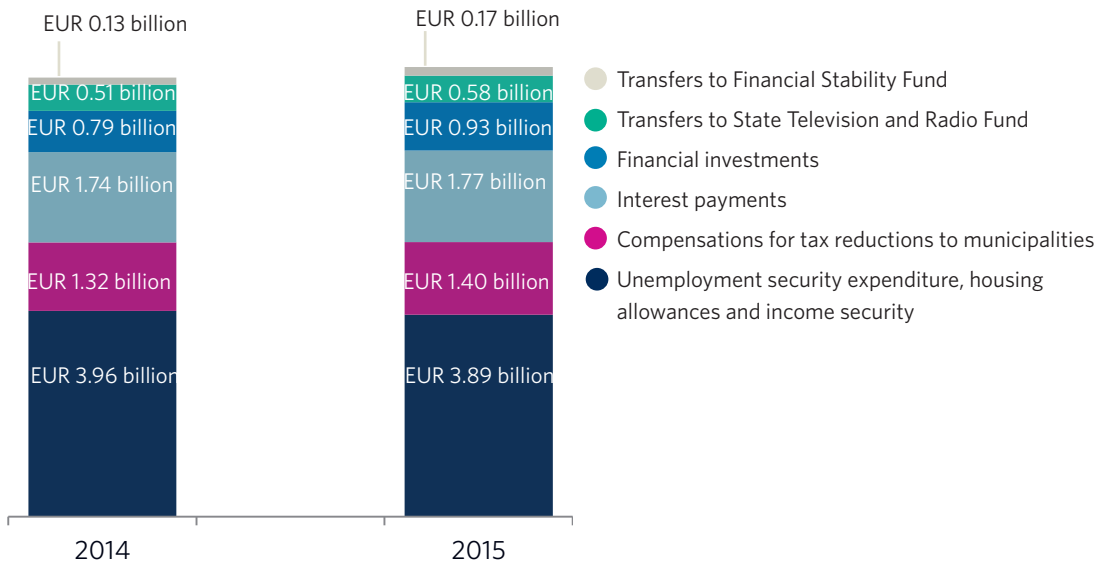
The biggest expenditure items outside spending limits (about 3.9 billion euros each year) are unemployment security, housing allowance and income security. This expenditure functions as what is called automatic stabiliser, which means that it is expected to increase in a downturn and decrease during a period of economic growth. As a result of a rising unemployment rate, the unemployment security expenditure outside the spending limits has continued to increase in 2014 and 2015. This expenditure has also been subject to discretionary changes during the parliamentary term as a result of which it is difficult to compare their overall levels with the situation in earlier years.

Other important expenditure items outside the spending limits are debt interest payments, compensations to municipalities arising from tax cuts and financial investments. Interest on central government debt has remained unusually low, which has reduced interest payments even though central government debt has increased. Reduction in interest payments has helped to keep the overall expenditure outside the spending limits more or less unchanged. In spring 2015, the credit rating agencies that have provided the long-term loans of the State of Finland with top rating have changed the outlook for Finland into negative, which may also have an impact on interest payments.

Compensations paid to municipalities for tax cuts have remained at high levels in 2014 and 2015. Central government transfers to local government paid as compensations for lost tax revenue increased as a result of higher earned income tax credits, basic deductions and household deductions, elimination of the deductibility of student loan interest, restrictions in the deductibility of housing loan interest and the deductions for families with children.

Unemployment security is the biggest expenditure item outside the spending limits

Expenditure outside the spending limits has remained stable despite the economic downturn - this is partially due to a reduction in interest payments



Source: Budget proposals, amendments to the budget proposals and supplementary budget proposals 2014 and 2015.

Figure 4: Biggest expenditure items outside the spending limits in 2014 and 2015.

Financial investment expenditure mostly consists of one-off loans and other financial investments. Most financial investments are expected to retain their value. The financial investments made in 2014 and 2015 totalled between 700 and 900 million euros each year, which means that financial investments have remained at high level since 2009. As the investments have remained at high level for many years, it is important to make careful assessments of whether the investments will retain their value or do they include expenditure that could be categorised as state aid.

In the 2014 supplementary budgets, it was decided to make inputs into the submarine optical fibre cable from Finland to Germany and allocate additional funding for capital investments of Finnish Industry Investment Ltd and Tekes-managed research and innovation loans. Such expenditure is normally categorised as financial investments. At the same time, however, a total of 97 million euros was allocated in the 2015 budget for the establishment of Terrafame Oy as financial investment. The purpose of the investment is to ensure that the company can take part in the corporate, ownership and contractual arrangements involving the Talvivaara mine. If no party is interested in continuing mining operations in

Financial investments have remained at high level since 2009

Talvivaara, Terrafame Oy can wind down the mining operations at the site. It is stated in the report *Kehysjärjestelmän kehittäminen* (VM 17/2011) that the use of financial investment expenditure should not be expanded to cover spending with the character of grants, by for example, capitalising loss-making companies or companies winding down their capital base in a systematic manner.

It seems that the funding outside the spending limits given to Terrafame Oy is also intended to be used as grants. The National Audit Office would like to draw attention to the fact that some of the additional expenditure arising from the bankruptcy of Talvivaara Sotkamo Oy has also been budgeted as spending limits expenditure, which may make it more difficult to estimate the total expenditure incurred by the state as a result of the bankruptcy. A total of 150 million euros has been separately allocated for preventing environmental damage as spending limits expenditure. It is estimated that this amount will secure the continuation of the work aimed at preventing environmental damage until autumn 2015.

In the second supplementary budget for 2015, expenditure pertaining to Terrafame Oy has, however, been treated as spending limits expenditure.

The use of financial investment expenditure should not be expanded to cover grant-type expenditure

3 Compliance with the Stability and Growth Pact

The National Audit Office has concluded that Finland was in compliance with the Stability and Growth Pact in 2014. The National Audit Office has prepared an assessment of compliance with the preventive arm of the Stability and Growth Pact on the basis of an overall assessment. The preventive arm covers the assessment of the achievement of the medium-term objective and assessment of compliance with the expenditure benchmark.

Finland is in breach of the medium-term objective laid out in the preventive arm of the Stability and Growth Pact. According to the information supplied by the Ministry of Finance, Finland's general government structural deficit reached 1.4 per cent of the gross domestic product in 2014. This means that the structural deficit has grown by 0.6 percentage points from 2013, which means that the deviation from the required level is significant. At the same time, total general government expenditure grew substantially more slowly in 2014 than the reference growth rate set by the expenditure benchmark.

Based on an overall assessment, the view of the National Audit Office is that Finland was in compliance with the preventive arm in 2014. This conclusion is based on the fact that Finland was in compliance with the expenditure benchmark pillar with a clear margin, despite the existence of a significant deviation in the structural balance pillar. According to the assessment of the National Audit Office, growth in the structural deficit may be the result of the lower than expected tax revenue and a growth in cyclical unemployment expenditure. The National Audit Office is of the view that compliance with the preventive arm is due to the moderate growth in total expenditure.

The National Audit Office has also assessed compliance with the corrective arm of the Stability and Growth Pact. Based on the statistical data published in spring 2015, Finland was in breach of the deficit criterion because according to the information published at the end of March, the deficit is 3.2 per cent of the gross domestic product, General government debt to GDP ratio reached 59.3 per cent in 2014, which means that Finland was in compliance with the debt criterion. However, compliance with the corrective arm is also assessed on the basis of forecasts, according to which general government debt will exceed the limit set for it in 2015 and will remain over 60 per cent in 2016 and 2017. The National Audit Office

is of the view that in 2015, the situation can be justified with solidarity transfers to other EU Member States. However, forecasts indicate that Finland will be in breach of the debt criterion in 2016.

In the view of the National Audit Office, it is not yet necessary to initiate excessive deficit procedure for Finland as we are only slightly in excess of the nominal deficit. The effects of the measures laid out in the new Government Programme should only be assessed in autumn 2015 when the Government decides on the first general government fiscal plan for the parliamentary term. For this reason it is too early to assess whether the excess will be of temporary nature. It should also be noted that Finland was in compliance with the debt criterion in 2014. Moreover, according to the assessment made by the European Commission in June 2015, there is no need to initiate excessive deficit procedure. This means that Finland is still in the preventive arm of the Stability and Growth Pact. The Commission will produce its next assessment of the situation in autumn 2015 in connection with Finland's preliminary budget plan.

It should be noted that even though Finland is in compliance with the preventive arm of the Stability and Growth Pact, it will soon be in breach of the criteria laid down in the corrective arm. For this reason, the National Audit Office would like to draw attention to the functioning of the preventive arm of the Stability and Growth Pact in a prolonged downturn. The flexibility elements of the preventive arm, in which consideration is given to such factors as economic circumstances and structural reforms, are useful instruments for ensuring that it will not become necessary to introduce strong economic adjustment measures in a downturn. As a result, Finland will soon be in a situation where compliance with the preventive arm will not provide us with sufficient margin for the criteria laid down in the corrective arm.

3.1 Assessing compliance with the Stability and Growth Pact

In this fiscal policy evaluation report, the National Audit Office assesses compliance with the provisions of the Stability and Growth Pact. Some of the provisions of the Stability and Growth Pact have also been incorporated into Finnish legislation on the basis of the Fiscal Policy Act (869/2012), which entered into force in early 2013.¹ The National Audit Office assesses compliance with the Stability and Growth Pact on the basis of the calculations and forecasts produced by the Ministry of Finance that the ministry has presented in its General Government Fiscal Plan for 2016–2019, which contains the stability programme submitted to the European Commission. The National Audit Office has independently verified the calculations of the structural balance, which is part of the preventive arm of the Stability and Growth Pact, on the basis of the Ministry of Finance information and the forecast presented by the Commission in spring 2015. The National Audit Office has also, on the basis of the stability programme supplied by the Ministry of Finance, calculated total general government expenditure in accordance with the expenditure benchmark of the preventive arm. The National Audit Office states that most of the calculations of the Ministry of Finance concerning the structural balance have been made in a correct and reliable manner. The National Audit Office would like to draw attention to the fact that the Ministry of Finance should have its own internal quality assurance procedures for its calculations.

The figures presented by the National Audit Office in this report may differ from those presented by the Ministry of Finance in its General Government Fiscal Plan because the ministry's calculations are based on its own forecast. However, most of the differences are so insignificant that they are not considered in this report. The interpretation of the rules of the Stability and Growth Pact and the calculation of the preventive arm is mainly based on the interpretations presented in the report *Vade mecum on Stability and Growth Pact* (European Commission, 2013).² Even though the report is not a legally binding document, it contains Commission's interpretations of the application of the Stability and Growth Pact. The National Audit Office also bases its interpretations on other memoranda published by the European Commission³ and the interpretations of the Commission's assessment reports on Finland, the latest of which is the updated assessment of Finland's stability programme for 2015 (published on 10 June 2015). The Nation-

al Audit Office is an independent fiscal policy evaluation body and for this reason the interpretations of the European Commission are not legally binding on the National Audit Office. The National Audit Office evaluates the Commission's interpretations of the legal norms of the Stability and Growth Pact and the application of the pact and, if it does not consider Commission's approach appropriate or applicable for Finland, states the reasons for its view.

3.2 Assessing the preventive arm

The preventive arm of the Stability and Growth Pact consists of two pillars: 1) medium-term objective, which is set on the basis of structural balance and the 2) expenditure benchmark, which sets out the growth rate for total general government expenditure. Assessment of the compliance with the rules consists of three stages:

- 1 Achievement of the medium-term objective or remaining on a path leading to its achievement at an adequate rate of progress
- 2 Compliance with the expenditure benchmark.
- 3 Overall assessment of compliance with points 1 and 2.

Medium-term objective and structural balance

The first pillar of the preventive arm is the achievement of the medium-term objective. The medium-objective is set on the basis of the structural balance. The structural balance reflects the difference between revenue and expenditure for the entire public sector (central and local government and social security funds) in proportion to the gross domestic product, when the effects of fluctuations in the economy and one-off and temporary measures are eliminated from the nominal balance. Using the nominal fiscal position as a fiscal policy indicator ignores the impacts of automatic stabilisers on public sector revenue and expenditure. Examining the nominal balance without the impact of economic cycles gives a picture of the public sector fiscal balance in a situation where cyclical changes are eliminated as a factor impacting general government revenue and expenditure. Thus the purpose of the structural balance is to function as an indicator in discretionary fiscal policy.

The medium-term objective is always set for three years at a time. The medium-term objective for Finland has been set so that the structural deficit may not exceed 0.5 per cent of the gross domestic product. Determining whether the Member State has achieved the medium-term objective is the first stage in the assessment of the achievement of the objective. If the Member State has failed to achieve the medium-term objective (the structural deficit exceeds the targeted level) the change in the structural balance is examined. The structural balance should be in the process of changing so that the Member State is on an adjustment path towards the medium-term objective.

The extent of the required change is influenced by economic circumstances, general government debt, the sustainability of general government finances and structural reforms. If the Member

Setting medium-term objective on the basis of structural balance

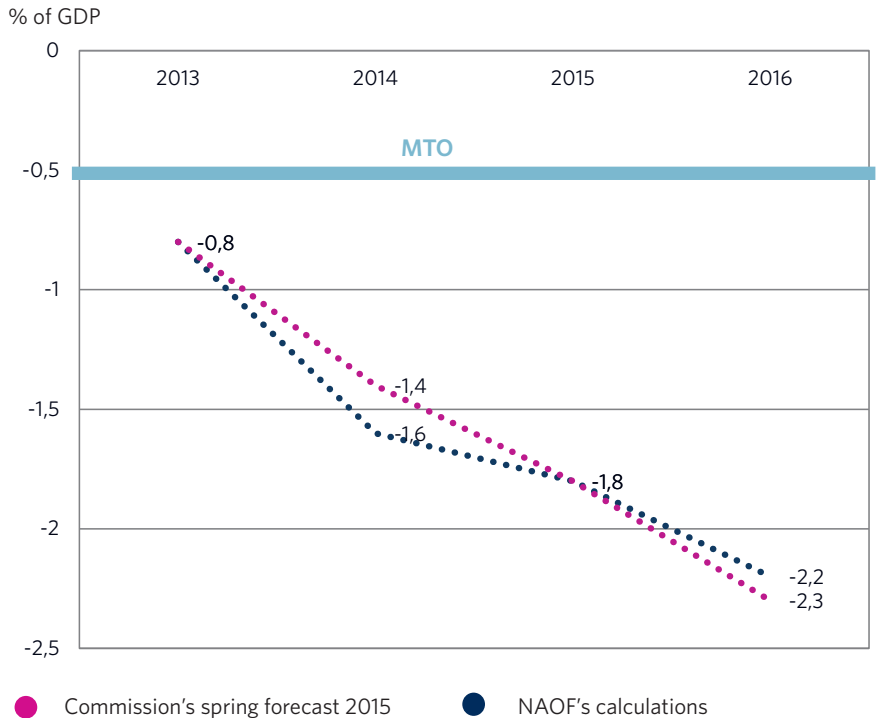
In the medium term, Finland aims to have a structural deficit of no more than 0.5 % of GDP

State has not achieved the medium-term objective the structural balance must improve by 0.5 percentage points when the state of the economy is normal. In times of economic difficulties the change required in the structural balance is smaller. The value used by the National Audit Office and the European Commission for times of economic difficulties is 0.1 percentage points. During times of rapid economic growth and when the sustainability of general government finances is at risk, the structural balance must improve more: the value used by the National Audit Office and the Commission for such situations is 0.6 percentage points. At the same time, however, if the Member State has achieved the medium-term objective in the year preceding the review, the required change is zero (the structural balance must remain at previous year's level).⁴

If the Member State has not achieved the medium-term objective, the most important factor concerning compliance with the preventive arm is whether the deviation from the required change is significant. In the case of structural balance the deviation is significant if it is more than 0.5 percentage points (for the year in review) or 0.25 percentage points (as average for the year in review and the year preceding it).

According to the calculations of the National Audit Office, Finland's structural deficit was 1.4 per cent of the gross domestic product in 2014. This means that Finland did not achieve the medium-term objective in 2014. According to the revised figures obtained in spring 2015, Finland's structural deficit in 2013 was 0.8 per cent of the gross domestic product. This means that the structural deficit has grown by 0.6 percentage points since 2013. As the structural fiscal position has weakened by more than 0.5 percentage points, the National Audit Office is of the view that the deviation from the objective set for the structural balance is significant and that Finland was thus in breach of the objective laid out in the first pillar of the Stability and Growth Pact in 2014.

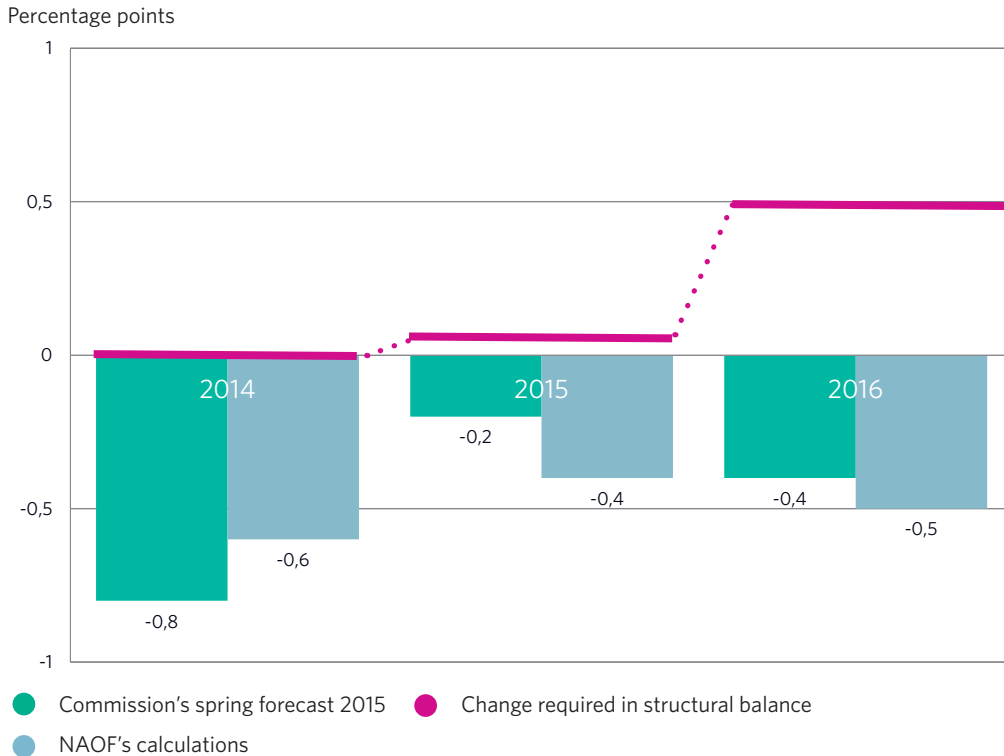
Calculations of the National Audit Office and the European Commission of the trends in structural balance between 2013 and 2016 are shown in Figure 5. According to both parties, Finland's structural fiscal position will continue to weaken in 2015 and 2016. The differences between the calculations are the result of differences in the estimates of output gaps and the size of the one-off measures. The National Audit Office bases its calculations of one-off measures on the estimates of the Ministry of Finance, which differ from the Commission's 2014 estimate by 0.1 percentage points



Source: European Commission and calculations of the National Audit Office (based on the information supplied by the Ministry of Finance).

Figure 5: Trends in Finland's structural balance between 2013 and 2016.

If a Member State fails to achieve its medium-term objective, the structural balance must improve in the required manner. If the actual change in structural balance deviates more than 0.5 percentage points from the required change, the conclusion is that there is a significant deviation in the structural balance. Figure 6 shows the weakening of the structural balance between 2014 and 2016 in proportion to the required change for each year on the basis of the calculations of the National Audit Office and the Commission's 2015 spring forecast.



Source: European Commission and calculations of the National Audit Office (based on the information supplied by the Ministry of Finance).

Figure 6: Required change in structural balance and changes in it between 2014 and 2016.

As Finland had achieved the medium-term objective in 2013 the required change in structural balance for 2014 is zero. According to the Commission's spring forecast, structural deficit has grown by 0.8 percentage points from the 2013 level, while according to NAOF's calculations, the change is 0.6 percentage points. Thus, according to both institutions, the deviation is significant.

In its *General Government Fiscal Plan for 2016–2019*, the Government concluded that, considering the Ministry of Finance forecast in spring 2015, there is still a significant deviation in the general government structural balance that may endanger the achievement of the medium-term objective. However, no new measures were added to the *General Government Fiscal Plan for 2016–2019*; instead the measures are laid out in the new Government Programme and the first General Government Fiscal Plan for the parliamentary term, which will be published in autumn 2015. The National Audit Office states that this is in accordance with the Fiscal Policy Act.

The required change in structural balance in 2015 is 0.1 percentage points. This is the result of poor economic performance; in normal times the required change would be 0.5 percentage points. Thus, the structural balance should improve by 0.1 percentage points from the 2014 level. According to spring 2015 forecast of the Ministry of Finance, structural balance will weaken by 0.4 percentage points in 2015, compared with 2014. This means that according to the calculations made by the National Audit Office on the basis of the Ministry of Finance data, the change in the structural balance in 2015 would deviate 0.5 percentage points from what is required. Thus, the deviation in 2015 would also be significant in the light of the forecasts made in spring 2015.

According to the Commission's spring 2015 forecast, Finnish economic growth will return to normal path in 2016, when the structural balance should improve by 0.5 percentage points, compared with the 2015 level. The calculations of the structural balance in Figure 6 do not take into account the impacts of the new Government Programme on general government finances. Without the measures presented in the Government Programme, the structural balance will continue to weaken in 2016, both according to the calculations of the National Audit Office and the calculations presented by the European Commission in its spring forecast.

On 10 June 2015, after the publication of its spring forecast, the Commission presented a new estimate of the trends in the structural balance. The estimate was part of an update of the assessment of Finland's stability programme and was based on the Government Programme of 27 May 2015 and the measures laid out in it. The Commission estimated that in 2016 Finland's structural balance will improve by 0.4 percentage points, compared with 2015. This means that in 2016 the deviation from the required level would be 0.1 percentage points. In its calculations, the Commission has taken into account the public sector adjustment measures planned for 2016, which will push the nominal deficit to under three per cent and the impacts of the public sector spending cuts on economic growth.

Expenditure benchmark

Expenditure benchmark is the second pillar of the preventive arm. The expenditure benchmark sets the rate of growth for total public sector expenditure on a level that allows the Member State to remain on the path towards its medium-term objective or, if the medium-term objective has not been achieved, on a level that leads to convergence with the medium-term objective. A net expenditure aggregate sets the limit for the growth in total expenditure in such a manner that the expenditure can be increased on a discretionary basis provided that the increases can be offset with revenue. Thus, the expenditure benchmark does not limit the growth in expenditure if the additional spending is fully offset with revenue. At the same time, if a revenue item is cut on a discretionary basis, spending should be cut or other revenue items should be increased.

The applicable expenditure benchmark (rate of growth in expenditure) depends on whether the Member State has achieved the medium-term objective. If the Member State has achieved the objective, growth in expenditure may not exceed the rate of growth in potential output in the medium-term.⁵ The expenditure benchmark is stricter if the Member State has not achieved the medium-term objective. The convergence margin for expenditure growth is set so that the rate of growth in total expenditure is slower than the medium-term potential output growth rate. The convergence margin depends on the size of the country's public sector and the required change in structural balance. The determining factor is that the growth rate in public sector expenditure must grow at such a rate that the country will achieve its medium-term objective.

Compliance with the expenditure benchmark is assessed at the level of the entire public sector. In this report, the National Audit Office assesses expenditure growth in 2014 on an ex post basis. The assessment of the compliance with the expenditure benchmark is carried out as follows: First, expenditure items (such as certain types of unemployment expenditure, EU contributions and interest payments) are deducted from total public sector expenditure. A real growth rate is calculated for the adjusted total expenditure and this rate is compared with the limit set in the expenditure benchmark for the growth in total expenditure. If the expenditure has increased more rapidly than what is set in the expenditure benchmark, it will be examined whether there has been a significant deviation. A significant deviation occurs when the gap between the real rate of growth in total expenditure and the limit set in the expenditure benchmark is more than 0.5 per cent of GDP during the year in review or in a cumulative manner during two years.

The first stage in the assessment of compliance with the expenditure benchmark is the calculation of the real growth in total expenditure. However, not all public sector expenditure is considered: certain adjustments are made to the total expenditure, which will give the adjusted expenditure aggregates AEA1 and AEA2. Table 1 shows the adjustments made to the total public sector expenditure so that the first expenditure aggregate (AEA1) can be obtained. AEA1 represents expenditure that can be affected by measures decided by public sector decision-makers. The second expenditure aggregate (AEA2) is obtained when discretionary revenue and expenditure funded from earmarked revenue is deducted from the first aggregate. The National Audit Office has calculated the adjusted expenditure aggregates (AEA1 and AEA2) for the period 2013–2018. The figures for 2013 are finalised, those for 2014 are preliminary data and those for 2015–2018 are forecasts (Table 1).

Table 1: Calculating adjusted expenditure aggregate 2013–2018							
	Expenditure benchmark figures, EUR billion	2013	2014	2015e	2016e	2017e	2018e
1	Total public expenditure	116.7	119.6	122.0	124.8	127.7	131.2
-2	Interest payments	2.6	2.6	2.5	2.4	2.4	2.4
-3	Expenditure incurred in EU programmes, fully compensated by revenue from EU funds	1.2	0.9	1.3	1.2	1.1	1.2
-4	Changes in expenditure on unemployment due to economic trends	0.6	0.7	0.8	0.8	0.6	0.3
-5a	Fixed capital (gross)	8.4	8.4	8.8	9.0	9.2	9.4
+5b	Average for fixed capital (over four years)	7.7	8.1	8.4	8.7	8.9	9.1
= AEA1	Adjusted expenditure aggregate (AEA1)	111.6	115.1	116.9	120.0	123.3	127.0
- 6	Effect of discretionary measures on revenue	1.5	0.7	0.8	0.4	0.4	0.1
- 7	Expenditure financed from earmarked revenue	0.44	0.11	0.05	0.05	0.05	0.10
= AEA2	Adjusted expenditure aggregate (AEA2)	109.7	114.3	116.1	119.6	122.9	126.7

Source: NAO's calculations (based on the information supplied by the Ministry of Finance)

Nominal growth in total expenditure is calculated by comparing the adjusted expenditure aggregate 2 (AEA2) in the year in review with the adjusted expenditure aggregate 1 (AEA1) in the year preceding the year in review. The aim of such a comparison is to take account of the effect of discretionary revenue on the way expenditure is covered. According to the calculations of the National Audit Office, the nominal growth in net total expenditure in 2014 was 2.4 per cent. For reasons of comparability, the nomi-

nal growth in total expenditure is converted into real growth on the basis of the GDP deflator used by the European Commission. The deflator value used by the Commission for the year 2014 was 2.1 per cent. Thus, the real growth in net total expenditure in 2014 was 0.3 per cent (Table 2).

Table 2: Real growth in adjusted total expenditure, calculated on the basis of Commission's GDP deflator 2014–2018

	2014	2015e	2016e	2017e	2018e
Growth in total expenditure (nominal)	2.4%	0.8%	2.3%	2.4%	2.8%
GDP deflator	2.1%	1.4%	1.4%	1.4%	1.4%
Growth in total expenditure (real)	0.3%	-0.6%	0.9%	1.0%	1.4%

Source: NAOF's calculations (based on the information supplied by the Ministry of Finance)

Next, the real growth in adjusted total expenditure is compared with the reference growth rate set by the expenditure benchmark. The applicable reference rate is determined by whether the Member State has achieved the medium-term objective by the end of the preceding year.

As Finland achieved the structural balance objective at the end of 2013, a more general expenditure benchmark is applied in the ex post assessment for 2014. Under this benchmark, maximum real growth in Finland's public sector expenditure in 2014 should not have been more than 0.8 per cent. As the adjusted total public sector expenditure in Finland has grown by 0.3 per cent in real terms, the National Audit Office concludes that total public sector expenditure in Finland has grown substantially more slowly than what would have been allowed under the expenditure benchmark.

As regards the expenditure benchmark, the deviation from the objective is not examined as the difference between actual growth rate and the growth rate permitted under the expenditure benchmark. Instead the difference between the two growth rates is converted into euros and proportioned to the GDP. The total public sector expenditure in Finland (in euros) in proportion to GDP is 0.3 per cent lower than what is permitted under the expenditure benchmark (Table 3). The Commission has reached the same conclusions concerning the growth in Finland's total public sector expenditure in proportion to the expenditure benchmark. This means that Finland was in compliance with the expenditure benchmark in 2014.

Finland was in compliance with the expenditure benchmark in 2014

Table 3: Expenditure benchmark for Finland and compliance with it 2014–2015

	2014	2015e
Expenditure benchmark if MTO has been achieved	0.8	0.8
Expenditure benchmark if MTO has not been achieved	-0.1	0.6
Was the MTO achieved by the end of the previous year?*	Yes	No
Expenditure benchmark to be applied	0.8	0.6
- Real growth in adjusted expenditure aggregate %	0.3	-0.6
= Difference between expenditure benchmark and growth in expenditure	0.5	1.2
Deviation in euros/GDP**	-0.3	-0.7
Is the deviation significant?	No	No
Has the expenditure benchmark been complied with?	Yes	Yes

Source: NAOF's calculations (based on the information supplied by the Ministry of Finance)

*Achievement of MTO at the end of the year preceding the year in review. Finland's compliance with MTO at the end of 2013 will be examined in 2014.

** Negative figure means that total expenditure is lower than the permitted limit, while a positive figure means that the limit has been exceeded.

In Table 3, the National Audit Office presents its estimate of compliance with the expenditure benchmark for 2015 on the basis of the information supplied by the Ministry of Finance. As Finland did not achieve the medium-term objective in 2014, the 2015 reference growth rate will be stricter. The convergence margin is calculated on the basis of the required change for the structural balance in 2015, which means that the total public sector expenditure should not grow more than 0.6 per cent in 2015.⁶ According to the preliminary information supplied by the Ministry of Finance, total public sector expenditure will decrease by 0.6 per cent in 2015. Moreover, the euro deviation in proportion to GDP is 0.7 per cent lower than would be permitted under the expenditure benchmark. Thus, Finland will be in compliance with the expenditure benchmark in 2015.

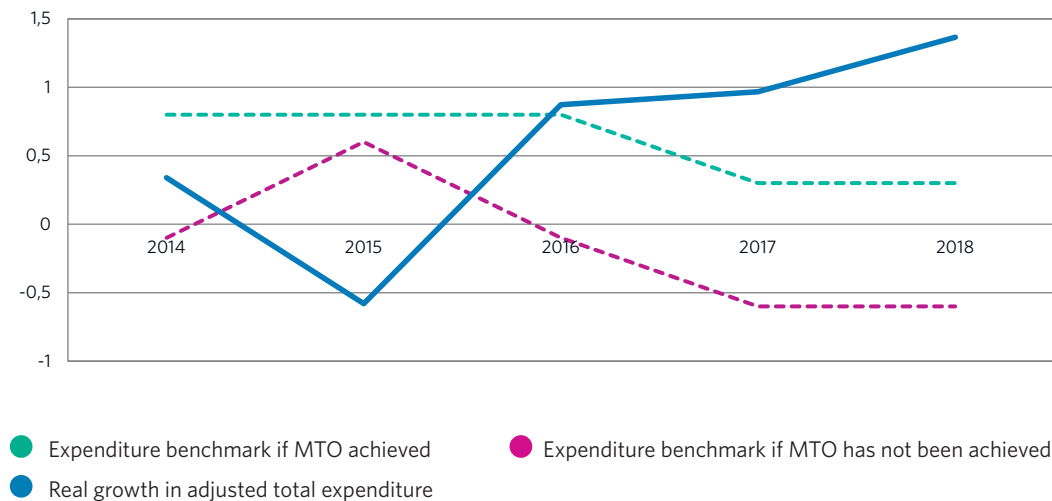
Figure 7 illustrates real growth in total expenditure in proportion to the expenditure benchmark between 2014 and 2018. The estimate of expenditure growth presented in Figure 7 does not contain the spending cuts for the years 2016–2018 proposed in the new Government Programme.

Preliminary figures indicate that Finland will not achieve the medium-term objective in 2015 and for this reason the expenditure trends in 2016 will also be examined on the basis of the stricter expenditure benchmark. When consideration is given to the required change in structural balance for 2016, total public sector expenditure should decrease by 0.1 percentage points in 2016. Figure 7 also shows the estimate of the National Audit Office of the expenditure benchmark that might be applied for the years 2017 and 2018.

Finland will also be in compliance with the expenditure benchmark in 2015

It is forecast that Finland's potential medium-term growth will slow down to 0.3 per cent. Thus, the reference growth rate based on the medium-term potential growth for 2017 and 2018 would be 0.3, while the stricter value for these years would be -0.6. The stricter expenditure benchmark is based on an assumption that the economic growth will return to its normal path and on the change required in structural balance set on that basis.

It should be noted that predictions about compliance with expenditure benchmark in the coming years involve a great deal of uncertainty as the Commission will update the expenditure benchmark each year. In this report the National Audit Office presents its estimate of the growth in revised total public sector expenditure for the coming years on the basis of the regulations that are in force in 2015.



Source: NAOF's calculations (based on the information supplied by the Ministry of Finance).

Figure 7: Trends in total expenditure and expenditure benchmark, 2014-2018.

Overall assessment

The two pillars of the preventive arm are separate but complementary rules. The aim of both rules is to ensure that general government finances are on a sustainable path. Significant deviation is the main criterion in the assessment of compliance with the rules. If there is no significant deviation from either rule, the Member State is in compliance with the overall rule. If there is a significant deviation from one of the pillars of the preventive arm, compliance with the rules is assessed on an overall basis. If there is a significant

deviation from both pillars, the Member State is in breach of the rules laid down in the preventive arm of the Stability and Growth Pact. Figure 8 shows how compliance with the preventive arm is assessed in accordance with the two pillars for 2014.

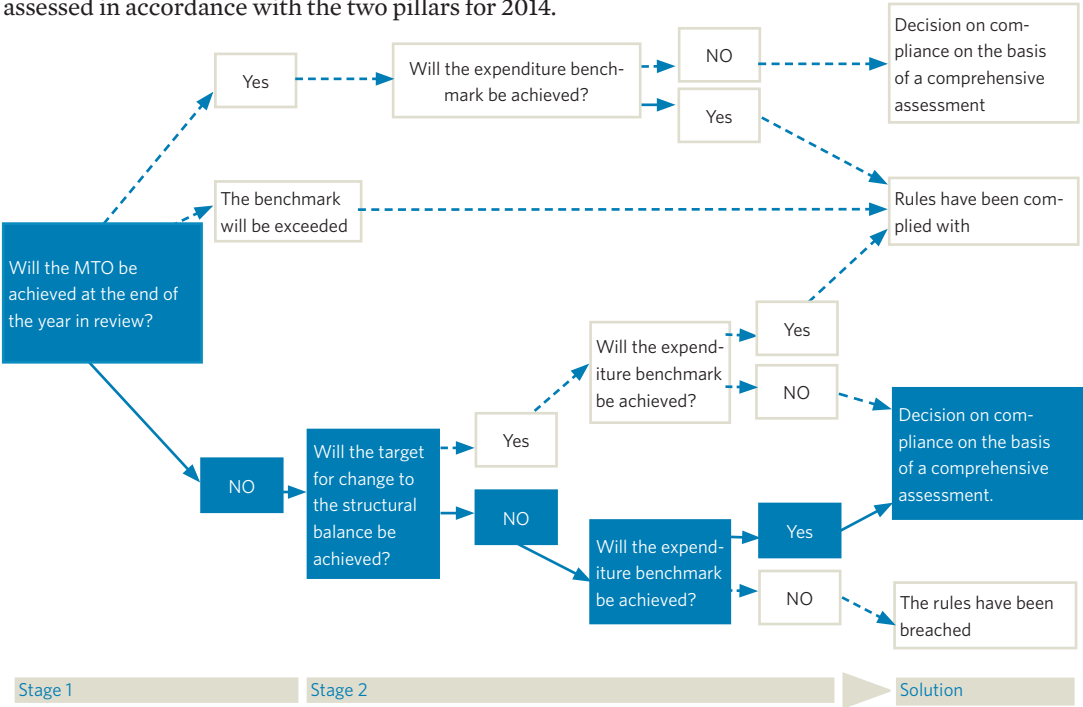


Figure 8: Compliance with the rules of the preventive arm in 2014

As Finland did not achieve the objective laid out for structural balance in 2014, but was in compliance with the expenditure benchmark, compliance with the preventive arm of the Stability and Growth Pact will be assessed on an overall basis. The aim of the overall assessment is to determine the reason for the discrepancy between the results generated by the two pillars.

As regards the ex post assessment of Finland for 2014, the National Audit Office states that the differences between the two pillars of the preventive arm are due to following factors: In the calculation of the structural balance, cyclical fluctuations are eliminated from the nominal deficit by weighing the output gap by the elasticities of certain public sector revenue and expenditure items. In practice, it is possible that the observed elasticities differ from the standard elasticities in which case cyclical adjustment fails to eliminate all cyclical changes in expenditure and revenue from the nominal deficit. If there is an unexpected decline in the public sector revenue, the structural balance as a fiscal policy indicator can underestimate the impact of discretionary policy on the size of the

deficit. This was the case in 2014 when a lower than expected inflation resulted in lower than expected tax revenue. Moreover, cyclical adjustment in expenditure was not necessarily able to fully take into account the impact of the growth in cyclical unemployment expenditure on nominal deficit in 2014.⁷

The total public sector expenditure calculated in accordance with the second pillar of the preventive arm is statistically cleaned from factors such as cyclical unemployment expenditure. According to the information supplied by the Ministry of Finance, Finland's cyclical unemployment expenditure has grown by about 20 per cent since 2013. This means that the increase in unemployment expenditure can explain the growth in the structural deficit at the time when spending under the expenditure benchmark has only grown very modestly.

The National Audit Office sums up the situation by stating that a decrease in revenue caused by lower than expected inflation and an increase in unemployment expenditure caused by an economic downturn may explain the size of the structural deficit 2014. Especially the lower than expected tax revenue has come as a surprise as in the forecasts made in autumn 2014, the nominal deficit was still put at less than three per cent. However, as the growth in Finland's public sector expenditure will be substantially slower than the requirement laid down in the expenditure benchmark, the National Audit Office states that Finland was in compliance with the preventive arm in 2014.

3.3 Assessing the corrective arm

The corrective arm of the Stability and Growth Pact comprises the deficit and debt criteria. Under the deficit criterion, nominal deficit may not exceed three per cent of the gross domestic product. Under the debt criterion, general government debt of a Member State may not exceed 60 per cent of the gross domestic product. If a Member State is in breach of either or both of the criteria, it may be subjected to the excessive deficit procedure (EDP). Excessive deficit procedure may be initiated on the basis of actual figures (debt criterion) and on the basis of actual and planned figures (deficit criterion). Excess of nominal limits may, however, prompt the Commission to prepare the report laid down in Article 126(3) on the basis of actual or planned figures or forecasts that concern both criteria. In the report, the Commission will state the reasons for initiating or not initiating the excessive deficit procedure for the Member State in question.

According to the statistics published by Statistics Finland on 31 March 2015, Finland's public sector deficit in 2014 was 3.2 per cent of GDP. The deficit has grown by 0.7 percentage points from 2013 and Finland has exceeded the three per cent deficit limit. Breaching the nominal criterion does not, however, automatically lead to the initiation of the excessive deficit procedure for Finland. If the excess has been small, temporary and exceptional, the Member State is deemed to be in compliance with the criterion. Excess of the deficit criterion is considered temporary if according to the Commission's forecast, the deficit will drop under the three per cent limit. Moreover, the exceptional nature of the excess (such as a severe economic downturn) is also a consideration in the assessment of the deficit criterion.

In its report based on Article 126(3) (published on 13 May 2015) and in its assessment covering Finland's stability programme (published 27 May 2015), the Commission concluded that the nominal deficit threshold has been exceeded. The Commission updated its assessment of Finland's stability programme on 10 June 2015. The measures laid out in the Government Programme of 27 May 2015 have been taken into account in the new assessment. If the adjustment of general government finances proceeds in accordance with the Government Programme, general government deficit will be less than three per cent in 2016. Thus, the Commission is of the view that the excess of the deficit criterion is temporary.

Finland exceeds the deficit criterion by 0.2 percentage points

It should also be noted that in the statistics published by the Statistics Finland on 31 March 2015, Finland's general government deficit was 0.2 percentage points lower than in the preliminary figures published on 2 March 2015. For this reason, it is possible that the deficit estimate will be revised upwards or downwards as Statistics Finland publishes new statistics in autumn 2015.

Based on the statistics published by Statistics Finland on 31 March 2015, Finland's general government debt was 59.3 per cent of GDP in 2014. This means that Finland remains in compliance with the general government debt criterion, the second criterion of the corrective arm. The debt has grown by 3.5 percentage points since 2013 and is approaching the 60 per cent limit laid down in the Stability and Growth Pact. Based on the Ministry of Finance forecasts, general government debt will exceed the debt threshold in 2015 and it will remain above the 60 per cent limit in the next few years (Table 4).

Finland remains in compliance with the debt criterion

Table 4: General government debt to GDP ratio and cyclically adjusted debt 2011–2019									
	2011	2012	2013	2014	2015e	2016e	2017e	2018e	2019e
General government debt, % of GDP	48.5	52.9	55.8	59.3	62.5	64.4	66.0	67.0	67.8
Cyclically adjusted debt, % of GDP*	42.6	52.1	52.6	53.2	56.8	60.9	64.1	66.6	68.2

Source: Ministry of Finance, European Commission, NAOF's calculations

*Cyclically adjusted GDP

Even though, according to preliminary figures, Finland's debt-to-GDP ratio will exceed the nominal limit laid down in the debt rule in 2015, the excess taking place in 2015 can be justified with solidarity transfers to other EU Member States. However, from 2016 onwards solidarity transfers can no longer be used as the sole explanation for exceeding the nominal limit. On the basis of the forecasts, Finland will be in breach of the nominal threshold for the general government debt from 2016 onwards and for this reason, there are grounds for examining the assessment criteria used by the Commission when a Member State is subjected to the excessive deficit procedure for breaching the debt regulations. The following factors are assessed when compliance with the debt criterion is examined:

- 1 Does the general government deficit exceed 60 per cent of GDP at the time of the assessment?
- 2 If the answer is yes, the debt trends are examined on the basis of a backward-looking criterion; if at the time of the assessment, the debt is under the threshold value laid out in the back-

ward-looking criterion, the Member State is considered to be in compliance with the debt criterion.

- 3 a) If the debt exceeds the backward-looking criterion, the two-year debt forecast is examined on the basis of the forward-looking criterion.
- b) Is the excess of the debt criterion a result of economic cycles?

In the case of Finland, stages 2 and 3a are not relevant in the assessment of the compliance with debt rules as the purpose of the backward-looking and forward-looking criteria is to examine the debt trends in such countries where the debt-to-GDP ratio is well over the 60 per cent limit but nevertheless diminishing at an adequate pace. For this reason, in the case of Finland, it is relevant to examine stage 3b or whether the excess of the debt criterion is caused by cyclical factors.

Table 4 shows the cyclically adjusted debt-to-GDP ratio in Finland's general government finances for the period 2011–2019 on the basis of the calculations of the National Audit Office. Cyclically adjusted debt is calculated by eliminating the cyclical part from the nominal debt. During a period of economic growth this increases the amount of cyclically adjusted debt. During an economic downturn, cyclical adjustment decreases the amount of the debt. The resulting cyclically adjusted debt is divided by cyclically adjusted GDP, which is calculated by adjusting the nominal GDP by potential output growth and GDP deflator. As shown in Table 4, after cyclical adjustment of Finland's general government debt, Finland will exceed the 60 per cent threshold laid down in the debt criterion in 2016. This is because, according to the calculations of the National Audit Office, cyclically adjusted debt will reach 60.9 per cent.

Even though the nominal deficit in Finland's public sector exceeds the threshold laid down in the corrective arm of the Stability and Growth Pact, the National Audit Office is of the view that the excess is only slight. The measures laid out in the new Government Programme will only be given concrete shape during autumn 2015 when the Government decides on the first General Government Fiscal Plan for the parliamentary term. Thus the National Audit Office is of the view that it is too early to assess whether the excess is a temporary phenomenon. In terms of the debt criterion, the National Audit Office is of the view that there is not yet any reason to initiate the excessive deficit procedure for Finland. The excess of the debt criterion in 2015 can be explained with solidarity transfers to other EU countries. According to the calculations of the National Audit Office, cyclically adjusted debt will, however, exceed the 60 per cent limit in 2016.

The National Audit Office is of the view that a prolonged economic downturn has led to a situation where the nominal thresholds of the deficit and debt criteria have been broken or are being broken. Estimates of the deficit and debt trends are based on an assumption that policies will remain unchanged and no consideration in them is given to the measures laid out in the new Government Programme. On the basis of what is said above, the National Audit Office is of the view that in Finland's case there is not yet any reason to initiate the excessive deficit procedure covering either of the two criteria.

The Commission also reached the same conclusion in its assessment of Finland's stability programme, which it updated in June 2015. The Commission will produce its next assessment of the Finnish situation in autumn 2015 on the basis of its autumn forecast and Finland's preliminary budget plan.

The National Audit Office would like to draw attention to the functioning of the preventive arm of the Stability and Growth Pact in a prolonged economic downturn. Even though Finland is in compliance with the preventive arm of the Stability and Growth Pact, it will soon be in breach of the criteria laid down in the corrective arm. The flexibility elements of the preventive arm, in which consideration is given to such factors as economic circumstances and structural reforms, are useful instruments for ensuring that it will not become necessary to introduce strong economic adjustment measures in a downturn. As a result, Finland will soon be in a situation where compliance with the preventive arm will not provide us with sufficient margin for the criteria laid down in the corrective arm.

References:

- 1 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 framework.
- 2 Vade Mecum on the Stability and Growth Pact, European Commission, Occasional Papers 151 / May 2013.
- 3 "Making the best use of the flexibility within the existing rules of the Stability and Growth Pact", (13.1.2015); "The significant deviation procedure in the preventive arm of the SGP. Note for the Alternates of the Economic and Financial Committee." (3.4.2014).
- 4 In the assessment of compliance with the preventive arm of the Stability and Growth Pact, consideration is given to the economic circumstances so that the required change in the structural balance depends on prevailing economic circumstances. During a period of rapid economic growth a more substantial change in the structural balance is required than in normal times, while the change required in a severe economic downturn is smaller than in normal times. Temporary deviation from the required change in structural balance is permitted in exceptional circumstances. Exceptional circumstances mean a situation where the negative output gap is sufficiently wide or the GDP is contracting. In the view of the National Audit Office, basing the definition of exceptional circumstances solely on the contraction of GDP is problematic (see Audit of the compliance with the Stability and Growth Pact 2014, audit memorandum p. 9). In this audit report, the National Audit Office has considered the effect of economic circumstances on the required change in structural balance in the same manner as the Commission in its assessment of the 2015 Stability Programme for Finland, which was updated on 10 June 2015 (Addendum to the assessment of the 2015 Stability Programme for Finland", table 1, page 7). In this connection, when discussing the required change in structural balance, the Commission refers to page 28 of the Vade mecum report, which details the factors that should be taken into account. The change required in 2015 is also presented on page 10 of the report on Finland published by the Commission under Article 126(3). The Commission updated the manner in which economic circumstances are considered in the laying down of the required change in structural balance in its flexibility communication published on 13 January 2015 (Making the best use of the flexibility within the existing rules of the Stability and Growth Pact).
- 5 The Commission defines medium-term potential output growth as ten-year average so that in year t the average is calculated from year t-5 to year t+4.
- 6 The stricter value for the 2015 expenditure benchmark can be calculated by giving the convergence margin a recalibrated value by considering the required change in the structural balance (see "The significant deviation procedure in the preventive arm of the SGP. Note for the Alternates of the Economic and Financial Committee." (3.4.2014).
- 7 The greatest uncertainty in the calculation of structural balance concerns cyclical adjustment. As regards expenditure, cyclical adjustment of nominal deficit is based on semi-elasticity calculated for cyclical unemployment expenditure, which describes the link between cyclical unemployment expenditure and the output gap. In practice, semi-elasticity is calculated statistically and may be unable to take into account all changes in cyclical unemployment expenditure, which will weaken the structural balance. The National Audit Office has highlighted the problems concerning the use of structural balance as a fiscal policy indicator (Audit report of the National Audit Office 13/2013).



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