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The National Audit Office of Finland (NAOF) monitors and assesses fiscal policy in its role as an independent national fiscal institution under the Fiscal Stability Treaty (Fiscal Compact) and within the meaning of European Union law. Monitoring activities are defined in the Act on the National Audit Office (676/2000) and the Act on the implementation of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, the implementation of Treaty provisions of a legislative nature as well as requirements concerning multi-annual budgetary frameworks (the "Fiscal Policy Act", 869/2012) and the Decree on the General Government Fiscal Plan (120/2014, amended by decree 619/2017) issued under it. Monitoring comprises the assessment of the setting and implementation of the fiscal policy rules. It also covers monitoring the preparation and implementation of the General Government Fiscal Plan, assessing the reliability of the macroeconomic forecasts and budgetary projections used as a basis for the fiscal policy and evaluating compliance with the EU Stability and Growth Pact. NAOF also monitors adherence to the medium-term objective (MTO) and its correction mechanism. By monitoring the fiscal policy, NAOF promotes transparency and intelligibility of fiscal rules as well as stable and sustainable general government finances.

This report presents the findings made by NAOF as part of fiscal policy monitoring in spring 2018.

Helsinki 8 June 2018

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Fiscal policy evaluation assessment

Fiscal policy evaluation assessment

As part of its statutory fiscal policy monitoring task, NAOF has assessed whether the General Government Fiscal Plan has been prepared in accordance with the legislation, the fulfilment of the targets set by the Government for the general government finances, compliance with the central government spending limits and the EU Stability and Growth Pact in 2017, and the reliability of the Ministry of Finance's forecasts that form the basis of the 2018 General Government Fiscal Plan. The assessment is based on the background material of the General Government Fiscal Plan and the Finland's Stability Programme included in it, the Ministry of Finance's independent forecasts and economic forecasts of economic research institutes. The calculation of the structural balance and expenditure benchmark defined in EU Stability and Growth Pact, as well as related interpretations are based on governing EU regulations and guidance. Compliance with spending limits was assessed on the basis of the Government's spending limits decisions and budget documents, budget implementation data and the state's financial statements.

The conclusions and findings made by NAOF on the basis of its assessment are as follows:

1. The General Government Fiscal Plan for 2019–2022 has been prepared, in key parts, in accordance with the governing decree.
2. The multi-annual target introduced by the Government for the nominal financial position of general government and the financial position targets set in the first General Government Fiscal Plan of the parliamentary term for general government sub-sectors are not fully consistent.
3. As a result of the improved economic situation, the Government is reaching the medium-term objective for general government structural balance (MTO) set for 2019. In addition, the general government debt-to-GDP ratio is bending in accordance with the goal set.
4. The central government spending limits were complied with in 2017.
5. Finland complied with the preventive and corrective arms of the EU Stability and Growth Pact in 2017.
6. The Ministry of Finance's forecast used as a basis for the General Government Fiscal Plan is realistic , although the health, social care and regional government reform involves a risk for larger-than-expected government expenditure during the planning period.

Summary of the findings

Summary of the findings

On the basis of NAOF's assessment, the majority of the targets set for the financial position and debt in the first General Government Fiscal Plan of the government term will be achieved. The medium-term objective (MTO) regarding the general government structural balance was already achieved in 2016. In addition, the achievement of the nominal financial position targets is not far. General government debt in relation to GDP has turned to a decline. The long-term sustainability gap of the general government has decreased significantly, while the risk of contingent liabilities, such as state guarantees to the long-term sustainability of general government finances has increased substantially.

In the assessment no significant shortcomings in compliance with the Fiscal Policy Act or the regulations issued under it were detected. The fulfilment of the MTO defined in the Fiscal Compact has proceeded in accordance with the legislation. The multi-annual targets for the general government and its parts, required by the amended decree on the General Government Fiscal Plan, concerning the nominal financial position have been set. The content and structure of the General Government Fiscal Plan are largely in line with the requirements. However, the targets set for general government finances remain inconsistent. In addition, the data content of the General Government Fiscal Plan needs to be improved regarding certain details.

According to NAOF's assessment, Finland complied with the preventive and corrective arms of the EU Stability and Growth Pact in 2017. According to a preliminary assessment, Finland will fulfil the requirements set out in the preventive arm regarding the fulfilment of the medium-term objective in 2018 and 2019. According to a preliminary assessment, the criteria set out in the corrective arm will be complied with in 2018 and 2019.

The Ministry of Finance's forecasts of GDP growth and the general government net lending for 2018–2020 are close to estimates of Finnish economic research institutes and the European Commission. According to currently available information, the forecasts can be regarded as realistic. However, the health, social care and regional government reform involves risks of general government expenditure being higher than expected during the planning period. The risk of an upward or downward revision of the forecast of economic growth is neutral, while the risk is expected to be slightly negative following this year. The Ministry of Finance's macroeconomic forecasts have been proved reliable in comparison with forecasts produced by other institutions.

According to NAOF's findings, the central government spending limits were complied with in 2017 and expenditure outside the spending limits remained stable. Adjustments made to the 2017 spending limits were carried out in accordance with the principles of the spending limits procedure. However, problems have been discovered in the functionality of the spending limits procedure as a mechanism for limiting expenditure. Special attention should be paid, in particular, to the transparent presentation of the reasons for structural adjustments.

Contents

1 General Government Fiscal Plan and outlook on general government finances

In NAOF's assessment, no significant defects were discovered in compliance with the Fiscal Policy Act and the regulations issued under it. The fulfilment of the MTO defined in the Fiscal Compact has proceeded in accordance with the legislation. The multi-annual objectives for the general government and its parts concerning the nominal financial position have been set. The setting of these objectives is required by the amended decree on the General Government Fiscal Plan. However, the setting of targets for general government finances is partly unclear, and the data content of the General Government Fiscal Plan needs to be developed.

The targets set for the financial position and debt in the first General Government Fiscal Plan of the government term will be largely achieved in the light of currently available information. The long-term sustainability gap of the general government has decreased significantly, while the risk of contingent liabilities presented to the sustainability of general government finances has increased substantially.

The clarity of targets set for general government finances needs to be developed – targets are not fully consistent

The statutory duty of NAOF is to monitor compliance with the Fiscal Policy Act[1] and the regulations issued under it. The Fiscal Policy Act and the decree issued under it[2] enter regulations of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union into force. The Fiscal Compact forms part of the treaty. NAOF is a national body referred to in the Fiscal Compact that is responsible for the supervision of compliance with the rules set out in article 3.

Under the Fiscal Policy Act, the Decree on the General Government Fiscal Plan has been issued[3]. The requirements set out in the decree are linked with the content of the EU Budgetary Frameworks Directive[4]. The most recent amendments to the Decree on the General Government Fiscal Plan entered into force in September 2017[5]. The amendments concerned the content of the General Government Fiscal Plan, information to be included in the state's budget proposal, and the consideration of conclusions of NAOF's assessments of forecasts used as the basis of the fiscal policy. An assessment of the fulfilment of the obligations set out in the Decree on the General Government Fiscal Plan, the Fiscal Policy Act and the Fiscal Compact is presented below.[6]

According to the Decree on the General Government Fiscal Plan, the General Government Fiscal Plan sets multi-annual objectives for the ratio between the financial position and GDP for general government as a whole and targets for different parts of general government (central government, local government, employment pension institutions and other social security funds). The Fiscal Plan defines a target path for the ratio between the financial position and GDP for general government until 2021. The targets set for different parts of general government extend until the end of 2019.

The target set for general government finances in 2019 deviates from the sum of sub-sector-specific targets

The targets set are not fully conistent. The target path for the general government will lead to a weaker financial position in 2019 (-0.8%) than the targets set separately for sub-sectors in the first General Government Fiscal Plan of the parliamentary term (0.0%). This leads to uncertainties over what is the actual target for the general government in 2019. According to the Decree on the General Government Fiscal Plan, financial position targets must be set so that they, taking into account the forecast of the Ministry of Finance, enable achieving at least the target set for the structural financial position of the general government. The target set under the Fiscal Policy Act and the Fiscal Compact for the structural financial position in 2019 is -0.5% in relation to GDP.

The target of -0.8% set for the nominal financial position of the general government for 2019 may not lead to achieving the target of the structural balance. The reason is that, in the light of the current outlook on the business cycle, the structural deficit will be higher than the nominal deficit in 2019. The situation would not be in line with the requirement set out in the Decree on the General Government Fiscal Plan. On the basis of an independent forecast, the target set for the nominal financial position will be clearly exceeded, meaning that this has hardly any practical significance on the basis of current forecasts. However, this situation represents the partly unclear relationship between different targets, which should be taken into account in the future.

The content and structure of the General Government Fiscal Plan are largely in line with the requirements

The Decree on the General Government Fiscal Plan defines the content of the General Government Fiscal Plan in detail. The plan corresponds materially with the requirements. Not all details of revenue and expenditure in sub-sectors of general government are presented in accordance with the decree. In addition, the compliance of certain other details with the decree needs to be ensured by expanding and clarifying the data content.

According to the Decree on the General Government Fiscal Plan, the plan must cover all parts of the general government. It must include sections on central government finances, local government finances and statutory employment pension institutions as well as other social security funds. The coverage and structure of the plan are in accordance with the decree, even though its sections on employment pension institutions and other social security funds have a fairly limited content. In addition, the Decree on the General Government Fiscal Plan defines that the plan should include forecasts of key revenue and expenditure in all sub-sectors. However, these are not presented regarding separately employment pension institutions and other social security funds. In this respect, information is only presented at a total level, covering all social security funds.

According to the Decree on the General Government Fiscal Plan, forecasts of revenue and expenditure must be prepared on the basis of two alternatives: on an assumption that the legislation impacting revenue and expenditure is not amended, and on an assumption that the legislation impacting revenue and expenditure is amended as defined by the Government. The impact of both options on the structural medium-term financial position and the long-term sustainability of general government finances should be presented.

According to the independent forecast, the target set for the financial position of general government finances in 2019–2022 in the Decree on the General Government Fiscal Plan will be achieved. As a result, the plan does not describe any actions defined by the Government to achieve the target, the expenditure and revenue projections are not presented on the basis of the two alternatives and information about the structural financial position and sustainability are not presented on the basis of the two alternatives.However, NAOF notes that the General Government Fiscal Plan does not include information (e.g. regarding major revenue and expenditure items) about the key differences between the development defined in the independent forecast and the current target path defined by the Government. As a result, the data content could be developed so that it presents these key differences.

According to the Decree on the Regional Government Fiscal Plan, the section on local government finances of the General Government Fiscal Plan must set, in addition to the target set for the financial position of the local government, a restriction on fiscal impacts caused by central government activities to local government finances. In general, the restriction set for expenditure caused by central government activities to local government finances in the Decree on the General Government Fiscal Plan is consistent with the target set for the financial position of local government finances. However, the spending limit cannot alone guarantee that all central government measures targeted at the local government sector are in line with the objective of achieving the local government financial position target. Actually the spending limit better reflects the potential for savings in local government enabled by central government measures than actual reductions in the level of expenditure.

According the the decree, the General Government Fiscal Plan must present a comparison between the most recent macroeconomic and fiscal forecast of the Ministry of Finance and the European Commission and explain the differences between the assumptions that form the basis of the forecasts, if they are significant. In general, the comparison has been presented in accordance with the decree. However it would have been useful to present the underlying reasons (e.g. possible differences between assumptions, as mentioned in the decree) for the partly significant differences regarding the latest (of that time) GDP forecasts of Ministry of Finance and the European Commission..

The General Government Fiscal Plan includes information about units outside budgets

The plan includes a reference, in accordance with the decree, to a list of public units that do not form part of regular budgets of public units, maintained by Statistics Finland. Furthermore, the plan presents the combined impact of these units on the financial position and debt. Therefore, the procedure fulfils the requirement set out in the decree, whereas the presentation method does not offer a transparent view of the factors underlying the impact. It would be useful to present more detailed information about the impact of the units in the plan.

According to the decree, the General Government Fiscal Plan must present the impact of various growth and interest rate assumptions on the macroeconomic forecast and general government forecast, as well as key aggregates related to general government finances. The sensitivity analysis presented in the plan largely covers the requirements of the decree, whereas information provided about the impact of interest rate assumptions is somewhat inconsistent. The analysis describes the annually fluctuating impact on the central government's interest expenses. In addition, one forecast of the total impact of interest rate changes on the government sector's property income and expenditure is presented. The presentation method should be developed so that the impact of interest rate changes on general government finances would convey as clear a view as possible.

The legislation on the fiscal policy has been mostly complied with

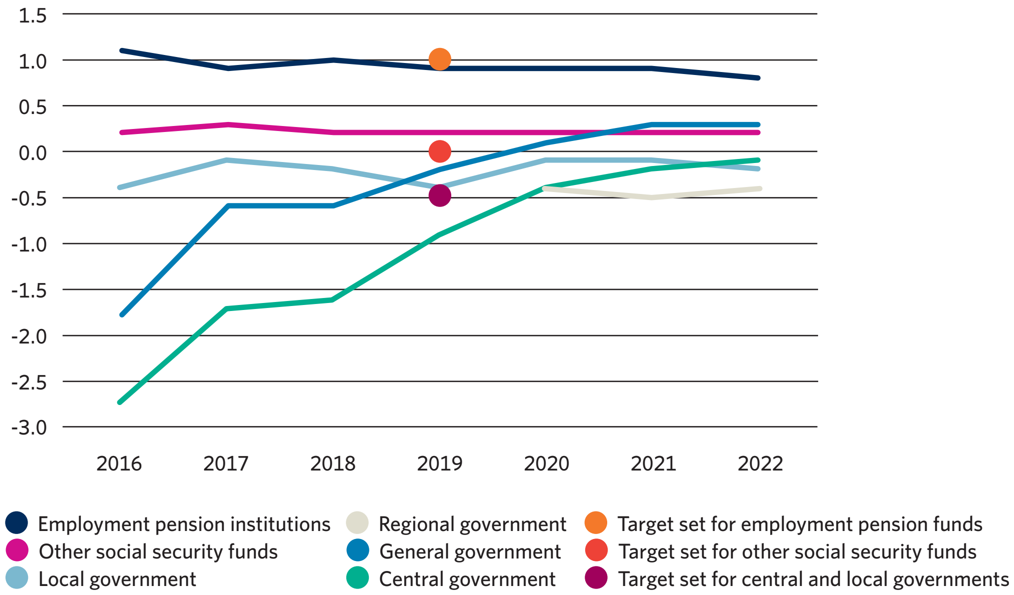
On the basis of the assessment made, no significant defects were discovered in compliance with the Fiscal Policy Act and the regulations issued under it. The medium-term objective for general government structural financial position (MTO) defined in the Fiscal Compact has been set, the achievement of the target has proceeded in accordance with rules (see chapter 2 of this report), and a corrective mechanism has been defined in the national legislation for situations where a significant deviation is discovered in progress towards the target. The General Government Fiscal Plan is largely in accordance with the regulating decree. Sub-sector-specific financial position targets and a multi-annual target path for the financial position of the general government have been set. However, NAOF considers that the data content of the plan and the targets set should be developed by addressing the viewpoints presented in the assessment above. Particular attention should be paid to ensuring the clarity and intelligibility of the targets set and the symmetry between the targets path for the general government and sub-sector-specific targets.

Financial position targets are close to being fulfilled

The target regarding the structural balance was already achieved in 2016

During the past year, the development of the national economy and general government finances has improved and the near-future outlook has brightened noticeably. The fulfilment of the financial position targets set in the first General Government Fiscal Plan of the government term is not far in the light of the development and forecasts. According to the most recent information, the target of the structural balance (-0.5% in relation to GDP) was already reached in 2016. On the basis of the Ministry of Finance's forecast and NAOF's calculations, the structural balance in 2019 will be -0.6% in relation to GDP. Therefore, on the basis of the forecast the target of -0.5% can be reached, taking into account the interpretation to be applied to the assessment (see chapter 2 of this report).

Furthermore, the nominal financial position targets set in the first General Government Fiscal Plan of the parliamentary term are close to being fulfilled. According to Figure 1 the central government would fall behind its deficit target of -0.5% by 0.4 percentage points. The local government would reach its deficit target of -0.5%, employment pension institutions would have a surplus in relation to GDP nearly in accordance with their target (1.0%) and other social security funds would be approximately in balance, in accordance with their target. In addition, general government deficit would be 0.2% in relation to GDP, i.e. clearly lower than the multi-annual target path of 0.8% set in 2017, but slightly higher than the sum of sub-sector-specific targets (0.0%).



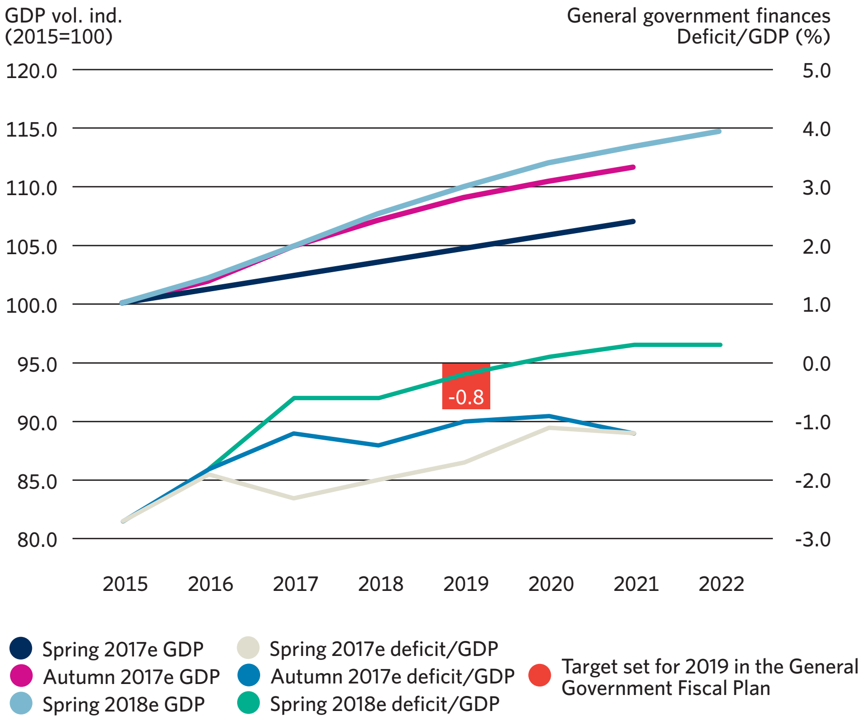
Source: General Government Fiscal Plan for 2019–2022

Figure 1: Development of the nominal financial position of the government sub-sectors and related targets in relation to GDP. The regional government will be defined as a separate sector in the General Government Fiscal Plan, starting from 2020. This has no impact on targets set for 2019 and interpretations of their fulfilment.

In addition to the Ministry of Finance's forecast included in the General Government Fiscal Plan, estimates of other institutes providing forecasts support the view that the financial position targets are close to being fulfilled. Estimates of the Research Institute of the Finnish Economy (Etla), Pellervo Economic Research (PTT) and the Labour Institute for Economic Research (PT) of the nominal financial position of public organisations in relation to GDP in 2019 range from -0.1% to 0.2%. The most recent estimates of the nominal financial position of the general government in 2019 conducted by these institutions range from -0.9% to -0.6%.

The assessment of the fulfilment of targets has changed rapidly

The rapid change in estimates of the development of GDP and the general government deficit represents significant changes in the economic outlook during the past year. Figure 2 describes the development of the GDP estimate from spring 2017 to spring 2018. The figure also represents the development of the estimate of the financial position of the general government during the same period (in relation to GDP). Changes in the financial position forecast have significantly changed the assessment of the fulfilment of the financial position target (2019).



Sources: Ministry of Finance, Statistics Finland

Figure 2: GDP forecasts and forecasts of the general government deficit from spring 2017 to spring 2018. The figure highlights in red the sum of targets set for sub-sectors of general government in 2019 (0.0%) and the target defined for the general government as a whole (-0.8%).

The debt ratio has started to national accounts decrease

It seems that the target set in the first General Government Fiscal Plan of the government term for starting the decrease of the debt ratio by the end of the parliamentary period will be fulfilled. According to statistics, the ratio between general government debt and GDP decreased already in 2016 and 2017. Furthermore, according to forecasts by Etla, PTT and PT, the debt ratio will continue to decrease in 2018 and 2019. The decrease in the debt ratio already in 2016 was partly attributable to the decrease in the state's cash assets.

Technical challenges in interpreting and forecasting the development of general government debt

The decrease in the debt ratio of general government in 2016 was affected, among other things, by the decrease in cash assets from the end of the previous year. The decrease in short-term debt is typically connected to decreased cash assets. In addition to fluctuation in liquid assets and short-term debts, forecasting the debt ratio of general government and interpreting its development is complicated by the uncertainties resulting from statistical practices. Changes in the sector definition of public organisations may have an impact on the debt ratio. In addition, the amount of central government debt instruments in the investment portfolio of employment pension institutions has a direct impact on the general government debt. According to the current practice, received cash collaterals related to derivative contracts are recognised as debts in statistics, also regarding employment pension institutions, even though cash collaterals received by employment pension institutions do not have any debt-reducing impact. Changes in these components alone can be significant, especially if their direction is the same.

The development of regional government finances causes uncertainties for the planning period

In the most recent General Government Fiscal Plan, regional government finances have, for the first time, been presented as a separate entity, and the Ministry of Finance's forecast handles regional government finances as a separate sub-sector. Regardless of the government sub-sector to which the regional administration will be classified in the national accounts, this is a good and transparent method.

In the interests of keeping the plan up to date, it is also good that the forecast and General Governance Fiscal Plan already take into account possible changes caused by the reform on the structure of public administration, even though the reform was not approved when preparing the plan. In the Ministry of Finance's forecast, regional government finances have a deficit during the first years (see Figure 1). Financing and expenditure of regional government finances follow separate and independent paths, which is a justified solution in order to have a realistic forecast.

The General Government Fiscal Plan takes into account possible changes in the structure of general government finances

The forecast of regional government finances does not include temporary transition costs arising from the health, social services and regional government reform, or any long-term costs arising from the harmonisation of salaries or the increased use of services. These costs and other additional costs are difficult and uncertain to forecast.

Some transition costs arising from the health, social services and regional government reform are included in the central government forecast. These include expenditures included in central government spending limits and, for example, expenditures of units outside budgets. Furthermore, the realisation of these central government transition costs included in the forecast depends

The forecast of regional government finances includes cost risks partly on the approval of the social services and healthcare reform and they are partly subject to an assessment. Therefore, they have common features with the transition costs of regional government. In the forecast, it has not been possible to assess the magnitude of the regional government transition costs. Therefore, the forecast of regional government finances may offer a partly optimistic view of the financial position of regional government. NAOF agrees with the Ministry of Finance in that transition costs present a cost risk in the forecast.

Risks remain in general government finances, despite the narrowed sustainability gap

According to the recent estimate of the Ministry of Finance, the sustainability gap of general government finances is about 2.5% in relation to GDP. The improvement of the structural balance reduced the gap by one percentage point from the previous estimate. This was affected, for example, by the development of employment, which improved from the previous estimate. At the same time, the projection included new assumptions about the long-term economic development, which have been agreed upon in the EU cooperation. These increased the estimated gap by half a percentage point. Without the inclusion of these new assumptions, the gap would have decreased to 2% in relation to GDP. In spring 2015, the Ministry of Finance estimated the sustainability gap at 5% in relation to GDP. The estimate has changed as a result of the development of the national economy and general government finances and changes in accounting assumptions.

Finland's sustainability gap has decreased as a result of positive development

In EU member states, the long-term sustainability gap ranges from 6.1% to -1.8%, and the average is 1.5%[7]. In Finland, the European Commission estimates the gap to be 2.8%. In the Commission's evaluation framework, a sustainability gap of less than 2% refers to a low risk, a gap of more than 2% to an average risk and a gap of more than 6% to a high risk. As a result of the positive development in recent years, Finland's sustainability gap has approached the low risk category in the Commission's evaluation framework.

The sustainability gap estimate is sensitive to assumptions of long-term development, in addition to which uncertainties and sensitivity related to the estimate of the structural balance are directly reflected in the estimate. These uncertainties are not limited to the overall estimate alone. Instead, there typically are uncertainties over the impact of policy decisions on the sustainability gap. Therefore, NAOF's recommendation is that when estimates of the impact of the sustainability gap are presented in conjunction with significant structural reforms, the sensitivity of the estimate should also be pointed out. Regardless of these uncertainties and sensitivities, the sustainability estimate is one viable tool for assessing fiscal risks and policy decisions. However, its applicability as an indicator, to which fiscal policy targets could be tied comprehensively, is limited.

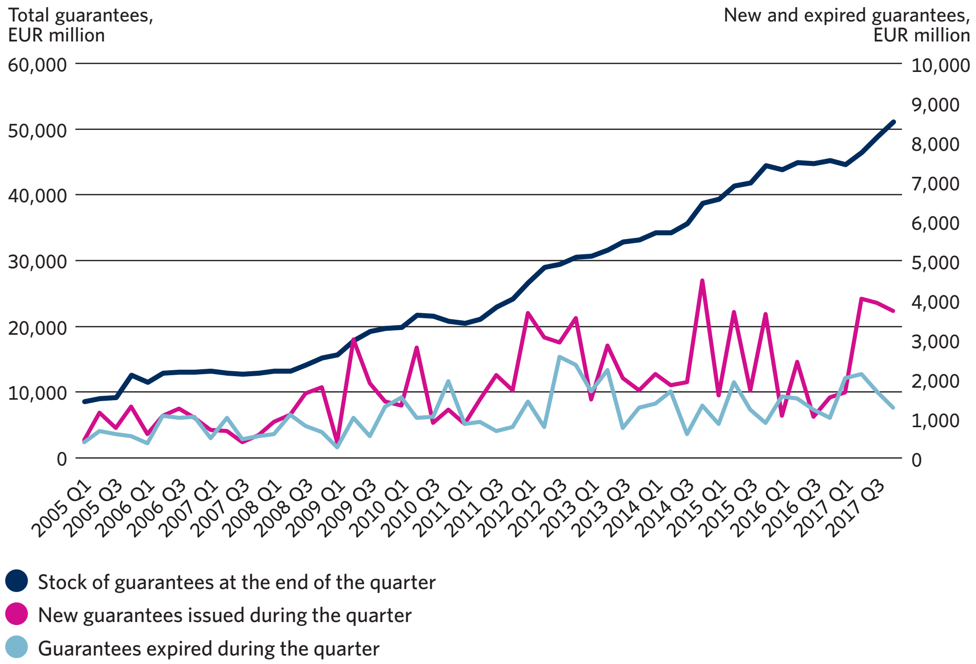
Cutting down the duties of municipalities partly changed into a typical cut of operating costs

The sustainability gap can be affected through short-term revenue and expenditure measures and long-term structural reforms. During the current government term, the aim has been to decrease the sustainability gap using both ways. The exact impact of the revenue and expenditure decisions made on the sustainability gap is difficult to assess, for example, because expenditure cuts have reduced the structural deficit, while tax cuts have increased it. The completion of short-term revenue and expenditure decisions is often more certain than that of major structural reforms, and their impact is typically easier to assess. On the other hand, securing long-term growth also requires structural changes. The target included in the government programme to reduce the sustainability gap by reducing the duties of municipalities by a billion euros is a good example of this problem. Carrying out the reform in this way turned out to be difficult, and the project expanded to cover the entire public sector. In the most recent General Government Fiscal Plan, the proportion of savings allocated to the central government is represented not as a structural reform, but partly as a typical cut of operating costs covering all administrative fields.

Not all general government risks are reflected in the sustainability gap estimate. General government finances involve many contingent liabilities, and the realisation of the risks associated with these may cause significant additional expenditures for the general government. The weight of these risks has been very low in the EU fiscal policy framework and in the target setting in the national fiscal policy compared with the short-, medium- and long-term targets set for the financial position and debt of the general government.

The number of guarantees is alarming and the adoption of risk limitations should be assessed

In Finland, public sector guarantees are the highest in the EU on the basis of Eurostat statistics. The uncertainty whether statistical methdods are consistent between countries complicates the interpretation of the statistics. However, this does not change the overall view. As presented in Figure 3, the amount of state guarantees has increased steeply in recent years. In addition, the municipal sector had more than EUR 22 billion of guarantees at the end of 2016. Therefore, there is a reason to consider the adoption of risk limitations in the central government. In addition to guarantees, liabilities of public corporations are noteworthy contingent liabilities, even though they are very different by nature. At the end of 2016, they totalled EUR 73 billion.



Source: Statistics Finland

Figure 3: Stock of state guarantees, new guarantees and expired guarantees in 2005–2017

2 Compliance with central government spending limits

The central government spending limits were complied with in the budgeting procedure for 2017

NAOF evaluates compliance with spending limits annually. According to the final assessment of fiscal policy evaluation in 2017, the central government spending limits were complied with in the budgeting procedure for 2017. The final 2017 budget fell about EUR 45 million below the 2017 spending limits. The remaining provision of EUR 45 million can be carried forward to the next year, as presented in the Government's annual report, without being prevented by spending limits rules.

The spending rule laid out in the government programme and the central government spending limits are important parts of Finland's national fiscal framework. The central government spending limits decision is included in the General Government Fiscal Plan.

In Finland, central government spending limits are in real terms, and for this reason, price adjustments and structural changes are made to them during the parliamentary term. This makes the spending limits framework procedure less transparent, and it is difficult for outsiders to monitor compliance with the spending limits rule. On the basis of findings, structural adjustments made to the 2017 spending limits were, however, carried out in accordance with the principles of the spending limits procedure. Nevertheless, there are problems in the functionality of the spending limits procedure in limiting expenditure. The division of costs from reform projects partly inside the spending limits and partly outside them, the non-harmonised compensation procedures of tax-type revenue cuts of municipalities and social security funds, and the compensation of revenue cuts using increased central government expenditure reduce the functionality of the spending limits procedure in limiting costs. Special attention should be paid to the transparent presentation of the basis for structural adjustments in budgets so that the functionality of the spending limits procedure in limiting costs can be evaluated more effectively than at present.

2.1 Findings of the 2017 spending limits rule

NAOF assessed the correctness and transparency of information provided about compliance with the 2017 spending limits in the Government's spending limits decisions, the preparation of budgets and supplementary budgets, and the Government's annual report of spring 2018. The functionality of the spending limits procedure in restricting any increase in central government expenditure steers the calculation of spending limits. Since spending limits are always drafted for the following four-year term, the findings may also concern other years of the parliamentary term 2016–2019.

Spending was EUR 45 million below the 2017 spending limits

According to NAOF's calculation, the level of spending limits in the final 2017 state budget, including supplementary budgets, was EUR 44,891 million, expenses included in the spending limits were EUR 44,846 million and the remaining undistributed provision was EUR 45 million. Thus, the estimate presented in the Government's annual report that the actual spending was about 45 million euros below the 2017 spending limits can be considered correct.

Like in previous years, the Government's annual report presents a table of all costs in the final 2017 spending limits decision, the budget proposal, the actual budget and three supplementary budgets. In addition, the table presents costs included in the spending limits, the level of spending limits adjusted by prices and structures, and the remaining provisions of each phase. This is a transparent presentation method.

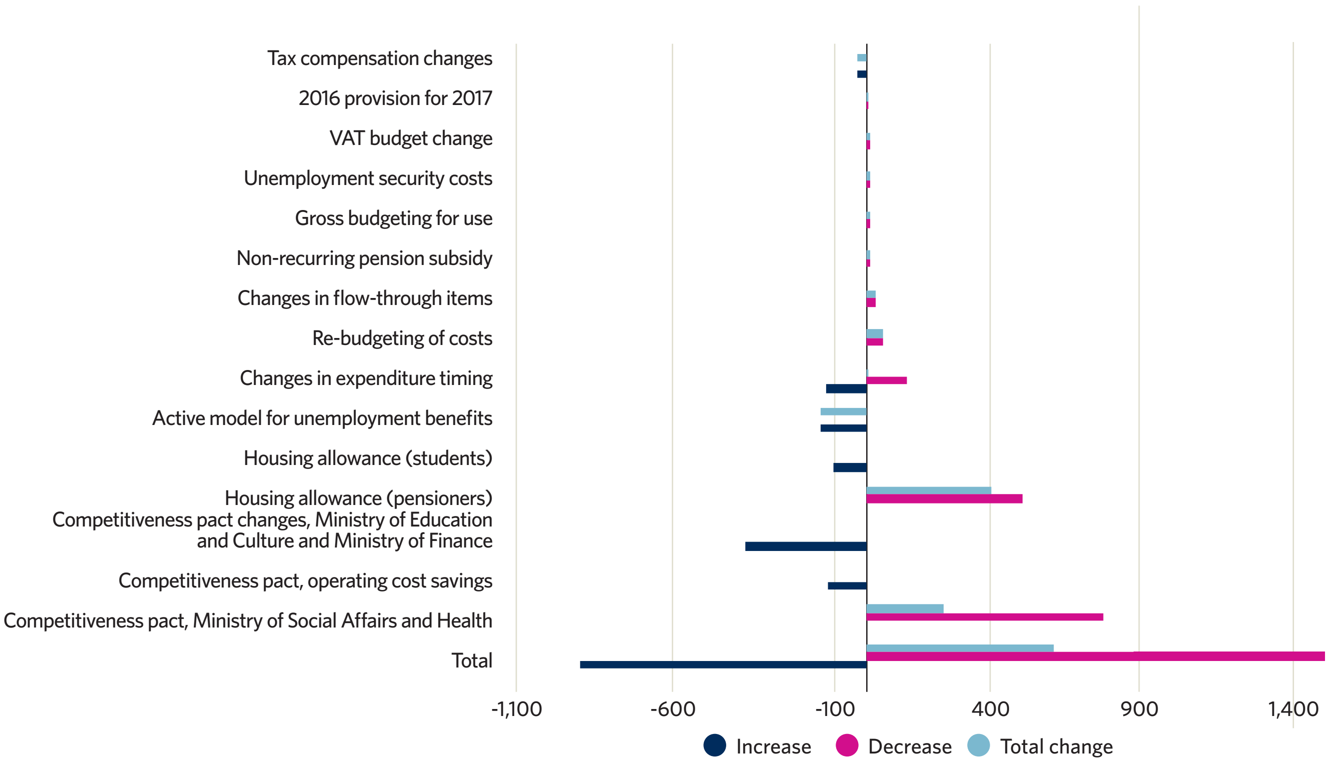
In addition, the actual use of spending limit appropriations in 2017 remained within the scope of the spending limits. The 2017 spending limits of EUR 44,846 million were compared with the actual use of spending limit appropriations in NAOF's calculation. The proportion of spending limit appropriations, i.e. EUR 44,320 million of the total use of appropriations, has been calculated in accordance with the proportion of spending limits in the final budget. The goal of the comparison of financial statements was to assess the functionality of the spending limit procedure in limiting any increase in central government expenditure. Of the costs budgeted in spending limits, EUR 526 million remained unused in accordance with the assessment of spending limits.

The actual use of the 2017 spending limit appropriations was within the scope of the spending limits

Processing reform projects within spending limits

From the first spending limits decision of the parliamentary term to the third and final supplementary budget of 2017, structural adjustments of EUR 605 million were made in the 2017 level of spending limits. Of these adjustments, 85% or EUR 527 million were based on the inclusion of the budget changes resulting from reform project's of Prime Minister Sipilä's Government, i.e. the competitiveness pact, the housing allowance reform, the active model for unemployment benefits and the non-recurring pension subsidies, in the 2017 level of spending limits.

The majority of structural adjustments to the 2017 spending limits were related to reform projects



Sources: Spending limits decision 2016–2019, General Government Fiscal Plan 2016–2019 and 2017–2020, and 2017 budget proposals and supplementary budget proposals

Figure 4: Structural changes to the 2017 spending limits, breakdown in euros

The competitiveness pact includes several structural adjustments to spending limits, and their justification is very brief and not transparent in the budgets. In total, the impact of the competitiveness pact increases central government expenditure by EUR 256 million, which leads to an identical increase in spending limits. The decrease in employers' social security contributions included in the competitiveness pact would increase spending limits expenditure within the administrative field of the Ministry of Social Affairs and Health, while the cost savings included in the pact would reduce spending limits expenditure within the administrative fields of the Ministry of Education and Culture and the Ministry of Finance. In addition, the competitiveness pact would reduce operating costs in various administrative fields.

Limited and non-transparent information about structural adjustments related to the competitiveness pact is provided in budgets

According to the budget proposal, the competitiveness pact will increase the use of budget costs by EUR 460 million in 2017, of which increased appropriations within the spending limits make up EUR 188 million and those outside the spending limits comprise EUR 273 million. Furthermore, the competitiveness pact includes EUR 244 million in losses of tax revenue for the state. The competitiveness pact reform was adjusted in a supplementary budget proposal, after which the increase in spending limits was EUR 256 million. According to the Government's spending limits rule, any adjustments made to spending limits must ensure that all changes in taxation are treated in the same manner if they have similar impact on general government finances.

Grounds for increasing the level of spending limits include the equal treatment of the increase in state expenditure (EUR 736 million) related to the decrease in the employers' social security contributions, as a similar cut in central government taxation would have increased the central government deficit by the amount of lost revenue. The interpretation of the equal treatment of tax-related changes is based on decreases in tax-type revenue shifting the focus from taxation in the state budget, while there are no changes in expenditure.

The competitiveness pact also includes compensation for tax losses paid to municipalities of EUR 273 million as an increase in expenditure outside the spending limits. The reason for tying the lost revenue in the municipal sector to the increased expenditure in the central government is that the aim is to enable decision-making on changes in income tax in the short term, without being restricted by the spending limits. From the point of view of spending limits, the solution is not to increase the spending limits equally to the increase in central government expenditure. Instead, the solution is to accumulate expenditure outside the spending limits. However, compensation for tax losses will be transferred to the spending limits between government terms. Therefore, it seems that compensation for decreases in tax-type revenue outside the central government is treated in two different ways in the spending limits.

Compensation for decreases in tax-type revenue of municipalities and social security funds is not harmonised in the spending limits procedure

From the point of view of general government finances, attention should also be paid to the procedure in which decreases in revenue are compensated with increases in expenditure. Increases in expenditure are possibly more permanent than changes in revenue. This is particularly emphasised in compensation paid to municipalities for tax losses. A compensation item calculated for a specific year will not change later, even if the tax rate changed. In 2017, the compensation item comprises a non-variable and continuously increasing item of roughly EUR 1.6 billion inside the system of central government transfers. Within the spending limits, this type of a non-variable expenditure item is inflexible and, as part of a significant central government transfer item included in the spending limits, it may increase pressure to reduce expenditure from those parts of the system that are more flexible. Furthermore, it should be noted that compensation measures that are based on a separate appropriation narrow the opportunities of municipalities to have an impact on their own revenue through taxation.

Changes in spending limits expenditure between parliamentary terms should be documented more transparently than at present

The transfer of the management of basic social assistance from municipalities to the Social Insurance Institution (Kela) was already included in the final technical spending limits decision of the previous Government as a decrease in central government transfers to local government. The planned transfer of housing allowances for pensioners to general housing allowances was included in planned permanent cost savings in the government programme. The changes made in spending limits expenditure before the first spending limits decision of the new Government are not as transparent as those made during the parliamentary term, as no structural adjustments are made to the level of spending limits as a result of the changes. Considering the goal to limit expenditure, it is recommended that any changes made in spending limits expenditure between parliamentary terms be documented more transparently than at present.

The functionality of the cost-limiting capacity is difficult to assess as expenditure is divided within the spending limits and outside them

In conjunction with the transfer of basic social assistance to Kela and the implementation of the housing allowance reform and the active model for unemployment benefits, costs included in the spending limits were transferred outside the spending limits. The integration of housing allowances for students into general housing allowances and the implementation of the active model for unemployment benefits required that EUR 259 million were transferred from within the spending limits outside the spending limits. The transfer of housing allowances for pensioners to general housing allowances would have required the transfer of EUR 519 million outside the spending limits. However, the reform was cancelled and the appropriations were returned inside the spending limits. The functionality of spending limits in restricting expenditure is improved by the lowering of the level of the spending limits corresponding to reductions in spending limits expenditure, while it is deteriorated by the lower coverage of the spending limits. The division of costs arising from reform projects within the spending limits and outside them makes it more difficult to assess the functionality of the cost-limiting capacity.

2.2 Expenditure outside spending limits

Since 2004, budget expenditure has been divided into spending limits expenditure and expenditure outside the spending limits. Cyclical expenditure, such as allowances arising from the unemployment situation and income security, is included in expenditure outside the spending limits. Debt interest payments, compensation to municipalities arising from tax cuts and expenditure generated by financial investments are also included in expenditure outside the spending limits. Some of the expenditure items outside the spending limits are different types of pass-through items, which means that revenue offsetting the expenditure in question is also allocated in the budget. Expenditure corresponding to revenue from the EU and the revenue generated by the national lottery are examples of such expenditure items. A total of about EUR 3.6 billion of flow-through items were classified as expenditure outside the spending limits in 2017.

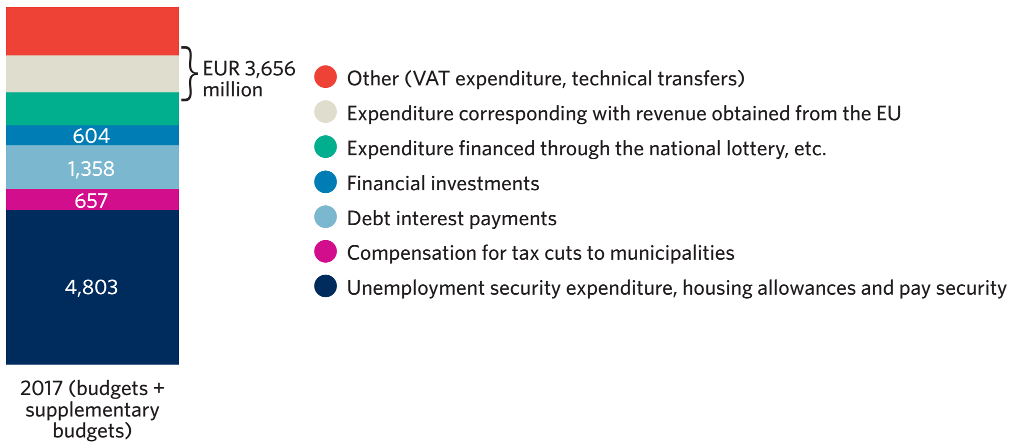


Figure 5: Budgeted outside the spending limits in the 2017 budget and supplementary budgets

The largest expenditure items outside the spending limits, EUR 4.8 billion in 2017, are unemployment security, housing allowance and pay security. These expenditure items function as an automatic stabiliser, which means that they are expected to increase in a downturn and decrease during a period of economic growth. The total level of expenditure has increased since 2012. In 2017, housing allowances increased in particular. This was largely explained by the transfer of housing allowances for students to general housing allowances. The total amount of unemployment security expenditure decreased slightly from 2016, mainly due to a decrease in basic daily allowance expenditure.

The amount of financial investments outside the spending limits has been high since 2009. In 2017, significant items included financial investments related to development cooperation and development cooperation loans, which was a new form of development cooperation included in the budget in 2016. Because one of their purpose is to replace direct development cooperation expenditure, it is particularly important that the fulfilment of the goals set for financial investments related to development cooperation are reported in an open and transparent manner.

In 2017, Parliament made an exceptional solution to transfer EUR 50 million in the state's shareholdings to the children's foundation Itsenäisyyden juhlavuoden lastensäätiö. The appropriations related to the acquisition of shares are outside the spending limits, as they are assumed to maintain their value. Shares owned by the state cannot be transferred at a price lower than their fair value. If the price is significantly lower than the fair value, the approval of Parliament is required. The donation was approved by Parliament and, to carry out the donation, a specific act (1004/2017) was prescribed. However, the justification of the decision does not discuss the interpretation of the spending limits rule, according to which the value of appropriations allocated to the acquisition of shares should be maintained so that they can be handled as expenditure outside the spending limits. In the future, it should be assessed whether the transfer of similar asset items should be included in the central government spending limits.

Furthermore, financial investments include general questions of the significance of central government activities in the market and of the types of investment activities the state should carry out. In addition to the revenue target, societal objectives are also often set for financial investments. The use of financial investment assets to capitalise state-owned limited liability companies or foundations operating outside the budget decreases transparency and the opportunities of Parliament to decide on the final use of appropriations allocated to financial investments. Shareholdings have also been transferred outside the budget to State Business Development Company Vake Oy, which has capitalised SoteDigi Oy. Considering the monitoring and overall management of change expenditure arising from the regional reform, special attention should be paid if significant expenditure items related to the reform are used outside the budget.

3 Compliance with the Stability and Growth Pact

Finland is committed to complying with the rules of the EU Stability and Growth Pact. Finland is also committed to complying with the Fiscal Compact. In this chapter, NAOF presents an ex-post assessment of compliance with the rules of the Stability and Growth Pact in 2017 and an ex-ante assessment for 2018 and 2019.

NAOF assesses compliance with the Stability and Growth Pact on the basis of the General Government Fiscal Plan for 2019–2022 prepared by the Ministry of Finance and the Stability Programme appended to the plan. The calculations are mainly based on the methods presented by the European Commission in the report Vade Mecum on the Stability and Growth Pact.[8]

The preventive arm of the Stability and Growth Pact assesses compliance with the medium-term objective (MTO) for the structural financial position of general government finances and progress towards it. The assessment is prepared by means of the structural financial position and compliance with the expenditure benchmark. The corrective arm of the Stability and Growth Pact assesses compliance with the deficit and debt criteria. Finland has been reviewed as part of the preventive arm. According to NAOF's assessment, Finland complied with the criteria set out in the preventive and corrective arms of the EU Stability and Growth Pact in 2017. According to a preliminary assessment, Finland fulfils the requirements set out in the preventive arm regarding the fulfilment of the medium-term objective in 2018 and 2019. According to a preliminary assessment, the criteria set out in the corrective arm will be complied with in 2018 and 2019.

NAOF points out that there are uncertainties related to the calculation of the structural balance

NAOF's view of compliance with the Stability and Growth Pact is mainly in line with the assessment made in the Stability Programme of spring 2018. However, NAOF points out that there are uncertainties related to the calculation of the structural balance. The structural balance is not an identifiable figure, and different methods, assumptions and forecasts can produce different views of the structural financial position. NAOF deems it to be justified that the European Commission has strengthened the role of the expenditure benchmark alongside the structural balance rule. It should be noted that the current expenditure benchmark aims at reaching the target of the structural balance. In particular, the calculation of the applicable expenditure benchmark rate has been linked to the calculation method of the structural balance. Therefore, any uncertainties over the structural balance are also present in the assessment of compliance with the expenditure benchmark. NAOF's calculations are presented in the workbook appended to this report and published on NAOF's website.

3.1 Assessment of the preventive arm

The aim of the preventive arm of the EU Stability and Growth Pact is to ensure balance in general government finances. Furthermore, compliance with the rules of the arm should prevent any excess deficit and debt. The preventive arm focuses on a member state-specific MTO that is expressed as a target level for the structural balance. The structural balance describes the general government financial position in relation to the value of GDP when the impact of business cycles and temporary and non-recurring measures has been eliminated from the nominal financial position of general government. Also the Fiscal Compact includes a rule that concerns progress towards the MTO. Compliance with it is assessed in accordance with the Stability and Growth Pact.

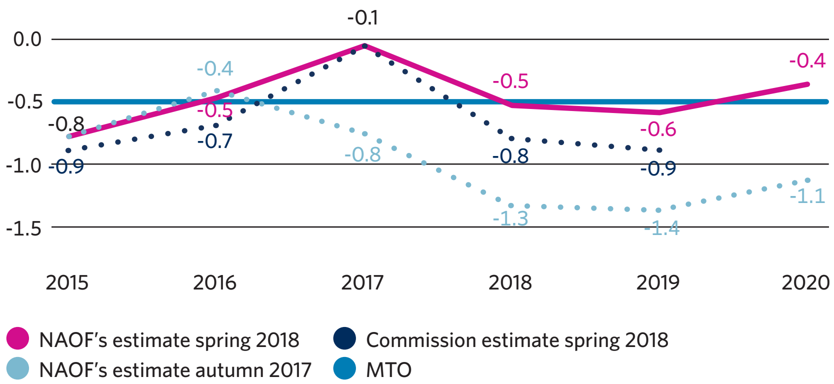
The fulfilment of the MTO is assessed on the basis of two separate criteria. First, it is assessed whether the targeted structural balance has been achieved or whether general government finances in the specific member state have progressed towards the targeted balance as required. With regard to the second criterion, i.e. the expenditure benchmark, an increase in general government expenditure is compared to the expenditure limit set for it. Compliance with the expenditure benchmark supports the fulfilment and maintenance of the structural balance in accordance with the MTO.

The MTO is set for three years at a time in accordance with the rules of the Stability and Growth Pact. Setting the MTO is also required by the national legislation, in the Fiscal Policy Act (869/2012). In autumn 2016, the Government confirmed that Finland's MTO is to achieve a structural balance of -0.5% in relation to GDP.

The structural financial position has strengthened

The MTO was exceeded in 2017

The estimate of the structural balance in general government finances in 2017–2019 has strengthened significantly from NAOF's assessment made in autumn 2017. According to Figure 6 below, the estimate has strengthened by 0.7–0.8 percentage points per each year under review (2017–2019) from the previous assessment. According to NAOF's assessment, the structural balance in 2017 was -0.1% in relation to GDP, and it will be -0.5% and -0.6% in 2018 and 2019 respectively in relation to GDP. Therefore, Finland exceeded its MTO in 2017. According to the current estimate, the MTO will also be reached in 2018 and 2019. According to the rules of the Stability and Growth Pact, the MTO is reached when the margin to the MTO is 0.25 percentage points.



Sources: European Commission, Ministry of Finance and NAOF's calculations

Figure 6: Level of structural balance 2015–2020, % in relation to GDP

The strengthening of the structural balance compared to autumn 2017 assessment is mainly based on the more positive estimate of the nominal financial position, i.e. net lending in general government. According to preliminary information of Statistics Finland in March 2018, the general government deficit in 2017 was -0.6% in relation to GDP, while the Ministry of Finance estimated in autumn 2017 that the balance is -1.2% in relation to GDP. The nominal balance estimated for 2018 and 2019 improved in the spring forecast by 0.9 percentage points regarding both years. The revised estimates of the nominal balance in 2018 and 2019 is based on the increase in employment and GDP that is stronger than expected, which translate into increased tax revenue and decreased unemployment expenditure. The nominal balance in 2017 was updated with data of individual revenue and expenditure items. The Commission's estimate of the level of the structural balance mainly differs from NAOF's estimate in terms of a different output gap.

The output gap estimate which represents the current business cycle and, therefore, the business cycle component of the structural balance has only changed slightly between NAOF's reports of autumn 2017 and spring 2018 (Figure 7). The output gap is calculated as a difference between potential output and GDP in relation to potential output. Potential output is no identifiable figure. Instead, its magnitude is assessed on the basis of the selected method, any assumptions made and available statistics and forecasts. There are challenges in real-time assessment of the output gap, and in particular with business cycle turning points. Compared with the previous estimate conducted in spring 2017, the output gap estimate has changed more clearly, meaning that understanding of the cyclical position has changed. This was also reflected in the estimate of the structural balance in autumn 2017. Forecast updates and the resulting changes in the estimate of the structural balance indicate the uncertainty associated with the structural balance and its use as a guiding rule of fiscal policy.

The updates of forecasts and the resulting changes in the estimate of the structural balance indicate the uncertainty associated with the structural balance

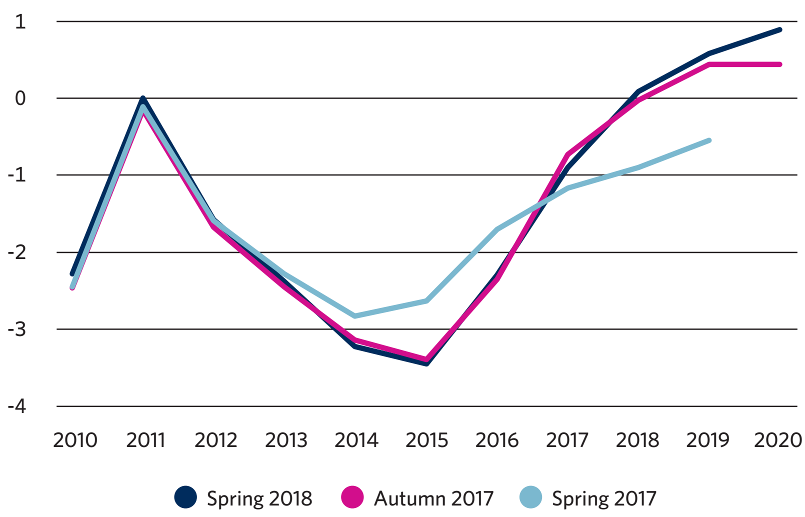


Figure 7: Output gap estimate in accordance with NAOF's reports prepared in 2017 and 2018

Change in the structural financial position

The rules of the Stability and Growth Pact assess the level of the structural balance of general government finances and any changes in it from the previous year. If the target set for the structural balance is not fulfilled, it must be assessed whether the change towards the target level is large enough. Even though, according to the current estimate, the MTO will be fulfilled during the period under review, Figure 8 presents the change in the structural balance from the previous level and a division between changes in the nominal balance and the business cycle component. In 2017 the nominal balance improved significantly, but this did not fully extend to the structural balance due to a decrease in the negative output gap. In 2018, the output gap will become positive and the structural balance will deteriorate. In 2019, the structural balance will improve slightly, even though one-off revenue items will weaken the balance.

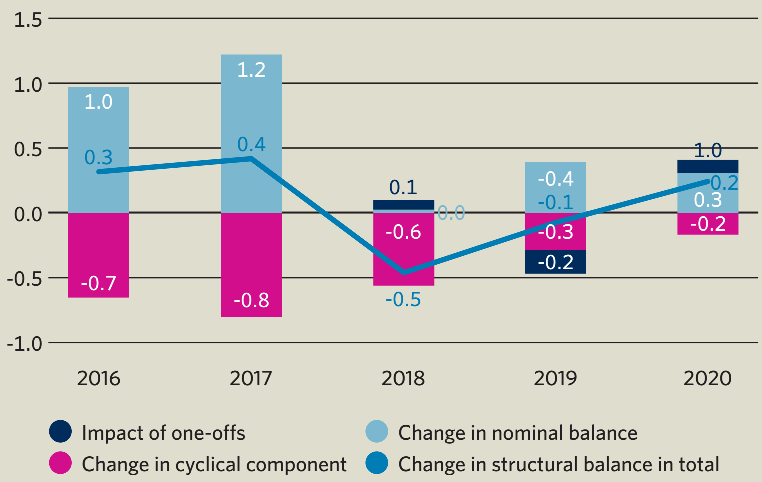


Figure 8: Change in the structural balance divided into the change in the nominal balance and the change in the cyclical component of the balance

General government expenditure increases within the expenditure benchmark

A calculation in accordance with the expenditure benchmark assesses the development of general government expenditure in relation to the maximum rate set for an increase in expenditure. The maximum rate, i.e. the limit for an increase in expenditure, indicates how much expenditure can increase in order to keep up with the MTO or remain on an adjustment path leading to the MTO.

In the calculation, the cyclical component of unemployment expenditure, debt interest payments and spending arising from EU programmes that are funded directly from EU subsidies are deducted from total general government expenditure. These expenditure items are considered to be such that they cannot be influenced through fiscal policy. In terms of investment expenditure, a four-year average is examined, which means that the rules allow an increase in investments during the year under review. Furthermore, the expenditure benchmark allows an increase in expenditure, provided that the increase in expenditure is funded with a corresponding increase in revenue. Table 1 presents calculations for 2017–2019 in accordance with the expenditure benchmark. One-off measures have also been taken into account in the calculation of the expenditure benchmark as part of the overall assessment.

NAOF has made an independent assessment of the expenditure growth limit for 2017–2019 that is based on NAOF's estimate of the structural balance and its adjustment requirement. The adjustment requirement for the structural balance includes the alleviation of 0.5 percentage points in the requirement for 2017–2019 resulting from the structural reform clause included in the flexibility elements of the rules. The NAOF report of autumn 2017 also included the flexible component of 0.1 percentage points granted for 2017–2019 as a result of the investment clause. One requirement for granting this flexibility component is that the specific jointly funded investment projects do not replace domestic investments. According to the preliminary information of Statistics Finland from March 2018, general government investments are expected to decrease in 2017 compared with the previous year, as a result of which the flexibility component in accordance with the investment clause has not been included in this calculation.

According to NAOF's calculations based on the Stability Programme, the growth rate of the total adjusted general government expenditure in accordance with the expenditure benchmark falls below the limit set for it in 2017. Thus, Finland will be in compliance with the expenditure benchmark in 2017. On the basis of a preliminary assessment, expenditure will increase faster than the limit in 2018, resulting in a deviation from the expenditure benchmark. However, this deviation will not be significant. If the deviation is less than -0.5 percentage points, a deviation from the expenditure benchmark is considered significant. If the difference is on average less than -0.25 percentage points in the course of two years, a deviation is also considered significant. In 2019, expenditure will increase below the limit. However, a minor cumulative deviation from the expenditure benchmark is expected in 2018–2019. According to the spring 2018 Stability Programme, there will be no deviation from the expenditure benchmark. These differences in calculations result from different adjustment requirements for the structural balance in the calculation of the limit under the expenditure benchmark in 2018 and different GDP deflator values for 2019.

Table 1: Calculation under the expenditure benchmark

	Expenditure benchmark items, EUR billion	2016	2017	2018*	2019*
	Total general government expenditure	120.8	120.1	122.7	126.2
-	Debt interest payments	2.3	2.2	2.0	2.0
-	Expenditure arising from EU programmes, fully compensated by income from EU funds	1.2	1.1	1.1	1.2
-	Fixed capital (gross)	8.7	8.7	9.1	9.6
+	Average for fixed capital (over four years)	8.5	8.5	8.7	9.0
-	Cyclical changes in unemployment expenditure	0.8	0.8	0.6	0.5
+	One-offs on the expenditure side	0	0	0	0
= AEA1	**Adjusted expenditure aggregate 1**	**116.3**	**115.8**	**118.5**	**121.9**
-	Revenue measures mandated by law	0.1	0.1	0.1	0.1
	Effect of discretionary measures on revenue	0.5	-1.6	-0.9	-0.1
	One-offs on the revenue side	0.0	0.0	-0.2	0.3
-	Effect of discretionary measures on revenue, including one-off revenue items	0.5	-1.6	-0.7	-0.6
= AEA2	**Adjusted expenditure aggregate (AEA2)**	**115.7**	**117.3**	**119.1**	**122.3**
Growth in total general government spending					
	Nominal growth in total spending (calculated in accordance with the expenditure benchmark), %	0.4	0.9	2.9	3.2
	GDP deflator	1.3	0.9	1.2	1.6
	Real growth in total spending (calculated in accordance with the expenditure benchmark), %	-0.9	0.0	1.6	1.6
Reference rate to be applied, NAOF's estimate, real		**0.4**	**1.3**	**0.9**	**1.8**
Reference rate to be applied, NAOF's estimate, nominal				**2.1**	**3.5**
Deviation					
	Difference between the growth rate under the expenditure benchmark and total spending (percentage points)	1.3	1.3	-0.7	0.3
	Deviation, EUR billion	1.6	1.5	-0.8	0.3
	GDP, EUR billion	216	224	233	243
	Deviation, % in relation to GDP	0.7	0.7	-0.4	0.1
	Is the deviation significant (< -0.5)?		No	No	No
	Cumulative deviation		0.7	0.2	-0.1
	Is the cumulative deviation significant (< -0.25)?		No	No	No

Reference rate for expenditure growth

The limit for expenditure growth calculated in compliance with the expenditure benchmark depends on the fulfilment of the MTO. If the MTO expressed as the target level of the structural balance is fulfilled, expenditure can increase in accordance with the ten-year average of growth in potential output. The Commission's calculation uses the Commission's spring forecast preceding the year under review as the estimate of growth in potential output. The ten-year average includes six years before and three years following the year under review.

Therefore, the assessment of compliance with the expenditure benchmark is based on the Commission's calculation method for potential output, using which the structural balance is assessed. Figure 8 presents the forecast growth in potential output, on which the limit for expenditure growth in 2017-2019 is based. The figure indicates that the estimated modest growth in potential output in spring 2016 and 2017 resulted in a fairly strict growth limit for 2017 and 2018 respectively. As the forecast growth in potential output has increased in the Commission spring 2018 forecast, there will be a looser expenditure growth limit for 2019 compared with the two previous years.

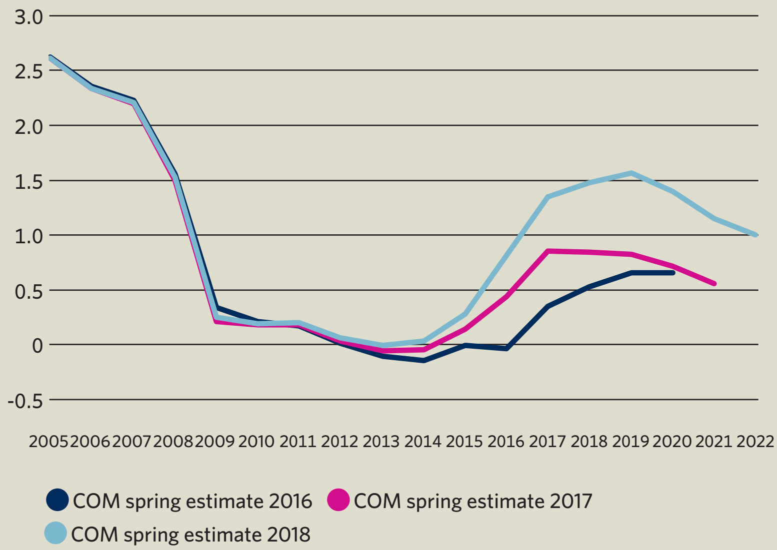


Figure 9: Estimate of growth in potential output in the Commission forecasts from spring 2016, 2017 and 2018

If the MTO is not achieved, the allowed expenditure growth rate will be set so that it supports the fulfilment of the MTO. In this case, a convergence margin will be calculated for the specific member state. The convergence margin is determined on the basis of general government expenditure and the adjustment requirement set for the structural balance. The adjustment requirement depends on the level of the structural balance and the distance to the MTO but, depending on the situation, also on other factors, such as the business cycle, debt ratio and flexibility clauses. Therefore, the estimate of the level of the structural balance also has an impact on the magnitude of the expenditure limit through the convergence margin.

In the calculation, the convergence margin is deducted from the average potential output growth rate, and the idea is that the convergence margin sets a stricter expenditure limit. However, the convergence margin sets a looser expenditure limit for Finland for 2017–2019, as it includes a flexibility component granted for the adjustment requirement for the structural balance as a result of the structural reform clause. The calculation of the limit under the expenditure benchmark is presented in more detail in the workbook appended to this report.

Requirements set out in the preventive arm will be followed in 2017–2019

According to NAOF's assessment, Finland will be in compliance with both pillars of the preventive arm of the Stability and Growth Pact in 2017. The rule of the structural balance will also be followed in 2018 and 2019. A deviation from the expenditure benchmark is expected in 2018 and cumulatively in 2018–2019, but these deviations are not expected to be significant. Therefore, according to NAOF's preliminary assessment, Finland will meet the requirements set out in the preventive arm for fulfilling the MTO, also in 2018–2019.

3.2 Corrective arm

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

The deficit will remain clearly below the limit of 3%

According to Statistics Finland, the general government deficit decreased to 0.6% in relation to GDP in 2017. According to the Ministry of Finance's spring forecast, the deficit will remain at 0.6% in relation to GDP this year and, during the forecast period, the financial position will become positive (Table 2). The positive turn in the business cycle will be clearly reflected in improved deficit figures. On the basis of the ex-post assessment, Finland will follow the deficit criterion in 2017. It is not likely that Finland will be in breach of the deficit criterion in the near future.

Table 2: General government deficit and debt in 2015–2022, % in relation to GDP. Source: Statistics Finland and the Ministry of Finance's forecasts

	2015	2016	2017	2018*	2019*	2020*	2021*	2022*
General government deficit	-2.8	-1.8	-0.6	-0.6	-0.2	0.1	0.3	0.3
General government debt	63.5	63.0	61.4	60.4	58.9	57.4	56.7	56.0

The general government debt ratio was at its highest in 2015, i.e. 63.5% in relation to GDP. The debt ratio turned into a decline in 2016. According to the preliminary information of Statistics Finland, it decreased last year to 61.4% in relation to GDP. The Ministry of Finance expects the debt ratio to fall below the limit of 60% next year and continue to decrease throughout the entire forecast period, until 2022.

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

The backward-looking criterion assesses whether the debt ratio has decreased sufficiently in the past three years. The forward-looking criterion assesses whether the debt ratio will decrease sufficiently during the next two years. The cyclically adjusted debt criterion takes into account the impact of business cycles on the debt ratio. These criteria are assessed in accordance with the decision chart below. According to NAOF's assessment, Finland will be in compliance with the backward-looking criterion in 2017–2019. In addition, it should be noted that the debt ratio is expected to be below 60% in 2019. Therefore, Finland will comply with the debt criterion in 2017–2019.

The debt criterion will be complied with in 2017–2019

Compliance with the debt criterion is based on a downward trend and decrease of the debt ratio. However, the Ministry of Finance expects the debt ratio to turn to an increase in the 2020s, which may put compliance with the debt criterion at risk in the long term.

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

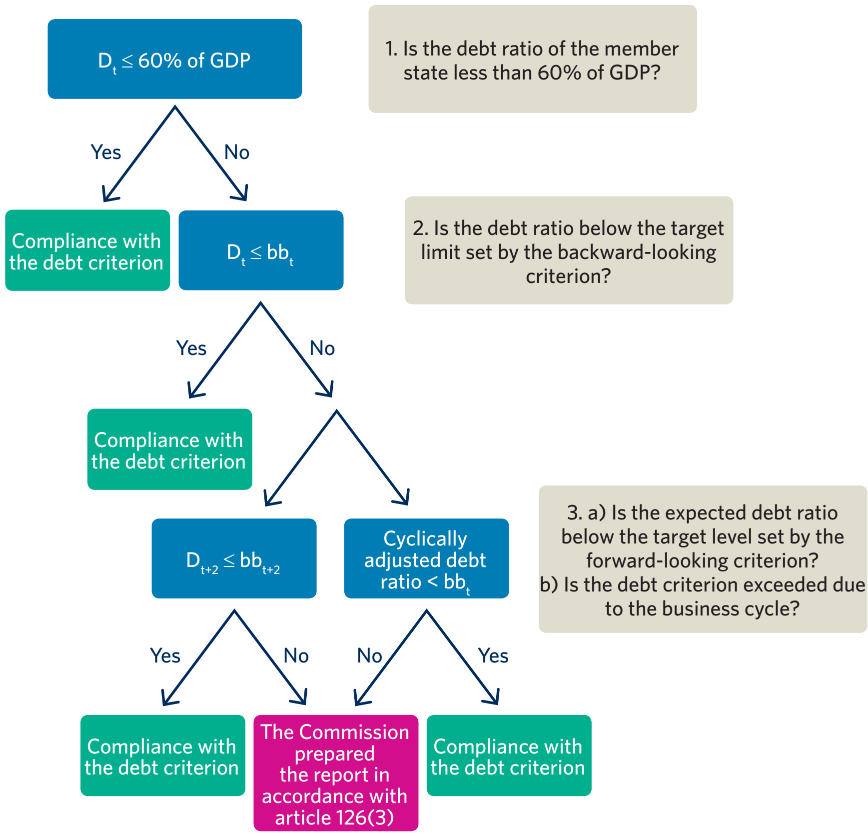


Figure 10: Phases in assessing compliance with the debt criterion

4 An assessment whether the current economic forecasts are realistic and whether the forecasts have been reliable in the long-run

General government fiscal planning must be based on realistic, reliable and independently produced forecasts

NAOF's one duty in terms of fiscal policy monitoring is to regularly assess the Ministry of Finance's economic forecasts. The key legal basis for this duty consists of the European Union Budgetary Frameworks Directive (2011/85/EU) and the Government Decree on the General Government Fiscal Plan (120/2014, as amended by decree 601/2017), which is based on the Budgetary Frameworks Directive and the Fiscal Policy Act (869/2012).

Under the EU Budgetary Frameworks Directive (2011/85/EU), member states must ensure that the planning of general government finances is based on realistic macroeconomic and general government budgetary forecasts. Fiscal policy planning must also be based on the most likely macroeconomic and general government budgetary development scenario or on a more prudent scenario.

The Decree on the General Government Fiscal Plan (120/2014), as amended by decree 601/2017, defines that: "The Ministry of Finance must, when preparing its economic forecasts, take into consideration NAOF's conclusions on the macroeconomic and fiscal forecasts. If, according to the conclusions, the macroeconomic forecasts have included a bias that has had a major impact on the forecasts during four consecutive years, the Ministry of Finance must publish the actions taken to correct the bias or issue a public opinion, insofar as it does not concur with the conclusions of NAOF." No such characteristics (bias) that would require corrective action based on the Decree on the General Government Fiscal Plan were detected in the assessed GDP, unemployment rate and inflation forecasts of the Ministry of Finance.

Official macroeconomic forecasts for 2018–2020 are realistic

Macroeconomic forecasts for 2018–2020, on which the General Government Fiscal Plan is based, are close to the median forecasts of a group of main forecasters. According to current understanding, the forecasts are, therefore, at least close to most likely scenario. Then again, the regional reform includes risks of higher general government expenditure than estimated during the planning period for general government finances.

The Ministry of Finance's forecasts were found reliable in the ex-post assessment

Macroeconomic forecasts are required to be both reliable and independently prepared. In the NAOF's assessment conducted under fiscal policy monitoring in 2018 regarding the reliability of the Ministry of Finance's macroeconomic forecasts, the Ministry of Finance's GDP growth, unemployment rate and inflation forecasts for 1976–2016 were among the best with Etla's forecasts in terms of reliability (NAOF 7/2018).[9]

In Finland, official forecasts are produced by the Economics Department of the Ministry of Finance. According to NAOF's previous audit on the reliability of macroeconomic forecasts, no factors that would have compromised the independence of the Ministry of Finance as a forecasting body emerged in the audit (NAOF 11/2016).[10] However, this does not guarantee that, as circumstances and personnel change, independence can also be ensured in the future. For this reason, and in addition to reliability, attention must be paid to the verification of independence.

The forecasts used as a basis for the fiscal policy in Finland are prepared by the Ministry of Finance, and they are not confirmed by any independent third party. Elsewhere in the eurozone, macroeconomic forecasts are produced by independent institutions or the forecasts prepared by a member state's finance ministry are approved by an independent body. According to the European Commission, the Finnish arrangement is exceptional in the EU, but it is not in violation of the EU regulations.

Attention needs to be paid to the verification of both reliability and independence

4.1 An assessment on whether the General Government Fiscal Plan forecasts are realistic

The Ministry of Finance's forecasts for 2018–2020 are close to the median of all forecasts

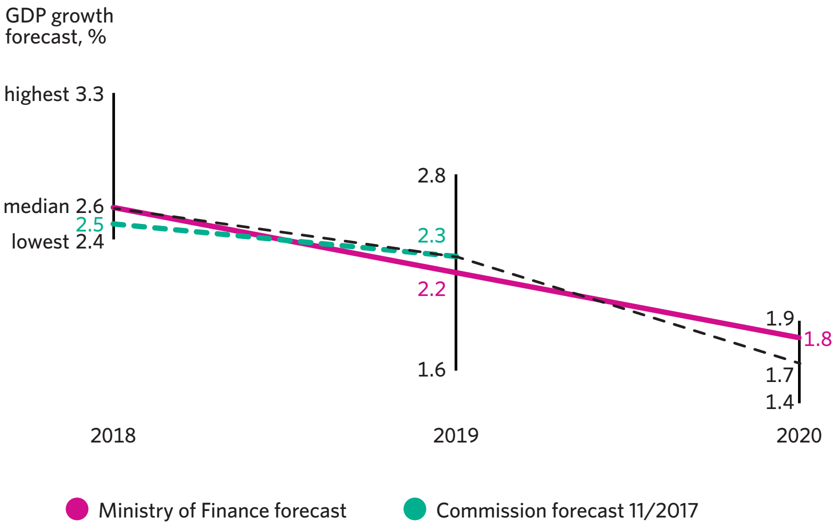
This subsection examines the Ministry of Finance's forecasts for 2019–2022 under the General Government Fiscal Plan and the Finance Ministry's forecasts for 2018–2020 published in conjunction with the economic survey of spring 2018. These are compared with the forecasts produced by a group of main forecasting institutes, and an assessment whether the forecasts, and the changes in them, can be seen realistic. The forecasts in the economic survey of spring 2018 of the increase in GDP and the development of the general government deficit in 2018–2020 are close to the median offered by forecasters, and they cannot be considered to be overly optimistic or pessimistic. The Ministry of Finance's forecasts on GDP growth and on general government deficit development for the current and next years are fairly close to the European Commission's forecasts. The Ministry of Finance's forecasts on economic growth and the general government deficit are realistic. The risk of revising the forecasts of economic growth upwards or downwards is in principle neutral, however, the protectionist trade policy in the world trade would give a higher risk weight to the downward revision. The price forecast is realistic. The pressure to price increases is still not high. However, the price pressure may increase in the next years if economic growth continues as expected.

The General Government Fiscal Plan is based on the Ministry of Finance's short-term forecast and on forecasts for medium-term and long-term economic growth. Finland's economic outlook has improved significantly since spring 2017, and the predictions have been accordingly revised. This has been affected, for example, by international trade which had a better development than originally expected in 2016–2017.

The improved cyclical situation has revised the short-term projections upwards

In 2016–2017, Finland's economy stopped losing export market shares and exports recovered quickly. This, combined with domestic demand growth, clearly improved the overall economy. Since autumn 2017, forecasts have continued to be revised upwards, mainly as a result of the more positive development of employment than expected in 2017. The Ministry of Finance increased the growth rate forecast for 2018 to 2.6% (from 2.1% last autumn). Furthermore, the Ministry of Finance revised its forecast on the general government deficit in relation to GDP for the better from last autumn.

The upward revision of GDP growth and the general government deficit forecasts are sound. The forecast of GDP growth for 2018–2020 is close to the median of the forecasts of a group of main forecasters published in spring 2018. The scenario for the macroeconomic development and for the general government deficit in relation to GDP can be considered realistic.



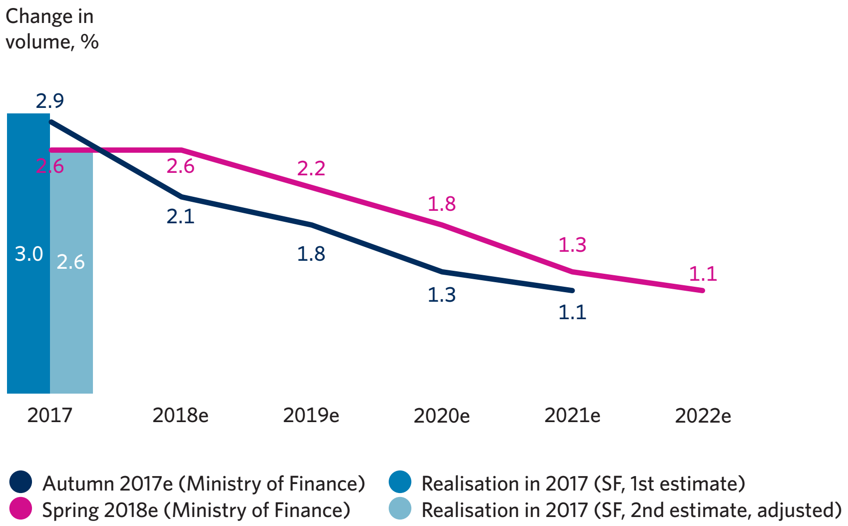
Sources: Ministry of Finance, Bank of Finland, Etla, PTT, PT, European Commission, IMF, OECD, Danske Bank, Nordea, OP

Figure 11: Variation between the GDP growth forecasts for 2018–2020 and median (dashed line) prepared in spring 2018

At the end of February 2018, Statistics Finland published a preliminary GDP growth estimate of 3.0% for 2017 on the basis of quarterly national accounts. The Ministry of Finance forecast the growth to be 2.9% in the autumn. By the end of March, Statistics Finland published a revised estimate of 2.6%. Therefore, the Ministry of Finance's estimate of GDP growth for 2017 published in the autumn seems to be 0.3 percentage points higher than the statistical figure.

GDP growth statistics for 2017 were revised from 3.0% to 2.6%

The Ministry of Finance has revised its growth forecasts for 2018 and 2019 towards a slightly faster growth. In the medium term, the 2021 forecast has been revised towards a slightly faster growth as a result of improved economic outlook. The growth rate of 1.1% estimated for 2022 is slightly lower than the long-term growth estimate of 1.5% by the Ministry of Finance.



Sources: Ministry of Finance, Statistics Finland (SF)

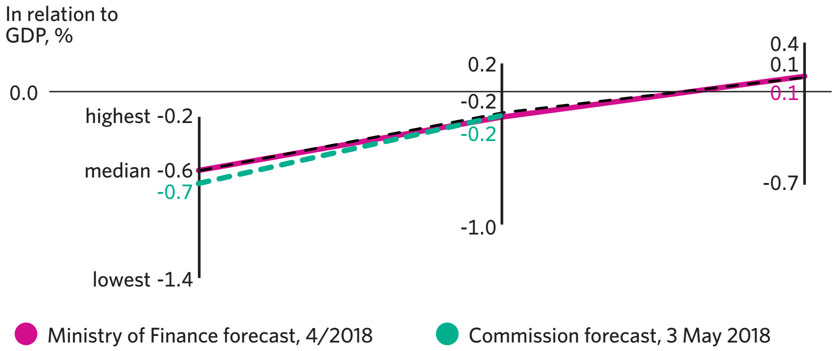
Figure 12: Change in GDP growth forecast

As a result of the upward revisions of GDP forecasts for 2018–2020, the forecasts of general government tax revenue are revised upwards. In addition, the general government deficit in relation to GDP improves because of the increases in the nominal GDP forecasts. Hence, the near-future forecasts for the deficit of general government finances in relation to GDP have become significantly more positive during the past year. For example, the Ministry of Finance estimated in spring 2017 that the 2018 deficit rate will be -2.0%, and in autumn 2017 it estimated the rate to be -1.4%. In spring 2018, it estimates the rate to be -0.6%. It should be noted that all forecasters have revised their forecasts similarly, so that the median of the distribution of different forecasters presented in Figure 5 has shifted from -1.9% in spring 2017 to -0.6% in spring 2018.

Short-term forecasts of GDP growth and the general government deficit in relation to GDP have been revised upwards

The Ministry of Finance's forecast for 2019–2020 published in spring 2018 expects the deficit ratio to improve to -0.2% in 2019 together with the median forecast and end up at 0.1% in 2020. Instead, the challenges presented by the long-term population structure changes to the general government finances have not disappeared, regardless of the positive short-term projections.

Long-term challenges for general government finances as a result of changes in the population structure remain in place



Sources: Ministry of Finance, Bank of Finland, Etla, PT, PTT, OP, Nordea

Figure 13: General government deficit forecasts for 2018-2020, variation in forecasts and median (dashed line) prepared in spring 2018

Price forecasts have a direct impact on the price adjustments made as part of the central government spending limits procedure and the assessment of the trends in tax rates. In addition, the nominal GDP is used as the denominator in the general government deficit and debt ratio. When assessing the development of these ratios, forecasts affecting the price of GDP must, therefore, be taken into account in addition to the GDP volume forecast.

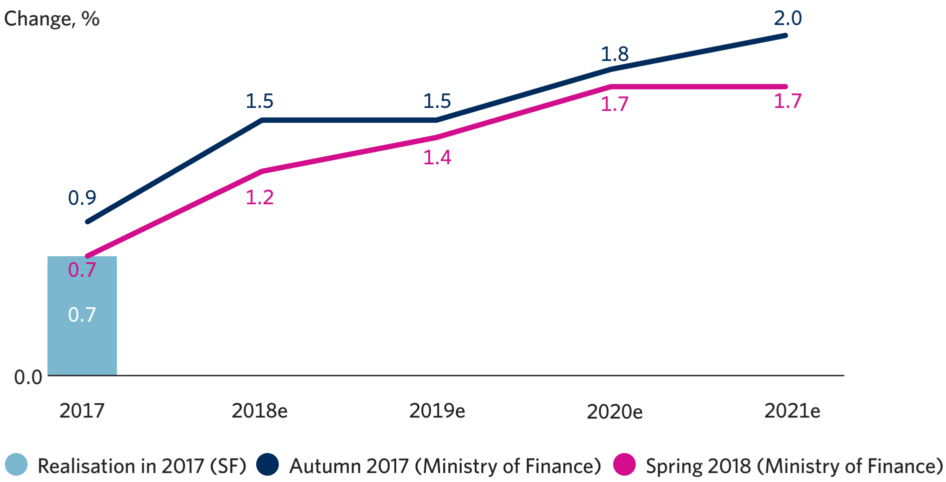
Compared with the forecast on which the autumn budget proposal is based, the development of consumer prices turned out to be slower than expected in 2017. Correspondingly, forecasts for 2018 and for the following years have been revised slightly downwards.

Forecasts of consumer and import prices in 2018 are lower than in the autumn. At the same time, the forecast of export prices is clearly higher than in the autumn. The joint impact on the price of GDP is neutral, and the forecast of the GDP price has remained nearly unchanged. Therefore, as the forecast of GDP volume growth has been revised upwards and the forecast of

The forecast of nominal GDP has been revised upwards in accordance with volume growth the price of GDP has remained unchanged, the forecast of the nominal value of GDP is higher than last autumn to the extent the forecast of volume growth has been revised. In addition, the forecast of nominal general government tax revenue has been revised upwards, which has reduced the deficit. At the same time, the forecast of nominal GDP used as the denominator of the deficit ratio has increased. Both of these factors have an impact on the evident upward revision of the forecasts of the general government deficit ratio.

Consumer prices are expected to increase close to the rate in the eurozone in 2018

The price forecast is realistic. The increase in consumer prices, i.e. the inflation rate, is expected to accelerate to 1.2% this year, i.e. closer to the average increase of 1.4% estimated for the eurozone. This year's domestic inflation forecast is affected by the price of crude oil being higher than in the previous year and increases in the prices of processed food products. In the next years, pressures to price increases will remain moderate, but they will intensify if economic growth in accordance with the short-term economic boom continues as expected.



Sources: Ministry of Finance, Statistics Finland (SF)

Figure 14: Change in inflation forecast

Forecasts are realistic, and the Ministry of Finance's forecasts are close to the median

The economic forecast published in conjunction with the General Government Fiscal Plan in spring 2018 is fairly close to the median scenario. The forecast was prepared independently at the Economics Department of the Ministry of Finance. An upward revision in the projection compared to the forecast of autumn 2017 on which budget planning was based is justified, as the realised statistics have changed the forecast to be more positive. For example, the realised increase in employment has exceeded all expectations.

Under the Budgetary Frameworks Directive, the macroeconomic and general government fiscal forecasts must examine the development of main fiscal variables under different assumptions of growth and interest rates. Correspondingly, NAOF has previously emphasised that it is important to thoroughly process the impact of economic development slower than estimated as part of fiscal planning. The General Government Fiscal Plan published by the Ministry of Finance for 2019–2022 presents a sensitivity analysis, similarly to in the previous plan, concerning the impact of an increase in interest rates on general government expenditure. It also presents alternative growth options: an option with growth faster by one percentage point and an option with growth slower by one percentage point.

The range of alternative assumptions used in macroeconomic and general government fiscal forecasts must be informed by the performance of past forecasts. In spring 2018, NAOF published a fiscal policy monitoring assessment of the reliability of the Ministry of Finance's GDP growth, employment rate and inflation forecasts.

The risk of revising the forecast for 2018–2020 upwards or downwards is neutral, even though pointing slightly to the downwards direction

In 2011–2015, the Ministry of Finance predicted growth faster than realised growth, whereas the budget forecasts for 2016–2017 underestimated the rate of economic growth. The revision risk associated with the spring 2018 forecast can be considered by the direction of revision to be neutral. Any threats, if realised, will reduce growth, while e.g. more positive than expected development of employment in the eurozone and Finland will accelerate economic growth. However, the revision risk is pointing slightly downwards, as risks of trade wars have increased and, if realised, they can decelerate the development of international trade and have a negative impact on Finland's economic growth.

4.2 Long-term reliability of economic forecasts

No defects requiring action were discovered in the reliability of the Ministry of Finance's forecasts

In April 2018, NAOF published, in relation to its statutory duties, an assessment under fiscal policy monitoring of the reliability of the Ministry of Finance's macroeconomic forecasts (NAOF's audit reports 7/2018). The assessment focused on whether the Ministry of Finance's GDP, unemployment rate and inflation forecasts have been reliable in 1976–2016. No such characteristics (bias) that would require corrective action based on the Decree on the General Government Fiscal Plan were detected in the assessed GDP, unemployment rate and inflation forecasts of the Ministry of Finance.

The reliability of the Ministry of Finance's (FM) forecasts was examined using the following questions:

1. How accurately have the FM's forecasts predicted future economic development when compared to forecasts by other key forecasters (accuracy)?
2. Have errors in the FM's forecasts been temporally independent and non-persistent?
3. Have the FM's forecasts been unbiased?
4. Have the FM's forecasts encompassed the naïve forecast?
5. Have the FM's forecasts covered all the pertinent information at the time of forecasting?

Question 1 was answered by depicting the accuracy of the year ahead (t+1) budget forecasts and the current year's (t+0) forecasts produced by the Ministry of Finance during the autumn forecast round and by comparing the Ministry of Finance's forecasts with the accuracy of the forecasts of Etla, OECD, PT and PTT.

The accuracy of the forecasts was examined by comparing the averages of the absolute values of errors in the forecasts of the Ministry of Finance and other forecasters. In general, the Ministry of Finance's mean was within the 95% confidence range of the two best forecasters. Only Etla was statistically slightly better than the Ministry of Finance in the current year's unemployment rate forecasts. In terms of the accuracy of the current year's GDP growth and all of the variables for the year ahead forecasts, the Ministry of Finance was statistically one of the most accurate forecasters. In the case of forecasts for the budget year (t+1), the accuracy of the Ministry of Finance in 1976–2016 was statistically as good as the other forecasters. The Ministry of Finance, PTT and Etla were the most accurate in forecasting the GDP and unemployment rate during the period under review. In inflation forecasts, the Ministry of Finance was, together with the OECD, the least accurate in the sample period, but the differences were minor.

The Ministry of Finance's forecasts have been unbiased and forecast errors non-persistent

Questions 2–5 were answered by comparing the reliability of the forecasts of the Ministry of Finance and the reference group with similar statistical tests the European Commission uses to assess its forecasts. The Ministry of Finance's budget forecasts for the upcoming year (t+1), together with Etla's forecasts, passed the highest number of reliability tests. Both passed 13 tests out of 15. The Ministry of Finance's forecasts proved to be statistically unbiased in the case of all three variables, and there was no temporal persistence in the forecast errors. Forecasts by the Ministry of Finance and Etla most often passed the test on encompassing the naïve forecast and the test on coverage of all relevant information at the time of the forecast.

Forecasts of the Ministry of Finance and Etla passed the highest number of information coverage tests

The results regarding the current year's forecasts (t+0) were nearly identical. The Ministry of Finance and Etla passed 14 reliability tests out of 15, with PTT and PT following close behind with 13 passed tests. The Ministry of Finance's forecasts were unbiased and there was no temporal persistence in the forecast errors. Comprehensiveness of the information included in the forecasts on the current year's GDP, unemployment rate and inflation by the FM and Etla proved to be good.

Based on the results, the reliability of the Ministry of Finance's forecasts on GDP growth, unemployment rate and inflation for the year ahead (t+1) and the current year (t+0) was, together with the forecasts by Etla, among the best of the compared forecasts. However, other forecasters (PT, PTT and the OECD) were fairly close and they also performed did quite well. Their forecasts were unbiased as well, and only with some exceptions, the forecast errors were non-persistent.

References

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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 frameworks.

2 Government decree (1030/2012) on the implementation of the Treaty on stability, coordination and governance in the Economic and Monetary Union, the implementation of regulation under the legislation of the Treaty, application of the Treaty, and the entry into force of the act on requirements concerning multi-annual budgetary frameworks.

3 Government Decree on the General Government Fiscal Plan (120/2014).

4 Council Directive 2011/85/EU.

5 Government decree (601/2017) on amending the Government Decree on the General Government Fiscal Plan.

6 Due to the estimated entry into force of the Decree on the General Government Fiscal Plan, the current assessment does not cover the provision on information to be included in a budget proposal as referred to in the Decree on the General Government Fiscal Plan, and the assessment does not cover the provision on any comparison between government terms (to be proposed in the first General Government Fiscal Plan of the government term). With regard to the Treaty, the rules included in the Fiscal Compact will be assessed. With regard to the Fiscal Policy Act, currently applicable sections will be assessed.

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