

Fiscal policy monitoring assessment on management of government finances

This memorandum contains the main points of the National Audit Office's preliminary assessment regarding trends in government finances in 2018 and 2019. The assessment takes into account the Government's draft budgetary plan and budget proposal for 2019. The assessment is based on an independent economic forecast produced by the Ministry of Finance and other economic forecasts. The National Audit Office presented its previous assessment in a fiscal policy monitoring report published on 7 June 2018. The National Audit Office will publish a more extensive report on the fiscal policy audit and fiscal policy monitoring as a separate report to Parliament in December 2018.

The statutory task of the National Audit Office is to supervise compliance with the Act on Stability, Reconciliation, Guidance and Control of the Economic and Monetary Union, Enforcement of Regulations Included in the Scope of the Treaty on Stability, Coordination and Governance of the Economic and Monetary Union, Application of the Treaty and Requirements on Multiannual Public Fiscal Frameworks (the "Fiscal Policy Act", 869/2012) and the provisions issued under it, such as the Government Decree on the Central Government Fiscal Plan (120/2014; as amended by Government Decree 601/2017), as part of the auditing of central government finances.

In order to carry out its supervisory task, the National Audit Office has assessed the draft budgetary plan and the materials used as a basis for it on the basis of the regulations specified above, including the Government's budget proposal for the year 2019 and the macroeconomic forecast produced by the Ministry of Finance used as a basis for it.

The budget proposal was submitted to Parliament on 17 September 2018, and Finland's draft budgetary plan for 2019 was published on 4 October 2018. The European Commission will provide its view on the draft budgetary plan in compliance with the regulation on common provisions for monitoring and assessing draft budgetary plans in November 2018.

Assessment summary

According to the National Audit Office's assessment, parliamentary term objectives on the fiscal position of general government will be reached, thanks to strong economic growth. According to calculations based on the forecast by the Ministry of Finance, the structural balance of general government, from which the impact of the improved economic situation on the fiscal position has been removed, will be -0.7% in 2019. The set medium-term objective (MTO) is -0.5%.

Objectives regarding the nominal general government fiscal position and debt ratio will also be reached, mainly thanks to a cyclical increase of revenue and a decrease of expenditure. On the basis of calculations and the updated source data, the structural balance of general government bodies has not experienced any major improvement during the parliamentary term.

According to the preliminary assessment, Finland will comply with the preventive arm and the corrective arm of the Stability and Growth Pact in 2018. Although the structural balance of general government will weaken, the development will not remain significantly behind the required change when taking into account the flexibility factors granted by the Commission. On the basis of the currently available information, Finland will be compliant with the rules also in 2019, at which time the structural balance is expected to improve from the current year's level.

The forecasts by the Ministry of Finance that were used as the basis for the draft budgetary plan cannot, according to observations made by the National Audit Office, be considered unrealistic in the manner

specified in the legislation. The Ministry did increase its economic growth forecast for 2018 and decrease the 2019 forecast in the autumn. The mean value of growth for the years 2018 and 2019 combined remained the same. There is a slight risk of a need to decrease the autumn 2018 forecast, and the forecast is higher than the median forecast, whereas the forecast by the Ministry for 2019 is more conservative than the median forecast of all the forecasters that the NAOF follows.

Government's fiscal policy objectives and government finances

At the beginning of the parliamentary term, the fiscal position objectives for the sub-sectors of general government (central government, local government, employment pension institutions, other social security funds) were set in a manner that would lead to an overall balance in general government revenue and expenditure in 2019. The objective allows for a slight deficit for central and local government (0.5% in ratio to GDP), while the objective for employment pension institutions is a clear surplus (1% in ratio to GDP) and the objective for other social security funds is a balanced fiscal position.

According to the medium-term objective set for the structural balance of general government finances, the deficit should be at most 0.5% in ratio to GDP. The objectives specified in the Government Programme are a decrease in the debt-to-GDP ratio during the parliamentary term and an end to the increase of the amount of general government debt by 2021. An additional objective was no further increase of the overall tax rate during the parliamentary term.

Estimates on the achievement of these objectives have experienced relatively significant changes during the parliamentary term. Estimates on the deficit objectives, in particular, clearly changed between the spring of 2017 and the spring of 2018. When studying government finances as a whole, development of the combined nominal fiscal position of the sub-sectors is, according to the estimates, close to the target level. According to the median forecast, general government finances will be almost balanced in 2019. Central government will remain slightly behind its deficit target of 0.5%. Local government will reach its deficit target of 0.5%, employment pension institutions will have a surplus in ratio to GDP nearly in accordance with their target (1.0%) and other social security funds will be relatively balanced, in accordance with their target.

According to the latest information, the structural balance objective for the parliamentary term was achieved in 2016 and 2017, but the deficit is expected to experience a major deterioration in 2018. In 2019, the deficit is expected to be close to the target level of 0.5 in ratio to GDP but still slightly behind the target level: the median forecast is -0.8% in ratio to GDP.

The fact that the structural balance will not, according to the currently available information, improve during this parliamentary term but the target level that was considered difficult to reach (-0.5% in ratio to GDP in 2019) will still be almost reached illustrates how difficult the setting of the objectives in structural terms is. The reason behind the reaching of the target is that the structural balance estimate that describes the initial status, i.e. the situation in 2015, has experienced a major change. This also emphasises the great uncertainty involved with the 2019 estimate.

According to the objective set in the Government Programme, the overall tax rate is not to increase during this parliamentary term. The objective regarding the overall tax rate will be clearly achieved and even exceeded. On the basis of the forecasts, the tax rate will decrease by some two percentage units from 2015 to 2019.

The central government debt-to-GDP ratio has started to decrease according to the set objective, and the debt is expected to be less than 60% in ratio to GDP in 2019. However, assessing the reaching of the objective related to the amount of government debt is very difficult at this point, because the objective lies far in the future (2021). According to the current forecast, the objective will not be reached. However, the essential issue in terms of the debt sustainability of government finances is the development of the debt-to-GDP ratio.

Table 1 presents the rule-based objectives and other objectives set by the Government for the parliamentary term and an assessment on their achievement.

At the beginning of the parliamentary term, the National Audit Office noted that the objective regarding the tax rate limits the number of available fiscal policy measures. When considered retrospectively, however, the deficit, debt and tax objectives specified in the Government Programme and the first Central Government Fiscal Plan could be simultaneously achieved, because the economic growth picked up speed during the parliamentary term. On the whole, the deficit objectives will be nearly reached and the tax rate objective will be clearly exceeded. This means that the set objective would have allowed for a stricter tax policy, which would have assisted in the reaching of the nominal and structural deficit objectives as well.

Compliance with EU fiscal policy rules

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

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

The structural balance is predicted to be around -1.1% in ratio to GDP in 2018, which is 0.7 percentage points weaker when compared to the previous year. According to the preliminary assessment, there will be a deviation from the structural balance rule in 2018, but the deviation will not be significant in the manner specified in the rules.

According to calculations based on the forecast by the Ministry of Finance, Finland will reach the MTO in 2019, at which time the structural balance is expected to be -0.7% in ratio to GDP. According to the rules, the MTO is considered reached when the margin to the MTO is 0.25 percentage units.

The second pillar of the preventive arm is the expenditure benchmark, which sets the reference growth rate for central government expenditure. According to the assessment by the National Audit Office, Finland will also deviate from the expenditure benchmark, but the deviation will not be significant in the manner specified in the rules. Compliance with the expenditure benchmark will be achieved in 2019. The estimate of the level of structural balance and the required adjustment is presented in Table 2. The results of the expenditure benchmark calculation are presented in Table 3.

The corrective arm of the Stability and Growth Pact involves compliance with the deficit and debt criteria specified in the EU treaty. According to the debt criterion, general government gross debt may not exceed 60% in ratio to GDP. Similarly, the deficit criterion sets as the general government nominal deficit (net borrowing) limit value 3% in ratio to GDP.

Finland exceeded the 60 percent limit set for the debt ratio in 2014. The debt ratio has continued to decrease since 2016 and, according to the forecast produced by the Ministry of Finance, will continue to decrease throughout the forecast period. According to the forecast, the debt ratio will be slightly below 60 per cent already in 2018, mainly thanks to the economic development being more favourable than expected. The debt ratio is expected to reach 59.1% in 2019.

Compliance with the debt criterion is also assessed on the basis of cyclically adjusted debt and backward- and forward-looking criteria. Finland will comply with the debt criterion in 2018 and 2019 also when assessed using these criteria.

According to the forecast produced by the Ministry of Finance, the nominal general government balance will be 0.7% in ratio to GDP in 2018 and will continue to decrease to 0.1% by 2019. Thus, the reference value of 3% set for the deficit will be clearly reached.

Effect of structural reforms on government finances

The Government aimed to make decisions leading to eradication of the sustainability gap during the parliamentary term both with the help of the budgetary policy and by means of structural reforms. According to the most recent assessment by the Ministry of Finance, the sustainability gap of government finances is 2.5% in ratio to GDP. In spring 2015, the Ministry of Finance assessed the sustainability gap at 5% in ratio to GDP. The change was mainly due to an improved assessment of the structural balance during the starting year of the sustainability calculation, even though the structural balance is not expected to experience any major change during the parliamentary term.

Uncertainties involving the sustainability calculation, changes of the assumptions on which the calculation is based during the period under review and the major effect of non-discretionary factors on the assessment make the long-term sustainability indicator a less serviceable comprehensive economic policy objective, in addition to hindering the assessment of the achievement of the objective.

A key factor in the sustainability calculation, in addition to the structural primary balance, is, among others, an assessment on the long-term development of age-related expenditure, which can be influenced by structural reforms. Most of the structural reform sustainability objective in the Government Programme was earmarked for the social welfare and health care services reform. When setting the objective for the reform, the goal was to slow down the increase of social welfare and health care expenditure so that the annual expenditure would decrease by EUR 3 billion by the end of the 2020s when compared to the baseline expenditure forecast. The preparation process of the reform led to a very extensive reform, and the objective on the slowing down of the expenditure did not have a sufficiently strong role in the decision-making process. The reform according to the Government proposals involved plenty of uncertainties and also risks of increased spending.

Assessing the effects of the regional government, social welfare and health care services reform proved difficult, which is almost always the case in reforms of this size. The assessment could have been improved, however, by obtaining an overall picture and by specifying the degree of uncertainty in the case of each impact, and by more clearly presenting the economic risks. On the whole, on the basis of the available assessments, it is unlikely that the objectives of curbing the expenditure and the other objectives would be simultaneously met. This emphasises the fact that the progress should be gradual in reforming social and health care services, the objectives should be prioritised, the different effects should be monitored with care and a readiness for legislative reforms on the basis of the monitoring should be maintained.

To ensure the sustainability of central government finances, reforms that will have a permanent impact on government revenue and expenditure must be prepared also during the next parliamentary term. The reforms should be implemented by setting as clear objectives as possible and by ensuring that the contents of the reforms support the set objectives as comprehensively as possible. A good example of a reform implemented with such an approach is the pension reform that entered into force in 2017. Exact impact assessments of each alternative are not always possible, but even in such cases, risk analyses can be used to select an approach the effects of which can be best forecasted. The content and number of reforms must be dimensioned in a manner that allows for careful preparation and the making of the necessary decisions.

Assessment of the forecast used as the basis for the draft budgetary plan

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

The budget proposal and the draft budgetary plan are based on a short-term forecast and an assessment of medium- and long-term economic growth produced by the Ministry of Finance. The Ministry of Finance is forecasting a GDP growth of 3% for 2018 and a GDP growth of 1.7% for 2019, while spending limit decisions made in the spring were based on growth estimates of 2.6% and 2.2%, respectively. The autumn 2018 forecast is higher than the median forecast by all the parties that the NAOF follows and among the highest forecasts made. Of the followed parties, five forecasted a growth of 3.0% for 2018, which corresponds to the picture given by statistics early in the year on the economic development. Ministry's autumn 2019 forecast is in turn lower and more conservative than the median forecast. On the basis of the forecast sample, the GDP growth forecasts for both 2018 and 2019 remain within the 95% confidence bounds of the estimated normal distribution for each year. On this basis, the forecast by the Ministry of Finance cannot be considered unrealistic in the manner specified in the rules.

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Table 1. Objectives for central government finances set by the Government for the parliamentary term and an assessment on their achievement

| Objective | Initial status | Status in 2017 | Assessment on achievement of the objective |
|---|--|--|--|
| General government structural balance in 2019, percentage of GDP | | | |
| -0.5% | Based on the 2015 data - 1.8% in 2015. Based on current information -0.7% in 2015. | -0.3% | The objective will not be quite reached. The median of the forecasts is -0.8%, while the forecast by the MoF is -0.7%. Compliance with the rule is still deemed to have been reached. |
| Nominal balance in 2019, percentage of GDP | | | |
| Central government max. -0.5 % | -3.0% in 2015 | -1.8% | The objective will not be quite reached; the median deficit of the forecasts is 0.9%, while the forecast by MoF is 0.7%. |
| Local government max. 0.5% | -0.7% in 2015 | -0.1% | The objective will be reached. The median deficit of the forecasts is 0.3%. while the forecast by the MoF is 0.3% |
| Employment pension funds +1 % | 1.3% in 2015 | 0.9% | The objective will be nearly reached. The surplus in the forecast by the MoF is 0.9% |
| Other social security funds approximately 0% | -0.4% in 2015 | 0.3% | The objective will be reached. The surplus in the forecast by the MoF is 0.1% |
| General government debt | | | |
| Debt-to-GDP ratio will start to decrease by 2019 | 63.6 % in 2015 | 61.3% | The objective will be reached. The debt ratio will continue to decrease for the next few years. Median of the forecasted debt ratios for 2019 is 59.0%. The forecast by the MoF is 59.1% |
| Amount of debt will no longer increase in 2021 | The amount of debt stood at EUR 133.2 billion in 2015 | Stock increased by EUR 1.1 billion in 2017 | According to the forecast by the MoF, the objective will not be reached, even though the debt ratio is expected to continue to decrease in 2020 and 2021 |
| Total tax rate, percentage of GDP | | | |
| Total tax rate will not increase during the parliamentary term | 43.9% in 2015 | 43.3% | The objective will be reached. The median tax rate forecast for 2019 is 42.0% while the MoF forecast is 42.1%. |
| Sustainability gap, percentage of GDP | | | |
| Decisions leading to eradication of the sustainability gap will be made during the parliamentary term | 5% based on the spring 2015 estimate of the MoF | | Sustainability gap was estimated being some 3% by the MoF in autumn 2018. The objective will not be reached, but the assessment is somewhat limited. |

Table 2. General government structural balance, adjustment requirement (allowed deviation) and deviation. NAOF's calculations (based on the information supplied by the Ministry of Finance)

| | 2017 | 2018 | 2019 |
|---|------|-----------|-----------|
| Structural balance, % in ratio to GDP | -0.3 | -1.1 | -0.7 |
| Change, % in ratio to GDP | | -0.7 | 0.4 |
| NAOF's estimate of the adjustment requirement, % in ratio to GDP* | | -0.3 | -0.6 |
| Deviation from the adjustment requirement, % in ratio to GDP | | 0.4 | -1.0 |
| Is the deviation significant (>0.5)?** | | No | No |
| Cumulative deviation (two-year average) | | -0.2 | -0.3 |
| Is the cumulative deviation significant (>0.25)?** | | No | No |

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

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

Table 3. Growth in general government expenditure, applied expenditure benchmark and deviation. NAOF's calculations (based on the information supplied by the Ministry of Finance).

| | 2017 | 2018 | 2019 |
|---|-------|-----------|-----------|
| Nominal growth in total spending (calculated in accordance with the expenditure benchmark), % | 1.4 | 3.0 | 3.6 |
| NAOF's estimate of the applied expenditure benchmark (nominal), % | 2.3 | 2.3 | 3.7 |
| Deviation | | | |
| Difference between expenditure benchmark and growth in expenditure, percentage units | 0.9 | -0.7 | 0.1 |
| Deviation, EUR billion | 1.1 | -0.8 | 0.1 |
| GDP, EUR billion | 223.8 | 234.2 | 242.0 |
| Deviation, % in ratio to GDP* | 0.5 | -0.4 | 0.0 |
| Is the deviation significant (< -0.5)?** | | No | No |
| Cumulative deviation | | 0.1 | -0.2 |
| Is the cumulative deviation significant (<-0.25)?** | | No | No |

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

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