Separate report of the National Audit Office to Parliament: Fiscal Policy Monitoring and Audit Report on the 2015–2018 Parliamentary Term

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To Parliament

The National Audit Office monitors and evaluates fiscal policy in its role as a national independent fiscal institution under the European Union Stability Pact (Fiscal Compact) and within the meaning of European Union law. Provisions on the evaluation task are laid down in the Act on the National Audit Office of Finland (676/2000) and the Act on the Implementation and Application of the Provisions Governed by the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union and on Requirements Concerning Multiannual Budgetary Frameworks (869/2012, the "Fiscal Policy Act").

The evaluation comprises the assessment of the setting and implementation of the fiscal policy rules and the steering of government finances. It covers monitoring of the compliance with the Medium-Term Objective (MTO) and the related correction mechanism, monitoring of the preparation and implementation of the General Government Fiscal Plan and monitoring of compliance with the Stability and Growth Pact. It also covers the assessment of whether the macroeconomic forecasts used in fiscal policy-making are realistic as well as the ex-post assessment of the reliability of the macroeconomic and fiscal forecasts as laid down in the Government Decree on the General Government Fiscal Plan (120/2014, as amended by decree 601/2017)[1]. By monitoring the fiscal policy, the NAOF promotes transparency as well as stable and sustainable general government finances.

Under section 6 of the Act on the National Audit Office of Finland (676/2000), the National Audit Office hereby presents Parliament with this separate report on its fiscal policy monitoring and audit during the parliamentary term 2015–2018 for the 2018 parliamentary session.

Helsinki, 4 December 2018

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Main content

The fiscal policy monitoring and audit report includes assessments on compliance with fiscal policy rules, achievement of the Government's objectives and the fiscal policy framework during the current parliamentary term. It also covers the overall steering of general government finances, the functionality of steering procedures and the progress of structural reforms.

Due to the strong economic growth that started in 2016, a balance of the general government fiscal position has almost been reached at the end of the parliamentary term. According to the forecasts, most of the objectives regarding the general government fiscal position and debt set by the Government at the beginning of the parliamentary term will be reached.

The long-term sustainability gap of general government finances has not been eradicated during the parliamentary term, but it has become smaller. This is mainly because the estimate for structural balance in the initial phase has experienced a major improvement. The National Audit Office considers continuing with the structural reforms aiming at a reduction of the sustainability gap during the next parliamentary term important. The social welfare and health care reform offers an important opportunity to promote this objective.

The central government spending limits were followed during the parliamentary term, but the plausibility of the expenditure rule and transparency of the procedure have been challenged by, for example, the fact that funding of the Finnish Broadcasting Company is no longer included in the scope of the spending limits and the fact that some expenditure items outside the spending limits have not been clearly determined. The amount of tax expenditures also increased during the parliamentary term.

During the parliamentary term, Finland was in the preventive arm of the EU Stability and Growth Pact (SGP). The rules of this arm were followed in 2015–2017, and will also be followed in 2018 and 2019 according to the ex-ante assessment. According to the forecast, the medium-term objective will be reached in 2019 when examined in accordance with the rules. Similarly, the rules of the corrective arm of the Stability and Growth Pact were followed in 2015–2017. According to the ex-ante assessment, Finland will be in compliance with the deficit and debt criteria of the SGP corrective arm in 2018 and 2019. When setting the new medium-term objective, risks related to contingent liabilities on general government finances and existing fiscal buffers should be taken into account in addition to the EU rules and the assessment basis included in the Fiscal Compact.

The National Audit Office did not discover any significant deficiencies in compliance with the Fiscal Policy Act or the regulations based on it. Fiscal planning and governance in general improved during the parliamentary term, and related legislation was developed. The improved governance was partially due to the fact that governance of local government finances in its current form started. On the other hand, the governance does not take into account risks related to the contingent liabilities of central government entities, such as increased government guarantees, and the National Audit Office considers implementation of a risk-based limit for the liabilities justified.

According to an assessment by the National Audit Office, the economic forecasts produced by the Ministry of Finance forare at least as reliable as the economic forecasts produced by the other compared principal forecasting institutes of the Finnish economy.

1 Fiscal policy objectives for the parliamentary term

The economic situation in Finland and the outlook for the next couple of years improved during the parliamentary term. According to the forecasts, most of the objectives set for the government finances in the beginning of the government term will be reached. General government finances are expected to almost reach a balance at the end of the parliamentary term, thanks to the improved economic situation, and the general government debt ratio has started to decrease. During the parliamentary term, the fiscal policy has varied between pro-cyclical policy and counter-cyclical policy. Combined net assets of general government entities grew and net assets of the central government also grew in 2017.

The central government spending limits were followed during the parliamentary term. However, a deviation from the spending rule was made in the case of the funding of the Finnish Broadcasting Company. Functionality of the spending limits has also been challenged by, for instance, partially unclear determination of financial investments outside the spending limits, introduction of a new provision for unexpected expenses as well as arrangements related to the incorporation of Government functions.

The long-term sustainability gap of general government finances was not eradicated during the parliamentary term, but it became smaller, mainly due to improved initial balance of the general government finances. Reporting on the sustainability gap and its calculation was improved. Even though assessing the long-term impact of the policy measures on general government finances is important when preparing the actions, several limitations are related to using the sustainability gap as a comprehensive objective.

The tax rate decreased during the parliamentary term. The tax system as a whole was not developed nor was the system made clearer. Most tax change impact assessments are of a high quality, but there is not enough information available on the impact of tax subsidies.

1.1 Achievement of the objectives set for general government finances

The setting of objectives regarding general government finances during the government term consisted of the objectives included in the Government Programme and statutory objectives included in general government fiscal plans. The setting of objectives was based on actions on improving the European Union's multiannual governance that covers general government finances as a whole and the resulting Finnish Government Decree on the General Government Fiscal Plan. The consideration of general government finances as a whole in the setting of objectives was a useful change that improved the conditions for the management of general government finances.

In the first General Government Fiscal Plan of the parliamentary term, the fiscal position objectives for the sub-sectors of government sector (central government, local government, employment pension schemes, other social security funds) were set as binding objectives that would lead to an overall balance between general government revenue and expenditure in 2019.

The objective allowed for a slight deficit for central and local government, while the objective for employment pension schemes was a clear surplus and the objective for other social security funds was 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. According to the objectives regarding the general government debt, the debt-to-GDP ratio should start to decrease during the parliamentary term and the amount of debt should no longer increase in 2021. An additional objective was no increase of the tax rate during the parliamentary term.

The set objectives were based on, inter alia, an assessment on the long-term sustainability gap of general government finances. A commitment to make decisions that would lead to covering of the sustainability gap during the government term was made.

Table 1: Objectives for general 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 objective for 2019, % in relation to GDP			
-0.5%	Based on the 2015 data, deficit in 2015 -1.8%. Based on the current data, -0.7% in 2015.	-0.3%	The objective will not be quite reached; the median deficit of the forecasts is -0.8%, while the forecast by the Ministry of Finance is -0.7%. Compliance with the rule related to this objective is expected, however (see Chapter 3).
Nominal deficit objectives for 2019, % in relation to GDP			
Central government finances, deficit 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 the Ministry of Finance is -0.7%.
Local government finances, deficit max. 0.5%	-0.7% in 2015	-0.1%	The objective will be reached; median of the forecasts is -0.3%, while the forecast by the Ministry of Finance is -0.3%.
Employment pension schemes, +1%	1.3% in 2015	0.9%	The objective will be nearly reached; the surplus in the forecast by the Ministry of Finance 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 Ministry of Finance is 0.1%.
General government debt			
The debt-to-GDP ratio will start to decrease by 2019	63.6% in 2015	61.3%	The objective will be reached. The decrease has continued since 2016. The median of the forecasts for 2019 is 59.0%, the forecast by the Ministry of Finance is 59.1%.
Amount of debt will no longer increase in 2021	General government debt EUR 133.2 billion in 2015	The amount increased by EUR 1.1 billion.	According to the forecast by the Ministry of Finance, the objective will not be reached, even though the debt ratio is expected to continue to decrease in 2020 and 2021.
Total tax rate in relation to GDP			
Total tax rate will not increase during the parliamentary term	43.9% in 2015	43.3%	The objective will be reached; median of the forecasts for 2019 is 42.0%, while the forecast by the Ministry of Finance is 42.1%.
Sustainability gap in relation to GDP			
Decisions leading to eradication of the sustainability gap will be made during the parliamentary term	The sustainability gap estimate by the Ministry of Finance in spring 2015 was approximately 5%	The sustainability gap estimate by the Ministry of Finance in autumn 2018 was approximately 3%. The objective will not be reached, but there are limitations to the assessment (see Chapter 1.3).	

Sources of the actual and initial data: Statistics Finland, Ministry of Finance, NAOF. Forecast sources in this review: ETLA 9/2018, PT 9/2018, PTT 9/2018, SP 6/2018, VM 9/2018. The forecast by the Ministry of Finance (VM) has been separately mentioned. The initial data for 2015 has been described according to the current time series, unless otherwise stated.

Estimates on the achievement of these objectives have experienced fairly major changes during the parliamentary term. Estimates on the deficit objectives, in particular, clearly changed between spring 2017 and spring 2018. Development of the national economy and the public finances strengthened and the outlook for the next few years considerably improved, especially due to the development of employment being more favourable than anticipated.

According to forecasts, achievement of the objectives is close

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 relation to GDP but still slightly behind the target level.

A weakness of using structural deficit as a fiscal policy objective is that the assessment on the initial structural balance may experience a material change. According to the currently available information, the structural balance has not considerably improved during this parliamentary term, but the target level that was considered difficult to reach when setting the objective (-0.5% in relation to GDP in 2019) will still be almost reached. The assessment on the initial structural balance has experienced a major change, but the estimated change of the balance during the parliamentary term has also been stronger than in the 2015 forecast.

The structural deficit for 2015 in spring 2015 was 1.8% in relation to GDP. On the basis of the currently available information, the structural balance in 2015 was clearly lower, 0.7% in relation to GDP. This also emphasises the great uncertainty involved with the 2019 estimate.

When studying general government finances as a whole, development of the combined nominal fiscal position of the sub-sectors is close to the target level.

According to the objective set in the Government Programme, the total tax rate is not to increase during the current parliamentary term. Furthermore, the first General Government Fiscal Plan of the parliamentary term determined that the combined effects of tax-related measures on general government finances should be neutral at the 2019 level. The objective regarding the overall tax rate will be clearly exceeded. On the basis of the forecasts, the tax rate will decrease by some two percentage points from 2015 to 2019.

The 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 government debt objective is very difficult at this point, because the objective extends all the way to 2021. According to the current forecast, the objective will not be reached.

Development of the debt-to-GDP ratio is an essential issue in terms of debt sustainability

A more essential issue in terms of the debt sustainability of general government finances is the development of the debt-to-GDP ratio. Therefore, the development of the debt-to-GDP ratio should be emphasised when setting objectives on government debt also in the future. The development of general government net financial position can also be taken into account in the setting of the goals, where applicable.

Deficit and debt objectives form the core of the goal setting

At the beginning of the government term, the National Audit Office paid attention to the limitations caused by the tax rate objective on the fiscal policy, stating that if the GDP were to decrease during the parliamentary term, taxation would have to be lightened due to the set objective to prevent the tax rate from increasing. The objectives regarding general government finances included in the Government Programme should support the achievement of the rules-based general government finances objectives as well as possible. The objectives on structural and nominal deficit and general government debt should be seen as the core of the goal setting around which other objectives based on the economic policy choices that conform to the core objectives can be added.

However, when consideredretrospectively, the deficit, debt and tax objectives specified in the Government Programme and the first General Government Fiscal Plan were possible to achieve simultaneously due to the economic growth picking up speed during the parliamentary term. On the whole, the deficit objectives will be reached or nearly reached, and the tax rate objective will be exceeded. Thus, the tax policy could have been tighter even within the limits posed by the goal setting, which would have assisted in the achievement of the objectives regarding the nominal and structural deficit.

Fiscal stance

The National Audit Office assesses the fiscal stance using two indicators: via discretionary measures and on the basis of the change in structural primary balance. Figure 1 presents the results calculated using both methods, according to the currently available information. The calculation methods are described in detail on pages 15-16.

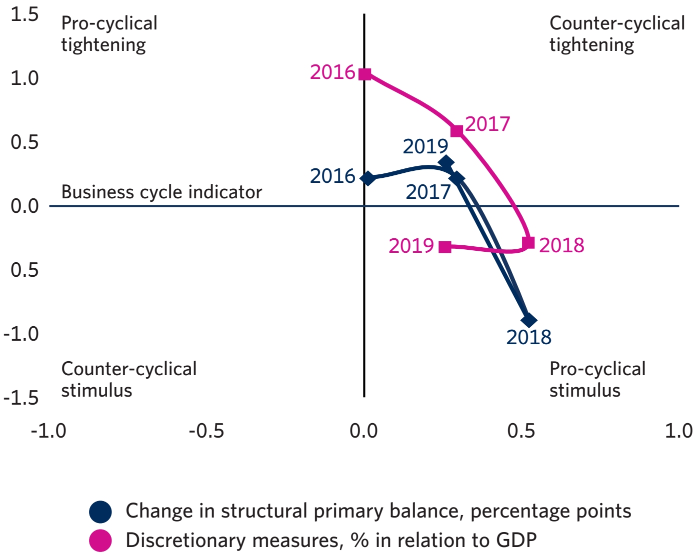

Figure 1: Fiscal policy framework, 2016-2019. Source: Calculations by the Ministry of Finance and the National Audit Office

Both indicators offer a fairly similar overall idea of the fiscal stance during the parliamentary term. The fiscal policy became more expansionary as the cyclical conditions improved from 2016 to 2019. Assessed using both methods, the fiscal policy was counter-cyclical, i.e. compensated for the economic cycle, and contractionary in 2017 and similarly pro-cyclical, i.e. promoted the economic cycle, in 2018. The fiscal policy becoming lighter in 2018 was mainly due to a tax relief and a reduction of social security contributions. The timing of the actions that negatively affected the revenue-side of general government finances cannot be considered fully successful from the perspective of the economic cycle and the striving to strengthen general government finances in the long term.

Estimated based on the change of the structural primary balance, the fiscal policy will become tighter in 2019, as the cyclical conditions are expected to weaken. Even though the indicators mostly offer a similar picture of the fiscal stance, the assessments on the magnitude of the impact vary, particularly in the case of 2019.

A precondition for using a counter-cyclical fiscal policy that compensates for the economic cycle and supports growth is a timely recognition of the prevailing economic cycle. There are significant uncertainties connected to up-to-date assessment of it, however. For example, still in autumn 2017 the National Audit Office estimated that the fiscal stance in 2017 was expansionary when measured with the change of the structural primary balance and neutral based on the discretionary measures. Therefore, one can assume that the judgement of the fiscal stance, particularly during the last years of the parliamentary term, will possibly still changeonce the assessments on the magnitude of the discretionary measures and the cyclical conditions, in particular, are updated.

There are deficiencies in both assessment methods and they partly measure different aspects, which means that the results they give may also differ. Assessments on the cyclical conditions are reflected in the results obtained using both methods, however. In the calculation of the structural primary balance, the cyclical adjustment is done on the basis of output gap estimates, which means that as the output gap estimates are specified, the assessment of the fiscal stance changes accordingly. In the case of the discretionary measures indicator, the increase of expenditure, with cyclical factors removed, is compared to the estimated average growth of potential output. Similarly, revenue-side actions are calculated on the basis of the estimated impact of individual tax policy measures, which always involves some uncertainties. Moreover, realisation of the impact assessments is not always systematically monitored.[2]

Assessing fiscal stance

Assessing fiscal stance by means of change in structural primary balance, ΔSPB

The structural primary balance (SPB) describes the cyclically adjusted fiscal balance without interest expenditure. Cyclical adjustment eliminates from the nominal balance the impact of the cyclical conditions on general government expenditure and revenue. Any non-recurring items are also eliminated from the primary balance in the process. A change in structural primary balance in which no consideration is given to interest expenditure or cyclical conditions gives a better idea of the impact of discretionary fiscal policy on the general government fiscal balance than a review based on changes in nominal balance. If the structural primary balance has improved, the fiscal policy is considered to have been contractionary. If the structural balance has weakened, the fiscal policy has been expansionary.

Assessing fiscal stance on the basis of discretionary measures, DFE

In the discretionary fiscal effort (DFE), the revenue side and expenditure side are separately examined.[3]

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

In the case of general government expenditure, it is more difficult to give an equally straightforward definition of the discretionary measures.

Interest expenditure and cyclical unemployment expenditure are eliminated from total general government spending. The remaining change in total expenditure is compared to the growth rate of potential output. If the expenditure has grown more rapidly than the potential output, the fiscal policy has been expansionary, and if the expenditure has grown more slowly than the potential output, the policy has been contractionary.

The DFE is examined as the difference between the discretionary measures directed at revenue and expenditure. If the difference is negative, the fiscal policy has been expansionary and if the difference is positive, the fiscal policy has been contractionary.

Cyclical conditions indicator

The expansionary or contractionary nature of the fiscal policy can only be assessed if an assessment of the cyclical conditions is available. Carnot an Castro (2015)[4] define business cycle indicator as a average of the normalised level of the output gap and changes therein. Thus, the business cycle indicator is not as sensitive to forecast revisions as an indicator that is solely based on the output gap.

Development of the financial position

Figure 2 presents market-priced assets and net assets of general and central government. The net assets presented in the figure have been calculated by deducting liabilities from total assets. The liabilities cover all liability side positions recorded in the financial accounts, which means that it is a broader measure and has a different valuation principle than the so called "EDP debt". The central government liabilities cover three-quarters of the total liabilities of the general government.

Net assets of central government started to increase in 2017

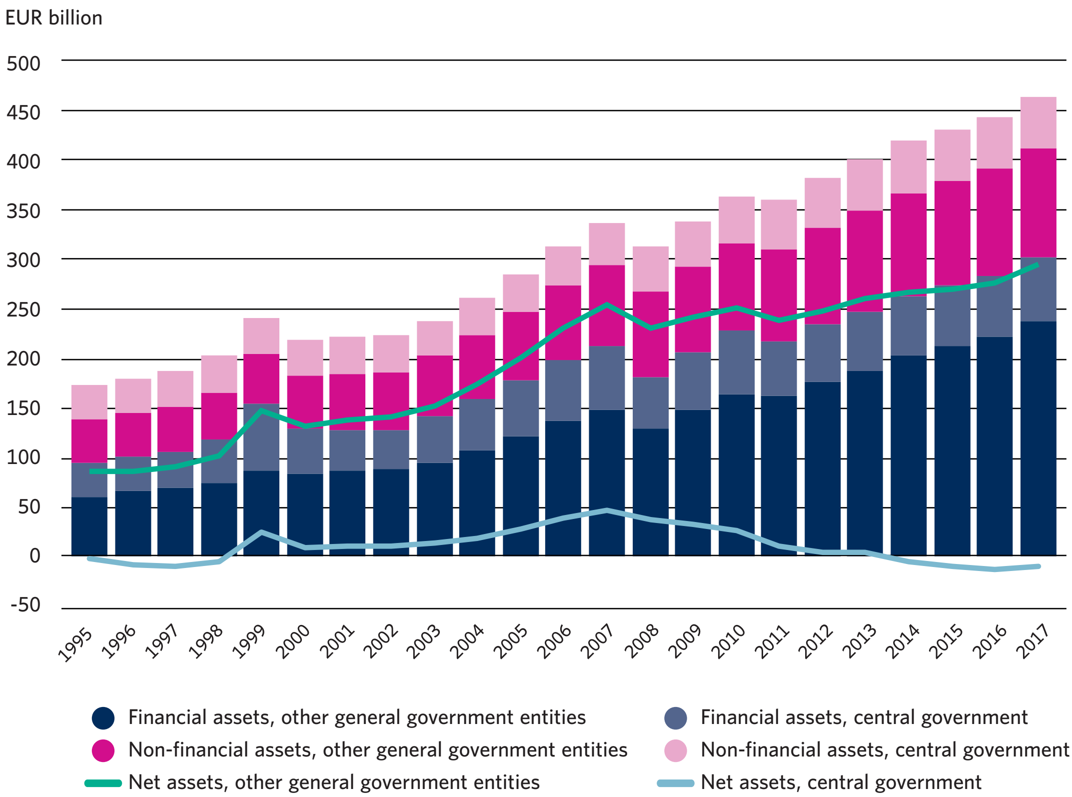

Figure 2: General government assets, EUR billion, 1995–2017. Source: Statistics Finland

Financial assets of employment pension schemes account for a little less than a half of the total general government assets. A total of 65% of the total assets are financial assets, the size of which mostly depends on the development of stock prices.

Value changes of non-financial assets, such as land and buildings owned by general government entities, are clearly smaller. Almost 70% of the general government non-financial assets are owned by local government entities.

Central government net assets which had diminished since 2008, grew again in 2017. The growth in net assets is mainly driven by an increase of the market value of shares owned by central government entities, reduced borrowing and a decrease of the market price of issued debt. As a result, the total liabilities of central government reduced for the first time since 2007 in 2017.

1.2 Compliance with spending rule

In the Government Programme, the Government commits to following a spending rule that covers some three-thirds of the budget expenditure during the four-year parliamentary term. The current spending rule system has been in effect since 2004. Figure 3 compares coverage of the spending expenditure in relation to the total general government expenditure; the coverage has varied between 35 and 38 per cent. The significance of the spending rule as a limiter of general government expenditure seems to have remained stable throughout the existence of the current spending rule system.

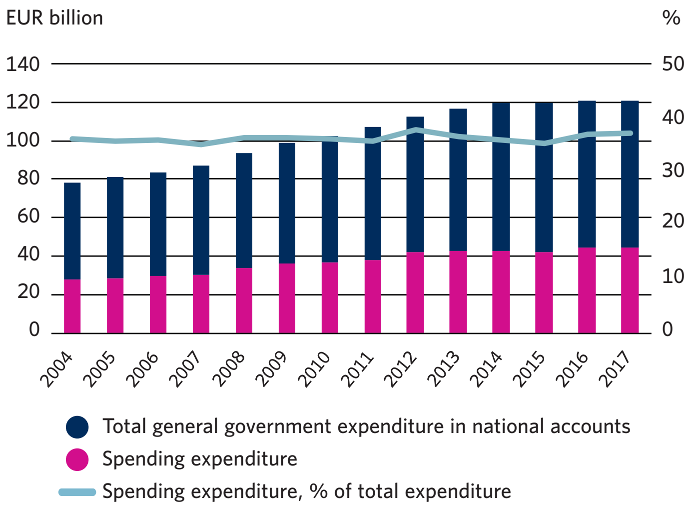

Figure 3: Total general government expenditure in relation to the spending expenditure. Source: Statistics Finland, budgets

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

Compliance with the spending rule during the 2016–2019 parliamentary term

According to observations made by the National Audit Office, the Government spending rule has been followed during the current parliamentary term, except when the funding of the Finnish Broadcasting Company was transferred to outside the scope of the spending limits. There are also factors that make assessing compliance with the spending rule more complex and make the rule less transparent, including corrections of the rule and interpretation of some expenditure items, such as financial investments.

A deviation from the spending rule laid down in the Government Programme deteriorates the plausibility of the spending limit system.

The National Audit Office evaluates compliance with the central government spending limits during the parliamentary term and monitors trends in budget expenditure and tax subsidies outside the spending limits. The National Audit Office's assessment also aims to take into account the period between parliamentary terms when the new spending rule is being prepared and assess the margin of manoeuvre of the spending rule used during the current government term. The budget proposal for 2019 complies with the spending limit adjustments.

Table 2: Spending limit level for the last year of the parliamentary term 2016–2019 from the last General Government Fiscal Plan of the parliamentary term for 2016–2019 to the 2019 budget proposal, EUR million. Source: The NAOF's spending limits calculations, preparation of the spending limits by the Ministry of Finance

Date	Budgeting phase	Spending limit level 2019	Level change	Spending limit expenditure	Supplementary budget reserve	Undistributed
2 April 2015	General Government Fiscal Plan 2016–2019, technical spending limits, 2016 prices	43,040		43,040	0	0
	Government policies		-1,292			
	Appropriations transferred to the spending limits		2,002			
28 September 2015	General Government Fiscal Plan 2016–2019, spending limit level before adjustments	43,750		43,393	300	57
	- Price adjustments		642			
	- Structural adjustments		136			
	- Decrease of spending limit level		-120			
14 September 2018	Adjusted spending limit level	44,408				
14 September 2018	Budget proposal 2019, 2019 prices	44,408		44,001	300	107

Preparation of the spending rule for the parliamentary term 2016–2019 was started from the "technical spending limits" of the previous Government, which are included in the General Government Fiscal Plan 2016–2019 that was published on 2 April 2015. The Government of Prime Minister Juha Sipilä committed to an expenditure rule according to which the expenditure items within the spending limits were EUR 1.2 billion lower than in the case of the technical spending limits. On the other hand, the Government agreed that tax compensation of EUR 1.5 billion to municipalities and EUR 0.5 billion of funding to the Finnish Broadcasting Company would be included in the spending limits. Improved coverage of the spending limits is in favour of the transfer of the tax compensation accrued during the previous parliamentary term to the spending expenditure, and general principles regarding the spending limits, such as the principle that expenditure is included in the spending limits unless there is a special reason caused by the spending limits to deviate from this principle, are in favour of transferring the Funding of the Finnish Broadcasting Company. No such justification was offered in the case of the funding of the Finnish Broadcasting Company, however. The spending limits increased to a level slightly higher than the technical spending limits regardless of the Government's savings policies, however.

The Funding for the Finnish Broadcasting Company was transferred to the scope of the spending limits in the beginning of the parliamentary term, but it was removed from the spending limits again later during the parliamentary term. The spending limit level was decreased by means of a structural adjustment, which is what should be done according to the spending limit principles. The Government Programme determines which expenditure items are included in the scope of the spending limits and which are not. However, the spending limit principles should remain unchanged during a parliamentary term to ensure plausibility of the spending limit system.

Processing of funding of the Finnish Broadcasting Company has been inconsistent during the parliamentary term.

Spending limit adjustments

The National Audit Office has paid attention to transparency of and justification for structural adjustments several times. Structural adjustments ensure that the tax payment burden remains the same in connection with changes to the spending expenditure items and expenditure items outside the spending limits. Furthermore, the spending limits treat allocation decisions neutrally, regardless of whether they are targeted to the spending limits or outside the spending limits. Structural adjustments are constantly implemented, and monitoring a specific structural adjustment may be difficult, especially if the adjustment is revised at a later time. As no structural adjustments of the spending limits are made based on policies included in the Government Programme, such as the cutting, increase and transfer of expenditure, the connection between the subsequent structural adjustments and the original Government policies is not clear without sufficient justification. The National Audit Office has pointed out that structural adjustments related to the Competitiveness Pact are not transparent. To promote transparency of the budgeting of the spending limits, justification for decisions to lower the level of spending limits should also be offered.

The most important adjustment measure of the Government was the freezing of statutory index increases. Price adjustments made in the preparation of the spending limits by the 2019 budget proposal were some EUR 1.3 billion lower than during the previous parliamentary term. The statutory index increases amount to approximately EUR 1 billion.

Statutory index adjustments were some EUR 1.3 billion lower than during the previous parliamentary term

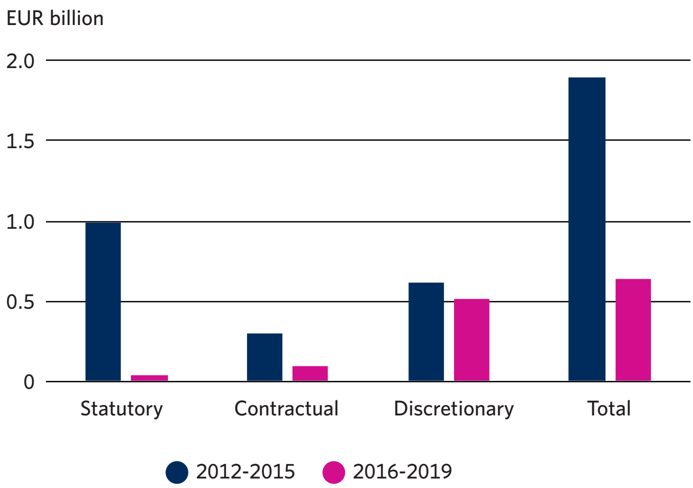

Figure 4: Price adjustments during the parliamentary terms 2012–2015 and 2016–2019, EUR billion. Source: Tables from the preparation of the spending limits from the Ministry of Finance, the NAOF's spending limits calculation

Spending limits' margin of manoeuvre

The use of the additional reserve budgeted in the spending limits for 2017 and 2018 should have been more clearly justified.

The spending limits for the parliamentary term included a margin of manoeuvre of some EUR 500 million, consisting of reserves for the years 2016–2018 and EUR 357 million for 2019. There was uncertainty regarding the size of additional expenditure items in the next few years arising from immigration, among other issues, in the beginning of the parliamentary term. Internal spending limit reserves from the administrative sector of the Ministry of Finance were used to cover unforeseen expenditure pressures when preparing the spending limits. From the perspective of the transparency of the spending limit system, budgeting reserves within the spending limits of an administrative sector is not as clear a way to increase the margin of manoeuvre as an undistributed reserve. Budgeting the additional reserve as part of the undistributed reserve for 2017 and 2018 would have been advisable.

Table 3: Spending limits' margin of manoeuvre during the government term, EUR million. Source: General Government Fiscal Plan 2016–2019, 28 September 2015

Reserve type	2016	2017	2018	2019
Supplementary budget reserve	300	300	300	300
Unallocated reserve	206	47	106	57
New reserve within an administrative sector		150	150	
Reserves total	506	497	556	357

Expenditure items outside spending limits

Cyclical expenditure, such as unemployment allowances and income security, are expenditure items outside the spending limits. Debt interest payments, compensations to municipalities arising from tax cuts and expenditure generated by financial investments are also included in expenditure items outside the spending limits. Some of the expenditure items outside the spending limits are different types of flow-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 revenue generated by the national lottery are examples of such expenditure items.

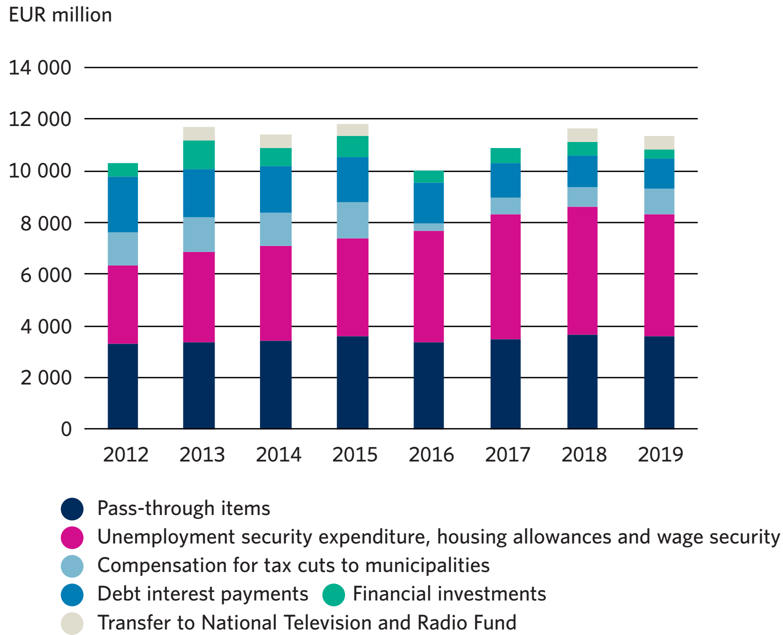

Figure 5: Expenditure items outside the spending limits 2012–2019.
Source: Budget proposals

Financial investment expenditure has remained at a high level throughout the government term. Financial investments related to development cooperation were a new form of development cooperation included in the budget in 2016. As their level has been high and because one of their purpose is to replace direct development cooperation expenditure, it is particularly important that the meeting of the goals set for financial investments related to development cooperation are reported in an open and transparent manner.

An appropriation used to fund the operations of Terrafame, which was previously processed as an expenditure item included in the spending limits, was transferred to outside the spending limits in 2018. EUR 46 million of funding included in this item was granted to increase the shareholders' equity of Suomen Malmijalostus Oy. Suomen Malmijalostus Oy owns 77% of Terrafame, and the business of Terrafame is expected to become profitable in 2018. Justifying in more detail how the rearrangements influenced the decision to transfer the item to outside the spending limits would be advisable.

Expenditure from the incorporation of operations of the state has previously been covered with expenditure items allocated for the acquisition of shares. It should be assessed how the incorporation of state operations and the related administrative expenses are different from the state operations funded within the spending limits.

Financial investments should be left outside the spending limits, as they are expected to retain their value. However, there is no clear and transparent practice as to how the expenditure related to financial investments is to be returned to the budget – or whether it should be returned to the budget at all. Some of the expenditure items remain as assets that may be liquidated at a later point for another purpose. This has been done during the government term in the case of share donations, for example. The spending rule principles regarding share donations and financial investments should be clarified.

1.3 Long-term sustainability and the implementation of structural reforms

The Government aimed for decisions leading to eradication of the sustainability gap during the government term both with the help of the budgetary policy and by means of structural reforms. According to the latest Ministry of Finance estimate, the general government sustainability gap is some 3% in relation to GDP, compared to some 5% in the Ministry's assessment of spring 2015. The change is mainly due to an improved assessment of the structural balance during the starting year.

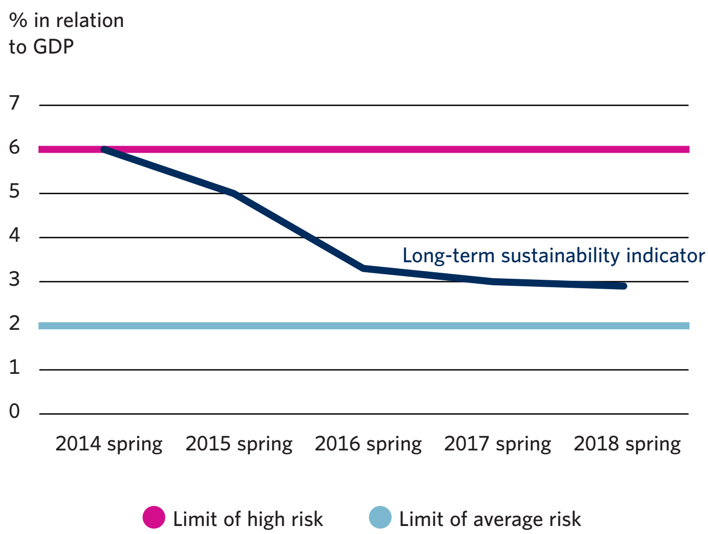

Figure 6: Development of the long-term sustainability indicator (S2) 2014–2018 and risk limits compliant to the basic forecast of the European Commission. Source: European Commission.

The sustainability gap has essentially decreased since 2014

The European Commission analyses the sustainability indicators on the basis of a risk assessment framework. In the past few years, the long-term sustainability gap has essentially decreased also in the Commission's estimates (see Fig. 6). In the Commission's assessment framework, a sustainability gap of less than 2% refers to low risk, a gap of more than 2% to average risk and a gap of more than 6% to high risk. An estimate according to the framework in spring 2014 indicated high risk in the long term. Ever since, the estimates have indicated medium risk.

Factors that are mostly outside the scope of influence of fiscal policy decision-making, such as factors connected to uncertainties of long-term development, also have a significant impact on the sustainability indicator. Furthermore, calculation principles of the sustainability indicator were revised during the period under review to correspond to new assumptions agreed upon within the scope of EU cooperation on long-term financial development, among other issues. The change increased the gap estimated by the Ministry of Finance by half a percentage point, which moved further away the sustainability gap objective when compared to the situation in 2015.

The sustainability gap assessment is sensitive to several assumptions on long-term development. These uncertainties are not limited to the overall assessment alone. Instead, there typically are uncertainties over the impact of political actions on the sustainability gap as well. In its reports published in 2017, the National Audit Office recommended that the Ministry of Finance should improve the transparency of the sustainability gap assessment by publishing a description of the methodology used in the calculation of the sustainability gap and sensitivity analyses in its regular reports and in impact assessments regarding major structural reforms. Ever since, the Ministry of Finance has published a regularly updated description of the methodology used in the calculation of the sustainability gap and added to its regular reports sensitivity analyses on the variables influencing the assessment.

Regardless of the uncertainties and sensitivities of the sustainability gap assessment, the National Audit Office considers the calculation to be a viable tool for evaluating risks and policy measures in general government finances. However, due to the above-mentioned limitations, its applicability as an indicator to which fiscal policy goals could be tied comprehensively is limited. The limitations also apply to some of the other indicators used as objectives, but the limitations are especially pronounced in the case of the sustainability gap.

Development of age-related expenditure can be influenced with structural reforms

In addition to the structural balance, a key factor in the sustainability calculation is an assessment on the long-term development of age-related expenditure. Of these expenditure items, the pressure to increase pension expenditure could be addressed with the pension reform that was prepared during the previous parliamentary term and that entered into force in 2017. The objective on sustainability of general government finances had major weight in the preparation of the pension reform, which supported the achievement of a good outcome from the perspective of general government finances. Finnish Centre for Pensions performed new sensitivity analyses on the impact of the pension reform based on an assignment from the National Audit Office for the National Audit Office's review published in spring 2017. The results did not suggest a high level of sensitivity.

Effects of the social and health care reform are unclear

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 objective was to slow down the increase of social 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 led to a very extensive reform and the second main objective of the reform, the curbing of expenditure, did not have a sufficiently guiding role in the decision-making process when basic decisions on the number of social and health care regions and introduction of the freedom-of-choice model were being made. Even though larger service provider entities and the financing model and the economic governance model basically support the financial objectives, a reform corresponding to the Government proposals would involve a great number of uncertainties and risks related to the increase of expenditure. The freedom-of-choice model, in particular, involves risks related to the overall expenses of the reform. In general, mechanisms that will cause temporary or permanent additional expenses were more automatic than mechanisms that will induce savings.

Assessing the impact of the health and social services and regional government reform proved very difficult, and comprehensive assessments could not be performed. Impact assessments are inevitably difficult in the case of such large reforms. The assessment could and should have been improved, however, by providing an overall picture of impcats and by specifying the degree of uncertainty in the case of each impact, and by more clearly presenting the financial 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 if the reform were realised in the manner specified in the Government proposals. This emphasises the significance of gradual implementation, careful monitoring of effects, readiness to amend legislation based on the monitoring results and prioritisation of objectives in the case of a social and health care services reform.

Another reform for which a sustainability objective in euros was specified in the Government Programme's structural reform package was a reduction of the municipalities duties by a total of EUR 1 billion. Its progress describes well the difficulty of implementing structural reforms. Carrying out the reform in the manner specified in the Government Programme 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 central government appears not as a structural reform, but as a cut of operating costs covering all administrative fields.

Other actions related to the sustainability of general government finances were also prepared and partially implemented during the parliamentary term. The Government Programme described a social contract, and the Competitiveness Pact was created during negotiations aiming at the social contract. The Pact supported improvement of Finland's cost competitiveness. However, analysing the total impact of the Pact on general government finances and the national economy is difficult already because an analysis would require an assessment of the content of the labour market solutions in a case where the Competitiveness Pact had not been created. This setting is different from the assessment of the effects of fiscal policy, for example, where the decisions made can be compared to the option of keeping the policy unchanged.

Agreements on the preparation of a business subsidy reform and a family leave reform were made in the budget session in 2017. The preparation schedules specified for both reforms were very tight. The objectives set for both projects were in correct direction, but preconditions limited the possibility of finding the best possible solutions for general government finances during the preparation processes. The preparation of neither of the projects led to the implementation of a reform.

To ensure the sustainability of general government finances, reforms that will have a permanent impact on general 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. Assessing the specific impacts of each alternative is not always possible, but even in such cases, risk analyses can be used to select an approach the effects of which can be best predicted. The content and number of reforms must be dimensioned in a manner that allows for careful preparation and the making of the necessary decisions.

1.4 Tax policy and preparation of tax reforms

The Government Programme set the strengthening of growth, entrepreneurship and employment as the tax policy objectives. The Government Programme includes both actions that will lower taxes and actions that will raise taxes. Key taxation actions include easing the taxation of earned income, which has been financed by increasing environmental taxes and real estate taxes. Most of the tax criteria changes specified in the Government Programme were realised between 2016 and 2018.

The Competitiveness Pact increased wage earners' pension insurance contributions and unemployment insurance contributions, and similarly decreased employers' social insurance contributions. The Government supported the Pact by easing the taxation of wages by, for instance, changing the marginal tax rates in the Government income tax scale, standard tax credit for work incomeand standard deduction for the production of income. The taxation of pension income was also eased by changing pension income deductionin state and municipal taxation and surtaxes for pension income. Furthermore, scope of the tax credit for household expenses was expanded and the percentage of tax credit for household expenses was increased. Inheritance taxation and gift taxation were also eased by lowering the tax scales throughout. In the case of excise taxation, vehicle tax was eased, favouring vehicles with low emissions, and excise tax from sweets was removed as of the beginning of 2017.

Actions that increase taxation have also been implemented during the parliamentary term. The top income bracket in the Government income tax scale has been valid throughout the parliamentary term, and its lower limit was lowered in 2016. The child tax creditwas abolished in 2017. The deductibility of interest expenses from mortgages has been lowered in the manner specified in the Government Programme. The taxation of capital income was tightened by increasing the upper tax rate. Tightening of companies' interest expense deduction right has been proposed for 2019 when Finland will enforce the EU Anti-Tax Avoidance Directive. Vehicle tax, as well as excise duties on fuel, tobacco products and alcoholic beverages have been increased. Real estate taxation has been tightened by increasing the top and bottom limits of the real estate tax rate. Municipalities can decide on their own real estate tax within the range set by law, however.

No major changes to the taxation system as a whole

The National Audit Office carried out fiscal policy audits of the taxation system in 2014 and issued recommendations on developing the taxation system as a whole. According to the economic theory, the taxation system should be simple, neutral and in accordance with overall needs of the national economy. Development of the taxation system has not been an objective in the Government Programme, however, and amendments of tax legislation have not developed the system as a whole. One of the objectives in the Government Programme was removing incentive traps by reconciling social security with taxation, but this objective was not implemented during this parliamentary term. The number of tax expenditures, which has a major impact on the tax base, remained largely unchanged during the government term. New tax expendituresadded during the parliamentary term include entrepreneur allowance and forest gift allowance. The existing tax expenditureswere increased by, for instance, increasing the lower limit of the liability to pay value added tax and raising the amount of turnover entitling a company to tax relief. An increase of the monthly maximum deduction for a second home for work has been proposed for 2019. Tax expendituresabolished during the parliamentary term include increased depreciationsfor investments in production and child tax credit .

EU reform projects may influence Finland's tax revenue

There are ongoing EU projects on taxation that may have an impact on Finland's tax revenue, such as a proposal on digital tax and a reform of the value added taxation system. The proposal on digital tax could, at least temporarily, make the taxation system more complex due to a variety of temporary solutions. However, development of the digital economy will probably lead to some sort of redefinition of the tax base internationally. The proposed change of the value added taxation system might not lead to any decrease of tax evasion in Finland or an increase of tax revenue; instead, it might even increase the tax gap, as the Finnish VAT gap is low when compared to other member states and the number of cross-border tax evasion cases is low.

Tax law reform impact assessments provide information for decision-making

When tax law reforms are introduced, it is important to ensure that the assessments of their impact are sufficiently accurate and as up to date and comprehensive as possible. In 2018, the National Audit Office published an audit report on a tax reform and tax expenditure impact assessment. The purpose of the audit was to examine whether the impact assessments of tax reforms and tax subsidies have been accurate and produced on the basis of comprehensive information.

According to the audit findings, the impact assessments of tax reforms provide a good information base for decision-making. Comprehensive information and the tools needed to perform calculations and perform impact assessments are available when preparing tax reforms. Impact assessments are made separately for each tax type and there are slight differences between the practices specific to tax types. The assessment of dynamic effects and the combined effects of several changes could be improved and developed. Due to changes of the calculation models, there is a risk of deteriorating quality of calculations and the slowing down of the carrying out of calculations.

Little information on the impact of tax expenditures is available

Tax expenditures cause substantial reductions in tax revenue. Even though they have a significant impact on general government finances, their effects and the costs arising from them are not regularly monitored and little information is available on their impact. Only the loss of revenue caused by the tax expenditure is calculated each year. Comprehensive impact assessments of individual tax expenditures have also been made. However, for one-third of all tax expenditures, not even the related reductions in tax revenue can be calculated.

Decision-makers need more information so that they can better assess the necessity and usefulness of each tax expenditure in effect. The currently used calculation practices are largely based on definitions made in 2009. Since then, more information may have become available, which means that it might be possible to estimate the size of some of the tax expenditures.

2 General government fiscal planning and steering

Comprehensive general government fiscal planning has improved as Finnish legislation has been developed over the course of the parliamentary term. According to the National Audit Office's assessment, the General Government Fiscal Plan meets most of the requirements laid down in legislation and Finland is in compliance with the Fiscal Compact. The General Government Fiscal Plan must be developed further, however.

A new medium-term objective for the general government structural balance will be set in 2019. The minimum objective level will be determined on the basis of the Stability and Growth Pact, practices agreed by the European Commission and the member states, and the Fiscal Compact. When preparing the setting of the objective within these limits, risks related to general government finances and existing financial buffers should be taken into account, among other issues.

Effectiveness of the fiscal policy steering system has improved as the steering of local government finances has improved. However, the steering of single municipalities should be better in line with the steering of local government finances as a whole, and functionality of the system of central government transfers should be assessed.

Contingent liabilities of general government entities, Government guarantees in particular, have continued to grow strongly, and the fiscal policy steering has not covered the contingent liabilities. Risk management of the liabilities should be improved. The National Audit Office recommends determination of a risk limit at the state level. The determination of the risk level should be based on an overall assessment of risks, and it should take into account the different risks of the liabilities and the Government's risk-bearing capacity. The Ministry of Finance has been preparing a reporting and decision-making framework for the Government's off-balance sheet liabilities. The National Audit Office considers this a positive development and a prerequisite for the improvement of the management of the liabilities.

2.1 General Government Fiscal Plan has been expanded

After the financial crisis, the European Union decided to strengthen the coordination of economic policies and the oversight of its fiscal policy regulatory framework. Multi-annual statutory frameworks for the individual member states were introduced as part of these actions to facilitate compliance with the fiscal policy rules jointly agreed in the EU. Fiscal planning provides better tools for steering general government finances as a whole. It lines up the national fiscal policy decision-making with the EU rules that create the framework for the fiscal policy, which are based on the multi-annual perspective. When functional, multi-annual planning can also support anti-cyclical fiscal policy.

The first General Government Fiscal Plan for Finland was prepared in 2014. Finnish legislation steering the preparation of the plan has been further developed during this parliamentary term to better correspond to the requirements of the Budgetary Frameworks Directive. The most recent amendments to the Decree on the General Government Fiscal Plan entered into force in September 2017. The amendments concerned the content of the General Government Fiscal Plan, information to be included in the Government budget proposal and the consideration of National Audit Office's conclusions about the forecasts used as the basis of the fiscal policy.

During the parliamentary term, the National Audit Office has annually assessed the information basis, preparation, implementation and correspondence with statutory requirements of the General Government Fiscal Plan. The assessments are based on the National Audit Office's duty laid down in the Act on the Implementation and Application of the Provisions Governed by the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union and on Requirements Concerning Multiannual Budgetary Frameworks (869/2012, the "Fiscal Policy Act"), according to which the National Audit Office must oversee compliance with the Fiscal Policy Act and regulations based on it, including the compliance with the Fiscal Compact.

Fiscal policy legislation has been followed in essential respects

The General Government Fiscal Plan complies with the requirements but needs to be further developed

The National Audit Office did not discover any significant deficiencies in compliance with the Fiscal Policy Act or the regulations based on it. The General Government Fiscal Plan is largely in accordance with the regulating decree[5]. Sub-sector-specific financial position goals and a multi-annual target path for the financial position of general government finances are set in the plan. The plan also includes the medium-term structural balance objective (MTO) that is determined in the Fiscal Compact. Achievement of the objective has proceeded according to the rules (see Chapter 3). A corrective mechanism has been defined in national legislation for situations where a significant deviation is discovered in the progress towards the goal.

The knowledge base and the goals set in the General Government Fiscal Plan should be further developed, particularly in terms of the clarity and understandability of the goals set and some content details.

Unclarities in balance objectives of general government finances

The Government's first General Government Fiscal Plan set objectives for the nominal balance of the different sectors of general government finances that, when combined, would lead to overall balance of general government finances in 2019 (see Chapter 1.1). The plan includes annually independent forecast by the Ministry of Finance on the development of general government finances in the next four years and a scenario based on unchanged policies which was prepared in 2015 and 2016 based on the assumption that no policy measures influencing revenue and expenditure would be implemented. In 2017, the content of the revenue and expenditure data in the scenario was changed to correspond to the information provided in the independent forecast.

A stability programme is included as an appendix to the General Government Fiscal Plan. On the basis of the stability programme, the European Commission assesses the status of Finland's general government finances. The stability programme includes a separate assessment on the development of general government finances. In 2017, a target path for the development of the nominal fiscal position was added to the plan due to an amendment of the Government Decree on the General Government Fiscal Plan.

Table 4 presents the objectives regarding the nominal general government deficit and the forecasts included in the General Government Fiscal Plans prepared during the parliamentary term.

Table 4: Objectives regarding the nominal general government deficit in the General Government Fiscal Plans 2015–2018. The scenario based on unchanged policies has been calculated on the basis of the revenue and expenditure information reported in the stability programme.

		2016	2017	2018	2019
		% in relation to GDP			
General Government Fiscal Plan 2015 (autumn)	General Government Fiscal Plan forecast	-2.8	-2.4	-1.9	-1.4
	Unchanged policy path	-4.5	-4.6	-4.0	-3.8
	Stability programme path	-2.8	-2.4	-1.9	-1.4
	Parliamentary term objective				0
General Government Fiscal Plan 2016	General Government Fiscal Plan forecast	-2.5	-2.1	-1.8	-1.4
	Unchanged policy path	-3.2	-3.4	-3.2	-3.1
	Stability programme path	-2.5	-2.1	-1.8	-1.4
	Parliamentary term objective				0
General Government Fiscal Plan 2017	General Government Fiscal Plan forecast	-1.9	-2.3	-2.0	-1.7
	Unchanged policy path	-1.9	-2.3	-2.0	-1.7
	Stability programme path	-1.9	-2.3	-1.6	-0.8
	Parliamentary term objective				0
	Target path set in 2017		-2.3	-1.6	-0.8
General Government Fiscal Plan 2018	General Government Fiscal Plan forecast	-1.8	-0.6	-0.6	-0.2
	Unchanged policy path		-0.6	-0.6	-0.2
	Stability programme path		-0.6	-0.6	-0.2
	Parliamentary term objective				0
	Target path set in 2017		-2.3	-1.6	-0.8

The objectives set are not fully consistent. A target path for the development of the nominal general government fiscal position was set in 2017, and the path was not changed in 2018. The objective according to the path for 2019 is clearly more lenient than the objective set in 2015. The target path will lead to a weaker financial position in 2019 (-0.8% in relation to GDP) than the objectives set separately for the subsectors in the first General Government Fiscal Plan of the parliamentary term (0.0%). This causes uncertainty regarding the actual nominal fiscal position objective for 2019.

Furthermore, legislation requires that the target path regarding the nominal fiscal position will lead at least to achievement of the medium-term objective set for structural deficit. This condition was met when the target path was set in 2017, but the estimate about the economic cycle has changed so that the target path objective for 2019 will not any more inevitably lead to achievement of the structural deficit objective.

Objectives regarding nominal fiscal position are more transparent than objectives regarding structural fiscal position

The problems described are connected on one hand to a special characteristic of this parliamentary term (legislation on the setting of the objectives was amended in the middle of the parliamentary term) and on the other hand on a problem of a more permanent nature: the cyclical conditions influence the size of the nominal deficit that is sufficient to achieve the set structural deficit objective. From the perspective of the binding regulatory framework, the nominal deficit objective can be considered a secondary objective when compared to the structural deficit, but from the perspective of the transparency of general government finances and the monitoring of the achievement of the objectives, the objectives on nominal deficit are clearly more practical. As assessing the cyclical conditions at the end of the parliamentary term is practically impossible in the beginning of the parliamentary term and the problem cannot be easily resolved, describing the status of the different objectives and their relationships in the General Government Fiscal Plans as clearly as possible during the parliamentary term is important.

Varying practices in the presentation of different scenarios must be justified

The forecast path in the stability programme corresponded to the forecast path according to the independent forecast in the 2015 and 2016 General Government Fiscal Plans. However, the stability programme path in 2017 included impacts that improve the balance of general government finances that were not included in the forecast path according to the independent forecast. The stability programme path corresponded to the multiannual target path specified in the Government Decree on the General Government Fiscal Plan (Valtioneuvoston asetus julkisen talouden suunnitelmasta, 120/2014). The forecast path and the stability programme path corresponded to each other again in 2018. The annually changing practices have blurred the relationship between the different scenarios. This emphasises the need to present clear justification for any variation of the practices from one year to the next.

An amendment of the Government Decree on the General Government Fiscal Plan expanded the requirements on the presentation of expenditure and revenue projections. The amendment entered into force at such a time that the first plan to which it applied was the 2018 plan. According to the Decree, expenditure and revenue projections must be prepared on the basis of two options: on the basis of the assumption that legislation on revenue and expenditure is not amended and on the basis of legislation on revenue and expenditure being amended in a manner specified by the Government. The impact of both options on the long-term sustainability of general government finances and on the structural balance must be presented.

In the 2018 General Government Fiscal Plan, information according to one of the options only was presented because according to the independent forecast, the fiscal position objective set for 2019–2022 in the General Government Fiscal Plan would be reached and thus the specified legislative amendments were not presented and the information for the two options was not presented. Implementing this information requirement, which is also mentioned in the Budgetary Frameworks Directive, has proven somewhat challenging in the EU member states, and the content of the requirement is subject to interpretation. Presenting the impact of planned actions on the structural balance and long-term sustainability also when the independent forecast estimates that the set objectives will be met would be beneficial to ensure the transparency of general government finances.

In the spring 2018 General Government Fiscal Plan, regional government finances were, for the first time, presented as a separately, and the Ministry of Finance's forecast considered regional government finances as a separate subsector. Considering regional government finances separately supports the transparency of general government finances. In the interests of keeping the plan up to date, it is also good that the forecast and the General Governance Fiscal Plan already take into account any impact of the social and health care and regional government reform on the structure of public administration, even though reform has not been approved yet. In the Ministry of Finance's forecast, regional government finances shows a deficit during the first years. Funding and expenditure of regional government finances follow separate and independent paths in the forecast, which is a justified solution in order to have a realistic forecast. After the spring of 2018, the Government announced that the schedule of the reform will be changed from the schedule that was available when the General Government Fiscal Plan was being prepared.

In the years to come, attention should be paid in the General Government Fiscal Plan to the clarity of the set objectives, clear presentation of the relationships of the objectives and consistency of procedures from one year to the next. Furthermore, it should be ensured that the plan provides sufficient information on the sensitivity of the indicators on general government finances (general government deficit and debt) to interest rate changes in a clear manner, that the plan provides revenue and expenditure items of employment pension institutions and other social security funds separately in the manner laid down in the Government Decree on the General Government Fiscal Plan and that the plan presents any differences between any assumptions in cases where there are significant differences in the background assumptions of the forecasts by the European Commission and the Ministry of Finance.

Table 5: Development needs of the General Government Fiscal Plan

Setting of objectives	The setting of objectives as a whole and the relationships between the different objectives must be clearly presented. Content and differences between the forecast path, the unchanged policy path, the target path and the stability programme path must be explained.
Content details	Revenue and expenditure items of employment pension institutions and other social security funds should be separately presented.
	Interest rate sensitivity of the indicators on general government finances should be presented in a comprehensive and clear manner.
	Any differences between any assumptions in cases where there are significant differences in the background assumptions of the forecasts by the European Commission and the Ministry of Finance should be presented.

2.2 Setting the new medium-term objective in 2019

In EU member states, the medium-term objective regarding the structural balance of general government finances is set every three years. The next update round will take place in the spring of 2019. The objective will be set in accordance with the Stability and Growth Pact in such a manner that it will create a sufficient safety margin in different cyclical conditions in relation to the nominal deficit reference value of three per cent and that the objective will simultaneously support sustainability of the development of debt. A more specific calculation method compliant with these preconditions is specified in codes of practice and technical guidelines prepared by the Commission and the member states. The Stability and Growth Pact sets as an additional criterion a lower limit for the objective for member states in the euro zone: deficit of one per cent in relation to GDP.

Sensitivity of general government finances to economic cycles and future debt development are taken into account when calculating the objective

In addition to the Stability and Growth Pact, Finland is bound by the Fiscal Compact, according to which the general lower limit for the objective is -0.5% in relation to GDP. When the ratio of general government debt to GDP is significantly below 60% and the long-term sustainability risk is simultaneously low, the Compact allows -1.0% in relation to GDP as the lower limit of the objective.

The ultimate lower limit for the medium-term objective is created by selecting either the option according to the Stability and Growth Pact or the option according to the Fiscal Compact, whichever is tighter. This ensures that the objective complies with all the criteria. Figure 7 presents the criteria.

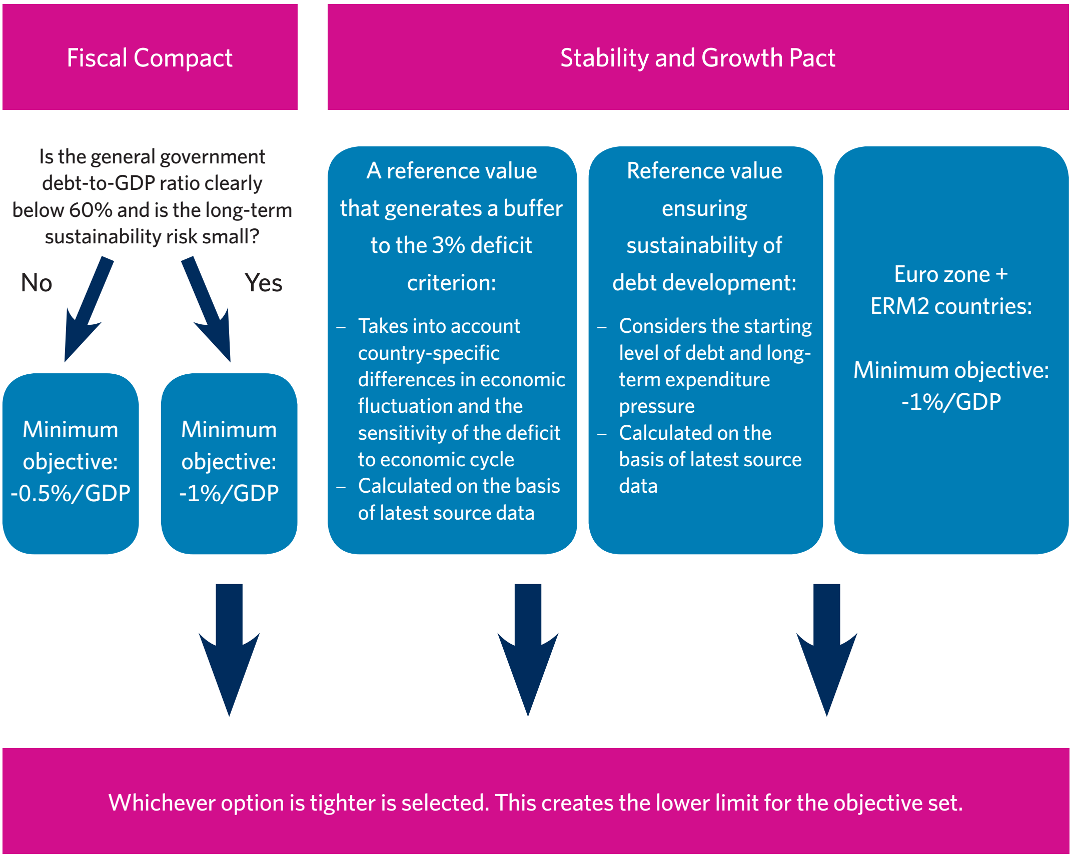

Figure 7: Criteria according to which the medium-term objective for structural deficit is set

When the minimum objective according to the Fiscal Compact is being determined, the current ratio of general government debt to GDP and the long-term sustainability risk of general government finances must be studied. According to forecasts, the ratio of Finland's general government debt to GDP will be slightly but not significantly below 60% in 2018 and 2019. According to the results of the Commission's assessment framework (see Fig. 6), the long-term sustainability risk of the general government finances of Finland is at the medium level. Determination of the sustainability risk is partly subject to interpretation, but already based on the ratio of general government debt to GDP, Finland is bound by the Fiscal Compact's tighter objective of -0.5%.

The National Audit Office has calculated an ex-ante assessment of the lower limit of the medium-term objective according to the Stability and Growth Pact. According to the calculations, Finland is bound based on the Stability and Growth Pact by the same objective of -0.5% in ratio to GDP as based on the Fiscal Compact. This objective is the result of a reference value that creates a buffer in relation to the 3% criterion on the nominal deficit of general government finances. The results are based on information available in the autumn of 2018 and the calculation method previously applied by the Commission. The result is sensitive both in terms of the technical details of the calculation and in terms of changes in the information used to assess the output gap on which the calculation is based. The Commission and the member states will make a decision on the details of the calculation in early 2019, which means that the result is preliminary and may change.

However, the reference value securing the sustainability of the debt development offers, according to the National Audit Office's preliminary calculations, a clearly more lenient minimum objective and does not pose a limitation stricter than the -0.5% minimum level according to the Fiscal Compact for the setting of the objective. The calculation of the reference value does not take into account the fact that a surplus of employment pension institutions does not influence the borrowing need in Finland (see Chapter 3.2), which is reflected in the result.

Stricter medium-term objective than the current one could be justified by risks related to general government finances

The procedure only sets the lower limit for the medium-term objective, which means that member states have the option of setting a tighter objective. A tighter objective may be based on a review that considers factors from outside the calculation framework, for example. In the case of Finland, such factors could include high contingent liabilities (see Chapter 2.4) and the uncertainty that is inevitably linked to the final expenditure from strategic capability projects of the Finnish Defence Forces and the impact of structural reforms. These factors would favour a tighter objective than the one given by the technical calculation. On the other hand, Finland's general government finances include a fairly high level of financial assets (see Chapter 1.1), which may partly be used as a buffer for the risks. This reduces the need to set a tighter objective than the one produced by the basic framework, which already takes into account uncertainties and country-specific conditions.

2.3 Steering of local government finances

Steering of local government finances plays a key role in ensuring the sustainability of general government finances. In 2015, the overall steering of local government finances (macroeconomic steering) underwent a major overhaul in connection with the reform of the general government fiscal planning. The goal of the reform was to meet the requirements laid down in the EU Budgetary Frameworks Directive. The system of central government transfers and the provisions of the Local Government Act steering the finances of individual municipalities (microeconomic steering) were also revised in 2015.

Steering system of local government finances is more functional than before

On the basis of an audit of the steering of local government finances made in 2018[6], the steering of local government finances mostly functions well and the reform of the steering of local government finances can be considered effective. The budgetary position target separately set in the General Government Fiscal Plan for local government finances (the balance target) and the limit for the expenditure arising to municipalities from central government measures (the expenditure limit) further bind the steering of local government finances as part of the overall steering of general government finances. The Local Government Finance Programme drawn up in connection with the General Government Fiscal Plan has also provided a deeper view of the state of local government finances and factors affecting it.

The reform of the local government legislation involved amendments to provisions concerning local government finances. The new provisions steer the finances of individual municipalities more clearly towards the balance target set for the entire local government sector. Another decision that has improved the efficiency of the steering of local government finances is that now adjustments to the division of costs between central and local government, which are part of the system of central government transfers, are made annually.

Setting a separate expenditure limit for the local government sector has improved the transparency of the funding issued by the state to municipalities to perform the tasks imposed on them.

It has also become an important addition to the range of tools facilitating the achievement of the local government balance target. However, the expenditure limit alone cannot guarantee that all central government measures targeted at the local government sector are in line with the objective of achieving the local government budgetary position target. Reduction in expenditure cannot improve the local government financial position if revenue is simultaneously reduced. Indeed, the expenditure limit better reflects the potential for savings in municipalities enabled by central government measures than actual reductions in the level of expenditure. On average, the savings achieved with measures performed to achieve the spending limit have, according to the audit observations, been overestimated.

The audit revealed that the justifications for the expenditure limit set, the monitoring of the implementation of the expenditure limit, and the related impact assessments are not reported in a systematic and open manner. Furthermore, the justifications for the expenditure limit do not specify the uncertainties related to the impact assessments performed, or contain any impact assessments on alternative measures.

In calculations, expenditure limit seems to be more effective than it actually is

The Programme for Local Government Finances provides information about the financial position of municipalities, but the practical impact of the programme on the steering of local government finances and on local government decision-making remains limited. The Programme for Local Government Finances also covers the implementation of the principle of adequate financial resources. The principle of adequate financial resources means that the state must ensure that the financing issued to municipalities to perform their statutory duties is adequate. However, the analysis provided in the Programme of the implementation of the principle of adequate financial resources is rather mechanical and does not take a clear stand on the effectiveness of the implementation.

Microeconomic steering of local government finances should better support the achievement of macroeconomic steering targets

The balance target set for the local government sector is determined on the basis of the concept of net lending according to National Accounts, while the thresholds for the steering of local government finances are based on the concepts of municipal accounting. The differences between these two accounting systems reduce the transparency and efficiency of the system for the steering of local government finances. Instead of deficit, a threshold determined on the basis of cash flows from operations and investments would be more compatible with the concept of net lending according to National Accounts, and its adoption would clarify the overall steering of local government finances. Cash flow from operations and investments has already been introduced as one of the key indicators in connection with the organisation of the steering of the regional government sector.

Deficit does not contain information about indebtedness of municipalities

The purpose of the financial steering criteria laid down in the Local Government Act is to identify municipalities in which the provision of the basic services is compromised. The criteria emphasise the need to cover any deficit in the municipality's balance sheet, which does not provide a sufficiently comprehensive view of the budget balance of the municipality. For example, depreciations have systematically been lower than recommended, which consequently has reduced the deficit. At the same time, investments in the local government sector have exceeded depreciations, which has enabled indebtedness to grow without breaching any thresholds set out in the Local Government Act.

The state contributes to the financing of basic services by means of central government transfers. The significance of central government transfers as the source of income for municipalities varies greatly: the significance is higher in municipalities with a higher need for services and a more limited revenue base. The system of central government transfers has been generally utilised in the practical implementation of adjustments to the financial relationship between central and local government, for example, to compensate municipalities for loss of tax revenue. Measures supporting the achievement of the macroeconomic steering targets, such as the incorporation of performance incentives into the system of central government transfers or cuts in central government transfers, could undermine overall effectiveness of the system and affect municipalities in an inappropriate manner. Key issues when developing the system of central government transfers are ensuring that the incentive impact of the system is analysed and that the system as a whole remains transparent and manageable.

The efficiency of the steering of local government finances could be enhanced by developing the underlying knowledge base, as well as efficient and timely use of information. There is still room for improvement in terms of the comprehensiveness and comparability of data collected for the needs of municipal steering. The creation of standardised data specifications within the framework of the Local Government Data Programme (Kuntatieto-ohjelma) has enhanced the quality of the knowledge base, but attention should still be paid to making the specifications binding. The regional government reform has aimed to ensure the collection of standardised up to date information on local government finances.

Abolishment of the practice of partial optimisation between central and local government finances was one of the objectives of the reform of the system for the steering of local government finances. It is essential to take into account of the overall situation of general government finances in order to achieve the national balance targets. Consequently, it is also important to coordinate the steering of local government finances outside the influence of representation of interests of individual subsectors of general government finances. Otherwise, the risk for over-emphasising the interests of central government finances increases in the preparation of measures targeted at the local government sector. Furthermore, continuous attention should be paid to ensuring independence of the party responsible for the overall steering of general government finances.

2.4 Risk management of contingent liabilities

For the drafting of fiscal policy and steering of general government finances, it is important that decision-makers have access to all essential information about the financial risks related to contingent liabilities ofgeneral government. Sustainable management of general government finances requires that all contingent liabilities are identified, the related risks are assessed and the possible long-term impacts on the general government balance is taken into consideration.

In the past few years, contingent liabilities have increased particularly due to a substantial rise in state guarantees. The growth can partially be explained by the policies laid out in the Government Programme under which export financing elements and the level of funding should be set at least at the level of the competitor countries. At the end of the second quarter of 2018, guarantees totalled almost EUR 54 billion. The amount of guarantees has increased by EUR 15 billion from 2014.

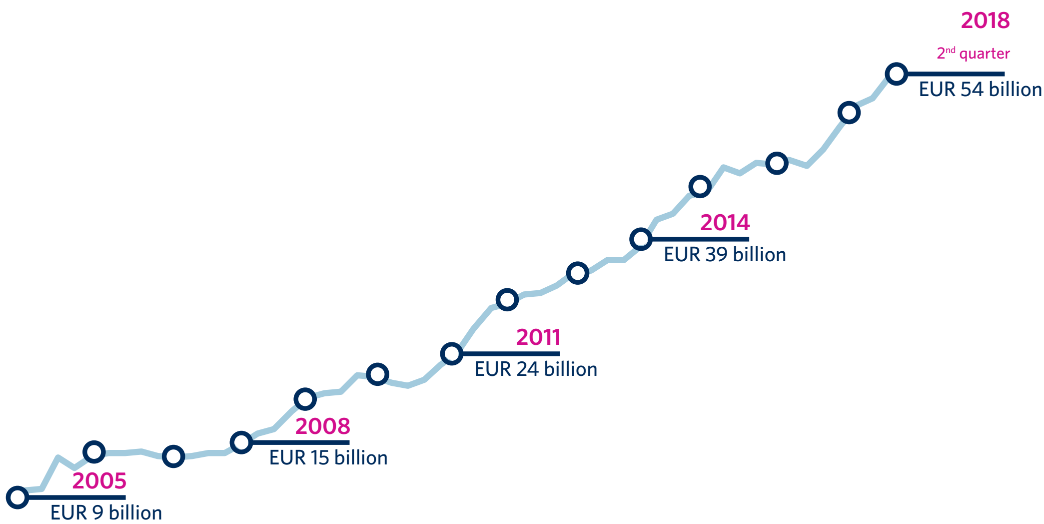

Figure 8: Development of state guarantees 2005–2018

No limits have been set for the growth of contingent liabilities

Determination of a risk limit could curb the growth of the contingent liabilities

According to the findings of an audit on the management of contingent liabilities (2018)[7], contingent liabilities have not been sufficiently taken into account in the drafting and steering of fiscal policy. A risk limit for contingent liabilities should be set to curb the growth of the risks arising from the contingent liabilities. The determination of the risk level should be based on an overall assessment of risks, and it should take into account the different risks of the liabilities and the Government's risk-bearing capacity. Already existing good international practices could be used in the management of guarantee liabilities. The creation of content requirements applied to the drafting of guarantee decisions and decisions to increase the authorisation to grant credits should be developed so that the financial impact of such commitments would be appropriately taken into account.

Contingent liabilities and fiscal policy steering

Contingent liabilities are liabilities the changing of which into direct financial liabilities depends on an uncertain event that the Government is unable to influence, such as a company for which a state guarantee has been granted becoming insolvent.

The spending limits rule laid out in the Government Programme and central government spending limits set out in Finland's national fiscal policy rules do not contain any elements that would limit the growth in contingent liabilities. The European Union has made the coordination of fiscal policy more effective by including additional reporting obligations concerning contingent liabilities in the preventive and corrective arms of the Stability and Growth Pact. The Budgetary Frameworks Directive is the key instrument regulating the reporting on and publication of contingent liabilities. The Directive does not include any target or limit values for contingent liabilities or their growth, however. In practice, rules of the European Union or national fiscal policy steering instruments do not take into account contingent liabilities.

Risks arising from contingent liabilities are not assessed at central government level

From the perspective of the sustainability of central government finances, information on the risks arising from contingent liabilities and the risk trends should be produced in the annual reports and when the liabilities are accepted. In the past few years, reporting on contingent liabilities in the Government's annual report, in the final central government accounts and in the annual risk report by the Ministry of Finance has been expanded. Nevertheless, the reports only barely cover the development of the risk position arising from all contingent liabilities.

A status report on off-balance sheet government liabilities was prepared on 13 February 2017 for the Government's strategy session. It was agreed in the session that based on the principles laid out in the report, a proposal for a reporting and decision-making framework concerning off-balance sheet government liabilities will be prepared. The purpose of the framework is to support the Government and the Cabinet Committee on Economic Policy in their decision-making. According to the Ministry of Finance, the key areas in the decision-making framework include a decision-making process for new liabilities and changes in existing liabilities, assessment criteria (burden of justification and proof would lie on the party proposing additional liabilities), as well as identification and assessment of the risks and reporting on them. The National Audit Office considers this proposal justified.

There are no minimum information requirements concerning the assessment of the risks arising from guarantee authorisations

Guarantees, collateral and interest equalisation loans granted by the specialised financing company Finnvera are used to support export companies and SMEs. By law, the State of Finland bears the ultimate liability for these commitments. The granting of the commitments is steered with granting authorisations laid down in legislation. The assessment of the economic impact on general government finances and the methods and information sources available are discussed in detail in the guidelines for assessing the impact of legislative proposals supplementing the instructions for drafting Government proposals. The instructions list a number of ways to assess costs and risks. However, no decision has been made on the minimum information requirements for the decision-making process and there is no legislation on the matter either.

Minimum information requirements should be defined so that the risks arising from guarantee authorisations could be assessed in a more comprehensive manner

According to the audit, economic impact assessments carried out for decisions to increase authorisations submitted to Parliament vary in content and provide an insufficient picture of the related risks. Compared with the information contained in the guidelines for assessing the impact of legislative proposals, impact assessments on increased authorisation in Government proposals can be considered rather meagre, especially with regard to quantitative estimates. The small number of quantitative estimates makes it more difficult to produce an overview of the costs and risks arising from the proposals and to assess them in a proper manner.

A quantitative assessment of the risks can be difficult in many cases. However, to make the risk assessments more uniform and comprehensive, the Government should perhaps use the methods set out in the guidelines for assessing the impacts of legislative proposals concerning the manner in which issues are presented. This would allow for the achievement of a more structured and comprehensive way of presenting the economic impact of guarantee authorisations in Government proposals to Parliament.

3 Compliance with the Stability and Growth Pact

In this chapter, the National Audit Office presents an ex-ante assessment on compliance with the rules of the Stability and Growth Pact for 2018 and 2019 and a review of the development of the rules. The National Audit Office's assessment on compliance with the Stability and Growth Pact is based on information from the draft budgetary plan for 2019 and the economic survey of autumn 2018 submitted by the Ministry of Finance. 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 or progress towards the MTO. The assessment is made by evaluating the structural financial position and compliance with the expenditure rule. The corrective arm of the Stability and Growth Pact assesses compliance with the deficit and debt criteria. Finland is subject to the requirements of the preventive arm.

According to the National Audit Office's ex-ante assessment, there will be a deviation from both the structural balance rule and the expenditure rule in 2018, but the deviations will not be significant. In light of the currently available information, it is more likely that the deviations will become smaller instead of exceeding the limit of a significant deviation by spring 2019 when the ex-post assessment on compliance with the rules in 2018 will be prepared. This is due to the future update of the adjustment requirement and the fact that general government finances have strengtened more than anticipated. According to the forecast, the MTO will be reached in 2019 in terms of both the structural balance and the expenditure rule. According to the ex-ante assessment, compliance with the criteria set out in the corrective arm will be achieved with in 2018 and 2019.

In its previous reports, the National Audit Office has stated that Finland was in compliance with the rules of the Stability and Growth Pact during the early years of the parliamentary term, in 2015–2017.

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 medium-term objective (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.

Achievement of the MTO is assessed on the basis of the structural balance and expenditure rule

Reaching 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 rule, an increase in general government expenditure is compared to the expenditure limit set for it. Compliance with the expenditure rule supports compliance with 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 national legislation, i.e. the Act on the Implementation and Application of the Provisions Governed by the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union and on Requirements Concerning Multiannual Budgetary Frameworks (869/2012; the "Fiscal Policy Act"). In autumn 2016, the Government confirmed that Finland's MTO is to achieve a structural balance of -0.5% in relation to GDP.

Structural balance deteriorates as the economy grows

In the process of assessing compliance with the Stability and Growth Pact, objectives for each year are set in the spring of the preceding year. A final assessment on compliance with the rules is made in the spring following the year under review. Various parties also assess the current status and progress towards the objectives in between these milestones. In the autumn of 2018, the National Audit Office assesses the years 2018 and 2019, but the final assessments regarding these years will not be made until in the spring of 2019 and 2020.

The assessment of the structural balance in general government finances in 2018–2019 has weakened from the National Audit Office's assessment made in the spring of 2018. According to the National Audit Office's assessment, in 2018 the structural balance will be -1.1% in relation to GDP and it will strengthen to -0.7% in relation to GDP in 2019 as presented in Figure 9.

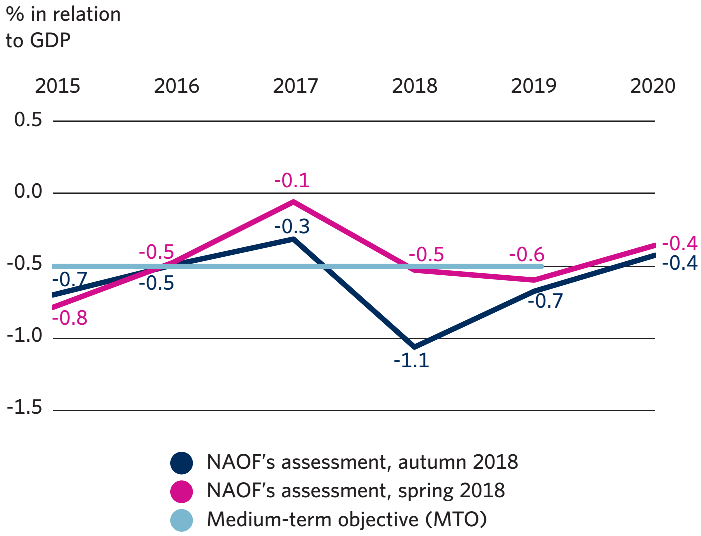

Figure 9: Level of structural balance 2015–2020, % in relation to GDP

Structural balance must get closer to the medium-term objective

If the objective set for structural balance is not met, it will be assessed in accordance with the rules of the Stability and Growth Pact whether the change towards the target level is large enough. In 2018, the structural balance will decrease by 0.7 percentage points when compared to the previous year, mainly due to the business cycle component (see Fig. 10). The output gap, or the difference between the observed GDP and the potential GDP, describes the current cyclical conditions. The potential GDP describes long-term economic trends that cannot be observed; instead, they must be estimated. In 2018, the output gap will close and turn into positive, as the observed GDP is expected to grow faster than the trend. As a result of this, the estimated structural deficit will increase, particularly as the nominal deficit will remain at the same level as in the previous year. The structural balance will be boosted by the reduction of the nominal deficit in 2019.

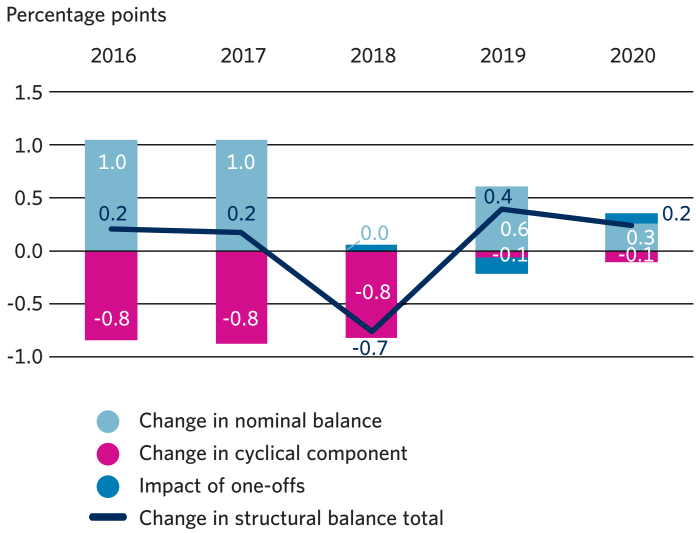

Figure 10: Change in the structural balance divided into the change in the nominal balance and the change in the cyclical component of the balance

According to the National Audit Office's assessment, compliance with the rules will be achieved if the structural balance deteriorates by a maximum of 0.3 percentage points in 2018. This structural balance adjustment requirement is based on an estimate of the structural balance according to the National Audit Office's calculations. The structural balance assessment for the year preceding the year under review (2017 and 2018, respectively) is used in the calculation of the adjustment requirement. This complies with the assessment of the current year as stated in the rules and the related principle of freezing, according to which the adjustment requirement is not to be updated in the current year's estimates. The adjustment requirement takes into account an alleviation of 0.6 percentage points for the requirement in 2017–2019 resulting from a structural reform clause and an investment clause, which are included in the flexibility elements of the rules.

Thus, there will be a deviation from the structural balance rule in 2018, but it will not exceed the limit of 0.5 percentage points, which means that it is not significant. 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. The National Audit Office's assessment slightly deviates from the assessment by the Ministry of Finance due to the different adjustment requirements[9]. The National Audit Office's assessment deviates from the assessment of the Commission as well, especially because the National Audit Office's calculations are based on the forecast by the Ministry of Finance, whereas the Commission uses its own forecast as the basis of its assessment.

According to the current assessment, the medium-term objective will be reached in 2019, which is why the adjustment requirement is not examined in this assessment in the case of 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.

Development of structural balance during the parliamentary term

The magnitude of the structural balance is assessed on the basis of the selected method, any assumptions made, as well as available statistics and forecasts. Figure 11 presents the structural balance assessments in the National Audit Office's reports during this parliamentary term on the basis of the calculation method agreed by the Commission and the member states. The assessments cover the year following the publication of each report in accordance with the assessment cycle.

Assessments on structural balance are often updated in a significant manner

The figure shows that the assessments on the structural balance may be updated in a significant manner, also during consecutive calculation rounds. Therefore, the opinions on compliance with the rules may differ a great deal from one assessment to the next in the biannual assessments, or the assessments may be based on different kinds of analyses and justification. The updates are caused by the general economic development and policy actions, as well as updates of the statistics and forecasts used as the basis of the calculations. Changes between calculation rounds are especially large during the latter years of a series. Furthermore, when comparing the level increase between the assessments made in the spring and autumn of 2017, one can see that anticipating the change in business cycles which occurred at that time was difficult.

According to the most recent assessment, the structural balance has remained close to the medium-term objective throughout the parliamentary term, except for the year 2018.

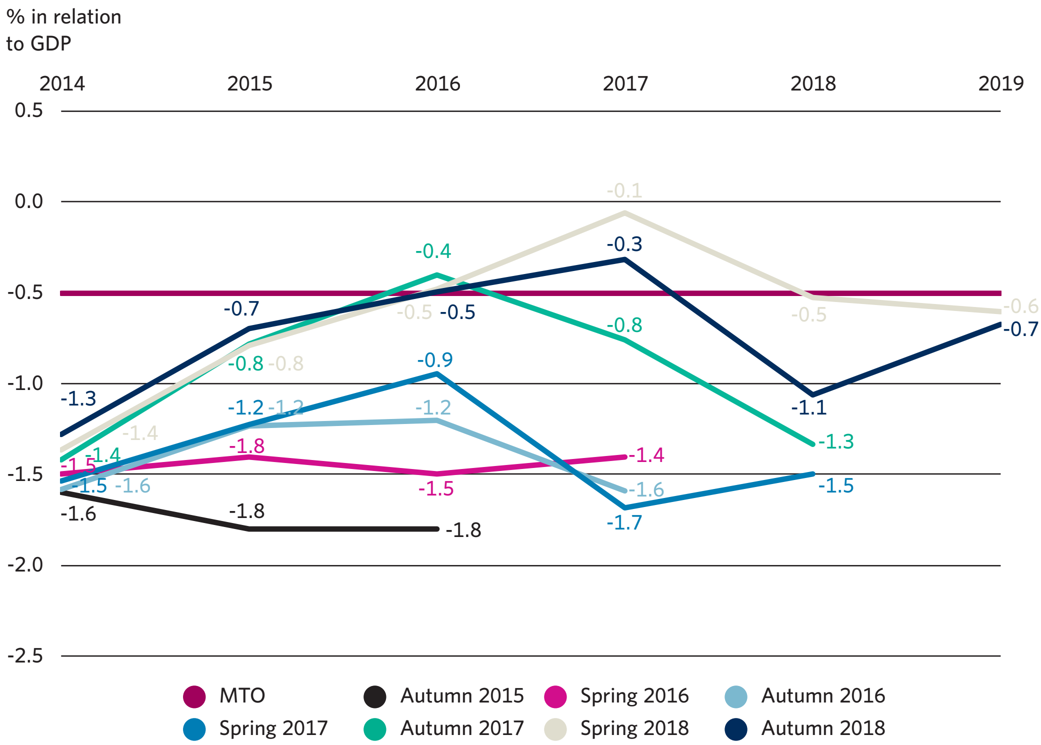

Figure 11: Structural balance in fiscal policy monitoring and evaluation reports during the parliamentary term, % in relation to GDP (assessment up until the forecast for the year t+1). Sources: European Commission, calculations by the Ministry of Finance and the NAOF

General government expenditure increases within the expenditure rule

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

In the expenditure rule, general government expenditure is compared with the expenditure limit

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 6 presents ex-ante calculations in accordance with the expenditure rule for 2018 and 2019. One-offs have also been taken into account in the calculation of the expenditure rule as part of the overall assessment. The National Audit Office has made an independent assessment of the expenditure growth limit, i.e. the expenditure rule to be followed, that is based on the National Audit Office's estimate of the structural balance and its adjustment requirement.

Table 6: Calculation under the expenditure rule

		2017	2018	2019
Expenditure rule items, EUR billion				
	Total general government expenditure	120.8	123.1	125.7
-	Debt interest payments	2.2	2.0	2.0
-	Expenditure arising from EU programmes, fully compensated by income from EU funds	0.5	0.4	0.5
-	Fixed capital (gross)	9.0	9.3	9.0
+	Average for fixed capital (over four years)	8.7	8.8	9.0
-	Cyclical changes in unemployment expenditure	1.0	0.4	0.2
+	One-off expenditure items	0	0	0
= AEA1	**Adjusted expenditure aggregate 1**	**116.8**	**119.7**	**123.0**
-	Revenue increases mandated by law	0.1	0.1	0.1
	Effect of discretionary measures on revenue	-1.7	-0.9	-0.8
	Non-recurring revenue items	0.0	-0.2	0.2
-	Effect of discretionary measures on revenue, incl. one-off revenue items	-1.7	-0.8	-1.1
= AEA2	**Adjusted expenditure aggregate 2**	**118.5**	**120.4**	**124.0**
Growth in total spending calculated in accordance with the expenditure rule (nominal), %		1.4	3.0	3.6
Applied expenditure rule, NAOF's estimate (nominal), %		2.3	2.3	3.7
Deviation				
	Difference between the growth rate under the expenditure rule and total spending (percentage points)	1.0	-0.7	0.1
	Deviation, EUR billion	1.1	-0.8	0.1
	GDP, EUR billion	224	234	242
	Deviation, % in relation to GDP	0.5	-0.4	0.0
	Is the deviation significant (< -0.5)?	No	**No**	**No**
	Cumulative deviation		**0.1**	**-0.2**
	Is the cumulative deviation significant (< -0.25)?		**No**	**No**

According to the National Audit Office's calculations based on the 2019 draft budgetary plan, the growth rate of the total adjusted general government expenditure in accordance with the expenditure rule will exceed the limit set for in 2018. This means that there will be a deviation from the expenditure rule, but it not a significant one according to the rules. On the basis of the ex-ante assessment, the expenditure will increase at the allowed pace in 2019. If the difference is less than -0.5 percentage points, the deviation from the expenditure rule 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. The cumulative deviation in 2018 and 2019 will also remain below the limit for a significant deviation.

According to calculations by the Ministry of Finance included in the 2019 draft budgetary plan, there will be no deviation from the expenditure rule in 2018, but there will be a deviation in 2019. The differences between the calculations by the National Audit Office and the Ministry of Finance are the result of different adjustment requirements for the structural balance in the calculation of the expenditure rule limit.

Requirements set out in the preventive arm will be followed in 2018 and 2019

According to the National Audit Office's ex-ante assessment, there will be a deviation from the structural balance rule in 2018, but the deviation will not be significant. There will also be a non-significant deviation from the expenditure rule in 2018. In light of the currently available information, it is more likely that the deviations will become smaller instead of exceeding the limit of a significant deviation by spring 2019 when the ex-post assessment on compliance with the rules in 2018 will be prepared. This is related to the details of the rules; the freezing principle, in particular, according to which an updated adjustment requirement can be used in the spring of 2019 instead of the frozen adjustment requirement. Furthermore, general government finances have strengtened more than anticipated. Therefore, according to the National Audit Office ex-ante assessment, the overall assessment according to the rules will end up with the conclusion that the rules of the preventive arm are followed in 2018.

According to the forecast, the MTO will be reached in 2019 in terms of both the structural balance and the expenditure rule. Therefore, the rules are followed.

In its previous reports, the National Audit Office has stated that Finland was in compliance with the rules of the preventive arm during the early years of the parliamentary term, in 2015–2017.

Table 7: National Audit Office's assessment on compliance with the rules of the preventive arm in 2015 and 2019

	Structural balance	Expenditure rule	Overall assessment
2015	Compliance	Compliance	Compliance with the rules
2016	Compliance	Compliance	Compliance with the rules
2017	Compliance	Compliance	Compliance with the rules
2018	Deviation	Deviation	Compliance with the rules
2019	Compliant	Compliant	Compliance with the rules

3.2 Corrective arm

The corrective arm of the Stability and Growth Pact considers thecompliance 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 relation to GDP. Similarly, the deficit criterion sets as the general government nominal deficit limit value 3% of GDP.

As Finland exceeded the limit of 60% set for the debt ratio in 2014, the Commission has assessed the compliance with the debt criterion in its reports in accordance with Article 126(3).

When evaluating the compliance with the debt criterion, the Commission considers the nominal debt ratio and the development of the debt ratio in the three preceding and two following years based on the backward-looking and forward-looking criteria. The assessments also take into account the cyclically adjusted debt ratio.

The most recent report by the Commission dates back to 2017, because the outlook in the spring 2018 stability programme and the Commission's spring forecast on the decrease of the debt ratio to below 60% met the conditions of the debt criterion and a separate assessment was no longer necessary.

Debt-to-GDP ratio will fall slightly below 60% in 2018

According to the most recent forecast by the Ministry of Finance (from the autumn of 2018), the debt ratio will drop to slightly below 60% already by the end of this year. The assessment on the debt ratio decreasing faster than the Ministry of Finance's own previous forecasts and the forecasts by the European Commission is largely based on a forecast of higher GDP growth. The distance from the 60% threshhold will be fairly small in the next few years, however.

As the debt ratio will, according to the forecast produced by the Ministry of Finance, continue its decrease that started in 2016 when the economic recession ended throughout the period under review, Finland will also comply with the Commission's backward- and forward-looking criteria in 2018 and 2019.

Even though the debt ratio will decrease, primarily as a result of the economic growth, the cyclically adjusted debt ratio will correspondingly increase. According to assessments by the National Audit Office, it will exceed the nominal debt ratio in 2018.

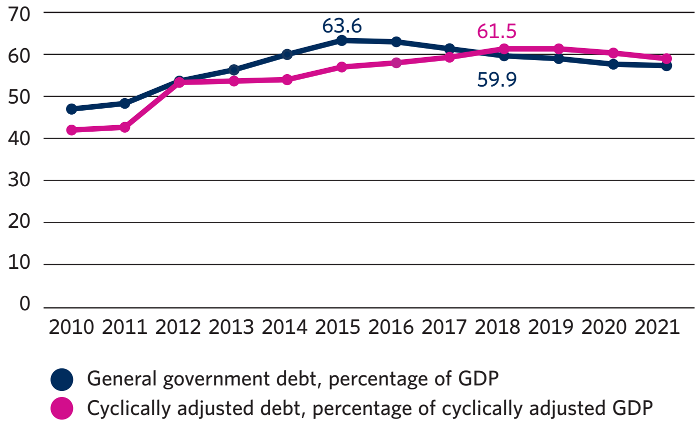

Figure 12: General government debt ratio and cyclically adjusted debt ratio. Source: Statistics Finland, calculations by the Ministry of Finance and the NAOF

The general government debt has increased mainly due to the general government deficit, central government in particular. The general government nominal deficit reached its maximum value of 3.2% of GDP in 2014, after which it has clearly narrowed.

According to the most recent forecast produced by the Ministry of Finance, the deficit will be 0.7% of GDP in 2018 and continue to decrease to 0.1% in 2019. Therefore, Finland will be in compliance with the deficit criterion of the EU treaty also in the near future.

In its previous reports, the National Audit Office has stated that Finland was in compliance with the rules of the corrective arm during the early years of the parliamentary term, in 2015–2017.

Table 8: National Audit Office's assessment on compliance with the rules of the preventive arm in 2015 and 2019

	Debt criterion	Deficit criterion
2015	Compliance	Compliance
2016	Compliance	Compliance
2017	Compliance	Compliance
2018	Compliant	Compliant
2019	Compliant	Compliant

The incurring of debt will continue regardless of the decreasing deficit, however, as the need borrowing need will exceed the general government deficit, particularly due to the surplus of the employment pension schemes included in general government which is not used to cover the deficit of the other general government entities.

Figure 13 shows the general government nominal deficit and the deficit-debt adjustment, i.e. the difference between the increase of debt and the deficit, as a percentage of GDP. When the deficit-debt adjustment is positive, the debt increases more than the nominal deficit or increases regardless of a surplus, which will be the case in 2020 and 2021 according to the forecast produced by the Ministry of Finance. As the GDP growth rate will exceed the increase of the nominal debt according to the forecast, the debt ratio is still expected to decrease also during these years. In the case of 2021, it should be noted that the estimated borrowing need is further increased by the funding of fighter planes acquired by the Finnish Defence Forces, which will not influence this year's deficit, however.

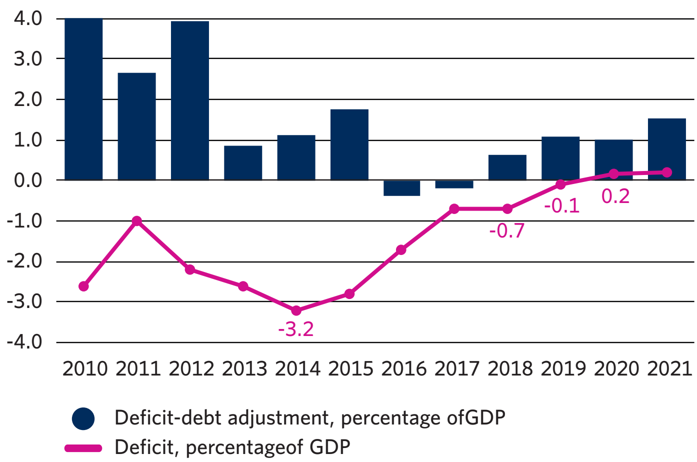

Figure 13: General government deficit and deficit-debt adjustment as a percentage of GDP. Source: Statistics Finland, calculations by the Ministry of Finance and the NAOF

3.3 EU rules are being developed

The rules steering fiscal policy in the Stability and Growth Pact have been criticised a great deal during their existence. Attention has been paid to the complexity of the rules; the rules being overly flexible and on the other hand the rules being overly rigid; the increase of the European Commission's discretion and related lack of transparency; and that the rules may be an inefficient means of steering the member states' fiscal policies to the desired direction. The calculation method of the structural balance that is at the core of the preventive arm and the use of this indicator as a tool for steering fiscal policy in general has also been criticised. This chapter deals with the development needs of the rules.

Measuring structural balance is challenging

Cyclical adjustment of the structural balance is difficult in practice

According to the preventive arm, member states must set a medium-term fiscal position objective as the target level for the structural balance. The structural balance is used to assess the general government fiscal balance from which the impact of economic cycles and one-off items has been removed. Therefore, the structural balance aims to describe the part of the general government deficit in relation to GDP that cannot be explained with economic cycles (or one-off revenue or expenditure items). Excessive structural deficit is considered to be a risk for sustainability in the long term, which is why the structural deficit should be limited. The attempt to cyclically adjust the general government deficit ratio is justified in theory, but real-time cyclical adjustment has been difficult in practice.

To keep the assessments of the member states equal, the European Commission has agreed with the member states that a production function method will be used to calculate the structural balance. It was originally the same for all member states. In Finland, the Ministry of Finance and the National Audit Office use the jointly agreed production function method in the calculations and assess compliance with the preventive arm's rules in compliance with it.

Real-time structural balance assessment changes at a later date

The main problems with the jointly agreed method that the European Commission uses are large revisions of the most recent projection and the structural balance, as well as pro-cyclical nature of the estimates due to data and forecast revisions. In Finland, Kuusi (2017)[10] has argued that the Commission's output gap method led, during the economic recession in real time, to an interpretation of a larger part of the decrease of GDP as a decrease in the trend and thus as a structural problem. This could have lead to a pro-cyclical fiscal policy. Similarly, the strength of the increase in economic trends and the timing of the cyclical peak are specified in arrears, which may delay the adaptation of the general government finances. In addition to Kuusi (2017), problems with the Commission's calculation method in Finland have been studied by Huovari, Jauhiainen & Kekäläinen (2017) in a working paper commissioned by the National Audit Office from Pellervo Economic Research PTT[11], for example.

Commission estimates reliability of real-time results with a special tool

Attempts are made to correct the problems with the commonly agreed method in an output gap working group with participants from the different member states, for example. In the autumn of 2016, the Commission introduced its new tool (plausibility tool)[12] for the assessment of the reliability and plausibility of the results of the shared production function method. The tool is meant to be used to ensure, by means of statistical testing, that no significant estimation errors have been made in the case of specific member states when using the shared method in calculations. An output gap estimate calculated using the shared method is considered credible if it remains within the confidence interval specified with the tool. The tool has been significant for Finland, as Finland complied with the criteria required for the adjustment granted based on the structural reform and investment clauses partially due to the tool: the criteria would not have been met without the tool[13].

Cyclical adjustment of structural balance

Originally unobserved long-term trend (potential output) must be separated from the GDP time series observed during the cyclical adjustment, after which the observed values will be compared with the trend value. If the GDP is higher (lower) than its long-term trend, the cyclical conditions are positive (negative).

When assessing the cyclically adjusted structural deficit, relative (i.e. percentual) deviation from the long-term trend is deducted from the general government deficit rate. It should be noted that the trend is originally an unobserved variable and it can be formed in countless ways. Therefore, the structural deficit can be estimated based on the observed general government deficit in a variety of ways.

A time series analysis has proved to be the most optimal way of separating the unobserved trend from the observed time series. This means calculating the trend observations at each given time by weighting an equal number of past and future observations. Such methods include time series models for unobserved components with a single variable (such as Tramo/Seats) or several variables, time series structure equation models and some ad hoc filters (such as Hodrick-Prescott or filters in the X11 series).

Unfortunately, observations starting from the last (e.g. as real-time GDP observations as possible) statistical observations of the time series are not available. These observations are usually replaced with forecasted values. The values of the trend at the end of the time series are specified over time when observations that follow the originally last observations become available. The above-mentioned specification of the tail end of the trend (or the potential output) similarly further specifies the tail-end structural deficit figures.

Code of conduct guides the interpretation of rules

Code of conduct guides the interpretation of the application of the European Union fiscal policy rules. Information on the interpretation of the code of conduct is available in the publication *Vade mecum on the Stability and Growth Pact* of the European Commission. In the preventive arm, details of the interpretation of the code of conduct are important especially in a case where a member state has not reached its medium-term objective for structural balance and is on the path towards the MTO.

The interpretation of the code of conduct is regularly amended and further specified. The development of the rules, which aims to improve them, has made the rules complex, which may hamper commitment in the rules and ownership of the rules by the member states. Clear communication on this matter is also challenging.

In its separate report published in the summer of 2018, the European Court of Auditors (ECA) discussed the functionality and implementation of the rules for the preventive arm of the Stability and Growth Pact[14]. The preventive arm focuses on the achievement of the medium-term objective. According to the ECA's assessment, because the interpretation of the code of conduct for the preventive arm are flexible and because of the Commission's discretion, the member states coming closer to the medium-term objective within a reasonable time cannot be verified. The ECA paid attention to the flexibility of the rules, such as the margin for significant deviation, which enable a deviation from the path towards the medium-term objective and prolonging the time it takes to achieve the MTO.

Finland has been allowed flexibility of 0.6 percentage points for the achievement of the medium-term objective in 2017–2019 based on the structural reform and investment clauses. Due to the flexibility, deterioration of Finland's structural balance during these years has been allowed without any consequences. The National Audit Office discussed matters concerning the granting of flexibility in its fiscal policy monitoring and evaluation reports in the autumn of 2016[15] and the spring of 2017[16], also pointing out the discretionary nature of the granting of the flexibility. On the other hand, it should be noted that the flexibility allows for taking into account special characteristics of the member states and exceptional conditions, as well as the implementation of structural reforms.

The rules need to be reformed

Simplification of the rules of the Stability and Growth Pact is included in the currently ongoing development of the Economic and Monetary Union. The Commission plans to reform the rules between 2020 and 2025. The need to reform the rules has been identified in academic discussion and by a variety of EU bodies, such as the European Fiscal Board (EFB 2017)[17].

There is no indication as of yet as to how the rules will be reformed. The European Commission has already strengthened the role of the expenditure rule in the assessment of the preventive arm. The goal is to increase the predictability and transparency of the rules.[18] In its spring 2018 report, the National Audit Office paid attention to the fact that the current expenditure rule is not independent from the calculation of the structural balance, which means that the above-mentioned problems regarding the structural balance are also present to some extent in the assessment of compliance with the current expenditure rule[19]. On the other hand, several variations on the rules limiting general government expenditure have been presented[20]. Several of the proposals connect the limitation of the growth of expenditure to the achievement or retention of a sustainable level of debt. The goal with these proposals is reducing dependence on unobserved variables, such as the structural balance.

4 Forecasts used as the basis for the fiscal policy

The National Audit Office has assessed the reliability of short-term macroeconomic forecasts in two reports published during the parliamentary term. A fiscal policy evaluation of the reliability of the Ministry of Finance's macroeconomic forecasts (2018)[21] examined reliability with statistical tests and covered forecasting years 1976–2016, and a fiscal policy audit on the reliability of macroeconomic forecasts (2016)[22] investigated the reliability of forecasts on general government finances.

The assessments by the National Audit Office revealed that the macroeconomic forecasts by the Ministry of Finance are at least as reliable as the compared forecasts by the principal forecasting institutes of the Finnish economy or the Ministry was among the most reliable forecasting institutes compared. Together with forecasts by Research Institute of the Finnish Economy (ETLA), reliability of the forecasts by the Ministry of Finance on GDP growth, the unemployment rate and inflation in 1976–2016 was among the best of the compared forecasting institutes. According to the previous audit (2016), forecasts of the Ministry of Finance on all variables regarding the balance of supply in 1997–2014 were unbiased and statistically as reliable as the forecasts by the other parties.

The forecasting practices of the Ministry of Finance and independence of its forecasting function were assessed in the above-mentioned audit in 2016 and in a follow-up audit of the said audit in 2018. Nothing that would endanger the factual independence of the forecasting activities of the Ministry was observed during the audit.

4.1 Reliability of forecasts by the Ministry of Finance

The fiscal policy evaluation on the reliability of the Ministry of Finance macroeconomic forecasts (2018) examined the reliability of autumn forecasts of GDP growth, unemployment rate and inflation produced by the Ministry of Finance during the 41 years between 1976 and 2016. The autumn forecasts by the Ministry are especially important, as they are used when planning the state budget for the year ahead.

The National Audit Office attempts to regularly audit the reliability of the forecasts by the Ministry of Finance. The 2018 report picked up where the 2016 audit left off, expanding the testing of the reliability from unbiasedness to other perspectives regarding reliability and prolonging the reviewed period. On the other hand, as the number of statistical tests increased, a smaller number of forecast variables were selected for the 2018 audit: GDP growth, unemployment rate and inflation.

Reliability of the forecasts was studied by using the same statistical tests that the European Commission uses to test the reliability of its own forecasts. The forecasts by the Ministry of Finance and the results of the statistical tests were compared with forecasts produced by the Research Institute of the Finnish Economy (ETLA), the Organisation for Economic Co-operation and Development (OECD), the Labour Institute for Economic Research (PT) and Pellervo Economic Research (PTT). To calculate forecast errors, the forecasts have been compared with the changes in the GDP growth, labour force survey unemployment rate and consumer price index for the same period of time recorded in the national accounts by Statistics Finland.

The reliability of the Ministry of Finance's forecasts was examined using the following questions: (a) What has been the success rate of the forecasts compared with other key forecasting institutes?, (b) Have any errors in the forecasts been temporally independent and non-persistent?, (c) Did the forecasts encompass information included in the naïve forecast? and (e) Did the forecasts cover all the current and pertinent information?

On the basis of the results, together with forecasts by ETLA, reliability of the forecasts by the Ministry of Finance on GDP growth, the unemployment rate and inflation was among the best of the compared forecasting institutes.

The forecasts produced by the Ministry of Finance proved to be statistically reliable and among the best in the group reviewed. The forecasts by the Ministry of Finance between 1976 and 2016 also proved to be statistically unbiased, and there was no temporal persistence of forecast errors. Forecasts by the Ministry of Finance and ETLA passed the test on encompassing the naïve forecast and the test on coverage of all relevant information at the time of the forecast most often. The other forecasting institutes (PTT, PT and OECD) did not fall far behind and their forecasts were not poor, either: the forecasts proved unbiased and no systematic recurrence of forecast errors was detected, except for some single cases.

The reliability of the Ministry of Finance's forecasts on GDP growth, unemployment rate and inflation has been among the best of the compared forecasts

In addition to the results of the above-mentioned statistical tests, it should be noted that forecasting the figures for specific years has not always been easy. None of the forecasting institutes was invariably accurate. For example, between 2013 and 2015, they all overestimated Finland's economic growth and underestimated the economic growth in 2017. In its overestimations and underestimations, the Ministry of Finance was usually in the middle of the group. Forecasting the development of the Finnish economy has been particularly difficult at economic turning points and in situations where Finnish exports was not growing at the same rate as world trade.

In the 2016 audit, the reliability of the forecasts by the Ministry of Finance was studied by comparing the accuracy of the Ministry's forecasts with the accuracy of the other principal forecasting institutes and by studying the unbiasedness of the Ministry's forecasts in 1997–2014. The reviewed period of time was shorter and the examination of reliability mostly focused on accuracy and unbiasedness, but more variables were studied. Accuracy and unbiasedness in 1997–2014 were studied in the case of all the variables in the goods and services account (the balance of supply). The principal forecasting institutes used for the comparison were otherwise the same, but the Bank of Finland was studied instead of the OECD. The Ministry has been statistically speaking as reliable as the other studied forecasting institutes in the case of the variables of the balance of supply.

According to the assessment results, the Ministry of Finance has been statistically as reliable as the other forecasting institutes, and the macroeconomic forecasts by the Ministry of Finance that are used as the basis for the fiscal policy were not statistically unbiased.

General government revenue and expenditure have been underestimated

The audit on the reliability of macroeconomic forecasts (2016) also discussed the short-term general government finance forecasts by the Ministry of Finance. The audit assessed the accuracy of the autumn general government finances forecasts by the Ministry when compared to the actual development of general government revenue and expenditure as well as net lending of the general government and its subsectors.

On the basis of the audit observations, the general government finance forecasts on average underestimated the development of the general government revenue and expenditure during the studied period (2005–2014). Except for social security funds, the expenditure underestimations were slightly higher than the revenue underestimations. According to the audit results, the underestimation was partly due to the fact that when forecasts are prepared, consideration is only given to already decided measures affecting general government revenue or expenditure. The revenue and expenditure forecasts for central and local government were more accurate in the past decade, before the start of the financial crisis, than in recent years. During the current decade, underestimations have been slightly higher, which is mainly due to the lower-than-forecasted macroeconomic growth. At the same time, however, the revenue and expenditure of the social security funds were underestimated more substantially in the past decade than in recent years.

Underestimation of expenditure in relation to revenue has led to overestimation of net lending

The forecast for total general government revenue was, on average, EUR 0.7 billion lower than the outturn in 2005–2014, while the underestimation of total general government expenditure averaged EUR 2.8 billion. The higher underestimation of expenditure in relation to revenue led to an average net lending overestimation of EUR 2 billion in the forecasts.

On average, central government revenue was underestimated by EUR 500 million and the expenditure by slightly over EUR 1 billion, which led to an average overestimation of slightly more than EUR 500 million in net lending.

The local government revenue forecasts were on average EUR 0.9 billion lower than the outturn and the expenditure forecasts were underestimated by an average of EUR 1.3 billion. The higher expenditure underestimation led to an overestimation of the net lending of local government by an average of EUR 0.4 billion.

4.2 Forecasting practices and independence

The forecasting practices of the Ministry of Finance and independence of its forecasting function were assessed in the audit on the reliability of macroeconomic forecasts (2016) and in a follow-up of the audit (2018)[23]. The follow-up assessed how the opinions offered in the audit report were taken into account by the Ministry of Finance.

The forecasts were statistically reliable and were prepared by independent experts. However, both the analysis of forecast errors and the documentation provided on the forecasting methods proved defective. The impression of independence received by outsiders should be further improved.

Documentation and openness of forecasting practices have been improved

The National Audit Office's audit (2016) revealed that there was no systematic description of the forecast preparation methods of the Ministry of Finance. Achieving a transparent, comprehensive overall idea of the procedures was not possible. The follow-up audit (2018) revealed that the documentation and openness of the forecasting methods had been improved; for example, a description on the general government finances forecasting methods had been published.

According to the audit findings, the economic forecasts of the Ministry of Finance were statistically reliable, but the Ministry did not provide a comprehensive analysis of the sources of forecast errors or on how systematic forecast errors were, or offer a comparison with forecasts by other parties.

Ministry of Finance annually publishes a forecast deviation report

Since the audit, i.e. since 2016, the Ministry has published a report on its forecast deviations in the spring. The forecast deviation report studies how much the Ministry's autumn forecast on the development the following year deviated from the actual development. The autumn forecast was selected because the autumn forecasts are used as the basis for the planning of the next year's budget. The key forecast variables are examined, such as demand items influencing economic activity, general government finances, employment, unemployment and inflation. The report aims to discuss forecast deviations and their magnitude also at a more general level. The Ministry's analysis of its forecast errors and publication of the related results have been significantly developed after the audit.

Forecast function is factually independent

No factors that would have compromised the independence of the Ministry of Finance in practice emerged in the audit. Under an amendment of the Fiscal Policy Act in 2015 (79/2015)[24], the head of the Ministry of Finance department responsible for the forecasting makes, based on a presentation, independent decisions on the matters that concern the forecasts regarding macroeconomic trends and that are used as a basis for the state budget proposal and fiscal planning. The arrangement did not meet all of the independence requirements laid down in the regulation on monitoring and assessing draft budgetary plans (473/2013), however. In addition to an entry on the department head's independent discretionary power, no arrangements deviating from the other departments of the Ministry of Finance that would guarantee its independence were detected in the Economics Department of the Ministry of Finance, the body responsible for the forecasts. Better documentation and adequate organisational independence of the forecasting activities could assist in ensuring that the forecasts are seen as reliable by outsiders.

The forecast deviation report published at a later date and the improved documentation have strived to ensure that forecasts are seen as reliable by outsiders.

In Finland, the Economics Department of the Ministry of Finance has been named as an independent institution responsible for macroeconomic forecasts. This arrangement is exceptional in the EU. Elsewhere in the euro zone, macroeconomic forecasts are produced by independent institutions or the forecasts prepared by a country's finance ministry are enhanced by an independent body. The Finnish arrangement can be considered compliant with the European Union legislation, however.

After all, the forecasts by the Economics Department are regularly audited by a party independent from the Ministry. Not only the forecasting process, but also the accuracy of the forecasts has been assessed. Furthermore, the Economics Department itself publishes the above-mentioned annual forecast deviation report. No matters that would give rise to any special need to adopt a practice where an independent external party separately confirms the forecasts by the Ministry have arisen in these assessments.

Independence of forecasts has also been promoted with new legislation

The authority of an independent external party over the forecasts by the Ministry of Finance has also been promoted by means of legislation. The Decree on the General Government Fiscal Plan (Valtioneuvoston asetus julkisen talouden suunnitelmasta, 120/2014) was supplemented with a new decree (601/2017) in the beginning of September 2017. According to the new decree, the Ministry of Finance must, when preparing its economic forecasts, take into consideration conclusions by the National Audit Office on the macroeconomic and fiscal forecasts. If, according to the conclusions of the National Audit Office, the macroeconomic forecasts have included a bias that has had a significant 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 National Audit Office.

Reliability of forecasts and independence of the preparation of forecasts used in state budget planning should be monitored in Finland also in the future.

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