Fiscal policy monitoring assessment of the management of government finances

This memorandum contains the final assessment of the National Audit Office regarding compliance with fiscal policy rules in 2018, as well as the NAOF's preliminary assessment of compliance with the rules of the EU's Stability and Growth Pact in 2019 and 2020. The assessment also takes account of the General Government Fiscal Plan for 2020–2023. The NAOF has also assessed whether the contents of the plan comply with the relevant regulations. The assessment is based on an independent economic forecast produced by the Ministry of Finance and other economic forecasts. The National Audit Office presented its previous assessment in the fiscal policy monitoring and audit report for the parliamentary term, published on 5 December 2018.

The statutory task of the National Audit Office is to monitor compliance with the Fiscal Policy Act (869/2012) and the provisions issued thereunder, such as the Government Decree on the General Government Fiscal Plan (120/2014; as amended by Government Decree 601/2017), as part of the auditing of central government finances.

In order to carry out its monitoring task, the National Audit Office has assessed the General Government Fiscal Plan for 2020–2023 on the basis of the regulations specified above, as well as related background materials, including the economic forecast produced by the Ministry of Finance.

The Government reached agreement on the General Government Fiscal Plan for 2020–2023 on 28 March 2019. The new plan is technical in nature, and a plan including the policy measures of the new Government will be drawn up in September 2019. The NAOF will publish a separate assessment of the latter plan in October–November 2019.

Summary of the assessment

The NAOF did not find any material deficiencies in the contents of the General Government Fiscal Plan in relation to the applicable regulatory requirements. Some elements of the plan have been further elaborated since the previous plan. In the future, attention should be paid to improving the reporting on the interest rate sensitivity of key indicators of general government finances, as well as to the consistent monitoring of the Government objectives as part of the plan. It should also be ensured that the Government's economic policy objectives are as clear as possible.

According to the NAOF's assessment, the central government spending limits were followed in drafting of the 2018 budget. The spending limits framework should be further improved; for example, the definition of 'financial investments' should be clarified. To ensure the effectiveness of the spending limits procedure, it is important that the framework also supports reforms and enables the funding of investment needs and the flexible reallocation of appropriations within the framework.

According to the NAOF's assessment, Finland complied with rules of the preventive arm and the corrective arm of the EU's Stability and Growth Pact in 2018. The general government structural balance amounted to -0.8% in relation to GDP, which is slightly weaker compared with the previous year. Nevertheless, the structural balance rule was followed, when taking into account the flexibility factors granted by the Commission. In 2018, there was a deviation from the expenditure benchmark, but this was not significant in terms of the compliance with the rules. The reference values of both the debt and deficit criteria were followed in 2018. It is forecast that Finland will comply with the rules of the Stability and Growth Pact also in 2019. According to the NAOF's estimate, the structural balance will amount to -0.7% in relation to GDP in 2019.

The contents of the General Government Fiscal Plan could still be improved

The NAOF did not find any material deficiencies in the contents of the General Government Fiscal Plan relative to the requirements set out in the relevant government decree[1]. The requirements set out for the final, technical General

[1] Government Decree on the General Government Fiscal Plan (120/2014; last amended on 8 May 2018).

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Government Fiscal Plan of the parliamentary term are less strict compared with the other plans drawn up in the parliamentary term. The General Government Fiscal Plan has been amended so that the key revenue and expenditure items concerning employment pension institutions are now reported separately from the figures of other social security funds. This amendment has further enhanced the compliance of the plan with the regulatory requirements. However, to ensure compliance with the requirements, the General Government Fiscal Plan should present more clearly the interest rate sensitivity of key indicators of general government finances (such as government debt and total general government revenue and expenditure).

In addition to the objective concerning the government debt-to-GDP ratio, the Government Programme also includes another indebtedness target, namely ‘living on debt will be brought to an end in 2021’. However, the interpretation of the latter objective is not clear, which is an issue that was also raised in the contribution by the officials of the Ministry of Finance published in February 2019. During the parliamentary term, the objective was covered inconsistently in the different General Government Fiscal Plans published during the period. In the plans published in 2015, 2017 and 2018, the objective was reviewed by assessing whether Finland will be able to stop taking on more debt by 2021. According to a recent forecast, indebtedness still seems to continue after 2021, which is also discussed in the most recent General Government Fiscal Plan. However, the latest plan no longer mentions keeping from taking on more debt as a Government objective. Instead, it specifies reaching the balanced general government fiscal position by the end of 2021 as a Government objective. According to the plan, it is likely that this target will be met. In the future, the Government should pay more attention to presenting its fiscal policy objectives as clearly as possible to ensure consistent and transparent target setting. Furthermore, achievement of these objectives should be consistently monitored throughout the parliamentary term.

The development of the debt-to-GDP ratio should be weighted when setting objectives on government debt also in the future. It is a more essential issue in terms of the debt sustainability of public finances than the development of the amount of public debt. In addition to the debt-to-GDP ratio, it would also be important to monitor the development of the general government net financial position, where applicable.

The 2018 spending limits were followed

According to the NAOF’s estimate, the central government spending limits were followed in drafting of the 2018 budget. The budget outturn statement in the final central government accounts also shows that the expenditure has remained within the spending limits.

According to NAOF’s calculation, the level of spending limits in the final 2018 state budget, including supplementary budgets, was EUR 44,555 million. Expenditure included in the spending limits totalled EUR 44,555 million, and, in practice, there was hardly any remaining undistributed provision. Thus, the estimate presented in the Government’s annual report for 2018 can be considered correct: the spending limits were followed, but the appropriations were all used up.

In the first spending limits decision of the parliamentary term, the spending limits for 2018 totalled EUR 44,397 million before spending limits adjustments. In the last decision, the spending limits amounted to EUR 44,555 million, i.e. EUR 158 million more than in the first decision. The increase was mainly due to discretionary price and cost level adjustments, the calculation of which is based on price forecast changes, which can budgeted as spending limits increases without allocating them to any specific appropriation.In contrast, price index adjustments concerning statutory expenditure have a direct impact on the appropriations. All price adjustments have been carried out in accordance with the principles of the spending limits procedure.

To ensure the effectiveness of the spending limits procedure, it is important that the framework also supports reforms and enables the funding of investment needs and the flexible reallocation of appropriations within the framework. The margin of manoeuvre that should be left within the spending limits framework can be implemented through various means, but it is important to ensure that the spending limits procedure remains transparent.

The amount of expenditure items outside the spending limits has remained stable: in 2018, it totalled approximately EUR 11.6 billion. The cyclical expenditure relating to housing allowances, unemployment security and income security slightly decreased, but the level of expenditure is still significantly higher than in 2015 or 2016. It is difficult to fully separate the impacts of the business cycle on the expenditure level from the impacts arising from changes made to the criteria for housing allowance, basic social assistance and unemployment benefits during the parliamentary term. Interest expenditure on central government debt continued to decrease. Compensations made to municipalities for tax criteria changes during the parliamentary term amounted to EUR 1.012 billion. This expenditure will be transferred in full to the spending limits in connection with the change of the parliamentary term.

Figure 1 presents the financial investments outside the spending limits authorised in the budgets for the 2015–2019 parliamentary term. The financial investments implemented during the parliamentary term differ in nature. In the case of some investments, it is not clear how it can be determined whether the investments will retain their value. Most of the financial investments were loans granted to promote exports (EUR 925.8 million) or R&D loans granted directly to companies and organisations (EUR 771.2 million). Capital investments (EUR 900 million), such as acquisitions of shares or investments in funds, accounted for another major share of the total financial investments. This was partially due to the new investments and loans related to development cooperation implemented in the parliamentary term.

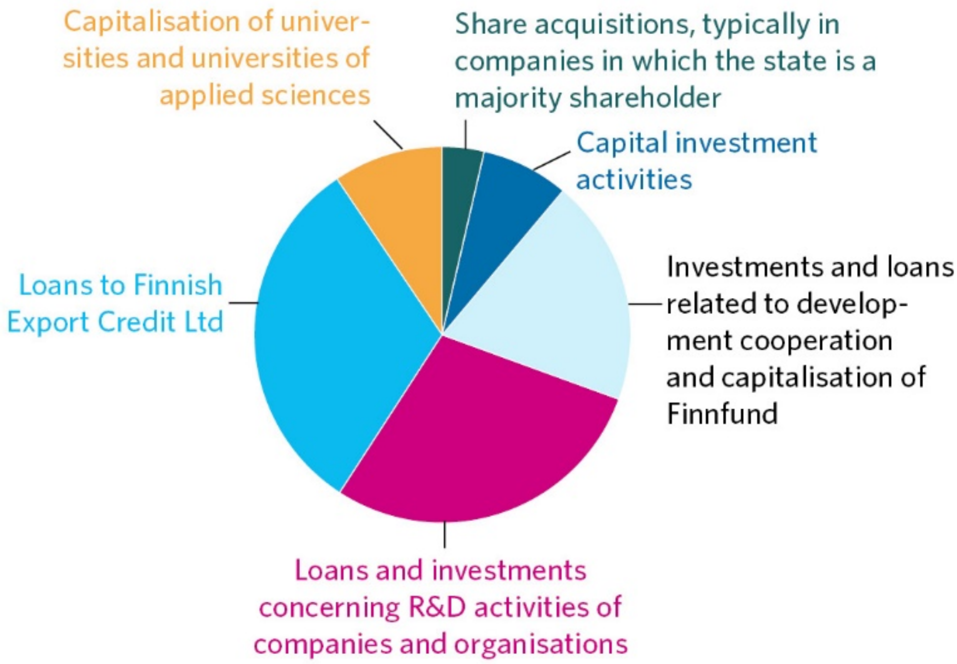

Figure 1: Financial investments outside the spending limits in 2015–2019 broken down by purpose (Source: budget data, NAOF calculations)

The definition of ‘financial investments’ should be further clarified. The purpose of a financial investment should be clearly stated, and it should be carefully specified how the investment retains its value or meets the set revenue requirement. Attention should also be paid to risks related to financial investments and any changes in them, including any increase in the amount of guarantees and liabilities.

EU fiscal policy rules are complied with

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

Structural balance describes the fiscal position in relation to GDP, from which the impact of economic cycles and one-off measures has been eliminated. The MTO set by Prime Minister Juha Sipilä’s Government is to achieve at least a structural balance of -0.5% in relation to GDP. The target complies with the Fiscal Compact and the rules of the Stability and Growth Pact. Finland has benefitted from the flexibility offered by the Pact: in accordance with the structural reform clause, Finland was granted with flexibility of 0.5 percentage points in relation to GDP for 2017–2019 with respect to the original requirements.

The NAOF has made an ex-post assessment of compliance with the Pact in 2018. According to the assessment, structural balance totals -0.8% in relation to GDP in 2018, which is 0.2 percentage points weaker compared to the previous year. Taking into account the flexibility granted to Finland, the structural balance rule will be met in 2018.

According to calculations based on the forecast by the Ministry of Finance, Finland will reach the MTO in 2019, at which time the structural balance is expected to be -0.7% in relation to GDP. According to the rules, the MTO is considered reached when the margin to the MTO is 0.25 percentage points or less. Although these figures are still preliminary and involve uncertainties, it is likely that Finland will also meet the rule in the final assessment performed a year from now, especially due to the flexibility granted to Finland.

The MTO is updated every three years. The Government approves the new MTO for 2020–2022 in the autumn of 2019. The NAOF’s assessment is based on the assumption that the MTO will remain at -0.5% in relation to GDP. The current estimate indicates that the structural balance will amount to -0.3% in relation to GDP in 2020, which means that the rule would also be met in 2020. This is a preliminary assessment and involves significant uncertainties, for example, because the forecast behind the calculation is based on the assumption that policies will remain unchanged. However, policy measures of the new Government will affect the forecast and any assessments based on the forecast.

The second pillar of the preventive arm is the expenditure benchmark, which sets the reference growth rate for central government expenditure. According to the assessment by the NAOF, the expenditure benchmark will not be reached in 2018, but the deviation will not be significant in the manner specified in the rules. According to a preliminary assessment, the expenditure benchmark will be met in 2019 and 2020, but also in this case, the assessment for 2020 is based on the assumption that policies will remain unchanged. The estimate of the level of structural balance and the required adjustment is presented in Table 1. The results of the expenditure benchmark calculation are presented in Table 2.

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

According to preliminary information of Statistic Finland (18 April 2019), the general government debt ratio was 58.9% in relation to GDP in 2018. The debt ratio decreased significantly compared with the previous year and fell below the 60% limit set for the debt ratio, which means that Finland complies with the debt criterion. According to the forecast of the Ministry of Finance, the debt ratio will continue to contract in 2019–2020, which suggests Finland will also likely meet the criterion in the coming years.

According to the preliminary information of Statistics Finland, the general government deficit amounted to 0.7% in relation to GDP in 2018. According to the Ministry of Finance’s spring forecast, the deficit will decrease to 0.3% in 2019 and Finland will reach the balance target in 2020. Thus, the limit value of 3% set for the deficit will be clearly reached during the period under review.

The forecast of the Ministry of Finance does not deviate from other economic forecasts

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

The General Government Fiscal Plan and the Stability Programme appended to the plan are drawn up on the basis of the macroeconomic and fiscal forecasts prepared by the Economics Department of the Ministry of Finance. For 2019, the Ministry of Finance forecast a 1.7% growth in GDP and a 1.4% growth for 2020. The forecast for each year is close to the median forecast by all the forecasters on the Finnish economy that the NAOF follows. The Ministry's forecast of the deficit of general government finances for 2019–2020 is also close to the median level of all the forecasters followed. On this basis, the forecast by the Ministry of Finance cannot be considered unrealistic in the manner specified in the rules.

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Table 1. General government structural balance, adjustment requirement (allowed deviation) and deviation. NAOF's calculations (based on the information supplied by the Ministry of Finance)

	2018	2019	2020
Structural balance, % in relation to GDP	-0.8	-0.7	-0.3
Change, % in relation to GDP	-0.2	0.1	0.3
NAOF's estimate of the adjustment requirement, % in relation to GDP*	-0.4	-0.5	0.2
Deviation from the adjustment requirement, % in relation to GDP	-0.2	-0.6	-0.2
Is the deviation significant (>0.5)?*	**No**	**No**	**No**
Cumulative deviation (two-year average)	-0.5	-0.4	-0.4
Is the cumulative deviation significant (>0.25)?*	**No**	**No**	**No**

*The estimate is based on NAOF's structural balance calculations. The flexibility granted in accordance with the structural reform clause, 0.5 percentage points, has been taken into account in the adjustment requirement. A negative adjustment requirement means that the structural balance may deteriorate.
**In the case of the structural balance, a significant deviation is a deviation of at least 0.5 percentage points from the requirement for one year or 0.25 percentage points on average for two years. A negative deviation means that the adjustment requirement was achieved and there was no deviation as referred to in the rules.

Table 2. Growth in general government expenditure, applied expenditure benchmark and deviation. NAOF's calculations (based on the information supplied by the Ministry of Finance).

		2018	2019	2020
Nominal growth in total spending (calculated in accordance with the expenditure benchmark), %		3.0	3.5	2.3
NAOF's estimate of the applied expenditure benchmark (nominal), %		2.4	3.5	2.6
Deviation				
	Difference between expenditure benchmark and growth in expenditure, percentage points	-0.6	0.0	0.3
	Deviation, EUR billion	-0.7	0.0	0.4
	GDP, EUR billion	233.6	241.7	249.8
	Deviation, % in relation to GDP*	**-0.3**	**0.0**	**0.2**
	Is the deviation significant (< -0.5)?*	**No**	**No**	**No**
	Cumulative deviation	**-0.1**	**-0.2**	**0.1**
	Is the cumulative deviation significant (<-0.25)?*	**No**	**No**	**No**

*A positive figure means that the expenditure is lower than what is permitted under the expenditure benchmark, while a negative figure means that the limit has been exceeded.
***In the case of the expenditure benchmark, a significant deviation means a deviation (in euro terms) which in relation to GDP is less than -0.5% for one year or -0.25% on average for two years.