

Conclusions and recommendations of the National Audit Office

Medium-term projections in the planning of general government finances

The audit was targeted at medium-term projections of general government finances prepared at the Ministry of Finance. Here, 'medium-term' refers to the period covering the current year and the next four years. Medium-term projections are used in the planning of general government finances and fiscal policy and in the setting of related targets. The purpose of the audit was to assess the knowledge base behind fiscal policy decision-making and its reliability, openness and transparency. It was also examined how the methods applied in medium-term projections of the real economy impact the projections of general government finances and their reliability.

Based on the audit conducted, the fact that output gap estimates often need to be significantly revised after their publication weakens the reliability of the medium-term projections of general government finances. The methods applied to the drafting of the cyclical condition estimates used as a basis of medium-term projections should be improved and broadened. There are substantial differences in the projection methods applied to medium-term projections compared with those applied to short-term forecasts. Going forward, methodology descriptions should also specify the features of medium-term projections in a comprehensive manner. Projection reporting should also be clarified to ensure access to information that is sufficient to safeguard the budgetary powers of Parliament.

Inadequacies in the description of medium-term projections in the methodology descriptions of the Ministry of Finance

The methodology descriptions published by the Ministry of Finance are lacking a description of the medium-term perspective and its special features. The methodology descriptions should be supplemented to this end. Medium-term projections of general government finances are prepared using supply-oriented methods, i.e. medium-term macroeconomic projections and estimates of the level and development of potential output and output gap. 'Output gap' means the difference between actual gross domestic product and potential output. The level of potential output illustrates the level of gross domestic product in a situation where the economy is on its long-term trend.

Based on the audit results, the Ministry of Finance has the necessary expertise and established calculation frameworks to prepare projections of general government finances. These projections are prepared at a very detailed level. The drafting of medium-term projections of general government finances is carried out in accordance with the methodology descriptions published by the Ministry of Finance, as well as with guidelines issued by the European Commission. The Commission guidelines specify, for example, the criteria applied to taking into consideration the effect of discretionary measures in fiscal forecasts. Regardless these criteria, taking account of the effect of discretionary measures in forecasts and projections always requires some interpretation and exercise of expert judgment. The audit did not reveal any significant inadequacies in the practices applied. The Ministry of

Finance also carries out ex-post evaluations of the effects of discretionary measures.

The same practices that safeguard the independence of the preparation of short-term forecasts are also applied to medium-term projections. Medium-term projections are prepared in the Economics Department of the Ministry of Finance, and according to the Rules of Procedure of the Department, the staff participating in the forecasting process may not accept any advice or instructions from parties outside the Department when drafting forecasts. The Economics Department is headed by a director general who independently approves all forecasts and projections prepared by the units.

Inconsistencies in the drafting of output gap estimates

The Ministry of Finance applies the method jointly developed by EU Member States and the Commission ('the Commission method') to the estimation of the level and development of potential output. The audit revealed that due to timing differences between the updating of the potential output calculation model maintained by the Commission and drafting of projections at the Ministry, it is possible that an outdated calculation model is used in the preparation of medium-term projections of general government finances. This may weaken the quality of the medium-term projections.

Assumptions made by the Ministry of Finance regarding the contraction of the output gap towards the end of the medium-term forecast period have varied without any clear explanation. This may result in inconsistencies and fluctuations in real economy projections and thus also in medium-term general government expenditure and revenue estimates.

When applying the Commission model in the drafting of national projections, it should be ensured that the model is up to date. In addition, any assumptions made about the prevailing economic cycle (the level of output gap) at the end of the forecast horizon should be justified in a more transparent manner.

There is room for improvement in the real-time estimation of the output gap

One deficiency in the Commission method is that potential output estimates often need to be revised afterwards. This means that the macroeconomic picture (the output gap estimates) used as a basis of medium-term projections of general government finances also often needs to be significantly modified afterwards.

Using real-time business cycle indicator data would likely improve the accuracy of the macroeconomic picture used as a basis of medium-term projections of general government finances compared with the current practice, which only utilises the potential output calculation model maintained by the Commission. Several recent studies have also come to the same conclusion. This is also why a number of other Member States use alternative estimation models alongside the Commission method.

The Ministry of Finance should develop and broaden the methods applied to the estimation of cyclical conditions in order to enhance the reliability of the medium-term projections of general government finances and thus also the setting of fiscal policy targets according to the estimated cyclical conditions.

The practices applied to the reporting of the medium-term economic outlook are varied and are based on the minimum requirements set out in the European Union legislation

The reporting practices were updated to meet the legal requirements during the government term that ended in 2019. The reporting is largely based on the reporting requirements set out in the European Union Stability and Growth Pact, the Fiscal Compact, the Budgetary Frameworks Directive, and the Regulation on Monitoring and Assessing Draft Budgetary Plans.

To better support the decision-making capability of the Government and Parliament, the reporting practices should be clarified, primarily by specifying the contents of the different development paths covered in the General Government Fiscal Plan and their interdependencies more clearly than at present. Furthermore, the reporting should be supplemented with a description of the uncertainties concerning the general government revenue and expenditure estimates, such as of the reliability of the impact assessments of significant discretionary measures and their effect on the achievement of the budgetary position target set for general government finances. The historical reliability of medium-term projections should also be discussed in the annual forecast deviation report published by the Ministry of Finance.

Recommendations of the National Audit Office

Based on the audit, the National Audit Office recommends that the Ministry of Finance:

1. supplement the methods applied to the drafting of real-time estimations of cyclical conditions for the purposes of the medium-term projections of general government finances, for example, by utilising indicators of production input use rates in the estimation;
2. supplement its methodology descriptions and forecast deviation reports so that they also discuss the medium-term projections in a comprehensive manner;
3. develop its medium-term projection reporting so that the different development paths are clearly specified and mutually comparable and that the estimated impacts of the measures planned on the budgetary position of general government finances are systematically described in the development path descriptions.